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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. "Kiddie Tax" - Section 120.4

This series of questions concerns certain aspects of the Kiddie Tax under section 120.4 of the *Income Tax Act* (the "Act").

Question 1(a)

Under the income attribution rules in general, income attribution ceases when the person who contributed the property dies or becomes a non-resident. For example, if a parent makes a gift to a minor child, income earned from the proceeds of the gift will be attributed back to the parent but only while the parent is alive and resident in Canada. However, if the parent is deceased or a non-resident, income attribution ceases.

It seems that the Kiddie Tax does not operate exactly in this fashion. The tax applies to certain income if the child has one parent resident in Canada even if that parent was not the contributor of the property.

Do you agree with this analysis?

CRA Response

The attribution rules and "split income" rules do not apply in the same way. One difference is that, under the attribution rules, the amount is taxed in the hands of the "individual" who contributed the amount, in most cases the parent of the minor. Under the split income rules, the amount is taxed in the hands of the minor "specified individual," not the parent. Subsection 74.5(13) is a specific provision that provides an exception to the attribution rules in respect of split income under section 120.4. Therefore, the two sets of rules are mutually exclusive.

Section 120.4 of the Act provides for a tax on split income of a specified individual. A specified individual for a tax year is an individual who:

(i) has not attained the age of 17 years before the year;

(ii) at no time in the year was non-resident; and

(iii) has a parent who is resident in Canada at any time in the year.

Split income includes certain passive income which does not include an "excluded amount." An excluded amount for a tax year means an amount that is the income from, or the taxable capital gain from the disposition of, a property acquired by or for the benefit of the individual as a consequence of death of:

1) a parent of the individual; or

2) any person, if the individual is

   (i) enrolled as a full-time post-secondary student as defined in subsection 146.1(1) during the year, or

   (ii) an individual in respect of whom an amount may be deducted under section 118.3 for mental or physical impairment for the year.

Thus, split income for a tax year does not include income from property inherited by a specified individual from a parent or any person if certain conditions apply.

If the amount of income in question is not an excluded amount and is "split income," as defined, section 120.4 can apply to the split income of a child who has one parent resident in Canada at any time in the year, even if that parent was not the contributor of the property.

Question 1(b)

The Kiddie Tax has recently been extended to apply to capital gains from the disposition of private company shares by a person under the age of 18 to a non-arm's-length person - see subsection 120.4(4). Another rule extends the application to a capital gain derived by a trust and allocated to the minor. As such, the capital gain is reclassified as a taxable dividend that is not an eligible dividend. Our question concerns certain aspects of this rule:

(i) First, would CRA take the position that a gain created in a crystallization-type transaction would be subject to the Kiddie Tax?

(ii) Secondly, where a Canadian-controlled private corporation that is a small business corporation becomes a public corporation, an election is available to deem the subject shares to be sold at any amount between cost and fair market value - see section 48.1 of the Act. Presumably, this is a relieving rule for persons to claim the capital gains deduction, where applicable, before the corporation becomes public and the shares thereby cease to qualify. In such a circumstance, if this election were made, would the capital gain be subject to the Kiddie Tax? It seems that it may not be caught by section 120.4 since the disposition is not to a non-arms-length party and also because section 48.1 appears to explicitly carve out the disposition for purposes of subsection 120.4(4). May we please have your views on this?

CRA Response

(i) A "crystallization" transaction can take many different forms. If the form of the crystallization involves the disposition by the specified individual to a non-arm's-length person, then subsection 120.4(4) can apply.

For example, if a parent controls Opco, and a child of the parent crystallizes an accrued gain on shares of Opco that he or she owns by transferring those shares to Opco in exchange for newly issued shares of Opco, the child would have disposed of the shares to a non-arm's-length person, such that subsection 120.4(4) could apply.

Where subsection 120.4(4) does apply, the specified individual would be deemed to have received a taxable dividend equal to twice the amount of the taxable capital gain. The taxable dividend is not an eligible dividend. More importantly, since the taxable capital gain is treated as a dividend, the specified individual would not be entitled to the capital gains deduction under subsection 110.6(2.1).

(ii) The deemed disposition under subsection 48.1(1) is expressly provided not to apply for the purposes of subsections 120.4(4) and (5). Therefore, a capital gain realized by a specified individual as a result of a deemed disposition under subsection 48.1(1) is not subject to the tax on split income under section 120.4.

Question 1(c)

Where a capital gain is subject to the Kiddie Tax, and accordingly deemed to be a taxable dividend, is it considered to be a taxable dividend paid by the corporation for purposes of a dividend refund under section 129 of the Act?

Question 1(d)

Where a dividend is deemed to result as described above, can one elect for the dividend to be a capital dividend pursuant to subsection 83(2) of the Act?

CRA Response

With respect to both questions (c) and (d) above, subsections 120.4(4) and (5) are deeming provisions, under which a taxable capital gain is deemed not to be a taxable capital gain and twice the amount is deemed to be received as a taxable dividend. The provision does not deem any amount to be paid by the corporation. As a result, a dividend refund is not available under subsection 129(1) and no election is available under subsection 83(2) in respect of a capital dividend. The September 2011 Department of Finance Explanatory Notes confirm that subsections 120.4(4) and (5) are intended to apply in this manner.

QUESTION 2. Prescribed Rate Loan

The prescribed rate of interest is currently 1%, which is the lowest that it reasonably can be. As a result, it is advantageous to make a loan at the prescribed interest rate to other family members (for example a spouse) such that income on the funds can be earned in the hands of that spouse (pursuant to the provisions of subsections 74.5(1) and (2)). The payment of 1% interest to the transferor should give rise to a deduction to the transferee, which may be an acceptable arrangement given the potential for the spouse (who is presumably at a lower income tax rate) to earn additional income. Our question concerns the terms of the loan at a fixed interest rate (say 1%). Can the 1% interest rate remain fixed where firstly the loan is a demand loan with no term, and secondly the loan is a term loan, with a term of say 20 years? In these cases, does CRA accept that this is a prescribed rate loan, which will not cause income attribution to arise?

CRA Response

Income and gains will not be attributed to the transferor (pursuant to subsections 74.1(1) and (2), and section 74.2) if the loan is set at the prescribed rate "…at the time the indebtedness was incurred…" as stated in subsections 74.5(1) and 74.5(2).

QUESTION 3. Extended Reassessment Period / Prescribed Form T1135

Section 8 of the Notices of Ways and Means Motions released pursuant to the 2013 Federal Budget on March 21, 2013 proposes to extend the normal reassessment period for taxpayers by three years in certain cases. One such case is where prescribed form T1135 was not filed on time or where the required information is not provided.

Can you confirm whether the extension of normal reassessment period applies for all purposes or just to income derived from the unreported foreign assets?

There is some uncertainty as to how to complete form T1135 as it now stands, here are two examples:

If U.S. shares or U.S. bonds are held in a UK brokerage account, should these be coded U.S. or U.K.?

If a person has capital gains and losses, where the gains are foreign and the losses are Canadian (so that no capital gains results overall), what should go on the T1135 form?

In view of the serious implications of the proposed change, will CRA be revising form T1135 and clarifying the instructions?

CRA Response

The proposed amendments in the 2013 Federal Budget would extend the normal reassessment period by three years for all purposes if both of the following conditions have been satisfied:

- the taxpayer has failed to file the T1135 as and when required or has filed this form but failed to provide the required information in respect of a specified foreign property; and
- the taxpayer has failed to report an amount, in respect of a specified foreign property, that is required to be included in the taxpayer's income.

In addition proposed legislative amendments in Bill C-48 will unconditionally extend the normal reassessment period by three years where the assessment, reassessment or additional assessment is made to give effect to sections 94, 94.1 and 94.2.

With respect to the questions on completing the T1135 we provide the following responses:

If U.S. shares or U.S. bonds are held in a U.K. brokerage account, these should be coded as U.S. It is the residence of the corporation that issued the shares or the residence of the bond issuer that is relevant for purposes of the T1135.

If a person has capital gains and losses, where the gains are foreign and the losses are Canadian only the foreign gains are reported on the T1135. Only foreign properties and the income (loss) or gain (loss) on disposition of those foreign properties are reported on the T1135.

The instructions on the revised T1135 have been redrafted in order to clarify the filing requirements. In addition, the revised T1135 will include a link to the CRA website where frequently asked questions related to the T1135 have been addressed.

QUESTION 4. <u>Foreign Tax Credits for U.S. Citizens</u>

A U.S. citizen who is required to pay U.S. tax by virtue of citizenship cannot claim a foreign tax credit in Canada for U.S. tax paid unless it is paid on foreign source income. This is because of paragraph (d) in the definition of "non-business-income tax" in subsection 126(7).

As you know, in conjunction with the so-called "fiscal cliff," the U.S. tax rate on certain dividends and capital gains has increased from 15% to 20% in 2013; a rate of tax that is now higher than the rate generally provided under international tax treaties. As a result, in respect of an amount of U.S. tax on applicable dividend income received by a US citizen who is resident in Canada, subsection 20(11) could result in the additional 5% being taken as a deduction and not allowed as a tax credit.

Can CRA comment further in this regard?

CRA Response

In recognition of the unique tax position of U.S. citizens that are resident in Canada for purposes of the Canada-U.S. Treaty, paragraph 5 of Article XXIV sets out how double taxation is to be eliminated in the case of dividends, interest, and royalties. Paragraph 5 has existed in its current form since the ratification of the Third Protocol to the Treaty in 1995. Since that time, periods have existed in which the U.S. *Internal Revenue Code* specified a maximum rate on capital gains and qualified dividends which was higher than the rates applied to such income under the Canada-U.S. Treaty, as well as other international tax treaties.

As such, it is reasonable to expect that paragraph 5 of Article XXIV will continue to apply to taxpayers subject to the rate increases in the United States. In fact, the CRA views paragraph 5 of Article XXIV as a complete code in respect of the deductions and credits available to U.S. citizens resident in Canada for the purposes of eliminating double taxation on dividends, interest, and royalties. The deductions available under paragraph 5 of Article XXIV are available in place of deductions under subsections 20(11) and 20(12), and are typically more advantageous to the taxpayer.

Further guidance on the application and operation of paragraph 5 can be found in our prior document 2002-0143605, and in the Technical Explanation to the Treaty from the Third Protocol. However, if a taxpayer believes they are being taxed in excess of what is provided for under the Treaty, the taxpayer may contact the Competent Authority in their country of residence in accordance with Article XXVI of the Treaty.

QUESTION 5. <u>Foreign Tax Credit/Part Year Resident</u>

It appears that the foreign tax credit which can be claimed in respect of a part-year resident is not limited to the portion of the foreign tax paid while the person is resident in Canada. In fact, it appears that the foreign tax for the entire year may be claimed as a foreign tax paid, although the foreign tax credit is subject to other limitations, such as the ratio of the net foreign income to net income, with adjustments.

Does CRA agree that the foreign tax paid for the entire year may be claimed as a foreign tax paid for purposes of the foreign tax credit?

CRA Response

The starting point in determining the amount of a foreign tax credit available to a part-year resident of Canada in respect of a particular foreign jurisdiction is the total "non-business-income tax" or "business-income tax" paid for the year to that foreign jurisdiction, as those terms are defined in subsection 126(7). However, the actual amount of a foreign tax credit available to a part year resident is determined by the formulas contained in subsections 126(1) and (2.1) of the Act. Whether the amount of foreign tax credit available to a part-year resident is limited will depend on the facts of any particular situation.

The operation of the foreign tax credit formulas, including their application in the case of a part year resident, is reflected in the workings of Form T2209.

In addition, guidance on the operation of the foreign tax credit formulas for both business-income tax and non-business-income tax paid to a country other Canada, and how the foreign tax credit may be altered in the case of non-resident individuals, is found in the recently released Income Tax Folio S5 F2 C1, *Foreign Tax Credit*, which is available through the CRA website. S5 F2 C1 replaces the prior Interpretation Bulletins IT–270R3, *Foreign Tax Credit*, IT–395R2, *Foreign Tax Credit – Foreign-Source Capital Gains and Losses*, and IT–520 (consolidated), *Unused Foreign Tax Credits – Carryforward and Carryback*.

QUESTION 6. <u>US Limited Liability Companies ("LLCs")</u>

Where an LLC resident in the US is a flow-through entity for US tax purposes, US tax is paid on the income of the LLC by the owners of the LLC and not by the LLC itself. Assume that the income of the LLC constitutes FAPI and that the LLC is a controlled foreign affiliate of a Canadian resident (the "taxpayer"). In these circumstances, is the US tax paid by the taxpayer considered to be foreign accrual tax in respect of the LLC?

Alternatively, would the FAPI income which arises in the hands of the taxpayer pursuant to subsection 91(1) be considered foreign source income and can a foreign tax credit then be claimed by the taxpayer against the FAPI inclusion?

CRA Response

In the above circumstances, the US tax paid is a tax paid by the taxpayer and not by the LLC and, therefore, it would not qualify as foreign accrual tax in respect of the LLC. In order for an income or profits tax to qualify as foreign accrual tax, the tax must be paid by the particular affiliate (or any other affiliate of the taxpayer in respect of a dividend received from the particular affiliate). It is implicit that any tax paid by the affiliate is, in fact, the affiliate's tax and not simply a payment on behalf of another person's tax obligation. Therefore, arranging the affairs so that the LLC actually makes the tax payment in respect of the taxpayer's obligations under the Internal Revenue Code would not cause the tax to become foreign accrual tax.

In computing the taxpayer's income, any amount included under subsection 91(1) in respect of the FAPI of the LLC would be considered income from sources in the US for purposes of subsections 20(11) and 126(1). Therefore, if the taxpayer is an individual, he or she may deduct under subsection 20(11) the portion, if any, of the US tax paid for the year that exceeds 15% of the subsection 91(1) income included in computing the individual's income for the year from the

LLC. Any excess will be eligible for a foreign tax credit under subsection 126(1) and any of the excess US tax paid that cannot be utilized by the foreign tax credit may be deducted from income pursuant to subsection 20(12).

If, however, the taxpayer is a corporation, any US tax paid in respect of the corporation's share of the income of the LLC would not be creditable for purposes of subsection 126(1) nor deductible for purposes of subsection 20(12) because the tax would be paid by a corporation in respect of income from a share of the capital stock of a foreign affiliate of the corporation. However, the CRA takes the view that a deduction under paragraph 113(1)(c) would be available in respect of the US tax paid by a corporation resident in Canada in respect of the income of an LLC where a dividend distribution out of taxable surplus is received from the LLC.

QUESTION 7. Price adjustment clauses

CRA has a long standing position concerning price adjustment clauses, which is documented in Interpretation Bulletin IT-169 dating back to 1974. This position basically states that the CRA will respect a price adjustment clause provided that certain conditions are met. One of the conditions is that the CRA is informed of the existence of the price adjustment clause.

Can you please explain why it is necessary for the CRA to be informed of the price adjustment clause in order for the price adjustment mechanism to actually operate? Put another way, does the price adjustment mechanism operate by virtue of legal documents surrounding it or purely by virtue of an administrative concession by the CRA?

It would seem that if the legal documents contain a valid price adjustment mechanism, which is legally effective, the price adjustment mechanism should operate as a function of law regardless of CRA's administrative position.

In addition, since the bulletin is now almost 40 years old, would the CRA be prepared to issue something which is more comprehensive?

CRA Response

In response to question 58 of the Revenue Canada Round Table at the 1990 Conference of the Canadian Tax Foundation (1990 Conference Report), the CRA has confirmed that the failure to notify the CRA of the existence of a price adjustment clause when filing a tax return will not, in and of itself, preclude the CRA from accepting the price adjustment as valid. The CRA subsequently confirmed its views in that regard in document E 9527537.

Income Tax Folio S4-F3-C1, *Price Adjustment Clauses*, which has replaced former Interpretation Bulletin IT-169, was released to the public on March 28, 2013. Paragraph 1.5 of Income Tax Folio S4-F3-C1 states the requirements governing the recognition of a price adjustment clause, which do not include the notification requirements formerly included in paragraph 1 (b) of IT-169.

QUESTION 8. Listed Personal Property

Personal use property, including listed personal property, is deemed to have a cost of $1,000 per item, unless the items constitute a set, in which case the $1,000 minimum cost is to be allocated across the set.

In certain cases, it is easy to understand what is meant by a set. For example, one would speak of a set of dishes or cutlery, as constituting a set. However, in other cases, it is not clear as to what constitutes a set. Accordingly, we would ask clarification in the following hypothetical circumstances:

> The taxpayer has a series of paintings produced by the same artist, which were sold as a "set," but would not have any particular value as a set, and have an equal value independently.
>
> A person has a stamp collection consisting of a multitude of different stamps from different countries.

One can think of other examples which might constitute or not constitute a set.

Can CRA please provide some guidance here?

CRA Response

The term "set" is not defined in the Act and therefore carries its ordinary meaning in the context in which it is used. The CRA considers that a set for these purposes is a number of properties belonging together and relating to each other. For example, in the case of the hobby of philately, in the past, the CRA considered that a set is a number of stamps which were produced and issued by one country simultaneously or over a short period of time. The fact that the value of a number of properties, if sold together, exceeds the aggregate of their values, if sold individually, may indicate the existence of a set. However, this is not in itself a decisive factor.

Regarding your question concerning what is a "set" insofar as paintings are concerned; it is our opinion that simply because they were painted by one artist would not in and by itself, mean that they are a set. Nor would all landscapes, waterscapes, figures, etc. necessarily be a "set." The criterion in the case of paintings would seem to be whether or not a group of paintings were painted as a set and would ordinarily be disposed of as a set. For instance, a painter might be commissioned to paint, as a set, all former premiers of a province or a family tree. These would ordinarily be inserted in identical frames. These facts would seem to conclusively establish that such a group of paintings were indeed a "set" for purposes of the Act.

The determination of whether a set exists is therefore a question of fact, and we have not been provided with sufficient information on the paintings and stamps, in order to establish whether they form part of a set or not.

QUESTION 9. Sommerer Case and Subsection 75(2)

Does CRA accept the Sommerer decision in its application to subsection 75(2)? In this case, it was held that a fair market value sale to a trust did not come within the ambit of subsection 75(2). If CRA does accept this, can CRA offer some broad guidelines now as to when subsection 75(2) would not apply in transactions between an individual and a trust?

CRA Response

Our comments that follow are in respect of the decision of the Federal Court of Appeal ("FCA") in the case of The Queen v Sommerer (2012 FCA 207). In paragraph 49 of her decision, Justice Sharlow, with concurrence of her two colleagues, Justices Blais and Letourneau, concluded that Parliament did not intend for subsection 75(2) to apply "in respect of property that the trust acquired from the beneficiary in a bona fide sale transaction." In her concluding statement in paragraph 57 of the decision, Justice Sharlow noted that the Crown's interpretation of the provision was "wrong because it is based on the incorrect premise that 75(2) can apply to a beneficiary of a trust who transfers property to the trust by means of a genuine sale."

As regards the terms "bona fide" and "genuine" in the decision, in our view, these are both concepts that suggest a question of fact approach to their determination. It would appear that the FCA used both terms interchangeably, and in the context of their normal meaning (i.e. the sale must be made honestly and in good faith; it must be what it purports to be).

With the exception of the limited definition of a "sale" in Regulation 230(1) for purposes of security reporting, the Act is silent as to what constitutes a sale. Accordingly, one would typically refer to its ordinary meaning. The Oxford English Dictionary defines a sale as an "exchange of a commodity for money or other consideration." Similarly, Black's Law Dictionary refers to a "transfer of property … for consideration." As was noted in H. W. Liebig & Co. v Leading Investments Ltd., [1986] 1 SCR 70, "the primary meaning of sale is the transfer of property to another for a price." In our view, it is clear that the FCA, in its decision in Sommerer, had a more definitive concept in mind when it referred to a bona fide or genuine sale.

It should be noted that the FCA expressed their approval of the conclusion reached by Justice Miller in the Tax Court decision at paragraph 91 where he noted "only a settlor, or a subsequent contributor who could be seen as a settlor, can be the "person" for purposes of 75(2) of the Act." It is our view that Justice Miller was simply referring to someone who has contributed value to the trust. This is further supported by the FCA comments in paragraph 58 of their decision which noted that “Peter Sommerer has not endowed the Sommerer Private Foundation with any other money or property.”

Accordingly, it is our view that the FCA decision in Sommerer does stand for the general proposition that where property is transferred to a trust by a beneficiary of the trust in return for consideration that constitutes a fair market value, subsection 75(2) will not apply to attribute income in respect of that property to that beneficiary. Note, however, that attribution pursuant to subsection 75(2) may occur in respect of that property to the beneficiary or another person, if the property in question is substituted property, as defined in subsection 248(5), in respect of that beneficiary or other person. For example, if a person settles a discretionary trust in which the settlor is a capital beneficiary with $100, and the trustee subsequently uses those funds to purchase shares from the beneficiary, at fair market value, then subsection 75(2) can apply to attribute income to the beneficiary in respect of income derived from the shares.

As was noted by the FCA in paragraph 13 of its decision in CIT Financial Ltd. v The Queen (2004 FCA 201), “the determination of fair market value is a question of fact rather than a question of law” and “there is ample authority for the proposition that a trial judge is entitled to arrive at his own opinion as to value.” In Carr v The Queen (2004 TCC 434), the Tax Court noted that the judicial definition accepted by the courts in Canada was “…the highest price an asset might reasonably be expected to bring if sold by the owner in the normal method applicable to the asset in question in the ordinary course of business in a market not exposed to any undue stresses and composed of willing buyers and sellers dealing at arm's length and under no compulsion to buy or sell.” This definition reflects the key elements of the CRA definition of fair market value, as noted in Information Circular IC 89-3 - *Policy Statement on Business Equity Valuations.*

In the recent 2013 Federal Budget, the Department of Finance (“Finance”) released a proposed amendment to subsection 75(2) and related proposed amendment to subsection 107(4.1), along with revisions to section 94 (the non-resident trust rules), in response to the FCA decision in Sommerer. The commentary that accompanied the proposed changes noted that the FCA interpretation of subsection 75(2) was not in accordance with intended tax policy. The commentary further noted that the proposals were intended to “protect the integrity of the tax rules that apply where a Canadian-resident taxpayer maintains effective ownership over property held by a non-resident trust.”

The revision to subsection 75(2), along with the proposed change to paragraph 94(4)(h), will effectively restrict the application of the attribution rule in subsection 75(2) to trusts that are factually resident in Canada. In general, proposed new subsection 94(8.1) will cause subsection 94(8.2) to apply, regardless of the amount of consideration exchanged, where a non-resident trust holds property on condition that it may revert to a Canadian-resident person, its distribution may be determined by that person, or it shall not be disposed of by the trust without the consent or direction of the person. These conditions mirror those in subsection 75(2) and, as noted in the Finance commentary to the Budget, are indicative of effective ownership of the property by the Canadian-resident person.

QUESTION 10. <u>Probate Fees and Related Cost Base Additions</u>

In Brosamler Estate v R. 2012 TCC 204, the estate of a deceased non-resident person added a portion of the probate fees and legal fees (that it incurred to obtain the required ancillary probate in British Columbia) to the adjusted cost base of certain Canadian properties that was previously owned by the deceased. The Minister of National Revenue assessed the estate of the deceased, removing costs of probate and legal fees from the adjusted cost base. The estate appealed the Minister's reassessment and the Appeal was allowed. Can the CRA please comment on its views of this decision notwithstanding the decision was decided through the Informal Procedure of the Tax Court of Canada?

CRA Response

The CRA generally does not seek judicial review of decisions rendered under the informal procedure since they are not generally regarded as having precedential value pursuant to section 18.28 of the *Tax Court of Canada Act*. The fact that CRA did not appeal the Brosamler decision should not be regarded as precedential.

The CRA considers that the decision in Brosamler was based on the unique facts of the case and does not represent the CRA's view on the general rule. In Brosamler, the court found that in order to acquire the title in the properties sold by the estate, there had to be conveyance of the title from the deceased person to the estate, and the conveyance could not take place until the estate incurred the probate and legal fees. As such, the portion of the fees incurred by the estate to acquire that title could be added to the adjusted cost base ("ACB") of the two properties disposed of. The court further noted that even if the fees had not been added to the ACBs for the two properties, they would have been deductible in determining the capital losses on disposition of the properties, because the expense was incurred towards an actual disposition of the property by the estate.

As explained above, the Brosamler decision is derived from a very fact specific situation. The determination of whether probate fees related to real property situated in Canada might be eligible to be added to the adjusted cost base of the property or constitute an outlay or expense to dispose of the property will depend on the unique facts in a given situation. However, it is our view that as a general rule, probate fees will neither be added to the ACB of the estate property nor be considered an outlay or expense to dispose of estate property for the purpose of subsection 40(1), which establishes the general rules for gain and loss calculations.

QUESTION 11. Deemed Disposition Day on a Trust-to-Trust Transfer

Paragraph 104(4)(b) of the Act generally provides for a deemed disposition at fair market value of certain property owned by a trust 21 years after the later of January 1, 1972, the day on which the trust was created, and the day on which certain deemed dispositions occurred. Paragraph 104(4)(c) provides for a deemed disposition every 21 years thereafter.

Consider a hypothetical scenario in which a non-spousal testamentary trust with multiple beneficiaries was created upon a testator's death prior to 1972. The first deemed disposition day of the trust under paragraph 104(4)(b) of the Act would have been January 1, 1993. However, the trust had an exempt beneficiary between 1993 and 1999 and made an exempt beneficiary election under subsection 104(5.3). As a result, the trust's deemed disposition day was deferred until January 1, 1999. Assume that on January 1, 2000, one of the beneficiaries died and a successor trust was established. The testamentary ("transferor") trust's assets were transferred to the successor ("transferee") trust in circumstances such that subsection 104(5.8) applies to the transfer. What is the "disposition day" of the transferee trust under subsection 104(5.8) where the trust-to-trust transfer takes place after the trust's January 1, 1999 deemed disposition day?

CRA Response

Subsection 104(5.8) prevents the avoidance of the 21-year deemed realization rule by the use of trust-to-trust transfers that do not involve dispositions of certain property at fair market value. The first deemed disposition day in respect of the transferee trust is generally advanced to such day in respect of the transferor trust. We assume that paragraphs 104(5.8)(b) through (b.3) are not applicable to this scenario.

Subparagraph 104(5.8)(a)(i) deems the "disposition day" of the transferee trust to be the earliest of five days determined in that subparagraph. Only two of these dates are relevant to this scenario:

- Clause 104(5.8)(a)(i)(A) determines the first day on or after the transfer date on which the transferor trust would have been deemed under subsection 104(4) to dispose of its property, without regard to the transfer or any transaction or event occurring after the transfer.

- Clause 104(5.8)(a)(i)(B) determines the first day on or after the transfer date on which the transferee trust would have been deemed under subsection 104(4) to dispose of its property, without regard to any transaction or event occurring after the transfer.

If the trust-to-trust transfer is disregarded, the first day ending at or after the January 1, 2000 transfer would be determined under paragraph 104(4)(c) in respect of the transferor trust to be 21 years after the January 1, 1999 deferred deemed disposition day. Therefore the day determined under clause 104(5.8)(a)(i)(A) is January 1, 2020.

The first day ending at or after the January 1, 2000 trust-to-trust transfer determined under paragraph 104(4)(b) in respect of the transferee trust would be 21 years after the latest of January 1, 1972 and the day on which the transferee trust was created, January 1, 2000. In this case the day determined under clause 104(5.8)(a)(i)(B) is January 1, 2021.

In this example, the earliest day determined under subparagraph 104(5.8)(a)(i) is the day determined under clause 104(5.8)(a)(i)(A). Therefore, the transferee trust's first deemed disposition day is January 1, 2020.

Under subparagraph 104(5.8)(a)(ii), the transferee trust in this situation would not also have a deemed disposition on January 1, 2021 for purposes of subsections 104(4) to (5.2).

QUESTION 12. <u>RDTOH and Dividend Refunds</u>

Subsection 129(1.2) can deny a dividend refund to a corporation in certain circumstances. In particular, this rule applies where a person acquires shares of the corporation where one of the main purposes was to enable the corporation to obtain the dividend refund. This limitation does not contain an exemption for related party transactions. Accordingly, the dividend refund could be denied in a wide range of circumstances. In 2005, the CRA was asked to clarify its position on this rule. Can you update us on the CRA's position in this regard?

CRA Response

We stated at the 2005 STEP CRA Roundtable (question 3) that the application of the purpose test in subsection 129(1.2) had to be determined in light of the specific facts of a particular situation. We further stated that a favourable subsection 129(1.2) ruling was issued on the proposed post-mortem estate planning transactions described in document #2004-008855. Lastly, we reaffirmed the position as stated at the 2002 APFF Roundtable (question 10) that where the purpose test in subsection 129(1.2) was met, subsection 129(1.2) could technically apply to deny a dividend refund to a payer corporation even if tax was paid by the shareholder on the dividend received from the payer corporation.

We confirm that the response to question #3 of the 2005 STEP CRA Roundtable remains our position. We would also mention that, recently, in documents #2010-0377601R3 and 2012-0456221R3, we have issued favourable subsection 129(1.2) rulings on proposed post-mortem estate planning transactions.

QUESTION 13. US LLCs and Subsection 20(11)

Subsection 20(11) provides for the deduction of certain foreign taxes paid in the computation of an individual's income from a property. Specifically, an individual may deduct under subsection 20(11) the portion, if any, of the foreign tax that exceeds 15% of the gross income included in income for the year from the particular property. The computation in subsection 20(11) is made on a property-by-property basis. It looks specifically at the income from a particular property and the foreign income or profits tax paid in respect of that income to determine whether the 15% limitation has been exceeded.

Where an LLC resident in the US is a flow-through entity for US purposes, US tax is paid on the income of the LLC by the owners of the LLC and not by the LLC itself. This tax is payable by the owners if the LLC has income regardless of whether any distributions are received from the LLC. Therefore, is it right to conclude that such US tax paid by an individual resident in Canada (a "taxpayer") is not paid in respect of a distribution from the LLC that has been included in computing the taxpayer's income for the year such that subsection 20(11) can never apply in these circumstances?

CRA Response

For the purpose of this question, it is assumed that the LLC is treated as a corporation for Canadian tax purposes and that it is not a controlled foreign affiliate of the taxpayer.

The "amount" referred to in paragraphs (a) and (b) of subsection 20(11) is the amount, if any, which has been included in computing the taxpayer's income for the year in respect of a distribution from the LLC. If no distribution has been made in the year by the LLC to the taxpayer, there would be no such amount. Therefore, no part of the US tax paid by the taxpayer would be deductible by virtue of subsection 20(11), however, it would be deductible pursuant to subsection 20(12). To the extent the tax was not deducted under subsection 20(12), the tax would be creditable for purposes of subsection 126(1).

On the other hand, in a year that the taxpayer receives a distribution from the LLC there would be an amount of dividend income included in computing the taxpayer's income for the year from the LLC. In our view the words "tax paid …as may reasonably be regarded as having been paid in respect of" in paragraph 20(11)(a) are broad enough to connect a US tax computed on the profits of the LLC to the dividend from the LLC. Therefore, in computing the taxpayer's income from the shares of the LLC, there may be deducted under subsection 20(11) the amount, if any, by which the amount of the US tax paid by the taxpayer exceeds 15% of the amount of such dividend income. It should be noted that the US tax paid by the taxpayer which is eligible for a foreign tax credit under subsection 126(1) does not include the US tax paid that was deductible by virtue of subsection 20(11), regardless of whether it was in fact deducted.

QUESTION 14. 2012 Federal Budget Follow Up

The 2012 Federal Budget included a description of the actions being taken by federal government organizations to find efficiencies in their operations and re-engineer the way they do business. The discussion related to the CRA noted that the Agency will leverage the expertise of the external tax profession. Can the CRA shed any light on what this statement might mean in the context of tax administration?

CRA Response

The CRA has developed Vision 2020, which is a suite of nine strategic directions to strengthen and modernize how we administer tax and benefits for Canadians. Extending our reach through third parties, including tax practitioners, is one of the levers required to deliver Vision 2020. We can elaborate on three examples in which the Agency is using strategic relationships to expand our ability to deliver results.

In a broader context, the Government has been taking action to reduce the red tape burden on Canadian businesses including forming the Red Tape Reduction Commission in January 2011 composed of parliamentarians and members of the private sector. The mandate of the commission included reducing the compliance burden on businesses, especially small and medium businesses. The Commission solicited feedback through consultations and 12 roundtable sessions with Canadians and businesses between January and March 2011. In January 2012, the Commission released its final report in which it provided recommendations on how government departments and agencies could address the irritants identified by small businesses on a long-term basis. The CRA conducted its own consultations to prioritize its commitments and develop action plans to reduce or eliminate the compliance burden on business. While the Red Tape Reduction Commission involves multiple departments and agencies across the government, the CRA was specifically acknowledged in the 2013 Budget for introducing measures that improve services at the CRA and reduce the burden placed on small businesses. The CRA's goal is to consult with stakeholders regularly.

Within the Income Tax Rulings Directorate (ITRD), we have undertaken an initiative to introduce a new technical publication product to update the information currently found in the income tax interpretation bulletins and to introduce improved web functionality. The new publications are known as the Income Tax Folios. The first 11 folios were rolled out on March 28, 2013. ITRD is partnering with various tax associations to deliver 19 additional folios in the next six months. More tax associations have indicated that they are also eager to partner with us this fall to work on additional folios. We are also building stronger relationships with the Canadian academic research community. For example, Master's degree students in tax at the Université de Sherbrooke can develop a folio as their thesis.

ITRD has been working closely with the Joint Committee to explore suggestions for streamlining and increasing the effectiveness of services it provides, such as issuing rulings and other technical publications. For example, ITRD and the Joint Committee are considering the merits of pre-ruling consultations for a fee. Other suggestions include having Joint Committee representatives who participated in groups which worked on the analysis of technical changes, assist with educating CRA staff on those changes, continue to identify issues related to the changes, and provide input on assessing practices. More details will be provided as these initiatives are further developed.

QUESTION 15. <u>Tax Preparer Registration</u>

At the 2012 Canadian Tax Foundation National Conference, the CRA hinted that it was exploring a registration style system for tax preparers. Can the CRA shed further light on this statement?

CRA Response

Like tax administrations throughout the world, the CRA is looking for better ways to make compliance easier and non-compliance more difficult. As mentioned in Budget 2013, the CRA is moving toward a new compliance approach that emphasizes helping taxpayers to avoid costly and time-consuming audits by getting it "right from the start."[i] This compliance approach is being used by tax administrations worldwide and is largely based on the Organization for Economic Co-operation and Development work entitled "*Right from the Start: Influencing the Compliance Environment for Small and Medium Enterprises.*"[ii]

Tax intermediaries are critical links between the CRA and the taxpayer. In fact, the majority of tax returns are prepared by tax intermediaries. In Budget 2012,[iii] it was announced that the CRA would be leveraging the expertise of tax professionals in order to improve the effectiveness of its operations. Consistent with Budget 2012 and as part of developing its new compliance approach, the CRA is looking at what other countries are doing to recognize and build on the important role played by tax intermediaries in the tax system.

Leading tax administrations such as the United States' Internal Revenue Service and the Australian Taxation Office have recently implemented registration programs for tax intermediaries, which require certain minimum standards of suitability, conduct and tax competency. Other countries are also consulting about or implementing programs relating to tax intermediaries, including the United Kingdom, South Africa and the Netherlands.

[i] Budget 2013 Chapter 3.2 and 4.1:

“The CRA is also expanding its small business focus across all operations, and is moving towards a “tell us once” approach, so that small businesses will not have to submit the same information several times. The CRA is helping small business owners avoid costly and time consuming audits by raising awareness of their tax obligations in order to help them to get it right from the start.”

“In addition, Economic Action Plan 2013 confirms that the Canada Revenue Agency will implement transformational changes to its compliance programs that will improve effectiveness and help to preserve the integrity of the tax system through targeting non-compliance in the highest-risk areas.”

[ii] Organisation for Economic Co-operation and Development, Forum on Tax Administration SME Compliance Sub-Group, January 2012.

[iii] Budget 2012: “The Canada Revenue Agency continues to modernize its operations and reduce red tape to enhance services to Canadians while reducing its overall costs. … In addition, the Agency will leverage the expertise of tax professionals to improve the effectiveness of its operations.”