2015 STEP Canada / CRA ROUND TABLE
FINAL CONSOLIDATED Q & As

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Unless otherwise stated, all statutory references in this document are to the Income Tax Act, R.S.C. 1985, c. 1 (5th Suppl.) (the "Act"), as amended to the date hereof.

QUESTION 1. **Graduated Rate Estate-Taxation Year**

A graduated rate estate (GRE) obtains graduated tax rates for a period of 36 months. Can CRA confirm in the example below that a graduated rate estate can obtain graduated tax rates for up to four taxation years?

Suppose an individual dies on March 31, 2016. The executors adopt a first year-end of September 30, 2016. The second year-end is September 30, 2017. The third year-end is September 30, 2018. Lastly, a year-end is deemed to arise on March 31, 2019 (36 months after death), which is the last taxation year during which the testamentary trust is a graduated rate estate. Thereafter, it is required to adopt a December 31 year-end and for that taxation year and all following taxation years will not obtain graduated tax rates.

The result of selecting a short year-end for the first taxation year is that in four taxation years during the 36 month period graduated tax rates should be available. Does CRA agree?

CRA Response

The definition of a graduated rate estate (GRE) in subsection 248(1) of the Act is effective on December 31, 2015. In the above scenario where an individual dies in 2016, the first taxation year of the estate that has been validly designated as the GRE begins on the day after the individual dies and ends at any time the executor selects within the next 12 months. Assuming the estate otherwise meets all the conditions to be the deceased individual's GRE throughout the first 36 month period, where the executor chooses to have a short first taxation year end for the estate the 36 month period would span four taxation years.

In the scenario provided, the first and fourth taxation years are less than 12 months long, and the estate would be subject to tax based on the graduated tax rates for individuals for the first four taxation years as indicated.

QUESTION 2. <u>Meaning of Graduated Rate Estate</u>

Under the new rules for testamentary trusts, a fundamental starting point is the definition of graduated rate estate, added to subsection 248(1).

It would seem extremely important for a testamentary trust to be a graduated rate estate for various reasons which include:

i. **The obtaining of graduated tax rates for the first 36 months;**
ii. **A $40,000 exemption from AMT;**
iii. **The making of an election under subsection 164(6);**
iv. **The reduction of the denial of capital losses to 50% of what would otherwise result, as provided for under subparagraph 112(3.2)(a)(iii);**
v. **Determining whether a donation made by will can be claimed by the deceased pursuant to clause 118.1(1)(c)(i)(C), which is a component of the definition of total charitable gifts; and**
vi. **Determining whether on a donation by will of a publicly traded security, a taxable capital gain is included in the income of the deceased at death (by virtue of a deemed disposition under section 70), or the amount is deemed nil.**

There may be other provisions which are also affected by whether or not a testamentary trust is a graduated rate estate.

As a result, we are keenly interested to understand more fully the definition of graduated rate estate.

It can be inferred, from the definition of graduated rate estate, that the government contemplates situations where an individual may have more than one estate (notwithstanding the fact that the Department of Finance's Technical

Notes state that generally there is only one estate for a deceased individual). Specifically, paragraph (e) of the definition of graduated rate estate states "*no other estate designates itself as the graduated rate estate of the individual".* It is also clear that more than one testamentary trust can be created by will.

Our specific questions are:

a. **As a general matter, while an estate is under administration during its first 36 months, will it be considered a graduated rate estate in its entirety? In other words, is the estate an over arching entity which encompasses all the property of the deceased, or is it necessary to identity one specific testamentary trust which will be the graduated rate estate? At what point in time does an estate transition into testamentary trusts, or is this a question of fact to be determined on a case-by-case basis?**

b. **Where an individual has two wills, does this preclude the possibility that the property of both wills can form one graduated rate estate?**

c. **Assuming that it is possible that two wills can be taken together to constitute the estate, does it make a difference if the executors are different, the beneficiaries are different, or the jurisdictions are different (for example, a will constituted under the laws of a province of Canada, and a will constituted under foreign law which governs only foreign assets)?**

d. **Are there any other helpful comments you can give concerning the meaning of graduated rate estate, which can be used as guidance for estate planning and tax planning purposes? It is noted that depending on the answers to the questions above, many persons may wish to consider major revisions to their estate planning in order to benefit from the traditional post-mortem estate planning methods used in the past.**

CRA Response (a)

Pursuant to subsection 104(1) for purposes of subdivision k, a trust or **estate** shall be referred to as a trust. Subject to several restrictions as to what type of property may be held, or as to who contributed the property, subsection 108(1) defines a "testamentary trust" as a trust (including, as per subsection 104(1), an "estate") that arose upon and in consequence of the death of an individual. The legal definitions of estate generally encompass the total property of whatever kind that is owned by a decedent prior to the distribution of that property in accordance with the terms of a will, or when there is no will, by the laws of inheritance in the state of domicile of the decedent. An estate encompasses the entire worldwide property owned by anyone, the realty as well as the personalty. Therefore we do not agree with your preceding statement that "It can be inferred, from the definition of graduated rate estate, that the government contemplates situations where an individual may have more than one estate".

While paragraph (e) of the definition of graduated rate estate requires that "no other estate designates itself as the graduated rate estate of the individual", in our view, this wording was used for greater certainty to ensure that there not be competing parties attempting to make the designation as the graduated rate estate of an individual. As used in connection with the administration of decedent's estate, the term includes all property of a decedent. The composition of the graduated rate estate for tax purposes will often depend on how the decedent wanted his/her assets to be administered as dictated by will. Where, for example, a will deals immediately with separating property to be held in a distinct testamentary trust apart from other assets of the estate, there can still only be one graduated rate estate allowed for tax purposes for the 36 month period (or earlier if administration is complete) following death.

You may recall our response to Question 8 of the 2012 STEP Roundtable:

> *A testamentary trust is defined in subsection 108(1) as a trust or estate that arose on and as a consequence of the death of an individual, subject to certain conditions. Consequently, the estate of the deceased and other trusts funded out of the residue of the estate will generally be testamentary trusts. Traditionally, the CRA has not attributed any tax consequences to the transition from estate administration to trust administration and generally has viewed the trusts created out of the residue as arising on death.*
>
> *Our colleagues in T3 Assessing advise that in practice each trust created out of the estate residue is given the same commencement date and taxation year end date as the estate. In circumstances where more than one trust is created out of the residue, a separate T3 trust number is assigned to each trust.*

CRA Response (b)

We understand that an individual may often have two wills for the purpose of reducing probate taxes, or for other estate planning purposes. There is nothing to preclude these being separately administered. By doing so, the individual is effectively determining how their entire estate is to be administered as two distinct but different parcels of assets.

As noted in our response to part (a) of this question, in our view, an individual's estate encompasses all of the worldwide property owned by the individual at death.

CRA Response (c)

Obviously, depending upon the manner in which the estate planning is undertaken, the use of multiple wills may create practical difficulties in regard to the designation as the graduated rate estate of the deceased individual. Information sharing issues, communication between executors, and other such issues can arise. These will need to be considered as an individual's estate planning takes place.

CRA Response (d)

CRA is, of course, prohibited from offering specific tax planning or legal advice. However, as was noted in our response to (c) above, we would emphasize the obvious importance of fully considering the potential practical issues that may arise from the use of multiple wills in terms of a designation as the graduated rate estate of a deceased.

QUESTION 3. Redeemable Preferred Shares

The CRA has previously commented that it is the legal form of the particular financial instrument, not its economic substance, that will usually determine its income tax treatment. As a result, redeemable preferred shares would be treated as equity irrespective of their accounting classification when applying the "thin-capitalization" rules under subsection 18(4). (Technical Interpretation 9619120).

Can the CRA please comment on whether this position continues to apply?

CRA Response

It continues to be the position of the CRA that the classification of a financial instrument (e.g. a redeemable preferred share) as debt or equity for the purposes of subsection 18(4) will be based on its legal form regardless of its accounting classification.

QUESTION 4. Canadian Resident Shareholder of US S Corporation

Paragraph 5 of Article XXIX of the *Canada-US Tax Convention* reads as follows:

> ***Where a person who is a resident of Canada and a shareholder of a United States S corporation <u>requests the competent authority of Canada to do so, the competent authority may agree, subject to terms and conditions satisfactory to such competent authority</u>, to apply the following rules for the purposes of taxation in Canada with respect to the period during which the agreement is effective:***
>
> ***(a) the corporation shall be deemed to be a controlled foreign affiliate of the person;***
>
> ***(b) all the income of the corporation shall be deemed to be foreign accrual property income;***
>
> ***(c) for the purposes of subsection 20(11) of the Income Tax Act, the amount of the corporation's income that is included in the person's income shall be deemed not to be income from a property; and***
>
> ***(d) each dividend paid to the person on a share of the capital stock of the corporation shall be excluded from the person's income and shall be deducted in computing the adjusted cost base to the person of the share.*** **[our emphasis]**

We recognize that the CRA provides its guidance on how to request assistance from the Canadian Competent Authority in Information Circular IC 71-17R5. However, can the CRA provide specific guidance with respect to paragraph 5 of Article XXIX of the Canada – US treaty? Are there any circumstances where such a request would be denied? When filing tax returns, should the returns be filed contemporaneously with the competent authority request assuming that such a request will be granted?

CRA Response

An S corporation is a United States (US) “small business corporation” that elects, for US federal income tax purposes, to be a flow-through entity. The effect of the election is that the shareholders of the S corporation are taxed, for US tax purposes, on their proportionate share of the corporation’s income in the year it is earned. For Canadian tax purposes, the S corporation is not a flow-through entity such that a Canadian resident shareholder of an S corporation is not subject to Canadian income tax on the active business earnings of the S corporation until they are distributed. As a result, in the absence of an S Corporation Agreement, the shareholder may not qualify for foreign tax credit relief, or may qualify for only limited foreign tax credit relief, for US taxes paid.

Under paragraph 5 of Article XXIX of the *Canada-United States Tax Convention* (Convention), the Canadian Competent Authority may agree to allow a shareholder of an S corporation to treat his or her share of the S corporation's income as foreign accrual property income (FAPI). The agreement (S Corporation Agreement) synchronizes the recognition of income in Canada with that of the US and allows the shareholder to claim a foreign tax credit in respect of the full amount of US tax paid on his or her share of the S corporation's income.

It is important to note that paragraph 5 of Article XXIX of the Convention does not apply automatically. This provision only applies to a shareholder of an S corporation who enters into an S Corporation Agreement with the Canadian Competent Authority. In addition, if the shareholder has an interest in more than one S corporation, a separate S Corporation Agreement is required for each corporation.

A Canadian-resident shareholder of an S corporation seeking to enter into an S Corporation Agreement with the Canadian Competent Authority should be aware that, for Canadian tax purposes:

- the income of the S corporation is computed under US tax rules (this means, for example, that the full amount of any capital gain realized by the S corporation is treated as FAPI);

- dividends paid to the shareholder by the S corporation are excluded from the shareholder's income only to the extent that they do not exceed the cumulative net amount of FAPI included in the shareholder's income under the S Corporation Agreement;

- S corporation losses cannot be deducted against other income (including income reported from another S corporation) - generally, losses from an S corporation may be carried forward and deducted against income of the S corporation realized in subsequent years;

- the income of the S corporation attributed to a shareholder is not earned income for purposes of the RRSP contribution limit;

- an S Corporation Agreement does not relieve the shareholder from a requirement to file Form T1134; and

- the S Corporation Agreement imposes an obligation on the shareholder to prepare worksheets and to retain those worksheets in the event of an audit – those worksheets must include annual and cumulative information on:

    i. the FAPI included in the shareholder's income,

    ii. the amount of dividends excluded from the shareholder's income, and

    iii. the adjustments to the cost base of the shares of the S corporation.

Refusal to Grant an S Corporation Agreement

The Canadian Competent Authority may refuse to provide an S Corporation Agreement if the shareholder does not submit the information requested by the Competent Authority or the shareholder is seeking to revise his or her Canadian tax reporting for past tax years.

Filing Returns

Ideally, the request for an S Corporation Agreement would be made well in advance of the filing-due date for the first tax year in which the agreement is intended to come into effect. However, it is not uncommon for a shareholder to request an S Corporation Agreement and, while the request is under consideration, to file a Canadian tax return on the expectation that an S Corporation Agreement will be provided.

QUESTION 5. <u>Designations to Include Income in a Trust</u>

New subsection 104(13.3) prohibits a designation under subsections 104(13.1) or 104(13.2) (to include income and taxable capital gains in the income of a trust, where that income is paid or made payable to a beneficiary of the trust) unless the taxable income of the trust for the year is nil. It would appear from this that the designations can only be made in circumstances where losses of other years (capital or non-capital) can be applied such that taxable income is nil.

a. Do you agree with our interpretation, and can you add any additional comments?

b. **If a trust realizes a loss (capital or non-capital) in one of its subsequent three taxation years, is it permissible to amend the trust's tax return for a particular year to include the amount of income otherwise paid or payable to the beneficiaries in the income of the trust, offset the resulting net income of the trust by the loss carried back (so that taxable income is nil), and request an adjustment to the beneficiaries' tax returns?**

CRA Response (a)

The Department of Finance's Explanatory Notes indicate that subsection 104(13.3) ensures that subsection 104(13.1) and (13.2) designations "are made only to the extent that the trust's tax balances (e.g., loss carry-forwards) are applied, under the rules that apply in Division C, against all of the trust's income for the year determined after the trust claims the maximum amount deductible by it under subsection 104(6)".

Therefore, any situation in which the trust's taxable income is greater than nil, will render the subsection 104(13.1) or (13.2) designation invalid. Such would be the case where a trust chooses to have taxable income in order to utilize certain credits (for example, the dividend tax credit, donation credit or investment tax credits) to reduce or eliminate the trust's tax payable.

CRA Response (b)

The Act does not specifically provide for the late filing of such designations. However, at the 2009 APFF Conference, we noted that the CRA would accept a late-filed subsection 104(13.1) designation where the trustee can demonstrate that an honest mistake was made or where the designation is made in respect of a carry-back of a non-capital loss. We expect the CRA would generally accept a late-filed subsection 104(13.2) designation, where the trust has a capital loss carry-back to apply against capital gains, subject to the caveats mentioned in respect of the 104(13.1) designation.

The CRA will only reassess beneficiaries' returns if the tax years to which they relate are not statute-barred. The CRA will not reassess the beneficiary's income when a corresponding adjustment to the trust's income tax return cannot be made because the year is statute-barred or in cases of retroactive tax planning.

QUESTION 6. <u>Spousal, Alter Ego, Joint Partner Trusts on Death</u>

This question concerns new subsection 104(13.4).

A spousal trust, alter ego trust or joint partner trust are subject respectively to a deemed disposition on the date of death of the spouse, the contributor to the alter ego trust, or the death of the later of the contributor and that person's spouse or common law partner. The deemed disposition arises at the end of the day on which death occurred. Income attribution would not apply because at the time the gain was realized, the person to whom the gain may attribute would be deceased. The consequence of this is that the gain is subject to tax in the trust. Tax planning may be carried out at a later date to potentially create, for example, a capital loss which can be carried back three taxation years to offset the capital gain. Post-mortem planning of this nature was and indeed is regularly carried out.

New subsection 104(13.4) provides for a different result. The trust is deemed to have a year-end at the end of that day, but the income of trust is deemed to have become payable in the year to the individual (whose death caused the deemed disposition).

Our questions concern how this new provision will operate from the perspective of post-mortem tax planning:

a) **Does this now preclude a strategy whereby a subsequent capital loss of the trust can be carried back to offset the capital gain, as might have been done in the past?**

b) **Subparagraph 104(13.4)(b)(i) states that the trust's income is deemed to have become payable in the year to the individual. However, at the time at which this rule becomes operative, the individual is deceased. So how does the income actually become that of the individual, or does it become that of his or her estate? What is the actual mechanism by which the amount becomes income (is it paragraph 12(1)(m)), and does the income preserve its nature (if so, how)?**

CRA Response (a)

For 2016 and subsequent taxation years, if the individual whose death is the death determined in respect of a particular trust under paragraph 104(4)(a), (a.1) or (a.4), as applicable, the trust's taxation year is deemed to end at the end of the day of the death pursuant to paragraph 104(13.4)(a). Paragraph 104(13.4)(b) deems the trust's income for that taxation year to have become payable in the year to the individual and not to another beneficiary (notwithstanding subsection 104(24)).

As a result, in that taxation year, an amount may be designated by the trust under subsections 104(13.1) and (13.2) only in respect of the deceased beneficiary. The Act does not specifically provide for the late-filing of such designations. However, as was noted in document 2009-0330181C6 at the 2009 APFF Roundtable, "*The CRA would accept a late-filed subsection 104(13.1) designation where the trustee can demonstrate that an honest mistake was made or where the designation is made to carry-back a non-capital loss. However, we will not reassess to reduce the beneficiary's income when a corresponding adjustment to the trust's income tax return cannot be made because the years are statute-barred. Similarly, we will not accept a late-filed designation in cases of retroactive tax planning other than loss carry-back*".

In our view, we would expect that CRA would generally accept a late-filed designation under subsection 104(13.2), subject to the same caveats as noted above in respect of a subsection 104(13.1) designation.

CRA Response (b)

Paragraph 104(13.4)(b) is a deeming provision. As was noted by the Supreme Court in its decision in *The Queen v Verrette*, [1978] 2 S.C.R. 838, "*A deeming provision is a statutory fiction; as a rule it implicitly admits that a thing is not what it is deemed to be but decrees that for some particular purpose it shall be taken as if it were that thing although it is not or there is doubt as to whether it is*". Accordingly, in the given instance, even though the individual may be deceased at the time at which this provision becomes operative, it functions as if the individual was alive at that instance, i.e., the income is deemed to have been made payable to the individual while still alive. Thus the income in the year of death will be included in the income of the beneficiary pursuant to paragraph 104(13)(a).

The Department of Finance Explanatory Notes for subsection 104(13.4) state that "*no amounts may be designated by the trust for the particular year under subsections 104(13.1), (13.2) and (19) to (22) in respect of any beneficiary other than the particular beneficiary*". The designations under subsections 104(19) to (22) allow the income to retain its character when included in the income of the beneficiary.

QUESTION 7. Deemed Resident Trust

a)

Under the rules concerning deemed resident trusts, an individual who becomes resident in Canada for the first time, and who has previously contributed property to a non-resident trust, will be considered a resident contributor. As such, the trust would come within the provisions of section 94 with the result that the trust would be deemed resident. Paragraph 94(3)(a) seems to deem the trust resident from January 1 of that taxation year. This pre-dates the time at which the person became Canadian resident. Does CRA agree with this interpretation?

b)

Suppose that the person was previously a long-term Canadian resident, left more than 5 years ago, and then made a contribution to the non-resident trust but within five years becomes Canadian resident again. Assume also that the trust has Canadian resident beneficiaries who are not successor beneficiaries (within the meaning of subsection 94(1)).

Our analysis of this situation is that upon the individual becoming Canadian resident, the non-resident trust is deemed to become Canadian resident, with retroactive application of potentially up to six taxation years, including the current year. We reach this conclusion because a contribution would have been made at a time which is not a non-resident time, and the trust throughout the taxation years in question had Canadian resident beneficiaries.

In such a situation, it would seem that the trust would be responsible for filing tax returns for up to five previous taxation years, furnishing foreign reporting forms in respect of its holdings (T1134 and T1135), and paying income tax on any income of the trust, computed in accordance with Canadian rules, subject to foreign tax credit relief. No relief would be provided under an international tax treaty, by virtue of the overriding provision of section 4.3 of the Income Tax Conventions Interpretation Act. In addition late filing penalties and interest may apply.

Does CRA agree with our interpretation in these circumstances? If so, can CRA offer any strategy whereby the adverse tax consequences described above can be mitigated (for example winding up the trust before becoming Canadian resident)?

CRA Response (a)

We have assumed, for the purpose of our response, that the individual becomes resident in Canada in 2015. As paragraph 94(3)(a) deems the trust to be resident in Canada throughout the particular taxation year, we would agree with this interpretation.

Analysis

Paragraph 94(3)(a) states that if, at a specified time in a trust's particular taxation year, the trust is a non-resident trust and there is a resident contributor to the trust, the trust is deemed to be resident in Canada throughout the particular taxation year for certain purposes described therein.

A resident contributor is defined in subsection 94(1) as "a person that is, at that time, resident in Canada and a contributor to the trust …" Contributor is defined in subsection 94(1) as "a person (other than an exempt person but including a person that has ceased to exist) that, at or before that time, has made a contribution to the trust." Since the individual has previously contributed property to the trust, the individual will be a contributor. Since the individual is a contributor and is resident in Canada, the individual will be a resident contributor.

Therefore, the non-resident trust will be deemed to be resident in Canada throughout the taxation year, even if the taxation year commenced before the individual became a resident of Canada.

CRA Response (b)

We have assumed, for the purpose of our response, that the individual was previously resident in Canada for more than 60 months. Provided that the person was a non-resident for more than 60 months prior to making the contribution to the non-resident trust, we would agree that the deeming provision in subsection 94(10) would result in the retroactive application of subsection 94(3) beginning in the taxation year during which the contribution was made to the non-resident trust. Where the person was not a non-resident for 60 months prior to making the contribution, the non-resident trust would be deemed to be resident in Canada by virtue of subsection 94(3) commencing in the taxation year during which the person makes the contribution to the non-resident trust.

Analysis

For the purpose of the analysis, assume the following facts:

- Mr. X was a long-term resident of Canada.
- In January 2005, Mr. X became a non-resident of Canada.
- In July 2010, Mr. X made a contribution to a non-resident trust (the “Trust”).
- In March 2015, Mr. X became a resident of Canada.
- Trust has Canadian resident beneficiaries who are not successor beneficiaries (within the meaning found in subsection 94(1)).

We need to determine for which taxation years Trust will be deemed to be resident in Canada by virtue of subsection 94(3). In order for Trust to be deemed to be resident in Canada for a particular taxation year, by virtue of subsection 94(3), Trust must have either a resident beneficiary or a resident contributor.

Once Mr. X becomes resident in Canada in 2015, Trust will have a resident contributor based on the same reasoning outlined in the analysis related to question 7(a). Therefore, Trust will be deemed to be resident in Canada for the 2015 taxation year.

The determination as to whether Trust will be retroactively deemed to be resident in Canada is based on the definition of resident beneficiary in subsection 94(1). As described in the facts, Trust has beneficiaries that are resident in Canada. In order for Trust to have a resident beneficiary at a specified time in a taxation year, as defined in subsection 94(1), Trust must also have a connected contributor at that time.

A connected contributor is defined as follows:

> “connected contributor”, to a trust at a particular time, means a contributor to the trust at the particular time, other than a person all of whose contributions to the trust made at or before the particular time were made at a non-resident time of the person.

Mr. X is a contributor to Trust, as defined in subsection 94(1). Therefore, we need to consider whether the contribution in 2010 was made at a non-resident time of Mr. X. Non-resident time is defined in subsection 94(1) as follows:

> “non-resident time” of a person in respect of a contribution to a trust and a particular time means a time (referred to in this definition as the “contribution time”) at which the person made a contribution to a trust that is before the particular time and at which the person was non-resident (or, if the person is not in existence at the contribution time, the person was non-resident throughout the 18 months before ceasing to exist), if the

> person was non-resident or not in existence throughout the period that began 60 months before the contribution time (or, if the person is an individual and the trust arose on and as a consequence of the death of the individual, 18 months before the contribution time) and ends at the earlier of
>
> > (a) the time that is 60 months after the contribution time, and
> >
> > (b) the particular time.

For the 2015 taxation year of Trust, Mr. X would be considered to have made the contribution to Trust at a time other than a non-resident time since Mr. X was a non-resident for more than 60 months before the contribution time but became resident in Canada within 60 months after the contribution time. As a result, Mr. X would be a connected contributor. Consequently, Trust would have resident beneficiaries, as defined in subsection 94(1). Therefore, Trust would be deemed to be resident in Canada for the 2015 taxation year.

Where subsection 94(10) applies there will be a retroactive application of subsection 94(3) to a non-resident trust. Subsection 94(10) reads as follows:

> In applying this section at each specified time, in respect of a trust's taxation year, that is before the particular time at which a contributor to the trust becomes resident in Canada within 60 months after making a contribution to the trust, the contribution is deemed to have been made at a time other than a non-resident time of the contributor if
>
> > (a) in applying the definition "non-resident time" in subsection (1) at each of those specified times, the contribution was made at a non-resident time of the contributor; and
> >
> > (b) in applying the definition "non-resident time" in subsection (1) immediately after the particular time, the contribution is made at a time other than a non-resident time of the contributor.

Subsection 94(10) provides that where a contributor to the trust becomes resident in Canada within 60 months after making a contribution to the trust, the contribution is deemed to have been made at a time other than a non-resident time of the contributor provided that the conditions contained in (a) and (b) of the definition are both met.

The condition in paragraph 94(10)(a) requires that when applying the definition of "non-resident time" at each of the relevant specified times, which is referring to the end of each taxation year that occurs before the particular time at which the contributor become resident, the contribution was made at a non-resident time of the contributor. At the end of 2010, the contribution by Mr. X would have been made at a non-resident time of Mr. X as he was a non-resident of Canada throughout the period from 60 months before the contribution up to that time (being the end of the 2010 taxation year). The same result would be obtained at the end of each taxation year up to the 2014 taxation year. Therefore, the requirement in paragraph 94(10)(a) is met.

The condition is paragraph 94(10)(b) requires that when applying the definition of "non-resident time" immediately after the particular time, the contribution must have been made at a time other than a non-resident time of the contributor. In this case, immediately after the particular time (being the time at which Mr. X became resident in Canada), the contribution by Mr. X would be considered to have been made at a time other than a non-resident time of Mr. X since Mr. X became a resident of Canada within 60 months of making the contribution to Trust. Therefore, the requirement in paragraph 94(10)(b) is met.

Consequently, subsection 94(10) will deem Mr. X to have made the contribution to Trust at a time other than a non-resident time for each taxation year commencing with the taxation year during which Mr. X made the contribution to the Trust. Therefore, Trust will be deemed to be a trust resident in Canada for each taxation year commencing in 2010. This would result in Trust being deemed resident in Canada pursuant to subsection 94(3) for a total of six taxation years (2010 – 2015 inclusive).

By virtue of subparagraph 94(3)(a)(vi) Trust will be required to complete foreign reporting forms (T1135 and T1134), if applicable, for each taxation year commencing in 2010. Trust will also be subject to Canadian tax by virtue of paragraph 94(3)(a) for each taxation year commencing in 2010. As noted, by virtue of section 4.3 of the Income Tax Conventions Interpretation Act, Trust will be deemed not to be a resident of any state other than Canada for purposes of applying a tax treaty. Subparagraph 152(4)(b)(vii) allows the Minister of National Revenue to assess or reassess tax, interest, or penalties within an additional 3 years where the assessment or reassessment is made to give effect to the application of section 94.

There is another example that meets the criteria provided in the question that would not result in a retroactive application of subsection 94(3). Assume the following facts:

- Mr. Z was a long term resident of Canada.

- In January 2007, Mr. Z became a non-resident of Canada.
- In July 2010, Mr. Z made a contribution to a non-resident trust (the “Trust2”).
- In March 2015, Mr. Z became a resident of Canada.
- Trust2 has Canadian resident beneficiaries who are not successor beneficiaries (within the meaning found in subsection 94(1)).

In applying subsection 94(3) at the end of the 2010 taxation year, Trust2 would have a resident beneficiary, as defined in subsection 94(1), as there are beneficiaries of the trust that are resident in Canada and Mr. Z would be considered to be a connected contributor. Mr. Z would be a connected contributor because at the time the contribution was made, Mr. Z would not have been a non-resident of Canada for a period of 60 months before the contribution was made. Consequently, the contribution would not be considered to have been made at a non-resident time of Mr. Z. As a result, Trust2 would be deemed to be resident in Canada from 2010 onward without any retroactive application.

With respect to the second portion of your question as to whether CRA could offer any strategy whereby the adverse tax consequences could be mitigated, please note that the CRA cannot offer tax planning or financial planning advice. Accordingly, we are unable to provide you with a definitive response to your question.

QUESTION 8. <u>Foreign Entity Classification</u>

The case of *Sommerer* highlighted the need for practitioners to carefully consider the issue of foreign entity classification when dealing with foreign legal entities / relationships. While we are certainly aware of the CRA’s approach to foreign entity classification that is outlined in Technical News No. 38 (now Archived), does the CRA keep a list of foreign entities that it generally (we appreciate that each case is a question of fact) considers to be foreign trusts that it would be willing to share with our members?

CRA Response

In our response to question 4 at the 2014 STEP National Conference Roundtable, it was noted that:

> “CRA's approach to entity classification is a two-step approach. That is, to determine the status of an entity for Canadian tax purposes, we would:

1) Examine the characteristics of the foreign business association under foreign commercial law and any other relevant documents, such as the partnership agreement or other contracts; and
2) Compare these characteristics with those of recognized categories of business associations under Canadian commercial law in order to classify the foreign business association under one of those categories".

In our view, the comments in our 2014 response are applicable to foreign legal entities and relationships in general. We continue to believe that the two-step approach is the most appropriate method to be followed.

In the context of considering whether a particular foreign legal entity or relationship constitutes a trust for Canadian tax purposes, Justice Miller, in his decision in Sommerer v The Queen (2011 TCC 212), provided useful commentary. He stated in paragraph 59

> "What needs to be analyzed, however, is not what the SPF is, but what relationship exists amongst the SPF (a separate legal person), Mr. Herbert Sommerer, and Mr. Peter Sommerer and the Sommerer family. Is there a trust relationship? Can Mr. Herbert Sommerer be seen as a settlor? Can the SPF be seen as a trustee, perhaps a corporate trustee? Can Mr. Sommerer be seen as a beneficiary? Do the three certainties, certainty of intention, certainty of subject matter, and certainty of objects exist"?

In the next paragraph, he noted

> "I agree with the Appellant's suggestion that, in characterizing a foreign arrangement, I rely on the Supreme Court of Canada's comments in Backman v. The Queen to look at the private law in Canada to determine the essential elements of a trust, and then compare the elements of the foreign arrangement to determine if it can be treated as its correlate under Canadian law".

His comments in paragraph 66 of the decision, when considered with his paragraph 82 conclusions on the classification issue specific to the facts in Sommerer, are worth noting. In paragraph 66 he stated

> "In summary, the essential ingredients of a trust under Canadian law that I wish to address are:
> a) segregated property;
> b) owned by a person (trustee) having control of the property;

c) for the benefit of persons (beneficiaries);
d) to whom the trustee has a fiduciary duty enforceable by the beneficiaries".

In paragraph 82, he provided the following clarification as to the scope of his findings on the issue (emphasis added)

> "It should be clear that in reaching this conclusion, I am not finding the SPF is a trust: I am finding the relationship between Mr. Herbert Sommerer, the SPF and the beneficiaries constitutes a trust, with the SPF as the trustee. **Further, I do not make this finding in any way as a generalization that all relationships involving an Austrian Private Foundation are trust relationships**. There may well be a Foundation Declaration that is found to be more akin to a power of appointment, for example, by stripping away any rights of enforceability a beneficiary might have. **Here, on balance, there are sufficient indices of the essential features of a trust to find the arrangement can be considered a trust**".

To summarize, it is our view that each case is a question of fact, and as such, CRA does not have a list of foreign entities that it generally considers to be trusts for Canadian tax purposes. We view the Sommerer decision as lending support to that view.

QUESTION 9. Non-Qualifying Country

For the purposes of section 95 of the Income Tax Act, income earned by a foreign affiliate from a business carried on through a permanent establishment in a non-qualifying country is considered to be income earned from a business other than an active business and will thus be included in computing the foreign accrual property income (FAPI) of the foreign affiliate.

A "non-qualifying country" is a country or other jurisdiction with which Canada does not have a tax treaty (including one that has been signed but is not yet in effect), one for which the Convention on Mutual Administrative Assistance in Tax Matters (the MAC) is not in force and effect, or one with which Canada does not have a comprehensive tax information exchange agreement (TIEA), unless Canada has not, more than 60 months before that time, begun or sought by written invitation to enter into negotiations for a TIEA. In effect, a country with which Canada has neither a treaty nor a TIEA and has not ratified the MAC will

only be a non-qualifying country if it has failed to enter into a TIEA with Canada within 60 months of being asked to do so or beginning negotiations towards one.

Are there any non-qualifying countries, and if so is CRA able to provide a list of them?

CRA Response

As of May 6, 2015, the only non-qualifying country is Liberia, which has been a non-qualifying country since February 24, 2015.

Finance Canada's website lists Canada's current tax treaties and the jurisdictions with which negotiations to enter into a TIEA have started and those that have been invited to start negotiations along with the relevant dates. The status of jurisdictions participating in the MAC is available on the OECD website.

QUESTION 10. Interest in a Trust as Taxable Canadian Property

The definition of "taxable Canadian property" (TCP) in subsection 248(1) provides that an interest in a trust (other than a unit of a mutual fund trust or an income interest in a trust resident in Canada) will be TCP if, at any particular time during the 60 month period that ends at that time, more than 50% of the fair market value (FMV) of the interest was derived directly or indirectly from one or any combination of real or immovable property situated in Canada, Canadian resource properties, timber resource properties, and options or interests in such properties. The CRA has previously indicated that where such a trust makes a distribution of capital to a non-resident beneficiary, the notification and withholding requirements of section 116 will apply.

It is common for a will to direct that the executors shall administer the deceased's estate, and on completion of the administration, transfer the residue to one or more trusts for the benefit of various beneficiaries. At common law, the estate and a trust constituted out of a portion of the residue are separate trusts.

In the following situation, would an interest in the "Son's Trust" be TCP at the time of the distribution?

A testator dies leaving an estate, more than 50% of which is comprised of real property situated in Canada, for example, the testator's house (a principal residence).

The testator's will directs his executor to administer the estate by converting the assets, paying the testator's debts and testamentary expenses, and upon the completion of the administration, to divide the residue into two shares. One of the shares is transferred to a resident trust (the "Son's Trust") for the benefit of the testator's son, who is a non-resident. Assume the executor and the trustee of the Son's Trust are different people.

The estate is administered within the first year after the testator's death. At the conclusion of the administration, the estate is comprised entirely of cash. The executor transfers half of the estate to the Son's Trust.

One year later, the trustee of the Son's Trust makes a capital distribution to the non-resident son.

CRA Response

We assume that in the above situation, the estate can or must transfer son's share of the cash to Son's Trust with no direction or agreement required from the son.

In a likely scenario, the transfer of the cash from the estate to Son's Trust would meet all of the conditions of paragraph (f) of the definition of "disposition" in subsection 248(1) such that there would be no change in the beneficial ownership of the property. As paragraph (f) applies, subsection 248(25.1) provides that Son's Trust is deemed to be the same trust and a continuation of the estate.

As a result, at the time the cash is distributed by Son's Trust to the son, to determine whether the son's interest in Son's Trust is TCP, one must consider the 60-month look-back rule described in paragraph (d) of the definition of "taxable Canadian property" in subsection 248(1). As more than 50% of the residue of the estate results from the sale of the principal residence (real property situated in Canada), we would consider the son's interest in Son's Trust to be derived directly or indirectly from that real property. Since the distribution of cash by Son's Trust occurs within 60 months of the sale of the principal residence by the estate, the son's interest in Son's Trust is TCP.

In an alternative scenario, the transfer of son's share of the cash from the estate to Son's Trust would not meet all of the conditions of paragraph (f) of the definition of “disposition”. Therefore, subsection 248(25.1) would not apply and we would look to determine whether the son’s interest in the estate is TCP.

Since more than 50% of the residue of the estate results from the sale of the principal residence, we would consider the son’s interest in the estate to be derived directly or indirectly from that real property. As the disposition of son’s interest in the estate occurs within 60 months of the sale of the principal residence by the estate, the son’s interest in the estate is TCP.

QUESTION 11. <u>New Charitable Donation Rules – Part 1</u>

The new rules regarding charitable donations from a graduated rate estate, contained in amended subsection 118.1(5.1), require that the donation be a gift of “property that was acquired by the estate on and as a consequence of the death” or “property that was substituted for that property”. This is not a requirement under the current law.

Consider an individual who dies, after 2015, owning shares of an investment holding company (“Holdco”) that owns marketable securities with fair market value greater than their adjusted cost base. The individual’s will provides for a charitable donation to be made on death. The graduated rate estate (“Estate”) requires Holdco’s marketable securities or cash from sale of such marketable securities to make the donation.

Scenario 1

Holdco sells securities and pays a dividend to Estate. Estate then makes the donation. Would the cash from the dividend be considered substituted property?

Scenario 2

Estate transfers the shares of Holdco, on a tax deferred basis, to Newco and takes back high PUC shares of Newco. Holdco is wound up and Newco gets a paragraph 88(1)(d) bump to increase the adjusted cost base of the marketable securities. Newco sells securities and uses the proceeds to purchase for cancellation some of Estate’s shares. Estate then uses the cash to make the charitable donation. Can the CRA confirm the donation is made with substituted property?

CRA Response

Scenario 1

When Holdco pays a dividend to the Estate, the Estate has not replaced the Holdco shares received as a consequence of the death of the individual. Therefore, the cash received by the Estate will not be property substituted for the Holdco shares. Consequently, the condition contained in paragraph 118.1(5.1)(b) would not be met.

Scenario 2

When the shares of Newco are received as consideration for the disposition of the Holdco shares, the Newco shares would be considered as substituted property for the Holdco shares. When Newco purchases its shares for cancellation, the cash received by the Estate would be substituted property for the Newco shares.

Based on the extended meaning for substituted property in paragraph 248(5)(a), the cash received by the Estate on the purchase for cancellation would be considered property substituted for the Holdco shares received by the Estate as a consequence of the death of the individual. Therefore, when the cash is used by Estate to make a donation, the condition in paragraph 118.1(5.1)(b) would be met.

Analysis

In determining whether the cash dividend on the Holdco shares or the cash received on the purchase for cancellation of the Newco shares is considered to be substituted property for the Holdco shares received by the Estate, we must consider the ordinary meaning of the term substituted property as well as the extended meaning of substituted property in paragraph 248(5)(a).

The Canadian Oxford Dictionary (2001) contains the following definitions of “substitute”:

> …A thing that is or may be used in place of another, often to serve the same function but with a slightly different effect….replace (a person or thing) with another…

Similarly, Black’s Law Dictionary (1999) defines “substitution” as “…the process by which one person or thing takes the place of another person or thing.”

Paragraph 248(5)(a) states that where there are multiple substitutions the final property held will be considered to be substituted for the original property held.

The term substituted property was considered in *McLaughlin v. MNR*, [1952] CTC 104 (Exch. Ct.). The taxpayer, Mr. X, sold shares of XCo to his wife, Mrs. X for par value. Mrs. X subsequently acquired shares of YCo for consideration consisting of the XCo shares. The issue before the Court was whether a dividend received on the YCo shares was subject to attribution under former subsection 32(3) of the Act by virtue of these shares constituting property substituted for property transferred from Mr. X to Mrs. X. The Court was of the view that the YCo shares were property substituted for the XCo shares as substituted property was property which replaces, or takes the place of, the original property.

Scenario 1

When Holdco pays a dividend to the Estate, the Estate has not replaced the Holdco shares received as a consequence of the death of the individual. Therefore, the cash received by the Estate will not be property substituted for the Holdco shares. Consequently, the condition contained in paragraph 118.1(5.1)(b) would not be met.

When the donation is made by the Estate, subsections 118.1(4.1) and (5) would apply such that Estate, and no other taxpayer, would be eligible to claim the donation. By virtue of subsection 118.1(3), the Estate would be eligible to deduct the donation in the year the Estate makes the donation or any of the subsequent five taxation years.

Scenario 2

When the shares of Newco are received as consideration for the disposition of the Holdco shares, the Newco shares would be considered as substituted property for the Holdco shares. When Newco purchases its shares for cancellation, the cash received by the Estate would be substituted property for the Newco shares.

Based on the extended meaning for substituted property in paragraph 248(5)(a), the cash received by the Estate on the purchase for cancellation would be considered property substituted for the Holdco shares received by the Estate as a consequence of the death of the individual.

Therefore, when the cash is used by Estate to make a donation, the condition in paragraph 118.1(5.1)(b) would be met. By virtue of subsection 118.1(3), the donation could be claimed by the individual in the year of death or the preceding year or by the Estate in the year the donation is made or a preceding taxation year of the Estate.

QUESTION 12. <u>New Charitable Donation Rules – Part 2</u>

Under the new tax legislation dealing with testamentary gifts, the "taxpayer" making the gift will be the deceased's estate (paragraph 118.1(5)(a) provides that the gift is deemed to be made by the estate and not by any other taxpayer). An estate is a "trust", and generally is both a "testamentary trust" and a "personal trust" for tax purposes. Under paragraph 251(1)(b), a personal trust is generally deemed not to deal at arm's length with any person that is beneficially interested in the trust. Therefore, as a beneficiary of the deceased's estate, the Public Foundation will be beneficially interested in the deceased's estate and will thus be deemed not to deal at arm's length with the deceased's estate. Since the Public Foundation and the estate will be deemed not to deal with one another at arm's length, the gift will not be an "excepted gift" under subsection 118.1(19). This seems like a bizarre result, in that it essentially prevents all gifts from an estate from being "excepted gifts". If the deceased had made the gift to an arm's length public foundation during his lifetime, the "excepted gift" rules would apply differently. Can the CRA provide its comment on the above interpretation of the new legislation?

CRA Response

Under the new tax legislation dealing with testamentary gifts, paragraph 118.1(5)(a) of the Act provides that for deaths occurring after 2015, where an individual by the individual's will makes a gift, the gift is deemed to be made by the estate and not by any other taxpayer. Thus, in applying the rules in respect of gifting under the Act, the taxpayer that will be considered to have made the gift will be the deceased's estate.

For the purposes of the Act, after 2015, an estate would typically be a personal trust (by virtue of the definition of a "personal trust" in subsection 248(1)). Under paragraph 251(1)(b), a personal trust is generally deemed not to deal at arm's length with any person that is beneficially interested in the trust. Hence, in the given situation, assuming the Public Foundation is a beneficiary of the estate, it will be considered to be beneficially interested in the estate pursuant to subsection 248(25). Accordingly, the estate will be deemed not to deal at arm's length with the Public Foundation. Consequently, where the gift is a non-qualifying security ("NQS"), as defined in subsection 118.1(18), and specifically, where the NQS is a share, we agree with your conclusion that the gift will not qualify as an “excepted gift” under subsection 118.1(19) of the Act.

QUESTION 13. <u>Question on the T3 guide</u>

Q 10 on the T3 Return asks:

“Did the trust receive any additional property by way of a <u>contribution of property</u> (as defined in the "Definitions" of the guide) since June 22, 2000? If yes, enter the year, and, if during this tax year, attach a statement giving details.”

The definition “*contribution of property*” in the Guide reads as follows:

Contribution of property – generally refers to a transfer or loan of property, other than an arm’s length transfer, <u>to a non-resident trust</u> including:

- ***a series of transfers or loans that results in a transfer or loan <u>to the non-resident trust</u>; and***
- ***a transfer or loan made as a result of a transfer or loan <u>involving the non-resident trust</u>.***

Accordingly, can it be concluded that for the purpose of Q10 a contribution can only be made to a non-resident trust, and therefore that it will never be appropriate to answer “yes” to this question in a T3 prepared for a trust that is a factual resident of Canada?

CRA Response

Please note that the definition of contribution has been modified in the 2014 T3 Trust Guide (the “Guide”). It now states as follows:

> “**Contribution of property** – generally refers to a transfer or loan of property, other than an “arm’s length transfer” (as defined in subsection 94(1)) to a non-resident trust by a person or partnership. A contribution is also considered to have been made by a person or partnership where the person or partnership makes (or becomes obligated to make) a particular transfer (other than an "arm's length transfer") as part of a series of transactions or events that includes

another transfer or loan (other than an “arm's length transfer”), to the trust, by another person or partnership.”

The question that you refer to on the T3 relates to the determination of whether a trust qualifies as a grandfathered inter vivos trust. Grandfathered inter vivos trusts are Canadian resident inter vivos trusts that were created before June 18, 1971 and that satisfy certain conditions. For 2015 and earlier taxation years, such trusts generally have full access to the graduated rates applicable to individuals. The conditions to qualify as a grandfathered inter vivos trust are set out in subsection 122(2) of the Act. Specifically, paragraph 122(2)(d.1) requires that the trust is not a trust to which a contribution (as defined by section 94 as it reads for taxation years that end after 2006) was made after June 22, 2000.

The significance of the reference to June 22, 2000 is due to the legislative proposals released by the Department of Finance by way of News Release number 2000-050 dated June 22, 2000 wherein changes were proposed to the non-resident trust rules.

Your concern is whether this question in the T3 return is relevant to a trust that is factually resident in Canada given that the definition of “contribution of property” in the Guide refers to a transfer or loan to a non-resident trust. It is our view that the fact that the Department of Finance chose to use the definition of contribution in section 94 for the purpose of paragraph 122(2)(d.1) does not support a conclusion that the paragraph will never apply to a factually resident trust. In fact, paragraph 122(2)(b) imposes the requirement that the trust was resident in Canada on June 18, 1971 and without interruption thereafter until the end of the year.

However, it may be noted that for 2016 and subsequent taxation years, the introduction of the Graduated Rate Estate rules and related amendment to subsection 122(2) will result in subsection 122(1) applying to all inter vivos trusts (i.e., they will pay tax at the highest marginal tax rate).

QUESTION 14. <u>Requirements for Question #6 on Page 2 of the T3 Return</u>

Question 6 of the T3 return reads as follows:

> ***Did the trust borrow money, or incur a debt, in a non-arm's length transaction since June 18, 1971? If yes, state the year, and, if during this tax year, attach a statement showing the amount of the loan, the lender's name, and the lender's relationship to the beneficiaries.***

In many cases, amounts of trust income are allocated to the beneficiaries of the trust but the corresponding amounts are not actually paid. Instead, the trustees ensure that the amounts are due to the beneficiaries and such amounts are legally enforceable against the trust property (in order to ensure that the conditions of subsection 104(24) are met). Given such, are amounts that are due to the beneficiary for reasons described above required to be disclosed pursuant to question #6 of the T3 return? The T3 Guide does not seem to address this specific question.

CRA Response

For the purposes of various provisions in the Act, including the deduction from income of the trust pursuant to subsection 104(6) and the inclusion in income of the beneficiary pursuant to subsection 104(13), an amount is deemed not to have become payable to a beneficiary in a taxation year under subsection 104(24) unless it was paid in the year to the beneficiary or the beneficiary was entitled in the year to enforce payment of it.

As Justice Rip (as he then was) noted in his decision in Fingold et al v MNR (92 DTC 2011):

> *A debt is a sum of money owed in respect of which a plaintiff has a right to bring and maintain an action* [Re Kerr and Smith (1894), 24 O.R. 473.].

Accordingly, where a trust allocates income to a beneficiary in a particular tax year, but rather than paying out the income at that time, provides the beneficiary with the right to enforce payment, in our view, it thereby establishes a debt to that beneficiary.

The instructions for responding to the questions on page 2 of the T3 Trust Income Tax and Information Return (the "T3 Return") can be found on page 21 of the 2014 T3 Trust Guide (Publication T4013). The instructions for question 6 refer the reader to Interpretation Bulletin IT-406R2 – *Tax Payable by an Inter Vivos Trust* (the "IT"). As is noted in paragraph 2 of the IT, graduated rate taxation, rather than flat rate tax on income, as is the general rule pursuant to subsection 122(1), is available to certain grandfathered trusts that meet all of the conditions of subsection 122(2) of the Act.

Note that the requirement in paragraph 122(2)(e) is that the trust has not, after June 18, 1971, incurred

(i) any debt, or
(ii) any other obligation to pay an amount,

to, or guaranteed by, any person with whom any beneficiary of the trust was not dealing at arm's length.

Reference may be made to Folio S1-F5-C1 – *Related persons and dealing at arm's length*, for discussion as to the meaning of the term "at arm's length".

Note that paragraph 12 of the IT states that:

> Paragraph 122(2)(e) is not contravened by a debt or other obligation of the trust to pay to a beneficiary an amount required by the terms of the trust, provided it is paid out to the beneficiary during the reasonable time needed to discharge the debt or obligation. A reasonable time will usually not be considered to extend beyond the end of the taxation year following the year in which the debt or obligation became payable by the trust. However, where subsection 104(18) applies with respect to the income of a trust in which a minor beneficiary has a vested interest, a reasonable time will usually not be considered to extend beyond the end of the taxation year following the year in which the child reaches the age of majority.

In response to the question posed, if a beneficiary not at arm's length with a particular trust has been provided with rights to enforce payment of income in a taxation year of that trust, then the information requested in question 6 on page 2 of the T3 Return should be provided upon filing.

QUESTION 15. Tax Audit and Net Worth Statements

Can CRA comment on the following:

a)

It has come to our attention that CRA is increasingly requesting personal financial information of the shareholders of Canadian corporations which are selected for audit. In some cases, the information is requested for all members of a household (for example husband, wife and children) even though only one of those persons is the owner.

b)

In addition, CRA auditors have requested individuals to furnish statements of net worth, even in circumstances where this would not have to be prepared, and is not readily available (most people do not routinely compile and maintain statements of net worth).

CRA Response (a)

When small businesses are selected for audit, the CRA seeks to gain assurance about the completeness of the income reported in their tax filings. In these businesses, internal controls are usually weak and segregation of duties is generally absent. The use of indirect tests in these situations is a generally accepted means of gaining assurance about the completeness of the income reported.

Indirect tests that are undertaken by the CRA include bank deposit analyses, rough net worth calculations, or analyses of sources and applications of funds. In order to undertake these tests and assess risk of unreported income effectively, auditors must obtain complete financial information of the individual taxpayer or corporation whose business is under audit.

Where the business is carried on in a sole proprietorship, or in a corporation with a sole shareholder or that is closely held, there is potential co-mingling of business and personal funds. As such, when performing indirect tests, auditors will also request personal financial information of the spouse (or common law partner), the shareholder of a corporation and his or her spouse (or common law partner), and other contributing individuals living in the same household.

The authority to request personal bank statements of the shareholder, spouse (or common law partner) and other contributing individuals is outlined in subsection 231.1(1) of the Act. This provision permits the CRA to inspect, audit or examine records of other persons where information in those records may relate to information that is or should be in the books and records of the taxpayer who is under inspection, audit or examination.

All personal information of the taxpayer and other persons is requested at the start of the audit enabling auditors to confirm, at the outset, that business transactions are reported within the business and not in the personal bank accounts of the proprietor, shareholder or their family members.

Note that the privacy and confidentiality of taxpayer information is protected and managed under the strict confidentiality provisions of section 241 of the Act, and we are also obliged to protect personal information under the provisions of the Privacy Act. Please be assured that the CRA respects these obligations when we obtain from taxpayers in the course of our audits.

CRA Response (b)

When conducting an audit where Indirect Verification of Income tests/techniques are necessary to verify the completeness of reported revenues, it would be a standard practice for an auditor to request that a taxpayer completes a questionnaire detailing his/her personal expenditures. While the questionnaire is quite detailed, it does not constitute a statement of net worth; a statement of net worth would include an exhaustive list of all assets and liabilities. It is not a standard audit procedure to request that statements of net worth be prepared by a taxpayer.

QUESTION 16. <u>Offshore Tax Informant Program</u>

The Government of Canada introduced a number of measures in the 2013 Federal Budget to strengthen the CRA's ability to address international tax evasion and aggressive tax avoidance, including a paid informant program. Can the CRA give a brief overview of the Offshore Tax Informant Program, as well as provide other information that may be of interest to our members regarding the new program?

CRA Response

Under the OTIP, the CRA is able to pay individuals who provide specific and credible details about major international tax non-compliance that leads to the assessment and collection of additional federal taxes. If this information helps the CRA to assess and collect more than $100,000 of additional federal taxes, the reward will be between 5% and 15% of the federal tax collected, excluding interest and penalties. Upon receiving a written submission from an informant, the program considers its eligibility for the program. If the informant and the submission appear to qualify for the program, the CRA will enter into a contract with the informant.

The payment process only begins once more than $100,000 of the associated additional federal tax (not including interest or penalties) is collected and after all the taxpayer's recourse rights have expired. This may take several years. As you may be aware, the reward is taxable in the year it is received. The CRA will withhold the applicable taxes upon payment.

In terms of what we are seeing in the submissions we have received so far, they are generally received directly from individual informants, though some are from their legal representatives, and most submissions are about individual taxpayers. The types of alleged international non-compliance issues and related mechanisms, as well as the countries and financial institutions have been diverse. We are seeing submissions that reflect the type of international non-compliance that the program was designed to identify.

Since the program's launch on January 15, 2014 through to March 31, 2015, the OTIP has received over 1,900 calls, 522 of which have been from potential informants, and 201 written submissions. Over 100 cases are being reviewed by the OTIP to determine program eligibility. Cases that do not qualify under the OTIP have been closed and where appropriate referred to other areas within the CRA for possible compliance action. The program is currently engaged in the contracting phase with several informants.

QUESTION 17. <u>Update on FATCA Information Exchange</u>

Articles 2 and 3 of the *Agreement between the Government of Canada and the Government of the United States of America to Improve International Tax Compliance through Enhanced Exchange of Information under the Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital* (the "IGA") sets out the timing of when information must be provided by a Canadian Financial Institution. Paragraph 12.29 of the CRA's publication *Guidance on enhanced financial accounts information reporting* nicely lays out the information deadline days. Given that the deadline for 2014 information exchange has already passed, can the CRA provide any comments on how the information exchange procedures / obligations has been proceeding?

CRA Response

Financial institutions (FIs) are required to file Part XVIII information returns on certain accounts of U.S. persons annually, starting with the 2014 calendar year, pursuant to Part XVIII of the Act. Paragraph 12.29 of the CRA Guidance refers to the information that is required in the Part XVIII returns. The deadline for FIs to file Part XVIII returns with the CRA for the 2014 year was May 1, 2015. The CRA has received the returns and is preparing for the information exchange to take place before the end of September 2015.

FIs that do not meet their reporting obligations under Part XVIII may be subject to penalties and interest and may be considered non-compliant. Any FI that is required to file Part XVIII returns for the 2014 year, but has not done so, should file immediately. More information, including filing instructions, can be found on the CRA website at the following links:

http://www.cra-arc.gc.ca/tx/nnrsdnts/nhncdrprtng/menu-eng.html
http://www.cra-arc.gc.ca/tx/nnrsdnts/nhncdrprtng/menu-fra.html