STEP Canada

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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

Would subsection 78(1) apply in respect of amounts payable by a trust to a beneficiary where the amounts so payable remained unpaid at the end of the second taxation year following the year that such amounts were deducted from the trust's income under subsection 104(6)? The question raised asks the Canada Revenue Agency to explain their position and interpretation of the meaning of the words "deductible outlay or expense" in the preamble of 78(1) and to comment on their IT-109R2.

CRA Response

We are unclear as to the context in which you were seeking our comments in respect of Interpretation Bulletin IT-109R2 – Unpaid Amounts.

Subsection 104(6) generally permits a trust to deduct, in computing its income for a taxation year, an amount not exceeding the portion of its income otherwise determined for the year that becomes payable in the year to a beneficiary under the trust. On the other hand, subsection 78(1) applies to an amount in respect of a deductible outlay or expense owing by a taxpayer if

(a) the amount is unpaid at the end of the second taxation year following the taxation year in which the outlay or expense was incurred, and
(b) the taxpayer and the person to whom the amount is owing were not dealing at arm's length, both at the time the expense was incurred and at the end of the second taxation year following the taxation year in which the expense was incurred.

In such cases, the amount owing is included in the taxpayer's income for the third taxation year following the taxation year in which the outlay or expense was incurred. This is so even if the amount is paid in that third taxation year, or in a later one, unless an agreement is filed under paragraph 78(1)(b).

In our view, the deduction of a portion of, what would otherwise be its income, under subsection 104(6) would not constitute a "deductible outlay or expense" of the trust in the context of subsection 78(1) for the following reasons:

- The Oxford Dictionary defines "outlay" as an amount of money spent on something. The deduction under subsection 104(6) is not an amount of money spent on something but is rather an allocation of trust income to beneficiaries.

- The concept of a “deductible outlay or expense” can be found in paragraph 18(1)(a), pursuant to which an outlay or expense incurred by a taxpayer generally is deductible to the extent that it is incurred for the purpose of producing income from property or from a business of the taxpayer. The deduction in subsection 104(6) is of a portion of the trust’s income (but for subsection 104(6)), and could not be said to be an outlay or expense incurred by the trust for the purpose of producing income from property or from a business of the trust.
- A deductible outlay or expense of a trust could include, for example, trustee fees subject to the limitations in paragraphs 18(1)(a) and (b) and section 67 or fees paid to investment counsel subject to the limitations in paragraph 20(1)(bb) and section 67 (see for example question 3 in severed document 2008-0278801C6 presented at the 2008 STEP conference).

For the purposes of 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.

QUESTION 2

Section 160 provides for joint and several liability between a transferor and a non-arm’s length transferee where a transfer has occurred at less than fair market value. In the case of a separation or divorce, an exception is provided for transactions between spouses.

In more complex divorce situations, it is not uncommon to carry out a corporate reorganization of one form or another (often a butterfly reorganization) to divide up the family’s assets between the spouses. A typical butterfly reorganization normally involves two share redemptions, giving rise to taxable dividends which offset one another. In such circumstances, does section 160 apply, or is there an exemption because fair market value consideration was paid in the form of shares which were tendered back to the corporation for redemption?

CRA Response

Subsection 160(1) provides that a non-arm's length transferee of property is jointly and severally liable to pay the taxes of the transferor in respect of the taxation year in which the property is transferred or any preceding year. Subparagraph 160(1)(e)(i) will limit the transferee’s liability to the excess of the fair market value of the property transferred over the fair market value of consideration given for the property.

In the case of a “butterfly reorganization”, it would be a question of fact as to whether subsection 160(1) would apply to any of the transfers of property that would form part of the transactions involved in the reorganization. Subsection 160(1) would not apply to any transfers of property where fair market value consideration is received in return.

Where subsection 160(1) is applicable to a particular situation, an exception may be available in subsection 160(4) in respect of property transferred by a taxpayer to the taxpayer’s spouse (or common-law partner) pursuant to a decree, order or judgment of a competent tribunal or pursuant to a written separation agreement if, at the time the property was transferred, the taxpayer and the spouse were living separate and apart as a result of the breakdown of their relationship.

Without additional details as to what the particular concern is, we cannot comment further. However, if you would like to submit the question to us along with your specific concerns, we can re-examine it in more detail.

QUESTION 3

Where indebtedness is forgiven by Will, a loss could result for the creditor.

Assuming this loss would otherwise meet the requirements for a capital loss (where the indebtedness was interest-bearing) and assuming the terms of the Will provide for a forgiveness of this debt, can the loss be considered a capital loss of the estate?

CRA Response

Where indebtedness is forgiven by Will, certain questions of law may arise as to the nature of the forgiveness and the timing of the extinguishment of the debt. For example, there may be circumstances in which the wording of a particular testamentary instrument leads to a conclusion at law that the indebtedness would be extinguished at death such that it never becomes a capital property of the estate. As such, the issue of a capital loss to the estate in those circumstances would never arise.

That said, however, for purposes of our response, we will assume that an estate holds indebtedness as a capital property that is subsequently forgiven pursuant to the terms of the Will.

The CRA has opined in the past that when indebtedness is forgiven, it would generally be considered a disposition to the creditor and if the debt is determined to be on account of capital, a capital loss may be incurred.

This loss may be denied pursuant to subparagraph 40(2)(g)(ii) unless the debt had been (i) acquired by the taxpayer for the purpose of gaining or producing income from a business or property (other than exempt income); or (ii) acquired as consideration for the disposition of capital property in an arm's length transaction. Where indebtedness is forgiven by Will, we are of the view that the stop loss rule in subparagraph 40(2)(g)(ii) would generally apply to deem the loss to be nil; however, this is ultimately a question of fact which would depend on the details of the particular debt forgiveness and the terms and conditions expressed in the testamentary instrument itself.

QUESTION 4

Subsection 70(1) provides a rule whereby in the year of death certain sources of income are to be determined on an accrual basis. Typically, income from these sources would normally be determined on a cash basis in other circumstances. Subsection 70(1) lists

certain types of income such as employment income, interest rent, royalty income, etc., paid on a periodic basis.

We have several questions concerning this provision.

a) Firstly, is the rule limited to the types of income specified in subsection 70(1) or does the rule apply generally to all items of income paid on a periodic basis?

b) CRA has stated in a technical interpretation that the rule could apply with respect to a bonus payment (making the income reportable on the terminal tax return rather than a right or thing) where the bonus is paid on a periodic basis. For an owner\manager who typically takes a bonus within 180 days of the end of the taxation year, based on an estimate of the income for that taxation year, and does so habitually even though the amounts vary from year-to-year, does this constitute a bonus paid on a periodic basis?

c) Suppose interest is paid on a guaranteed investment certificate (GIC) or on a term deposit at maturity. Thus interest is only paid once during the term of the investment. In these circumstances, is the interest paid on a periodic basis such that the rule in subsection 70(1) would apply?

d) Can subsection 70(1) apply to dividends in respect of a share where dividends are paid on a periodic basis? (For example, a preferred share of a public corporation). Note that dividend income is not specifically listed in subsection 70(1).

CRA Response

a) The list in subsection 70(1) is not exhaustive as the provision includes the phrase “other amount payable periodically”. However, whether subsection 70(1) applies to a particular item is a question of fact and law. As will be seen in our response to part d), other provisions of the Act must also be considered to determine whether the amount is included in income under subsection 70(1).

b) As indicated in paragraph 19.1 of IT-212R3:

> Where…the employer has a contractual obligation to pay an annual bonus or on some other periodic basis, but the bonus had not been declared at the time of death, the amount is remuneration “payable periodically” as described in paragraph 70(1)(a).
>
> Whether or not a contractual obligation exists in any specific situation is a question of fact. The fact that a bonus is paid habitually would not appear to offer any certainty that such an obligation exists.

The CRA’s general position on shareholder manager remuneration is set out in Income Tax Technical News #22 and 30 wherein we stated:

> We will not question the reasonableness of the payments as long as the salaries and bonuses are paid to managers who are shareholders of the CCPC (either directly or through a holding company), are Canadian residents, and are actively involved in the day-to-day operations of the company. The key is that the Canadian resident recipients

must be active in the operating business and contribute to the income-producing activities from which the remuneration is paid.

Please note that as set out in document E2006-0168181E5, this general policy does not apply in situations such as that described above and we reserve the right to challenge the reasonability of the amount paid under section 67.

c) It is the CRA's position that since interest accrues on a daily or other periodic basis, such interest is considered to be payable on a periodic basis even though it may not be due until maturity. Therefore, at the date of death the value of all accrued and unpaid interest on a GIC or term deposit should generally be reported on the final return of the deceased pursuant to paragraph 70(1)(a).

d) Subsection 70(1) does not specifically refer to dividends; therefore, the issue is whether an anticipated yet undeclared dividend is an "other amount payable periodically". In our view, these undeclared dividends would not be included in the deceased individual's income under subsection 70(1).

Preferred shares may have a stated dividend expressed in dollars, as a dividend rate or some other basis. Nevertheless, a shareholder is not entitled to a dividend until it is declared, and must typically hold the share on the day before the ex-dividend date. Subsection 82(1) provides that dividends are included in the recipient's income when received. Section 121 allows a dividend tax credit based on the amount that is included in income under paragraph 82(1)(b). For tax purposes, a taxpayer is generally considered to have disposed of each of his properties upon death; accordingly, the deceased's estate would be required to include in its income dividends declared after the deceased individual's death.

QUESTION 5

There can be an issue when an estate elects under subsection 164(6) to apply a capital loss to the terminal return of the deceased. It is possible to create "circularity" under 164(6), when an estate carries back a loss but then realizes a capital gain on other assets in its first taxation year. See Nick Moraitis and Manu Kakkar's Taxfind article "Potential Circularity Problem with Estate Loss Carryback" published by the CTF. How would CRA interpret 164(6) in such circumstances? Would you administratively ignore subsections 40(3.6) and 40(3.61) when determining the net capital loss for purposes of 164(6)?

CRA Response

Subsection 164(6) allows the estate of a deceased taxpayer to elect to have all or part of its capital losses (to the extent they exceed its capital gains) that are realized in its first taxation year to be deemed to be capital losses of the deceased. The election, which results in the carry back of the elected amount to the final return of the deceased, can be useful in addressing potential double taxation which may arise where the deceased held corporate shares with accrued gains at death.

Subsection 40(3.6) is a stop-loss rule that applies if a taxpayer disposes of a share of a corporation to the corporation, and the taxpayer is affiliated with the corporation immediately after the disposition. When subsection 40(3.6) applies, the taxpayer's loss from the disposition is deemed to be nil. Prior to the introduction of subsection 40(3.61), if the estate and the corporation were affiliated immediately after the disposition (typically, on the redemption of the shares by the corporation), the capital loss would be stopped, and could not be carried back to be applied on the terminal return.

In general, subsection 40(3.61) was introduced to override the effect of the stop-loss rules in subsections 40(3.4) and (3.6) where an estate's capital loss is being carried back pursuant to subsection 164(6). Subsection 40(3.61), which applies if the estate elects pursuant to subsection 164(6) in respect of a capital loss on the disposition of a share of a corporation, provides that subsections 40(3.4) and (3.6) apply "in respect of the loss only to the extent that the amount of the loss exceeds the portion of the loss to which the election applies".

We have reviewed the article referred to in your question and agree, based on a technical reading of the above provisions, that it is possible for a circularity issue to arise. If the estate realizes capital gains during its first taxation year, those gains must be applied against the loss on the share disposition, in accordance with the requirements of subsection 164(6), in order to determine the amount that can be carried back. Where this occurs, the application of subsection 40(3.61) will result in an amount of loss stopped pursuant to subsection 40(3.6), which in turn will reduce the amount available for the subsection 164(6) election, and the circular nature of these provisions becomes an issue.

To date, however, the Income Tax Rulings Directorate has not been informed of an actual case in which this issue has arisen. We suspect that the incidence of this potential circularity issue is likely quite limited, for a number of reasons:

1. One would expect that typically, estates should not realize significant gains in their first taxation years, as assets acquired at the time of death would generally be acquired at fair market value pursuant to subsection 70(5).
2. The ability to distribute assets of the estate to its beneficiaries on a rollover basis pursuant to subsection 107(2), where applicable, would avoid the generation of gains in the estate in respect of such asset dispositions.
3. Given that the issue was identified in the above-referenced article, many practitioners are no doubt aware of it and are ensuring that capital gains are deferred beyond the first taxation year of the estate.

We would appreciate if any of your members encounter such an example, that it be provided to CRA, so that we can review the issue further on a case-by-case basis.

QUESTION 6

It is common in dealing with an owner\manager business to see a shareholder draw money from the corporation during the year, and repay the amount at the corporation's year end, or within one taxation year, often by the offset of an amount credited to the shareholder from payment of a dividend or a bonus (net of withholding tax). In such circumstances, section 80.4 would impute a benefit to the shareholder if the advance was interest-free, but

otherwise there would not be any income inclusion to the shareholder. If the loan is outstanding beyond one taxation year from the end of the taxation year in which the loan was made, then the amount of the loan is included in income of the shareholder (in the year that the loan was made) and a deduction is given when the loan is repaid.

Our questions concern the circumstance where a shareholder loan is outstanding, and the shareholder dies before the loan is repaid.

1 - Where the legal representative ("Estate") pays back the loan to the corporation, within the timeframe permitted such that no income inclusion would arise had the shareholder repaid the loan, does CRA agree that the amount of the loan would not be included in the income of the shareholder?

CRA Response

Subsection 15(2.6) provides that the amount of the loan received in a taxation year by a person who is a shareholder of a particular corporation will not have to be included in computing the income of the person for that year under subsection 15(2) if the loan is repaid within one year after the end of the taxation year of the lender or creditor in which the loan was made where it is established that the repayment was not part of a series of loans and repayments.

Provided that the repayment was not part of a series of loans and repayments, the repayment of the loan within a period of one year after the end of the taxation year of the creditor in which the loan was made will prevent the application of subsection 15(2) irrespective of whether the loan is repaid prior to the person's death or by the Estate after the person's death.

2 - Where the loan is not repaid within the required timeframe, and the amount is included in the income of the shareholder, if the Estate repays the loan, will a deduction be granted either to the shareholder or to the Estate?

CRA Response

Paragraph 32 of Interpretation Bulletin IT-119R4 provides that the Estate can claim the deduction under paragraph 20(1)(j) in the year a repayment is made to the extent that the deceased person had included the amount of the loan in computing his or her income pursuant to subsection 15(2) in a preceding taxation year.

You should note, however, that the CRA has indicated in technical interpretation 9918015 that the position in paragraph 32 of IT-119R4 does not apply where the loan is subsequently repaid by a beneficiary of the Estate.

QUESTION 7

In handling the affairs of deceased taxpayers, it is not uncommon to find certificates of stocks, bonds, and other securities in a drawer or a safety deposit box. Very often such securities are old and may also be worthless. On the basis that the deceased had not previously deducted an amount for the loss on such securities, and assuming that the loss

arose in a year preceding the date of death and that the taxation year is statute-barred, will the CRA allow a capital loss for the worthless securities to be claimed by the deceased in the tax return for the year of death or is it possible for the statute barred taxation year to be re-opened for the purpose of claiming the loss?

CRA Response

For the purposes of the question, we assume that any losses are capital losses.

Generally, subsection 70(5) provides that a taxpayer is deemed to have disposed of each of the taxpayer's capital properties immediately before his or her death for proceeds of disposition equal to the fair market value of the property at that time. Any person who acquires the property as a consequence of the taxpayer's death is deemed to have acquired that property at a cost equal to those proceeds. Therefore, in a situation where securities are worthless at the time of the taxpayer's death, the taxpayer is deemed to have disposed of those securities for proceeds equal to their fair market value at that time. Any resulting capital loss may be included in the taxpayer's final return.

On the other hand, where there was a disposition of securities prior to the taxpayer's death (for example, the deceased owned shares in a corporation that was dissolved), the capital loss was incurred at the time of the disposition.

In general, subsection 111(8) defines a net capital loss for a taxation year as being the excess of allowable capital losses over taxable capital gains. A net capital loss exists independently of whether or not it is reported in the tax return for the taxation year when it was incurred. Any unused net capital loss can be carried forward to a year that is not statute barred.

Where the deceased realized taxable capital gains in the year the allowable capital loss was incurred, the deceased's representative may ask the CRA to apply the allowable capital loss to reduce the taxable capital gains so long as the request is made on or before the day that is ten calendar years after the end of that taxation year pursuant to subsection 152(4.2). It should be noted that, even if the CRA cannot reassess the year of the allowable capital losses to apply the losses against taxable capital gains of that year, only the excess of the allowable capital losses over taxable capital gains constitutes the net capital loss that may be carried forward. In other words, part of the losses would not be available to be claimed.

QUESTION 8

Suppose that under the terms of a taxpayer's Will, an estate is created and the estate trustees are instructed under the Will to set up a number of trusts from the residue of the estate. As a practical matter, it takes a period of time for the estate to be administered and for these testamentary trusts to be funded.

Do these trusts exist at the date of death even though they may not, at that time, actually have title to any assets (since the assets are in the name of the estate which is under administration)? If these trusts do exist as at the date of death, how does one file a tax return for these trusts? If so, what is to be included?

On the other hand, if these trusts do not exist until they are funded, when are they created and what taxation year would they have (is it the same as the year-end of the estate or can any taxation year be selected)?

CRA Response

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 us 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. It is of course always possible to request a change of fiscal period as set out in subsection 249.1(7).

QUESTION 9

On death, where property is transferred to a spouse or a spousal trust, it is possible to elect for the transfer to occur at fair market value rather than tax cost. CRA has taken the position that the election under subsection 70(6.2) of the Act is to be made on a property-by-property basis in respect of "a property". In certain circumstances, this may cause complications in the tax planning which might be carried out for the deceased, since it may be desirable to create a particular amount of capital gain at death. For example, suppose that the deceased owned a Canadian controlled-private corporation which would qualify as a small business corporation, but he or she held only one share of that corporation. Another example might be holding an interest in a partnership which is not denominated in units, such that the deceased held only one property, being the partnership interest.

In these circumstances, CRA has previously taken the position that an election cannot be made on a fraction of a property. Thus if the shareholder holds one share of the corporation, the election must be made in respect of that one share, and cannot be made in respect of a fraction of a share. Nevertheless, it is common today for fractional shares to be the subject of transactions and such fractional shares are recognized by corporate law. There appears to be no reason why a fraction of the partnership interest cannot be transferred if the partnership interest itself can be transferred.

Could the CRA provide an update on its view concerning this matter?

CRA Response

Subsection 70(5) deems a taxpayer to dispose of each of his capital properties immediately before death for proceeds equal to the property's fair market value. Any person who as a consequence of the taxpayer's death acquires the property is deemed to have acquired the property at a cost equal to its fair market value.

Where certain conditions are met, subsection 70(6) provides a rollover to the taxpayer's spouse who was resident in Canada immediately before the taxpayer's death or to a spousal trust created by the taxpayer's will. Where subsection 70(6) applies the taxpayer is generally deemed to dispose of his non-depreciable property immediately before death for proceeds equal to the adjusted cost base of the property and to dispose of depreciable property for the lesser of the capital cost and the cost amount to the taxpayer of the property immediately before death.

Where a subsection 70(6.2) election is filed by the deceased taxpayer's legal representative in respect of a particular property, subsection 70(6) will not apply to that property and subsection 70(5) will apply. An election is typically filed where the deceased taxpayer has unused capital losses or a capital gains exemption. Subsection 70(6.2) specifically refers to "any property of the deceased taxpayer".

We have opined in the past that each share of the capital stock of a corporation is a separate property. Accordingly, the subsection 70(6.2) election may be made with respect to a partial shareholding of a corporation. For example, where a shareholder owns 1,000 shares of ACo, the election under subsection 70(6.2) may be made in respect of some of the shares, and subsection 70(6) will apply to the remainder of the shares.

Where, however a single share was held by the deceased taxpayer prior to death, it is the CRA's position that the single share represents a property of the deceased taxpayer and as such the legal representative cannot elect in respect of a fraction of that single share so as to apply subsection 70(5) to an arbitrary portion of that share and subsection 70(6) to the balance of the share. We acknowledge that the definition of a share in subsection 248(1) includes a fraction of a share; however, in our view, this has no relevance in interpreting subsection 70(6.2). The legal representative cannot fractionalize a whole share after a taxpayer's death to enable the deceased's representative to utilize the subsection 70(6.2) election.

As far as recognizing a fraction of a partnership interest, we continue to hold the view that an election under subsection 70(6.2) must be filed in respect of the deceased taxpayer's total interest in a partnership, as the partnership interest constitutes a single property of the taxpayer. There is no provision which allows the legal representative to file an election in respect of only a portion of that interest.

QUESTION 10

Where an individual has a life interest in a property and the individual dies, the life interest is to be valued without taking into account the imminence of death of the individual. Because of this, the life interest is deemed to be disposed of immediately before death for an amount which would represent fair market value based on normal life expectancy, which may be substantially higher than the true value of the life interest to the individual given the actual circumstances. After death, the life interest has no value because it is extinguished by the event of death.

It appears in these circumstances that the individual would have a deemed disposition immediately before death with proceeds equal to the fair market value of the life interest,

but the estate would not acquire a property and therefore would not be able to obtain a capital loss in respect of what is now a worthless or non-existent asset.

It is noted that a special rule applies with respect to life estates in real property (section 43.1). However, there seems to be no rule which would apply in a more general situation. For example, an individual with a life interest in a trust might fall into these circumstances.

Can CRA comment firstly as to whether the analysis outlined above is correct in their view, and secondly, whether any steps or actions can be taken to mitigate this result which seems to suggest double taxation?

CRA Response

This question has arisen perhaps due to our response to a follow-up question that was presented at the 2011 CICA Roundtable. Therein we stated:

> *"The determination of the FMV of the life interest at the time of death of the life tenant is a question of fact. As a matter of practice, the Income Tax Rulings Directorate does not review nor provide advice with respect to the determination of FMV of a particular property at any particular point in time. Specific questions concerning the valuation of a particular life estate for tax purposes should be directed to the valuation section of the appropriate Tax Services Offices.*
>
> *As previously noted in our original response to the roundtable, under subsection 70(5) of the Income Tax Act (the "Act"), a life tenant is deemed, immediately before death, to have disposed of his or her life interest in a property for proceeds equal to the FMV of the interest at that time. For the reasons set out by the Federal Court of Appeal in The Queen v Mastronardi (77 DTC 5217), the imminence of death is not taken into account in determining the deemed proceeds of disposition of a life interest. Thus, the fact that a life interest ceases to exist upon the death of the holder is irrelevant for purposes of the application of subsection 70(5) of the Act.*
>
> *That said, however, one would reasonably expect the value of a life interest to decline over time but based on the above comments, we would not generally expect the facts to support a life estate valuation of nil at a time that is immediately before the death of the life tenant".*

When one refers to a life interest they are most often referring either to a life interest in real property, which as you have pointed out is dealt with in section 43.1, or a life estate, which is generally a beneficial interest under a trust. The corpus of such a trust in which a life estate is granted is usually personal property not real property. While we agree with your analysis, this should not be a major concern given that the fair market value of a life interest in the corpus of a trust will likely only be of significant value where it is transferable or where successive life interests exist. Fair market value and how it is calculated are questions of fact. The determination of the appropriate market is part of determining fair market value and is an issue of fact: (CIT Financial Ltd. v. Canada, 2004 FCA 201 at paragraph 13, Connor v. R., [1979] CTC 365 at 366 (F.C.A.), R. v. Friedberg, 92 DTC 6031 at 6034 (F.C.A.), R. v. Pustina, 2000 DTC 6001 at 6009, paragraph 39 (F.C.A.), leave to appeal denied, 266 N.R. 393 (note).). The Act does not define "fair market value" (FMV). The common definition of FMV found in the Black's Law dictionary defines FMV as "the price that a seller is willing to accept and a buyer is willing to pay on the open market and in an arm's-length transaction; the point at which supply and demand intersect". Generally, for the purposes of the Act the CRA relies on the definition of FMV provided in paragraph 3 of Information Circular 89-3 "Policy Statement on Business Equity Valuations", which is as follows:

> Definition
>
> 3. (a) Fair market value is the highest price, expressed in terms of money or money's worth, obtainable in an open and unrestricted market between knowledgeable, informed and prudent parties acting at arm's length, neither party being under any compulsion to transact.
>
> It does not require an actual market, rather it can be based on a hypothetical market. Given that an objective market does not exist for such an interest, if you presuppose a hypothetical market, it is unlikely that knowledgeable, informed and prudent buyers would pay any amount for an interest that cannot be transferred to them. However where the possibility of transfer or of successive life interests exists the determination of fair market may be significant and the estate would thereby acquire an asset with value. It should be noted that in Mastronardi, the fair market value was easily determinable due to the nature of the asset with the only issue being whether or not the imminence of death should factor in.

QUESTION 11

In a recent case, *Lipson v. R 2012 TCC 20,* the Court found that an Estate was not a trust for purposes of the subsection 116(3) reporting and the resulting application of penalties. Could the CRA comment on how it views this case?

CRA Response

The decision in *Lipson* was rendered in respect of two Tax Court cases heard on common evidence. The respective appellants were Howard and Harriet Lipson. The relevant facts in the case can be briefly summarized as follows:

1. Howard and Harriet were two of the three adult children who became the residual legatees of the succession of their mother, who had lived in Quebec and who died in 2003.
2. All of the assets of the succession were located in Canada and all administration was performed in Canada; the succession was at all times resident in Canada.
3. Howard and Harriet were non-residents.
4. Significant capital distributions were made to each of the residual legatees from the succession in five tranches, one in 2003, two in 2004, one in 2005 and the last in 2007.
5. Howard and Harriet were assessed pursuant to subsection 162(7) for failure to file the notices required under subsection 116(3) in respect of dispositions of taxable Canadian property ("TCP") as a consequence of the distributions noted in 4 above.

In rendering its decision, the Tax Court noted that under the Civil Code of Quebec, a succession is not a trust.[i] The Court then proceeded to focus its analysis almost exclusively on subsection

104(1), as referred to in the definition of “estate” in subsection 248(1); concluding that the effect was “not to treat an estate as a trust”.

In CRA’s opinion, the following provisions of the Act are relevant to the facts in *Lipson*:

Pursuant to subsection 248(1), the terms “estate” and “trust” have the meanings assigned by subsection 104(1). Subsection 104(1) states that references in the Act to a “trust or estate (in this subdivision referred to as a trust)” include a reference “to the trustee, executor, administrator, liquidator of a succession, heir or other legal representative having ownership or control of the trust property ….” Accordingly, in subdivision k of the Act, any reference to a trust includes an estate.

Subsection 108(1) defines a number of terms which apply for purposes of subdivision k, and for purposes of the Act where subsection 248(1) so directs (such as for the definition of a “capital interest”). Subsection 108(1) specifically provides that:

1. “trust” includes an *inter vivos* trust and a testamentary trust,

2. “testamentary trust” in a taxation year, means a trust or estate that arose on and as a consequence of the death of an individual…, and

3. “capital interest” of a taxpayer in a trust means all rights of a taxpayer as a beneficiary under the trust…

In our view, the fact that subsection 248(1) defines trust to have the meaning assigned by subsection 104(1), leads to a clear conclusion that the meaning must reflect the application of subsection 108(1), which states that an estate is a trust.

While we recognize that certain provisions of the Act reference an estate as distinct from a trust, we note that in general, they are those provisions that are intended to provide for tax treatment that is unique to the administration of the estate. For example, the ability to carry back capital losses to the terminal return of the deceased under subsection 164(6) and the inclusion of the more favorable treatment accorded capital losses under subsection 112(3.2) “where the trust is an individual’s estate, the share was acquired as a consequence of the individual's death and the disposition occurs during the trust's first taxation year….”.

It should be noted that the notice requirement provided for in subsection 116(3) applies where a non-resident person disposes of any TCP (other than property described in subsection 116(5.2) and excluded property) in a taxation year. Pursuant to paragraph (h) of the definition of TCP in subsection 248(1) (as it read during the period relevant to the Lipson case), a capital interest in a trust (other than a unit trust) resident in Canada constituted TCP. Accordingly, in our view, the decision in Lipson should have focused on the fact that the taxpayers had partial dispositions of their respective capital interests as a result of the capital distributions received from the succession.

QUESTION 12

Could the CRA comment on its progress to date with respect to its audit focus on high net worth individuals?

CRA Response

The background to our program to examine compliance by high net worth individuals (HNWI) was introduced in question #13 of the 2011 STEP Conference CRA Roundtable. We refer to this program as the Related Party Initiative (RPI) and as indicated last year the population under review includes:

- Individuals who together with related economic entities have a net worth of about $50 million or more.
- The number of entities in the group is approximately 30 or more.
- The entities in the group are not already included in the CRA's Large Files program.

The RPI is ongoing with a number of audits throughout Canada at various stages of completion. We continue to develop the RPI, as follows:

- We are improving our ability to identify taxpayers who meet the criteria for this program as we build on our understanding of HNWI.
- We have enhanced our risk assessment of RPI groups by assigning this function to a specialized team of auditors and monitoring developments within the HNWI population.
- Our questionnaire referenced in last year's question has been updated to be more relevant to the CRA while easing the burden on tax professionals, HNWI advisors and the HNWI by ensuring that there is no duplication of information provided.
- We are exploring ways of communicating effectively with HNWI to promote cooperative compliance for the benefit of all parties involved.

In addition, the CRA maintains a strong presence within the Organisation for Economic Co-operation and Development (OECD). Like many countries, Canada has serious concerns with respect to HNWIs. Commissioners of revenue authorities, through the work of the OECD Forum on Tax Administration (FTA), are giving particular attention to how tax administrations can cooperate more closely on identifying and addressing the HNWI population. Through our work with the FTA, the CRA has collaborated in increasing international cooperation. The overall aim of the network is to examine measures taken by tax administrations in the area of HNWIs and the extent to which tax administrations implement the recommendations given by the OECD studies and reports, new tendencies and strategies put in place to deal with HNWIs and combat aggressive tax planning. This participation provides global insights to improve our administration of this segment of the population.

QUESTION 13

If an individual (the "Borrower") uses borrowed money to purchase an income producing property and later settles this property (the "Initial Property") on an *inter vivos* trust – where subsection 75(2) applies to attribute income earned on the property back to the transferor, would the CRA agree that the income attributed to the Borrower pursuant to subsection 75(2) would be considered 'income from property' for purposes of paragraph

20(1)(c) of the Act such that any interest on the borrowed money would continue to be tax deductible?

CRA Response

In general, income earned on property held in a trust will be attributed to the person from whom the property was received by the trust where subsection 75(2) applies. It is a question of fact as to whether property is held by a trust under either of the conditions described in paragraphs 75(2)(a) or (b). 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.

Subparagraph 20(1)(c)(i) generally permits the deduction of an amount paid in the year or payable in respect of the year, pursuant to a legal obligation to pay interest on borrowed money used for the purpose of earning income from a business or property. It is CRA's general view that, provided that the Borrower continues to have a legal obligation to pay interest on the borrowed money, and that the trust continues to hold the Initial Property for the purpose of gaining or producing income which, pursuant to subsection 75(2), will be attributed to the Borrower, a deduction pursuant to paragraph 20(1)(c) may be claimed equal to the lesser of the interest paid in the year or payable in respect of the year (depending on the method regularly followed by the Borrower) or a reasonable amount thereof.

If the trust disposes of the Initial Property and acquires substituted property to which subsection 75(2) continues to apply, one issue that must be considered is the tracing or linking of the borrowed money to its current use. We refer you to the guidance provided in paragraph 18 of Interpretation Bulletin IT-533 – *Interest Deductibility and Related Issue*s.

In general, the tax consequences surrounding the deductibility of interest depend on the unique facts of each situation. It should be noted that where a series of transactions is entered into merely to derive the benefit of an interest deduction, the general anti-avoidance rule may be relevant.

QUESTION 14

A taxpayer ("Pensioner") with no spouse, common-law partner or children had retired before her death and had commenced drawing a monthly retirement pension, with a guarantee period, from the defined benefit registered pension plan ("RPP") of which she was a member. Rather than making a beneficiary designation pursuant to the terms of her will, prior to her death she had designated, in accordance with the terms of the RPP, her brother as the designated beneficiary ("Sibling") who would receive the lump-sum benefit provided by the RPP should she die before the guarantee period had ended.

After the death of the Pensioner, the RPP paid the lump-sum benefit to Sibling (net of required withholding tax), in accordance with the terms of the plan, and issued a T4A slip in respect of the payment. Pursuant to the terms of Pensioner's will, the residual assets of the estate were distributed to a friend of the Pensioner ("Friend"), after all estate expenses were determined and settled.

The executor of the estate of Pensioner, who knew her well while she was alive, is of the view that Pensioner wanted Sibling to receive the full value of the RPP lump-sum (before tax withholdings) and for the pension income to be reported as income on the final return of Pensioner, so that the tax in respect of the amount would be borne by the estate of the Pensioner, rather than by Sibling. The executor has asked, whether, pursuant to subsection 70(2), there is the possibility that he might report the lump-sum income as income of the Pensioner, rather than of Sibling.

Can CRA comment on whether the executor can choose to have the RPP lump-sum reported on the final return of the Pensioner? In this regard, can CRA comment on the following wording found in paragraph 15 of Interpretation Bulletin IT-212R3 *Income of Deceased Persons – Rights or Things* ("IT-212R3"):

> **"There may be exceptional cases where a pension fund or plan provides for voluntary withdrawal of contributions by an individual contributor (possibly with interest and/or employer's contributions) at a time or times other than on retirement or on leaving the employment. Where this is so, the portion of the lump-sum payment which would have been taxable had it been received by the decedent normally is still regarded as income of the estate or beneficiary; but if the executor desires, for any reason, to report that amount as income of the employee for the year of death pursuant to subsection 70(2), no objection will be made to that manner of reporting nor to any consequential election properly made under subsection 70(2)."**

CRA Response

It is our understanding that RPPs often provide that a guarantee period may attach to certain forms of pension provided to a pensioner. In the event of death of the pensioner prior to the expiry of the guarantee period, the plan may provide that the remaining pension payments will continue to a designated beneficiary, or, as is often the case, for a lump-sum commutation of those payments to the estate or to a designated beneficiary.

Subsection 70(2) provides for the tax treatment of "rights or things" that a taxpayer had at the time of death, the amount of which when realized or disposed of would have been included in the taxpayer's income. The Act provides that the value of "rights or things" at the time of death are to be reported in the taxpayer's final return, or alternatively, an election may be made to file a separate return in respect of these amounts. IT- 212R3 discusses the general views of the Canada Revenue Agency regarding the tax treatment of "rights or things".

It is our view that paragraph 15 of IT-212R3 would not apply to the facts described in this question. The exception noted in paragraph 15 of IT-212R3, which affords rights or things treatment if the executor desires, contemplates an uncommon situation whereby a pension plan or fund permits a member to voluntarily withdraw contributions from the plan prior to death, and other than at retirement or withdrawal from employment. This is not analogous to the facts here, as Pensioner had retired and commenced to receive a pension.

Accordingly, it is our view that the lump-sum payment paid from the RPP would not constitute a right or thing under the Act, the exceptional scenario discussed in paragraph 15 of IT-212R3 would not apply to it, and thus the amount, as reported on the T4A, must be included in the income of the recipient, Sibling, in accordance with subparagraph 56(1)(a)(i).

QUESTION 15

In U.S. estate planning, revocable trusts are well accepted and commonly used. Suppose a U.S. citizen moves to Canada with such a revocable trust structure in place. Assume the trustees are U.S. resident and the trust is U.S. resident. (The trust is not deemed Canadian resident due to the 60-month exemption.)

Our question concerns whether subsection 75(2) would apply if the proposed amendment of paragraph 75(3)(c.3) were passed into law.

Also, would CRA agree that a Canadian resident person with the power to revoke a foreign trust would not in itself cause the foreign trust to be considered factually Canadian resident?

CRA Response

We assume that the reference to a U.S. citizen moving to Canada with a revocable trust structure in place means that the U.S. citizen was not a resident of Canada prior to the move, that the trust was created in the U.S. while he or she was non-resident, and that he or she was both the settlor and beneficiary of the trust.

In general, where a trust receives property from a person, if:

- the property can revert to that person;
- the person can determine to whom the property may pass; or
- the person's consent or direction is needed before the trust can dispose of the property,

then while the person is resident in Canada, any income or loss from the property or any taxable capital gain or allowable capital loss from the disposition of the property is attributed to the person.

Subsection 75(3) provides for certain exceptions whereby subsection 75(2) will not apply to property held by a trust in a particular taxation year. The August 27, 2010 Department of Finance draft legislation in respect of non-resident trusts proposed to add paragraph 75(3)(c.3).

As the Department of Finance Technical Notes indicate, this new paragraph is meant to ensure that subsection 75(2) does not apply to a trust in respect of which all the contributors are either non-resident or recent immigrants (i.e. none of the contributors have been resident for more than 60 months). As the Technical Notes indicate, this is similar to the 60-month exemptions in proposed section 94 (see the definitions of "connected contributor" and "resident contributor" under the proposed legislation).

As per the wording proposed, new paragraph 75(3)(c.3) will except from the application of subsection 75(2), "a trust that is non-resident, but would be resident in Canada for the purpose of computing its income for the year if the definition “resident contributor” in subsection 94(1) were read without its paragraph (a)”.

Pursuant to proposed subsection 94(3), if a trust is not factually resident in Canada, it will be deemed resident in a taxation year if there is a “resident contributor” to the trust or a “resident beneficiary” under the trust. In general, the definition of “resident contributor” in proposed subsection 94(1) applies to a person who is resident in Canada at that time and is a contributor to the trust. However, paragraph (a) of the definition excludes an individual (other than a trust) who was non-resident and at that time was resident for a period or periods of not more than 60 months.

Accordingly, if the trust in question is otherwise not considered resident in Canada, and it has only one contributor (in accordance with proposed section 94 of the Act), it is our opinion that proposed paragraph 75(3)(c.3) will exempt the trust from the application of subsection 75(2) for the first 60 aggregate months of residency, where the contributor was previously non-resident.

For purposes of the second portion of the question, we have assumed that in referring to a Canadian resident person with the power to revoke a foreign trust, we are referring to the above settlor/beneficiary of the U.S. trust. We also assume that in referring to a revocable trust, we are discussing a trust under which the express power to revoke the trust has been reserved by the settlor from the outset.

As the Supreme Court has indicated, in their recent decision in *Fundy Settlement v Canada* (2012 SCC 14), the residence of a trust should be determined by the principle that a trust resides for the purposes of the Income Tax Act where its real business is carried on, which is where the central management and control of the trust actually takes place. As was the case in the above decision, this will always be a question of fact.

In our view, the fact that the settlor of the trust, in the above scenario, has a power to revoke the trust, would not, in and of itself, and absent additional facts that would impact on the central management and control analysis, lead to a conclusion that the trust would be considered factually a resident of Canada.

QUESTION 16

Can the CRA provide an update on recent administrative changes within the Income Tax Rulings Directorate that may be of interest to this audience?

CRA Response

We will address three changes within the Income Tax Rulings Directorate that may be of interest: (1) the announcement of the Directorate’s new Director General, (2) an update on the Folio project initiative; and (3) an overview of the email enquiry service.

(1) Our new Director General

The Income Tax Rulings Directorate recently welcomed back Mr. Mickey Sarazin in the role as Director General of the Rulings Directorate.

Mr. Sarazin plans to work with all staff and managers within the Directorate to find improvements in our business processes to maximize our limited resources to better meet clients' needs. For example, he will have the Directorate focus on ensuring that other areas of the CRA are familiar with the positions taken by the Directorate. To improve the timeliness of the Directorate's responses, in the future, the Directorate will refrain from opening files until a submission includes full disclosure of all research relevant to the question being asked.

(2) The Folios project

The Folio project, an initiative undertaken by the Directorate in 2009 to better communicate technical information to taxpayers, continues to develop.

At the TEI conference in December of last year, we acknowledged that being able to consult an authoritative source of technical tax information and the CRA's interpretation of the legislation it administers is of unquestionable benefit to taxpayers, their advisors and CRA staff. To that end, the Directorate has undertaken to review the content and improve the format of the income tax technical publications product. Each updated technical income tax publication will be known as an "Income Tax Folio" and will be entirely electronic based.

To date, officials from numerous areas within the CRA as well as members of tax professionals' organizations in the private sector have been consulted. All of this feedback and data has allowed us to identify and prioritize the current IT Bulletins that need to be reviewed and updated first. The Directorate is committed to the Folios project but given its magnitude, the process is expected to take a number of years. As such, we have encouraged external stakeholder associations to contact us should there be an interest in creating Folios related to areas of interest to their members.

(3) Email service

The Income Tax Rulings Directorate now offers an email service to better handle general tax inquiries that used to be addressed by the Directorate by telephone. Please forward these inquiries to itrulingsdirectorate@cra-arc.gc.ca.

This service is not intended to replace technical interpretation letters issued on various provisions of the Income Tax Act – but rather to provide a vehicle to efficiently address general questions of interpretation or to provide responses to issues which the Directorate has previously addressed. Where possible, we will provide an email response to the sender within five business days. However, where the question is complex and requires a more in-depth review by an officer, the request will be treated as a request for a technical interpretation.

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[i] See paragraph 17 of the decision. The Court noted that under the Code successions are dealt with in Book 3 (articles 613 – 898) whereas trusts are dealt with in Book 4 (articles 1260 to 1298)