2018 STEP CANADA / CRA ROUNDTABLE May 28-29, 2018

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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. Update on the Dedicated Telephone Service

The Income Tax Rulings Directorate formally launched a new dedicated telephone service (DTS) for income tax service providers in July of 2017. The DTS is a three-year pilot project which was initially offered to eligible Chartered Professional Accountants (CPAs) in Ontario and Quebec. The goal of the DTS is to assist professionals in the business of preparing income tax returns by providing them with access to experienced CRA staff who can help with more complex technical issues.

Can the CRA provide an update on this pilot project?

CRA Response

Background:

In Budget 2016, Finance announced that the Canada Revenue Agency (CRA) would pilot a new dedicated telephone support line for income tax service providers. After putting the necessary infrastructure into place, the Income Tax Rulings Directorate formally launched the Dedicated Telephone Service (DTS) pilot project in July of 2017.

At the outset, the DTS was initially offered to eligible CPAs in Ontario and Quebec in the business of preparing income tax returns for clients and practicing as sole practitioners or in groups of up to three professional partners/shareholders.

The goal of the DTS is to give income tax service providers greater access to the information they need to solve their complex tax issues.

Update:

Shortly after launch in July of 2017, the DTS pilot expanded to include eligible CPAs in Manitoba and New Brunswick. To increase the awareness of the service within the CPA community, in

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August of 2017, the DTS officers began reaching out to eligible CPAs in Ontario and Quebec who had not yet registered for the service.

Most recently, the DTS was further expanded to include eligible non-CPAs in the same four provinces currently being serviced. This expansion began in March of 2018 to ensure that more income tax service providers had access to the DTS during the busy individual tax filing season.

Feedback received on the DTS since its launch has been very encouraging. In the fall of 2017 the DTS launched a phone survey that registrants are invited to complete after using the service. The results from this survey have been very positive, with an overwhelming majority of the respondents strongly agreeing that they were satisfied with the service received. The DTS has also been receiving additional unsolicited feedback from registrants expressing their gratitude for the service.

The DTS team is looking forward to evaluating the first year of the new service and will be looking for ways to build on its achievements for the coming year. If the pilot is successful, the DTS may expand nationwide and to more income tax service providers on a permanent basis.

QUESTION 2. Creation of a Trust

Assume that the Will of a deceased person creates a graduated rate estate, and several testamentary trusts for the testator's children or grandchildren. For various reasons, no property is transferred to these testamentary trusts, and all property remains in the graduated rate estate for a period of time. When does CRA consider that the testamentary trusts came into existence for purposes of the 21-year deemed disposition rule?

CRA Response

The question of the creation date of a testamentary trust has been considered in past STEP Roundtables[2]. Traditionally, the CRA has not attributed any tax consequences to the transition from estate administration to trust administration and generally has viewed trusts created out of the residue of an estate as arising on death. This would generally apply to the situation you have described.

This view would also apply in a situation where the will directs the executor and trustee to hold the residue of the estate in trust for the testator's child during their lifetime. On the death of the child, the will of the testator then directs that the trustee is to continue to hold the residue in trust for the testator's grandchildren then living under certain terms and conditions specified in the will. It is our opinion that under those circumstances only one trust would have been created upon the testator's death.

Therefore, in the above situations where a testator's will establishes a trust for a beneficiary other than the testator's spouse or common-law partner, the timing of the 21 year deemed disposition under paragraph 104(4)(b) of the Act would be based on the testator's date of death[3]. To this end, the CRA T3 Assessing section will generally assign the same commencement date to each trust created out of the estate residue.

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[2] See 2007 Question 3 (CRA document # 2007-0233721C6), 2012 Question 8 (2012-0442931C6), 2015 Question 1 a) (2015-0572091C6) and 2016 Question 2 a) (2016-0634871C6).

[3] Where the testamentary trust is established for the testator's spouse or common-law partner, the deemed disposition of the trust's property occurs on the beneficiary's death, pursuant to paragraph 104(4)(a).

It is ultimately a question of fact as to when a trust is considered to be established and there may be situations where the creation date of a testamentary trust is not concurrent with the testator's date of death. For instance, certain terms of a will may provide that on the death of the first generation beneficiary (such as the spouse or common law partner), the trustee is to divide the remaining property into equal parts to be held in a new trust for the interest of each child. In this situation, the trust may be viewed as being created at a later point in time than the testator's date of death. That being said, the deemed disposition date of the new trusts for the purposes of paragraph 104(4)(b) will be determined in accordance with subsection 104(5.8) of the Act which generally prevents the avoidance of the 21-year deemed disposition through the use of trust transfers. As a result, the new trust's deemed disposition date will generally be based on the 21 year deemed disposition date applicable to the estate.

QUESTION 3. <u>Trust return due date in the year of wind up</u>

Where a trust winds up, by distributing all of its property to its beneficiaries, does the *T3 Trust Income Tax and Information Return* (T3 Return) need to be filed within 90 days of the date of wind up, or does the normal (calendar) year-end govern when the tax return must be filed?

CRA Response

For the purpose of our response, we assume that you are contemplating the wind up of a personal trust. We also note where another event occurs in the year in which the trust or estate is wound up, the other event may result in a deemed year end and the filing due date of the T3 Return would generally be 90 days after the deemed year end.

As the T3 Return is both a return of income and an information return, paragraph 150(1)(c) of the Act and subsection 204(2) of the *Income Tax Regulations* are relevant as both provisions require the T3 Return to be filed within 90 days from the end of the trust or estate's taxation year.

For a graduated rate estate, paragraph 249(1)(b) defines a taxation year, for purposes of the Act, to be the period for which the accounts of the estate are made up for purposes of assessment under the Act. This combined with subsection 249(5), causes the taxation year to cease when the period of accounts end. In the year of wind up, this would be the date of final distribution of the assets as trust law suggests that a trust may cease to exist at this point in time.

Paragraph 249(1)(c) defines, for purposes the Act, a taxation year of a trust, other than a graduated rate estate, to be a calendar year, except as expressly provided otherwise. In the year that a trust is wound up and final distribution of assets occur, there is no provision that would cause the taxation year to be a period other than a calendar year, regardless of when the period of accounts cease.

Therefore, it is our view that the filing deadline for a graduated rate estate in the year of wind up is 90 days from the final distribution of trust assets. For all other trusts, the filing deadline will be 90 days from the end of the calendar year in which the wind up occurs. As the T3 Guide notes, in this case the return for the year up to the final distribution may be filed early.

QUESTION 4. <u>Safe Income and an Estate</u>

At the 2017 STEP Roundtable, CRA made the point that safe income of a corporation owned by a person that died did not flow through to the estate of that person. The reason was not clearly stated but appears to be that the safe income became encompassed in the adjusted cost base of the shares to the estate. Can CRA clarify its reasoning? Also, if the shares of the corporation were deemed to be disposed of at adjusted cost base (ACB) because of the rollover under subsection 70(6), would the safe income then flow through to the testamentary spousal trust or spouse, or common-law partner, as the case may be?

CRA Response

This is a follow-up to a question of the 2017 STEP Roundtable (document 2017-0693421C6). The situation described in that question involved the death of an individual and an acquisition by the estate of the deceased of the shares held by the individual for an ACB equal to the FMV of those shares. We stated that there was no carry-over of the safe income that was previously attributable to those shares on the transfer of those shares by the estate to a holding corporation since there was no accrued gain on those shares. The main reason is that we would view the safe income as having crystallized in the ACB of the shares held by the estate. Where the shares are disposed of as a consequence of the death of the individual at ACB because subsection 70(6) applies, we are of the view that the safe income that can reasonably be considered to contribute to the accrued gain on those shares at that time would flow through to the acquirer of the shares.

QUESTION 5. <u>Split Income – Definitions</u>

In the definition of excluded shares within subsection 120.4(1), subparagraph (a)(i) refers to 90% of the "business income," of a corporation while in paragraph (c), the wording uses "all or substantially all of the income". We would like to understand what these terms mean within these definitions. It would seem reasonable that business income is the income of the corporation from a business, and refers to net income. Since subparagraph (a)(i) requires a determination of whether less than 90% of the corporation's business income is derived from the provision of services, does this mean that a segmented computation of business income needs to be done, allocating the business income between income from services and income from other sources, such as the sale of goods? In addition, there is uncertainty with respect to paragraph (c) of the definition of excluded shares and the words, all or substantially all of the income. Does this refer to net income or something else such as revenue?

CRA Response

The reference to "business income" in the definition of excluded shares is to the income of the corporation from a business. This is to be distinguished from the use of "income" in the definition which refers to the income of the corporation from all sources. Whether the income of a corporation is from a business (or from a source other than a business) will depend on a review of all of the facts and circumstances of each case.

As well, the references to "business income" and "income" in the definition generally means the gross income of the corporation.

Under subparagraph (a)(i) of that definition, one of the requirements that must be met for shares of a corporation to qualify as excluded shares of a specified individual is that less than 90% of the income of the corporation is from the provision of services.

Where a corporation has income from the provision of both services and non-services (including a service business that also involves a sale of property such as a business carried on by plumbers, mechanics or other contractors that sell replacement parts or building materials), the income from the provision of services and non-services should be computed separately and the non-service income should generally be taken into account in determining whether shares of a corporation are excluded shares of an individual unless such income can reasonably be considered to be necessary but incidental to the provision of the services (for instance as would be the case in an office cleaning service if it billed separately for the cleaning supplies used).

In general, the safe harbour for excluded shares is intended as a bright line test for situations where amounts received by individuals would otherwise be considered a reasonable return. In some cases, the requirement of a corporation to compute the income from the provision of services and non-services separately for purposes of determining whether the income of a specified individual is excluded from the tax on split income ("TOSI") as income from excluded shares may give rise to additional compliance requirements. In some of these circumstances, consideration can be given to whether it may be better for taxpayers to determine whether the amount is excluded from the TOSI because it is a reasonable return of the individual based on the factors applicable in the circumstances.

QUESTION 6. Split Income – Holding company qualifying as "excluded share"

In general terms, is it possible for shares of a holding company to qualify as "excluded shares"? Does the answer depend on whether the holding company has income or not, such as dividend income from a subsidiary which might be a related business?

CRA Response

Bill C-74[4], which has received Royal Assent, contains legislation to expand the tax on split income ("TOSI") in section 120.4 of the Act, to include adult individuals in order to restrict the benefits of income sprinkling. Under the legislation, TOSI will apply to the "split income" of a "specified individual" unless the amount is an "excluded amount", all as defined in subsection 120.4(1).

To alleviate its compliance burden, the legislation included in Bill C-74 expands the definition of excluded amount to include certain safe harbours from split income. In general, these safe harbour exclusions provide a bright line test and are intended to act as a proxy for situations that would have otherwise been a reasonable return and do not raise any policy concerns.

Subparagraph (g)(i) of the definition "excluded amount" provides that income from, or a taxable capital gain from the disposition of, "excluded shares" of an individual who have attained the age of 24 before a taxation year is an excluded amount.

"Excluded shares" – defined in subsection 120.4(1) – of a specified individual are shares of the capital stock of a corporation that are owned by the specified individual if:

(a) the following conditions are met:

  i) less than 90% of the business income of the corporation for the last taxation year of the corporation that ends at or before that time (or, if no such taxation year exists, for the taxation year of the corporation that includes that time) was from the provision of services, and

  ii) the corporation is not a professional corporation;

[4] Bill C-74, An Act to implement certain provisions of the budget tabled in Parliament on February 27, 2018 and other measures.

(b) immediately before that time, the specified individual owns shares of the capital stock of the corporation that:

   i) give the holders thereof 10% or more of the votes that could be cast at an annual meeting of the shareholders of the corporation, and

   ii) have a fair market value of 10% or more of the fair market value of all of the issued and outstanding shares of the capital stock of the corporation; and

(c) all or substantially all of the income of the corporation for the relevant taxation year in subparagraph (a)(i) is income that is not derived, directly or indirectly, from one or more related businesses in respect of the specified individual other than a business of the corporation.

As per the Department of Finance's explanatory notes:

> "This limitation [in paragraph (c)] is intended to prevent the circumvention of the TOSI rules by splitting services business into services and non-services business. For example, this would apply to the use of holding companies and so-called "side car" structures (e.g. where property used in a service business is leased to a corporation carrying on the services business by another corporation in which the specified individual has an interest."

The definition "excluded shares" should generally not include shares of a holding corporation. This is because, in the case of a holding corporation, all or substantially all of the income would be derived from a related business in respect of the individual (other than a business carried on by the holding corporation). As a result, the shares of a holding corporation held by a specified individual will not be excluded shares of the individual and any income from, or a taxable capital gain from the disposition of, such shares, will not be an excluded amount and will be split income of the individual and subject to the TOSI unless another exclusion applies.

Depending on the circumstances, the income from, or a taxable capital gain from the disposition of, shares of a holding corporation may not be split income if other exclusions apply. For example, where the income is from a related business that is an excluded business – as defined in subsection 120.4(1) – of the specified individual, the income will be an excluded amount of the specified individual and will not be subject to the TOSI.

The safe harbour exclusions, including the one for excluded shares, are not intended to apply in all circumstances. Where the safe harbours do not apply in a particular case, the general underlying rationale is that in such circumstances, the most appropriate test for determining whether the income of a specified individual from a related business should be excluded from split income should be based on the general test of whether the amount received is a reasonable return according to the specific factors applicable in the circumstances, including the work performed, the property contributed in support of the business, the risks assumed by the specified individual or a related individual, prior amounts received by them in respect of the business, and any other factor as may be relevant.

QUESTION 7. Split Income – Excluded shares and business income

Assume that a corporation has no business income because it derives income from property (possibly rental income from real property where the activities are not sufficient to constitute business income). In this case, can the shares of the corporation be excluded shares?

CRA Response

No. If a corporation has no business income, its shares cannot qualify as excluded shares.

Shares will qualify as excluded shares if and only if the conditions in paragraphs (a) to (c) of the "excluded shares" definition are met. In order to meet the condition in subparagraph (a)(i) that less than 90% of the business income of the corporation is from the provision of services, the corporation must have business income to test.

Expressed mathematically, the following must be true for the condition to be met:

(Services Income) < 0.9(Business Income)

If both Services Income and Business Income equal zero, that statement is not true.

QUESTION 8. <u>Subsection 70(5)</u>

In a recent case, *McKenzie v The Queen* (2017 TCC 56), the Court stated that subsection 70(5) of the Act does not apply to a non-resident person. Could the CRA comment on how it views this case?

CRA Response

The decision in *McKenzie v The Queen* dealt with a payment received by the appellant from a US individual retirement account (the "IRA") following the death of her mother. The appellant objected to the reassessment that had included the amount received in her income, pursuant to clause 56(1)(a)(i)(C.1) of the Act. The relevant facts in the case can be briefly summarized as follows:

a. The appellant, who was a resident of Canada as well as a US citizen, was the named beneficiary of her mother's IRA.
b. When her mother died, the appellant received a distribution from the IRA which was included in the appellant's income for US tax purposes and taxed accordingly.
c. The appellant did not include the amount received in her income in her Canadian tax return.
d. Her return for that year was subsequently reassessed by CRA to include the amount in income and to allow a foreign tax credit in respect of the US income taxes paid on the amount.

The appeal raised two issues for the Tax Court (the "Court") to address:

1. whether there is an alternate taxing mechanism, other than clause 56(1)(a)(i)(C.1) for an IRA, and
2. whether subsection 248(28) applied to the amount received.

In rendering its decision, the Tax Court rejected the appellant's argument that there is an alternative method whereby the IRA should be treated as an investment portfolio – and in doing so, clarified that clause 56(1)(a)(i)(C.1) correctly applied to include the amount received in income. The Court also dismissed the appellant's argument that there was double tax in respect of the IRA to which subsection 248(28) could apply. Accordingly, the decision confirmed CRA's reassessment of the appellant to include the IRA amount in her income.

However, we note that in its analysis of the first issue, the Court considered whether, as the appellant had asserted, subsection 70(5) had applied to deem there to have been a disposition of the assets of the IRA at fair market value on the death of her mother. In paragraph 45 of its written decision, the Court stated, in part,

> "The appellant's mother, Ms. Wicks, was not a resident of Canada. She was a resident and citizen of the United States. The appellant's mother would not have been subject to a deemed disposition pursuant to subsection 70(5) as this provision does not apply to non-resident person".

In CRA's opinion, the statement in the last sentence quoted above is incorrect.

The Court provides a brief analysis in paragraphs 46 and 47 of the decision. We agree with the statement in paragraph 46 regarding liability for tax under Division A of the Act. It is in the last sentence of paragraph 47 that, respectfully in our view, the analysis is incorrect.

Clarification with regard to the CRA's views with regard to the application of subsection 70(5) to a non-resident taxpayer was provided in published external technical interpretation 2002-0133410. That document was a follow-up to document 2000-0044165, which considered a scenario wherein a Canadian resident individual inherited publicly traded shares from a non-resident relative.

The response to question 2 in our document 2002-0133410 stated "Under paragraph 70(5)(a), a deceased taxpayer is deemed to have disposed of any capital property owned by the taxpayer immediately before her or his death at fair market value". This sentence reflects CRA's views as to the application of subsection 70(5) to both resident and non-resident taxpayers.

QUESTION 9. <u>Requirements for a trust to have all interests in the trust vest indefeasibly</u>

For purposes of the so-called 21-year deemed disposition rule, a trust does not include a trust where "all interests in which, at that time, have vested indefeasibly". Can CRA comment on what is required for all interests in the trust to have vested indefeasibly?

CRA Response

Paragraph (g) of the definition of "trust" in subsection 108(1) of the Act provides for a potential exception to the 21-year deemed disposition rule in subsection 104(4). When all interests in a particular trust are vested indefeasibly prior to the end of the day that the 21-year deemed disposition rule would otherwise apply, the trust property would not be subject to a deemed disposition at the trust level on that day. However, subparagraphs (g)(i) through (vi) exclude certain types of trusts from the "vested indefeasibly" exclusion found in the preamble of paragraph (g). For example, pursuant to subparagraph (iv), where interests in a Canadian resident trust have otherwise vested indefeasibly, but the total fair market value of all interests in the trust held by non-resident beneficiaries exceeds 20% of the total fair market value of all the beneficiaries interests in the trust held at that time the exclusion to the application of subsection 104(4) will not apply.

The Act does not define the term vested indefeasibly. Cancelled Interpretation Bulletin IT-449R entitled *Meaning of "Vested Indefeasibly"* provided the statement that "*vested indefeasibly refers to* *the unassailable right to ownership of a particular property"* and "*...that such right cannot be defeated by any future event, even though that person may not be entitled to the immediate enjoyment of all the benefits arising from that right."* Although the Bulletin dealt with provisions of the Act other than the definition of "trust" found in subsection 108(1), we believe the same views apply.

It is important to note that paragraph (g) of the "trust" definition refers to the vesting of the interests in the trust and not the property or assets of the trust being vested indefeasibly. In contrast various other rollover provisions in the Act dealing with, for example, the transfer of capital property to a spouse or spouse trust and the transfer of farming or fishing property to a child, in section 70, require that the particular property being transferred becomes vested indefeasibly in the recipient within a certain time period.

The decision in *The Queen v. Boger Estate* 93 DTC 5276 (FCA) dealt with the interpretation of the expression indefeasible vesting. This case involved the question of whether certain farm land had vested indefeasibly immediately upon the death of a taxpayer in the deceased taxpayer's children (so as to qualify for the rollover under subsection 70(9)). The Federal Court of Appeal approved the trial judge's statement of the determinative legal principles that vesting occurs where:

(i) there is no condition precedent to be fulfilled before the gift can take effect; and

(ii) the persons entitled (the children) are ascertained and ready to take possession forthwith, there being no prior interests in existence;

and that a vested interest is indefeasible where there is no condition subsequent or a determinable limitation set out in the grant.

It is a question of fact and law whether all interests in a particular trust have vested indefeasibly in the beneficiaries in order for the exception from the 21-year deemed disposition rule to apply. Such a determination can only be made following a review of the applicable law, jurisprudence, the will or trust agreement and all other relevant documents and circumstances in respect of those interests. It is also a question of fact and law as to whether a trustee has the power within the terms of a trust to vest all interests which are not currently vested indefeasibly.

For an interest in a trust to vest indefeasibly in a beneficiary of the trust, the situation must be such that that the beneficiary can be ascertained and that there is no condition precedent to the beneficiary holding such trust interest. Further, there must be no condition subsequent, or possible future event or limitation that could revoke, limit or defeat the beneficiary's interest in the trust.

In an article in the Canadian Tax Journal entitled *Vested Indefeasibly: Its Importance for Tax Purposes*[5], Catherine Brown offers the following framework for guidance in determining whether an interest is vested indefeasibly:

• *The interest must be ascertainable. What is the interest?*

• *The recipient must be identifiable or ascertainable. Who is the beneficiary?*

[5] CTJ 2006 4 968-991

• The interest must not be subject to a condition precedent (except for the expiry of a previous interest). Is the beneficiary's right dependent on a condition of acquisition (for example, successfully completing university)?

• The interest must not be subject to a condition subsequent. Such an interest is usually created by the use of words such as "but if" and "provided that." Is a condition of retention attached to the gift that might cause it to be defeated (for example, "to Jeremy provided that he remains a tax resident of Canada")?

• The interest must not be subject to a determinable limitation. Such an interest is usually created by the use of words such as "while," "during," "so long as," or "until." Does a limitation exist (for example, "to A so long as he maintains his primary residence in Canada")?

• The interest must not be subject to partial divestment. This can occur if the gift is to a class of recipients, such as "my children at age 25." Is the wording of the gift such that others might share in the gift at a future time (for example, might more children be born into a class)?

• The interest need not vest "in possession"; it may vest only "in interest." Does the interest provide either an immediate or a present subsisting future right to future enjoyment (for example, on the death of the life interest holder)?

In summary, in order to vest indefeasibly, the gift must be transferred "with no strings attached" that would prevent the recipient from acquiring the gift either immediately or in the future, or defeat the gift once it has been made.

Where none of the exceptions in subparagraphs (g)(i) through (vi) apply and it is clear in law that interests have vested indefeasibly since inception or where a trust gives the trustees the power to indefeasibly vest the interests in the trust and they lawfully do so before the 21st anniversary date specified in subsection 104(4), the 21-year deemed disposition rule will not apply.

Depending upon the facts in a given situation, where a trust agreement must be amended to allow the trustees the power to vest the interests, the change in trust terms may be seen as so significant so as to result in a resettlement of the trust and therefore a disposition and reacquisition of all trust property for tax purposes.

QUESTION 10. Pipeline Rulings

In light of the proposed and subsequent abandonment of proposed section 246.1, how will these developments impact the ability of a taxpayer to request an advance tax ruling on inter vivos or post-mortem pipeline plans?

CRA Response

Our Directorate continues to consider issuing favourable rulings on the potential application of section 84.1 and subsection 84(2) to post-mortem pipeline strategies on a case-by-case basis, after a review of all the facts and circumstances surrounding each specific situation. However, the CRA's general views on these types of post-mortem strategies as set out in our response to Question 22 at the 2011 Annual Canadian Tax Foundation Conference are still applicable.

Briefly, in our response to Question 22 we noted, *inter alia*, that in the context of certain post-mortem pipeline strategies, some of the additional facts and circumstances that in our view could lead to the application of subsection 84(2) and warrant dividend treatment could include the following elements:

> “The funds or property of the original corporation would be distributed to the estate in a short time frame following the death of the testator.
>
> The nature of the underlying assets of the original corporation would be cash and the original corporation would have no activities or business (“cash corporation”).
>
> Where such circumstances exist, resulting in the application of subsection 84(2) and dividend treatment on the distribution to the estate, we believe that double taxation at the shareholder level could still be mitigated with the implementation of the subsection 164(6) capital loss carryback strategy, provided the conditions of the provision would apply in the particular facts and circumstance.”

Accordingly, in cases where we have issued favourable rulings, the particular taxpayer’s facts and proposed transactions, amongst other things, did not involve a cash corporation and contemplated a continuation of the particular business for a period of at least one year following which, a progressive distribution of the corporation’s assets would occur over a period of time. Consequently, one or more of the conditions in subsection 84(2) were not met.

QUESTION 11. <u>Trusts subject to subsection 104(13.4) in year of death of the trust’s primary beneficiary</u>

For taxation years ending after 2015, where the lifetime beneficiary of an alter ego trust (AET) dies, the trust will be subject to subsection 104(13.4). As a result, the trust will have a deemed year end on the beneficiary’s day of death. Where the AET receives income, such as dividends, in the year and before the beneficiary’s death, does subsection 104(13.4) cause that income to be taxed in the trust? Where the trust realizes a capital gain arising from the deemed disposition of capital property pursuant to subsection 104(4) on the death of the beneficiary, can the capital gain be reported on the beneficiary’s final *T1 Income Tax and Benefit Return* (T1 Return)?

Would the results be different, if the trust was a post-1971 spousal or common-law partner trust?

CRA Response

Although it is a question of fact as to whether a trust meets the criteria to be considered an “alter ego trust” as described in the Act, for purposes of our response, we assume such is the case.

For the 2016 and subsequent taxation years, paragraph 104(13.4)(a) provides that the taxation year of an AET, and certain other trusts is deemed to end at the end of the day of death of an individual whose day of death is a day referred to in paragraphs 104(4)(a), (a.1) or (a.4) of the Act (“primary beneficiary”, in the case of an AET, this is the settlor).

Depending on the terms of the alter ego trust, the dividend income earned by the trust prior to the primary beneficiary’s death will generally be included in the beneficiary’s income by virtue of subsection 75(2) or subsection 104(13).

Where property is held by a trust under any of the conditions described in paragraph 75(2)(a) or (b), any income or loss from the trust property (or substituted property) and any taxable capital gain or allowable capital loss realized on the disposition of the trust property (or substituted property) prior to the primary beneficiary’s death in the year will be attributed to the person referred to in subsection 75(2) (in the case of an AET, the “person” is the settlor). Accordingly, the dividend income received by the AET prior to the settlor’s death will be included in the settlor’s final T1 Return.

The preamble to subsection 104(4) provides that an AET (and certain other trusts) is deemed to have disposed of its properties described therein at the end of the day on which the trust's primary beneficiary dies. As subsection 75(2) refers to the existence of the person, any taxable capital gain arising from the deemed disposition under subsection 104(4) will be taxed in the trust and not attributed to the deceased beneficiary.

Where subsection 75(2) does not apply to a trust, we note that for the trust to be considered an AET for purposes of the Act, the terms of the trust must ensure that the primary beneficiary is entitled to receive all the income of the trust arising before his or her death and no person except that individual may receive or otherwise obtain the use of any of the income or capital of the trust before that individual's death. Accordingly, any portion of the income of an AET that is not attributed to the settlor under subsection 75(2) would generally be included in that individual's income under subsection 104(13) as being payable to the primary beneficiary.

Paragraph 104(6)(b) will also apply, and the trust may claim a deduction. Paragraph 104(6)(b) calculates the maximum deductible amount available to the trust as A – B. Element A is the part of the trust's income for the year that became payable to, or was included under subsection 105(2) of the Act in the income of, a beneficiary. Element B restricts the deduction available to the trust as follows:

- for the trust's year in which the primary beneficiary dies and prior years, clause (i)(A) of element B ensures that no deduction may be made for income which became payable to a beneficiary other than the primary beneficiary, and
- for the trust's year in which the primary beneficiary dies, subclause (i)(B)(I) of element B ensures that no deduction is available in respect of any amount included in the trust's income because of the application of subsections 104(4) to (5.2) or subsection 12(10.2) of the Act.

Therefore, in the current AET situation, if either subsection 75(2) or subsection 104(13) applies to the dividend income earned by the trust prior to the primary beneficiary's death, it will be included in the beneficiary's income on their final T1 Return. The taxable capital gain realized by the trust upon the deemed disposition of trust property pursuant to subsection 104(4) will be reported by the AET.

<u>Testamentary spousal or common law partner trusts</u>

The above discussion in respect of subsections 104(6) and (13) and income which becomes payable to the beneficiary prior to their death also applies to a post-1971 spousal or common-law partner trust and the primary beneficiary under such trusts.

The above discussion in respect of the taxable capital gain realized by the AET upon the death of the primary beneficiary also applies to a testamentary post-1971 spousal or common-law partner trust; however, one additional result may be available. Where the following conditions are met, a joint election described in paragraph 104(13.4)(b.1), between the trust and the deceased beneficiary's graduated rate estate, may be filed to report the income of the trust arising from the application of subsections 104(4) to (5.2) or subsection 12(10.2) on the deceased beneficiary's final T1 Return:

- Immediately before death, the beneficiary was a resident of Canada.

- The trust is a testamentary trust that is a post-1971 spousal or common-law partner trust and was created by the will of a taxpayer who died before 2017.
- A copy of the joint election is filed with both the final T1 Return of the beneficiary and the T3 Trust Income Tax and Information Return for the deemed year end of the trust.

Where the election is made, the trust may deduct the corresponding amount from its income.

Question 12. US Transition Tax

Recently implemented US tax reform has introduced a one-time so-called "transition tax" that applies to US persons who own interests in certain non-US corporations. Consider the situation of a US citizen resident in Canada who holds a controlling interest in a UK company. The US imposes its one time transition tax on the "earnings and profits" of the UK company held at certain dates in 2017. Would Canada view such US transition tax as an "income or profits tax" as referred to under subsection 126(7) of the Act when applying the foreign tax credit ("FTC") rules in the computation of the US citizen / Canadian resident individual?

CRA Response

Our understanding of section 965 of the Internal Revenue Code ("IRC") is that the accumulated deferred foreign income (calculated at certain dates in 2017) of a specified foreign corporation will be included in the US "Subpart F income" of that corporation for its last taxable year that begins before January 1, 2018. US shareholders of the specified foreign corporation that are subject to this rule must then include (under section 951 of the IRC) their pro rata share of the foreign corporation's US Subpart F income in their income. A US shareholder may elect to pay the net tax liability resulting from the application of section 965 of the IRC (the "transition tax") in eight annual installments.

Assuming that the UK company has a calendar year end, we understand that the rules described above would result in the individual, in this example, having to include in the individual's US income, in 2017, the pro rata share of the UK company's US Subpart F income. Furthermore, the individual would likely pay the US income tax on this income over several annual installments.

As indicated in Folio S5-F2-C1, "*Foreign Tax Credit*", (the "Folio"), in order to determine if a foreign tax is an income or profit tax, the basic scheme of application of the foreign tax is compared with the scheme of application of the income and profits taxes imposed under the Act. Generally, if the basis of taxation is substantially similar to the ones in Canada, in the sense that it is also levied on net income or profits (but not necessarily as would be computed for Canadian tax purposes), the foreign tax will be considered as an income or profit tax for purposes of the Canadian FTC rules. We understand that the US Subpart F income rules resemble our Foreign Accrual Property Income ("FAPI") rules and that the US tax that is paid by the individual on the individual's share of the US Subpart F income, in this example, is an income tax that is similar to the one that is levied under the Act, and, as such, we are of the view that it should qualify as an income tax for purposes of the Canadian FTC rules. We have assumed for the purpose of the example that the US transition tax is entirely attributable to income from a source outside of Canada and therefore this tax should not be disqualified from being a "non-business-income tax" under paragraph d) of the definition under subsection 126(7) of the Act.

However, this does not fully resolve the issue as to whether a FTC should be available in this case. As indicated in the Folio, a separate FTC calculation is required for each foreign country and the maximum amount of FTC that the taxpayer may claim with respect to the foreign non-business-income tax is essentially equal to the lesser of two amounts: the applicable foreign income tax paid to the government of a country for the year; and the amount of Canadian tax otherwise payable for the year that pertains to the applicable foreign income from sources in that country ("non-business income").

In the example, the FTC would thus be calculated based on a formula which takes into account the amount of US-sourced income and it is not clear in this case if any income is sourced to the US. US Subpart F income is not deemed to be income under Canadian domestic law and would thus not be considered as US-sourced income for the FTC calculations.

To the extent that the individual doesn't have any non-business income that is US-sourced, it is our view that a FTC would not be available in this example. Note that our answer would be the same if the UK company had paid an actual dividend to the individual in 2017 since this dividend income would be sourced to the UK and not to the US. Furthermore, as indicated in the Folio, before an amount of FTC can be claimed under subsection 126(1) of the Act, it must be paid for the year (2017, in the example), whether it is paid before, during or after the year in question. We understand that the transition tax in the example would be paid for the year 2017 and that a Canadian FTC would thus not be available in any other year after 2017 even if the tax were to be paid over several annual installments.

QUESTION 13. Alter ego trust subject to foreign withholding tax

Assume that an individual (the "Settlor") creates an alter ego trust, and transfers various securities to the trust. Included with the securities are US stocks on which dividends are paid. These US stocks are subject to a 15% withholding tax.

Subsection 75(2) of the Act applies so that the income of the alter ego trust is considered to be the income of the Settlor, who created the trust and who is, under the trust, a lifetime beneficiary. Is it correct that in this circumstance, the foreign tax (being the withholding tax on the dividend) would not be attributed to the Settlor, and remains in the trust?

CRA Response

Pursuant to subsection 248(1) of the Act, the term "alter ego trust" refers to a trust to which paragraph 104(4)(a) applies, if read without reference to subparagraph 104(4)(a)(iii) and clauses 104(4)(a)(iv)(B) and (C). Accordingly, a reference to an alter ego trust in the Act is a reference to an inter vivos trust established after 1999 by an individual who is at least 65 years old when the trust is settled, and under which that individual is entitled to receive all the income of the trust arising before his or her death and under which no person except that individual may receive or otherwise obtain the use of any of the income or capital of the trust before that individual's death.

While it is given as a fact statement in the question posed that subsection 75(2) does apply to the US stocks held by the alter ego trust, it would be a question of fact as to whether property is held by a trust under either of the conditions described in paragraph 75(2)(a) or (b), such that subsection 75(2) may apply to attribute income received by the trust in respect of the property.

Where subsection 75(2) is determined to apply in respect of a particular property, it will deem any income or loss from the property, or any taxable capital gain or allowable capital loss from the disposition of the property to be that of the person from whom the trust received the property. Note, however, that in the scenario posed, subsection 75(2) would not attribute the payment of the foreign non-business income tax paid to the US (which was paid by the trust) to the Settlor.

Subsection 126(1) of the Act requires that any non-business income tax must have been paid by the taxpayer claiming the foreign tax credit. Since it is the trust that paid the tax, the Settlor would not be eligible to claim a credit pursuant to subsection 126(1) in respect of the US tax paid by the alter ego trust. It should also be noted that a deduction by the Settlor pursuant to subsection 20(11) or 20(12) in respect of the US tax paid would not be available, for the same reason. Note, however, that if the requirements of subsection 20(11) and subsection 20(12) are met, the alter ego trust may claim deductions pursuant to these provisions in computing the amount to be attributed to the Settlor.

QUESTION 14. <u>Non-resident trust filing obligations</u>

Question 14(a)

In certain circumstances, a non-resident trust will be deemed to be resident in Canada by virtue of section 94. The main circumstances will be situations where a resident of Canada has contributed property to a non-resident trust such that the non-resident trust has a resident contributor, as defined in subsection 94(1). Assume that a person immigrating to Canada has contributed property to a non-resident trust. Upon becoming resident, does the CRA agree that the non-resident trust will be deemed resident in Canada by virtue of paragraph 94(3)(a) as of January 1 of the taxation year in which the contributor immigrated to Canada?

CRA Response

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 (other than an exempt 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.

Question 14(b)

Assume that the non-resident trust has beneficiaries resident in Canada who are not successor beneficiaries (within the meaning of subsection 94(1)) when the contributor immigrates to Canada, and the contributor has made a contribution to the trust less than 60 months before becoming resident. Does the CRA agree that the non-resident trust may be deemed resident for up to five taxation years before the taxation year in which the individual became resident in Canada?

If so, would the CRA expect T3 income tax returns to be filed for these previous years? Would the CRA expect foreign reporting forms, such as the T1135 and the T1134, to be filed as well? Would the CRA apply interest and late-filing penalties to any tax owing by the non-resident trust for these prior years?

CRA Response

Provided that the individual 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 contributor 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 contributor makes the contribution to the non-resident trust.

This result can best be demonstrated through the use of an example.

Assume the following facts:

* In July 2013, Mr. X made a contribution to a non-resident trust (the “Trust”).
* In March 2018, Mr. X became a resident of Canada.
* Prior to immigrating to Canada in 2018, Mr. X had never been a resident of Canada.
* Trust has beneficiaries resident in Canada who are not successor beneficiaries (within the meaning found in subsection 94(1)).

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.

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, 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 2013 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.

Although Mr. X was a non-resident for more than 60 months before the contribution time, he became resident in Canada within 60 months after the contribution time; therefore, Mr. X would be considered to have made the contribution to Trust at a time other than a non-resident time for the 2018 taxation year of Trust. As a result, Mr. X would be a connected contributor. Consequently, Trust would have resident beneficiaries, as defined in subsection 94(1). In addition, since Mr. X is resident in Canada in 2018 and is a contributor to Trust, Trust will have a resident contributor for the 2018 taxation year. Therefore, Trust would be deemed to be resident in Canada for the 2018 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 paragraphs 94(10)(a) and (b) 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 2013, 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 2013 taxation year). The same result would be obtained at the end of each taxation year up to the 2017 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 2013 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 2013. This would result in Trust being deemed resident in Canada pursuant to subsection 94(3) for a total of six taxation years (2013 to 2018 inclusive).

Trust will be subject to Canadian tax by virtue of paragraph 94(3)(a) for each taxation year commencing in 2013. Trust will also be subject to interest and penalties, as determined under Division I, related to each taxation year for which a tax return was not filed (in the example provided, interest and penalties would be assessed for the taxation years of 2013-2017 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 2013. Again, any interest and penalties calculated by virtue of Division I will be assessed for the relevant taxation years.

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.

In addition, subparagraph 152(4)(b)(vii) allows the Minister of National Revenue to assess or reassess tax, interest, or penalties within an additional 3 years after the end of the normal reassessment period where the assessment or reassessment is made to give effect to the application of section 94.

As indicated above, where the contributor 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 contributor makes the contribution to the non-resident trust.

This situation can also be best described using an example:

* Mr. Z was a long term resident of Canada.
* In January 2010, Mr. Z became a non-resident of Canada.
* In July 2013, Mr. Z made a contribution to a non-resident trust (the "Trust2").
* In March 2018, Mr. Z became a resident of Canada.
* Trust2 has beneficiaries resident in Canada who are not successor beneficiaries (within the meaning found in subsection 94(1)).

In applying subsection 94(3) at the end of the 2013 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 2013 onward without any retroactive application.

Finally, as more fully explained in Question 7 at the 2015 STEP CRA Roundtable (document 2015-0572141C6), it is not necessary for the contributor to have never been a resident of Canada before making the contribution to a non-resident trust for subsection 94(10) to apply.

Consider the following example:

* Mr. Y was a long-term resident of Canada.
* In January 2008, Mr. Y became a non-resident of Canada.
* In July 2013, Mr. Y made a contribution to a non-resident trust (the "Trust3").
* In March 2018, Mr. Y became a resident of Canada.
* Trust3 has beneficiaries resident in Canada who are not successor beneficiaries (within the meaning found in subsection 94(1)).

Consequently, subsection 94(10) will deem Mr. Y to have made the 2013 contribution to Trust3 at a time other than a non-resident time for each taxation year commencing with the taxation year during which Mr. Y made the contribution to the Trust3. Therefore, when Mr. Y becomes resident in Canada in 2018, Trust3 will be retroactively deemed to be a trust resident in Canada for each taxation year commencing in 2013.

QUESTION 15. Subsection 164(6) and the application of paragraph 112(3.2)(b)

This question deals with capital loss of an estate on a redemption of shares and the carryback election under subsection 164(6).

In particular, the question relates to the stop-loss rule in subsection 112(3.2) which may be applicable to reduce the capital loss otherwise realized by the estate upon the disposition of a share of the capital stock of a corporation. There are two components to subsection 112(3.2). The first component, outlined in paragraph 112(3.2)(a), generally provides for a reduction of the capital loss where non-taxable capital dividends were received by the estate on the share, subject to certain limitations. The second component, in paragraph (b), provides for a further reduction of the loss where taxable dividends or life insurance capital dividends are received on the share and designated by the trust under subsection 104(19) or 104(20) in respect of a beneficiary that was a corporation, partnership or trust.

Assume that the estate provides that the beneficiary is a spousal trust. The will of the deceased creates an estate, and under that estate, amounts are to be paid to the spousal trust. That trust may, in turn, pay amounts to beneficiaries. In this circumstance, suppose that a taxable dividend is created on a redemption of shares. The graduated rate estate ("GRE") receives the taxable dividend. If this taxable dividend is designated to an individual, then paragraph 112(3.2)(b) would not apply. However, if the GRE designates the amount to the spousal trust, which then designates the amount to a beneficiary who is an individual, it seems that paragraph (b) could apply to reduce the capital loss. How does CRA administer this as a question of practice?

CRA Response

Generally, paragraph 112(3.2)(b) provides for a reduction in the capital loss realized by a trust (other than a mutual fund trust) on the disposition of a share in an amount equal to the amount of taxable dividends and life insurance capital dividends received on those shares by the trust and designated by the trust under subsection 104(19) or 104(20) in respect of a beneficiary that is a corporation, partnership or trust.

Subsection 112(3.32) provides an exception to the application of paragraph 112(3.2)(b). The exception applies in respect of taxable dividends that are "qualified dividends" received on the share by the trust and that are designated by the trust under subsection 104(19) in respect of a beneficiary that is a corporation, partnership or trust, where the trust establishes that:

1) the dividends were received by a beneficiary that was an individual (other than a trust), or
2) the dividends were received on a share that was owned by the trust throughout the 365-day period that ended immediately before its disposition and received when the trust (and the beneficiary as well as persons who did not deal at arm's length with the beneficiary) did not own in total more than 5% of the issued shares of any class of the capital stock of the dividend-paying corporation.

Accordingly, where the trust establishes that the taxable dividends paid to a beneficiary that is a corporation, partnership or trust are ultimately received by an individual (other than a trust), the exception in subsection 112(3.32) should be applicable provided that the taxable dividends are qualified dividends. In our opinion, this exception could apply if the individual is: (a) a shareholder of a corporation that is a beneficiary of the trust; (b) a partner of a partnership that is a beneficiary of the trust; or (c) a beneficiary of another trust that was a beneficiary of the initial trust.

The term "qualified dividend" is defined in subsection 112(6.1) to include: (a) dividends other than those deemed to be received pursuant to subsection 84(3) in respect of a redemption, acquisition or cancellation of shares; and (b) certain dividends deemed to be received pursuant to subsection 84(3). Where the dividend is deemed to be received pursuant to subsection 84(3) and the share is held by a trust, the dividend would be a qualified dividend pursuant to subparagraph 112(6.1)(b)(iii), if:

1) the dividend is received by the trust and taxed at the trust level;
2) the dividend is received on the share and designated under subsection 104(19) by the trust in respect of the following beneficiaries:
    (a) an individual other than a trust,
    (b) a corporation that is a private corporation when the dividend is received by it, where the dividend was paid by another private corporation,
    (c) another trust that does not designate the dividend under subsection 104(19), or
    (d) a partnership all of the members of which are, when the dividend is received, persons described by any of (a), (b) or (c) above; or
3) the dividend is received on the share and designated by the trust under subsection 104(19) in respect of a beneficiary that is another trust or a partnership, where the trust establishes that the dividend was received on the share by a person described by any of (a), (b) or (c) above.

In the scenario described, a GRE is deemed to receive a dividend (pursuant to subsection 84(3)) which is treated as a taxable dividend. In the event that the dividend is designated under subsection 104(19) by the GRE in respect of a beneficiary that is a spousal trust and in turn the dividend is designated under subsection 104(19) by the spousal trust in respect of a beneficiary that is an individual, the exception in subsection 112(3.32) should be applicable such that the taxable dividend received by the GRE and ultimately paid to the individual beneficiary of the spousal trust should not be considered in the application of paragraph 112(3.2)(b).

Note that in order for a dividend to be designated under subsection 104(19) by a trust in respect of a beneficiary the provision requires, inter alia, that the amount may be reasonably considered to be included in the beneficiary's income because of the application of paragraph 104(13)(a), subsection 104(14) or section 105. For paragraph 104(13)(a) to apply, the amount must have become payable to the beneficiary in the particular year. Subsection 104(24) provides that for certain purposes of the Act, including subsection 104(13), an amount is deemed not to have become payable to a beneficiary in the year unless the amount was actually paid to the beneficiary in the year, or the beneficiary was entitled in the year to enforce payment of it.

QUESTION 16. Implications of a US LLC making a check-the-box election

Given recent changes to the tax system in the US, Canadian resident persons who carried on business in the US through US LLCs may now prefer to alter this choice of entity for US tax purposes. An election is permitted in this case, the check-the-box election, whereby the US LLC may be designated to be a corporation for US tax purposes. In such a circumstance, where a check-the-box election is made, does CRA agree, generally speaking, that the making of the check-the-box election has no implications for Canadian tax purposes? It is noted that the Canadian tax treatment of the US LLC would be that it is a foreign corporation, and the check-the-box election would not alter this treatment for Canadian tax purposes.

CRA Response

It has become widely accepted that US limited liability companies ("US LLCs") are properly viewed as corporations for purposes of the Income Tax Act. The filing of a check-the-box election by a US LLC, after it had previously been treated as a fiscally transparent entity for US tax purposes, would not alter the US LLC's classification as a corporation for Canadian tax purposes.

The check-the-box election is made, and has implications, for US tax purposes, but does not impact upon the US legal attributes or laws regarding the governance and operation of an LLC. From a US legal perspective, a US LLC remains the same legal entity after checking-the-box as it was before the election was made. Consequently, a check-the-box election would not result in a disposition either of the units of a US LLC by its members or of the LLC's assets for Canadian tax purposes.

However, we would note that the application of the Canada-US Tax Convention to a US LLC as well as certain other Canadian tax consequences, such as foreign tax credits and deductions, may be different depending upon whether the US LLC is treated as a fiscally transparent entity or a corporation under US tax law. In general, when a US LLC is treated as a corporation for US tax purposes, it is the entity paying US tax on the US LLC's income rather than its members. Examples of various Canadian tax results to a Canadian member of a fiscally transparent US LLC have been discussed at previous STEP conference roundtables. The tax results outlined in the responses to those previous conference questions may be different after a US LLC makes a check-the-box election to be treated as a corporation for US tax purposes.

QUESTION 17. Section 84.1 and Capital Gains Reserve

Generally speaking, section 84.1 of the Act applies to prevent the tax-free extraction of surplus of a corporation through a non-arm's length transfer of share(s) by an individual resident in Canada to a corporation where the individual's adjusted cost base (ACB) of the particular share(s) so transferred has been increased by the capital gains exemption (CGE) or V-Day value. However, we are aware that section 84.1 could apply in a situation where the individual's ACB of the particular share(s) has not been increased by the CGE or V-Day value. More specifically, subsection 84.1(2.1) provides that, for purposes of determining ACB of the individual's share for the purposes of section 84.1 (and in particular the ACB reduction under subparagraph 84.1(2)(a.1)(ii)), where a capital gains reserve is claimed under subparagraph 40(1)(a)(iii) by the individual or a non-arm's length individual (herein referred to as the "transferor") and it is possible for the transferor to claim the CGE, the CGE is deemed to be claimed by the transferor in the maximum amount irrespective of whether it is in fact claimed.

Can the CRA provide any comments with respect to this interpretation of subsection 84.1(2.1)? Specifically, can the CRA comment on whether the application of subsection 84.1(2.1) could result in a transferor being deemed to have claimed CGE in the maximum amount where the transferor claims a capital gains reserve under subparagraph 40(1)(a)(iii) but has not, and has no intentions of, claiming CGE even though there is unused CGE room available?

CRA Response

In very general terms, section 84.1 is an anti-avoidance rule designed to prevent the removal of taxable corporate surpluses as a tax-free return of capital through a non-arm's length transfer of shares of one corporation (the "subject corporation") by an individual resident in Canada to another corporation (the "purchaser corporation"). Section 84.1 achieves its purposes by: (1) reducing the paid-up capital of the shares of the subject corporation, which reduces the ability to return paid-up capital of the purchaser corporation as the excess would be taxed as a dividend, and (2) deeming the individual shareholder to have received a dividend where the purchaser corporation pays non-share consideration for the shares of the subject corporation that exceeds the greater of the paid-up capital and the "hard ACB" of the particular shares transferred. The Act provides specific rules for determining the "hard ACB" for the purposes of section 84.1. "Hard ACB" is a term commonly used to describe arm's length ACB that was not created as a result of V-Day value or the utilization of the CGE.

In respect of this particular situation, the CRA's views on the application of subsection 84.1(2.1) can be found in Technical Interpretation 2015-059446. In that Technical Interpretation we stated the following:

> Paragraph 84.1(2)(a.1) was implemented in 1985 so that the benefit of the capital gains deduction on a gain realized on the disposition of a share would not also result in the additional benefit to the taxpayer or a person not dealing at arm's length with the taxpayer to receive a distribution from the corporation tax-free.
>
> At the time the Act was modified to allow capital gains reserves claimed under subparagraph 40(1)(a)(iii) to qualify for the capital gains exemption under section 110.6, there was no corresponding amendment to section 84.1. As a result, it was possible to circumvent the paragraph 84.1(2)(a.1) reduction in adjusted cost base for the purposes of section 84.1 by having the non-arm's length transferor of the shares claim a capital gains reserve in respect of the transfer and subsequently claim a capital gains exemption when the amount is brought back into income.
>
> Subsection 84.1(2.1) was introduced to address this unintended result. It provides a special rule for the purposes of subparagraph 84.1(2)(a.1)(ii) and applies where the transferor or an individual who does not deal at arm's length with the transferor disposes

of a share in a taxation year and claims a capital gains reserve under subparagraph 40(1)(a)(iii) on that disposition. This provision essentially treats the transferor as having claimed, to the extent that the transferor has unused capital gains exemption room in the year in which the disposition took place, a capital gains deduction on the disposition, irrespective of whether such exemption was actually claimed, because the reserve could potentially be eligible for a capital gains exemption when brought into income in the future. Whether the transferor intends to claim a capital gains exemption on the reserve in the future is not relevant. We understand that the effect of this rule is to treat a capital gain on a property to be sheltered by the capital gains exemption when there is unused capital gains exemption room in the year of the disposition regardless of whether such capital gains exemption room has been saved to cover a capital gain that could be realized on a disposition of other properties in a subsequent year.

In our view, these comments remain relevant and are supported by law and as such, remains the current position of the CRA.

The following examples illustrate the operation of subsection 84.1(2.1).

Example 1

Assume that a person who was not dealing at arm's length with a taxpayer realized a $100,000 capital gain on the transfer of a share to the taxpayer. The non-arm's length person claims a reserve under subparagraph 40(1)(a)(iii) in respect of $50,000 of the capital gain and pays no tax on the remaining $50,000 capital gain by claiming a $25,000 CGE under subsection 110.6(2.1). Assume also that the non-arm's length person had $25,000 of unclaimed CGE remaining after the end of the year in which the transfer occurred. Under subsection 84.1(2.1), the amount of CGE deemed to have been claimed by the non-arm's length person is determined as the lesser of (a) and (b) where:

(a) is the total of

(i) reserve under 40(1)(a)(iii)	$50,000
(ii) twice the amount deducted under section 110.6	$50,000 (2 x $25,000 CGE)
	$100,000

and

(b) is twice the maximum amount that could have

been deducted under section 110.6 in respect of the

taxable gain if no reserve under 40(1)(a)(iii) had been claimed $100,000 (2 x $50,000 CGE)

Pursuant to subsection 84.1(2.1), the non-arm's length person is deemed for the purposes of subparagraph 84.1(2)(a.1)(ii) to have claimed CGE in respect of the entire $100,000 capital gain realized on the transfer of the share.

Example 2

Facts are the same as in Example 1 except that the non-arm's length person had no unclaimed CGE remaining after the end of the year in which the transfer occurred. Under subsection

84.1(2.1), the amount of CGE deemed to have been claimed by the non-arm's length person is determined as the lesser of (a) and (b) where:

(a) is the total of

(i) reserve under 40(1)(a)(iii)	$50,000	
(ii) twice the amount deducted under section 110.6	$50,000	(2 x $25,000 CGE)
	$100,000	

and

(b) is twice the maximum amount that could have been deducted under section 110.6 in respect of the taxable gain if no reserve under 40(1)(a)(iii) had been claimed $50,000 (2 x $25,000 CGE)

Pursuant to subsection 84.1(2.1), the non-arm's length person is deemed for the purposes of subparagraph 84.1(2)(a.1)(ii) to have claimed CGE in respect of only $50,000 of the capital gain realized on the transfer of the share.

Example 3

Facts are the same as in Example 1 except that the non-arm's length person had $10,000 CGE remaining after the end of the year in which the transfer occurred. Under subsection 84.1(2.1), the amount of CGE deemed to have been claimed by the non-arm's length person is determined as the lesser of (a) and (b) where:

(a) is the total of

(i) reserve under 40(1)(a)(iii)	$50,000	
(ii) twice the amount deducted under section 110.6	$50,000	(2 x $25,000 CGE)
	$100,000	

and

(b) is twice the maximum amount that could have been deducted under section 110.6 in respect of the taxable gain if no reserve under 40(1)(a)(iii) had been claimed $70,000 (2 x $35,000 CGE)

Pursuant to subsection 84.1(2.1), the non-arm's length person is deemed for the purposes of subparagraph 84.1(2)(a.1)(ii) to have claimed CGE in respect of only $70,000 of the capital gain realized on the transfer of the share.

It should be noted that, as indicated in the wording of the provision, the application of the deeming rule in subsection 84.1(2.1) to a taxpayer applies only for the purposes of subparagraph 84.1(2)(a.1)(ii). In other words, the application of the deeming rule in subsection 84.1(2.1) does not impact that taxpayer's ability to claim a CGE exemption under the rules in section 110.6.

QUESTION 18. Reliance on archived interpretation bulletins and income tax technical news releases

In recent years, CRA has been working on its folio project to organize information by subject. As part of this, many interpretation bulletins have been archived. In general terms, to what extent can persons rely on interpretation bulletins which have been archived, and also to what extent can one rely on comments made in Income Tax Technical News releases?

CRA Response

In August of 2013, the CRA added an "archived content" notice at the top of the Interpretation Bulletin (IT) and Income Tax Technical News (ITTN) publications available on the CRA's website in anticipation of the new web-based folio chapters. We wish to highlight that this notice had no effect on the status or reliability of the particular publication. It merely confirmed that the publication's webpage is not subject to Government of Canada web standards, and that its content will not be altered or updated.

To that end, taxpayers and their representatives may continue to refer to these ITs or ITTNs for explanations of the CRA's interpretation of federal income tax law, keeping in mind that the publication is only current up to its stated effective date and is not a substitute for the law. Therefore, we note that any reliance on the content of an archived IT or ITTN must take into account the following:

- any relevant provisions of the law in force for the particular taxation year being considered,
- the effect of any relevant amendments to those provisions, and
- any relevant court decisions occurring after its effective date.

It is also important to note that once the subject matter of an archived IT or ITTN is reflected in an income tax folio chapter, the particular IT or ITTN will then be cancelled. Please refer to the Canada Revenue Agency (CRA) website for more information.