2014 CRA ROUND TABLE
STEP Canada – 16th National Conference
June 16-17, 2014 - Toronto

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. Transfer to Spouse and Common-Law Partner

A rollover is available under subsection 70(6) where property is left by a taxpayer resident in Canada to a taxpayer's spouse or common-law partner who is resident in Canada immediately before the taxpayer's death.

The term spouse is not defined in the Act, but is taken to mean a person to whom one is legally married. A common-law partner is defined in subsection 248(1) to be a person with whom one cohabits in a conjugal relationship and has either so cohabited for a period of at least one year or is the parent of a child of that person.

It would seem possible for a person to have both a spouse and a common-law partner at a given time. In this case, can the rollover provision of subsection 70(6) be applied in respect of a transfer to the spouse and also to the common-law partner?

CRA Response

Where certain conditions are met, subsection 70(6) provides a tax-free rollover to a taxpayer's spouse or common-law partner who was resident in Canada immediately before the taxpayer's death or to a trust for the spouse or common-law partner created by the taxpayer's will. Subsection 70(6) specifically refers to "any property of a taxpayer" and as such, the rules in subsection 70(6) would be applied on a property-by-property basis.

It is possible that a taxpayer could have a spouse and a common-law partner at the same time, for purposes of the Act. For example, in document 2010-0373901I7 the CRA addressed a scenario where a taxpayer was legally separated but not divorced and had a common-law partner at their death. We were asked, in part, whether paragraph 70(6)(a) would apply to two properties of which one property was bequeathed to the deceased taxpayer's spouse (separated but not divorced) and another property was bequeathed to the deceased taxpayer's common-law partner. Provided all the conditions in subsection 70(6) are met in respect of the deceased taxpayer and the spouse or common-law partner, the subsection would apply to the property transferred to each of the spouse and common-law partner.

QUESTION 2. <u>A Joint Spousal or Common-Law Partner Trust</u>

A "joint spousal or common-law partner trust" is defined in subparagraph 73(1.01)(c)(iii) to be a trust under which the individual or the individual's spouse or common-law partner, in combination with the other is entitled to receive all of the income of the trust that arises before the later of the death of the individual and the death of the spouse or common-law partner, and no other person may before the later of those deaths, receive or otherwise obtain the use of any of the income or capital of the trust.

Suppose that under the terms of the trust, the individual who transferred property to the trust is entitled to receive all of the income of the trust during his or her lifetime and the surviving spouse or common-law partner is only entitled to receive income thereafter.

In these circumstances, does the trust qualify as a "joint spousal or common-law partner trust", and can this arrangement meet the requirement that the two persons are entitled to receive the income "in combination with the other"?

CRA Response

A "joint spousal or common-law partner trust" is defined in subsection 248(1) and means a trust to which paragraph 104(4)(a) would apply if that paragraph were read without reference to subparagraph 104(4)(a)(iii) and clause 104(4)(a)(iv)(A). This results in the following requirements:

1. The trust must be created after 1999 by a living taxpayer;
2. The taxpayer must be 65 years of age or older at the time the trust is created;
3. The taxpayer and his or her spouse or common-law partner must, in combination, be entitled to receive all of the income of the trust that arose before the later of their respective deaths; and
4. No other person may receive or obtain the use of any of the trust income or capital before the later death.

In our view, if the terms of the trust provide that the taxpayer who transferred property to the trust was entitled to receive all of the income of the trust during his or her lifetime and the surviving spouse or common-law partner was only entitled to receive the trust's income after the death of the taxpayer and no other person could, before the later of those deaths receive or otherwise obtain the use of any of the income or capital of the trust, this in and of itself, would not prevent the trust from qualifying as a "joint spousal or common-law partner trust".

QUESTION 3. U.S. LLC/Share Capital

In amendments issued July 12, 2013, proposed section 93.3 contains specific rules for determining the share capital of a non-resident corporation which does not actually have share capital. Many types of foreign entities are constituted as companies without share capital, which, for Canadian income tax purposes, are considered foreign corporations (on the basis that a corporation includes a company with or without share capital). The most common example would be a U.S. LLC, where the capital may be divided into units, or may be stated as a percentage of income.

The purpose of this amendment seems to be, first and foremost, to characterize entities such as U.S. LLCs, for purposes of the foreign affiliate rules, but these rules apply throughout the Act.

The amendment provides that the equity interests are to be separately viewed to the extent that they are not identical, on the basis that each represents a class of capital stock, and each class has notionally 100 issued and outstanding shares. Each owner is considered to have ownership proportionate to the fair market value of each distinct equity interest.

We have a number of questions concerning this proposed amendment. Firstly, consider the situation of a U.S. LLC, which is constituted in a way similar to a partnership, with the equity interests being referenced by a formula. The formula might provide for one party (say the manager) to receive incentive compensation in the form of a 2% income allocation for management, and a 20% profit share in certain circumstances. The residual profits may then be shared in accordance with a sharing ratio.

Would it be correct to assume that in this instance there would be 3 classes of equity interests, the first providing for the 2% income allocation, the second for the 20% incentive allocation, and the third for the residual amounts.

Secondly, if the manager had a special voting right, would this also constitute another class of equity interest?

Thirdly, if the income is to be allocated based on, for example, the revenue or net income for the year, as between 2 owners say, A and B, would it be correct to say that A and B each have a distinct equity interest, where the value of these equity interests may change from year to year (like 2 separate classes of common shares). Alternatively would there be 1 class of equity interest and the ownership of equity interests changes from year to year between A and B?

Fourthly, if it is the latter, is there a disposition or acquisition when the equity interests change?

CRA Response

An "equity interest" in a non-resident corporation without share capital is defined in proposed subsection 93.3(1) and is described in Finance's Explanatory Notes as follows:

> "An equity interest in a non-resident corporation without share capital is defined to mean any right, whether absolute or contingent, conferred by the non-resident corporation to receive, either immediately or in the future, an amount that can reasonably be regarded as all or any part of the capital, of the revenue or of the income of the non-resident corporation. However, this does not include a right to receive an amount as creditor. For example, a contingent right, analogous to those of corporate shareholders, to receive a portion of an entity's income for the year, or a share of the entity's capital on its dissolution, would constitute an equity interest."

The first step in dividing the equity interests of a non-resident corporation without share capital (which is itself defined in proposed subsection 93.3(1) and herein referred to as the "non-resident corporation") into one or more deemed classes of the capital stock of the non-resident corporation under proposed subsection 93.3(2) would be to determine the rights and obligations of all the equity interests of the non-resident corporation. In our view, the determination of those rights and obligations may require looking to the constituting documents of the non-resident corporation, the law under which it was formed, and the agreements between the holders of the equity interests. Pursuant to proposed paragraph 93.3(2)(*a*), equity interests having identical rights and obligations, save for proportionate differences, would be deemed to be the same class of shares of the capital stock of the non-resident corporation.

For example, if all of the equity interests of the non-resident corporation have identical rights and obligations, save for proportionate differences, the non-resident corporation would be deemed to have a single class of capital stock. This is illustrated in the Department of Finance's explanatory notes which read in part:

> "For example, if one member of a U.S. LLC has, by virtue of its equity interest, a right to 30% of the LLC's income and three votes at a meeting of the partnership's members, and another member has a right to 40% of the LLC's income and four votes at a members meeting, these differences as to income entitlements and votes would not preclude the members' equity interests from being considered to have identical rights and obligations because in this case the differences in income entitlements are proportionate to the differences in number of votes."

Equity interests that are unique as compared to the other equity interests of the non-resident corporation would be deemed to be their own separate class of capital stock.

In response to your first two questions, consider the case of a non-resident corporation in which four individual members have equity interests, and the only non-proportionate differences between those members' equity interests is that one member's equity interest (say the manager's) grants special voting rights and allows for the receipt of an additional allocation of income for management services as well as the potential to receive a further additional allocation of income as a performance incentive. Assuming that under the non-resident corporation's constituting documents, the relevant law, and any applicable agreements each of the four members has a single equity interest, it is our view that there would be deemed to be two classes of capital stock of the non-resident corporation. We are of this view because the manager would have one equity interest and that equity interest has non-proportionate differences as compared to the equity interests of the other three members. If, in the alternative, the manager had two different equity interests under the non-resident corporation's constituting documents, the relevant law, and any applicable agreements, there could still be two deemed classes of capital stock but the allocation could be different. For example, each of the four members could be deemed to own a portion of one class of capital stock and the manager could be deemed to own all of a second class of capital stock to which the additional income allocation and voting rights were attached. In both situations the focus is on comparing the equity interests for non-proportional differences, not the number of those differences.

As a further example, the income allocation and voting schemes described in your first two questions could be the product of equity interests which would be deemed to be more than two classes of capital stock. This could be the result where the non-resident corporation's equity interests are divided into distinct units, or are otherwise divisible and transferable with particular rights and obligations attached to particular equity interests or portions thereof. For instance, if the manager could transfer his equity interest (or a portion thereof) in which the incentive allocation rights are attached to a fifth member while still retaining an equity interest, there could be three or more classes of deemed capital stock. Only after reviewing all the factors which impact the rights and obligations of the various equity interests could the number of deemed classes of capital stock be determined.

In response to your third and fourth questions, in cases where the non-resident corporation's income allocation could vary from time to time, we would expect that, in most cases, the differences in allocation would be due to differences in the rights and obligations of the equity interests which would result in different classes of shares being deemed to exist under proposed paragraph 93.3(2)(*a*). However, exact guidance in an abstract case such as that presented in this question is not possible since there are numerous ways such income allocation variability could be accomplished and could differ from case-to-case and jurisdiction-to-jurisdiction.

In conclusion, the number of classes of capital stock deemed to exist under proposed section 93.3 and the allocation thereof in each situation may be unique and specific to the non-resident corporation without share capital in question since the rights and obligations attached to its equity interests would be dependent on its constituting documents, governing law, and the agreements between the holders of its equity interests. Only after reviewing all the pertinent facts specific to the non-resident corporation in question could the number of deemed classes of capital stock, and the allocation of the shares thereof at any time, be determined.

QUESTION 4. US Limited Liability Limited Partnerships ("LLLPs")

Certain US States have enacted legislation to enable LLLPs. One of the unique features of LLLPs is that no partner is liable for the partnership debts. Considering this, how would the CRA view LLLPs? Would the CRA consider an LLLP to be a foreign partnership, a foreign corporation or some other type of arrangement?

CRA Response

The CRA has not previously had to consider whether an LLLP formed under US state legislation is a partnership, a corporation or some other entity for purposes of the *Income Tax Act*. As stated by the Supreme Court of Canada in *Philip Douglas Backman v. The Queen,* 2001 SCC 10,

> Whether a partnership has been established in a particular case will depend on an analysis and weighing of the relevant factors in the context of all the surrounding circumstances. That the alleged partnership must be considered in the totality of the circumstances prevents the mechanical application of a checklist or a test with more precisely defined parameters.

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

1) Examine the characteristics of the foreign business association under foreign commercial law and any other relevant documents, such as the partnership agreement or other contracts; and

2) Compare these characteristics with those of recognized categories of business associations under Canadian commercial law in order to classify the foreign business association under one of those categories.

The CRA would consider the classification of an LLLP in the context of an advance income tax ruling. Taxpayers should include with their request a complete description of the characteristics of the LLLP, their analysis as to its proper classification, a copy of the legislation under which the LLLP is to be created, and any other relevant documents, such as the partnership agreement or other contracts.

QUESTION 5. Subsection 75(2) - "Evil Trusts"

The term "evil trust" has become used within the tax community to denote a trust which is structured to deliberately cause the application of subsection 75(2). Sometimes the purpose of the arrangement is to cause the attribution of dividend income to a connected corporation, where the income will not be taxable, while at the same time distributing proceeds in the form of cash by way of either a capital distribution or a loan to the intended recipient (usually a shareholder of the corporate group or someone closely related to that person).

In addressing the case of Sommerer, CRA took the position that subsection 75(2) did apply to a fair market value sale to a trust by a person who was also a beneficiary of the trust.

However, the Tax Court and Federal Court of Appeal disagreed, and held that subsection 75(2) did not apply in this circumstance.

The case of Brent Kern Family Trust was recently decided by the Tax Court on the basis that the principle in Sommerer applied, and subsection 75(2) did not apply. CRA successfully argued that an anti-avoidance rule did not apply to a trust arrangement which was deliberately structured to cause subsection 75(2) to apply.

In light of these circumstances, and the evolving case law and positions adopted, can CRA outline its position with respect to subsection 75(2), and these types of arrangements?

CRA Response

Given that the Brent Kern Family Trust decision[1] is currently under appeal, it would be inappropriate to comment at this time as to the specifics of that case. However, CRA is pleased to provide general commentary in regard to the use of certain trust structures designed to purposely invoke attribution pursuant to subsection 75(2), with a view to avoiding the payment of tax on extracted corporate dividends.

We have reviewed a variety of tax structures of this type in recent years. As was noted in our discussion of these arrangements at the 2011 STEP Conference, the common elements that they share are that a trust is used to invoke subsection 75(2) in an attempt to have neither the trust nor its beneficiaries liable for tax on the corporate dividends declared.

The structure typically involves two Canadian corporations and a trust that acquires shares in one of the corporations ("Corp A"). In some cases, the acquisition is by subscription for the Corp A shares using cash contributed to the trust by the other corporation ("Corp B"), or the arrangement may involve having Corp B contribute shares of Corp A that it holds directly to the trust. In either case, when Corp A subsequently declares a dividend on the shares held by the trust, the scheme is intended to attribute the dividend income to Corp B, which then claims an offsetting deduction under section 112.

In some of these arrangements, the facts have led to a conclusion that the trust acquired the shares for fair market value consideration (perhaps by transferring cash to Corp B on the acquisition of the Corp A shares from it). As was noted in our 2013 STEP Conference comments

[1] The Brent Kern Family Trust v The Queen (2013 TCC 327)

regarding the Federal Court of Appeal decision in Sommerer[2], CRA agrees with the general proposition that where property is transferred to a trust by a beneficiary for fair market value consideration, subsection 75(2) will not apply to attribute income in respect of that property to the beneficiary.

In the alternative, if the facts are such that it may be concluded that the trust did not acquire the shares for fair market value consideration, CRA will typically challenge the arrangement on other grounds. Depending on the particular facts, assessments may be pursued to include the dividend income pursuant to paragraph 12(1)(j) or subsection 104(13), in calculating the income of the trust and/or its beneficiaries. Furthermore, CRA would typically hold the view that a strong GAAR argument would exist in support of an assessing position in such cases.

QUESTION 6. <u>Trust Audit Issues</u>

Can the CRA provide an update on the most common audit issues that it finds / reviews regarding trusts?

CRA Response

The Income Tax Rulings Directorate is often asked to provide technical assistance in regard to compliance issues encountered in respect of trusts. The following is a brief discussion of some of the interesting trust compliance concerns that we have dealt with in recent years.

Benefits under trust (subsection 105(1)):

In one audit that we dealt with, the taxpayer had been the sole shareholder and director of OPCO. The taxpayer settled a trust, purportedly for employees of OPCO, and was the sole trustee. Both taxpayer and the trust subscribed for new common shares of OPCO for a nominal amount. When an offer was received from an arm’s length party to buy OPCO several years later, the taxpayer and OPCO entered an agreement to allow OPCO to redeem the shares held by the trust (which now had a significant fair market value) for the nominal amount originally paid for them. This effectively inflated the value of the remaining OPCO shares held by the taxpayer, and thus the amount received by him on the sale of the company. CRA took the position that there was a benefit pursuant to subsection 105(1) in respect of the taxpayer. Furthermore, because the taxpayer, the trust and OPCO were all persons not dealing at arm’s

[2] The Queen v Sommerer (2012 FCA 207)

length, the trust could be assessed pursuant to subparagraph 69(1)(b)(i) in respect of the disposition of shares.

Gifts by will:

Compliance issues are often encountered in regard to claims in respect of gifts by will. For example, severed document 2012-0472161I7 dealt with the issue of whether the executors of an estate were empowered to make a gift to charities, and thus claim a deduction pursuant to subsection 118.1(3) in computing the tax payable by the estate. Based on the terms of the will in the particular case, it was our view that the executors did not have the power to make such a gift.

Late or amended 104(21) designation:

In severed document 2014-0517191I7, we provided advice in respect of the audit of a discretionary family trust, which determined that subsequent to filing its T3 return for a taxation year, had overlooked a capital gain for that year. The taxpayer requested an adjustment to designate under both subsections 104(21) and (21.2) of the Act the net taxable capital gain associated with the said gain to the adult children who were both income and capital beneficiaries of the subject trust. It was noted that the amount of the gain was actually paid to their father, who was also both an income and capital beneficiary.

It was our view that a late or amended designation under subsection 104(21) of the Act was not available to the trust. It was noted that in respect of the adult children, one of the requirements under subsection 104(21) is that the amount designated can reasonably be considered to have been included in computing their respective incomes for the year pursuant to paragraph 104(13)(a) or section 105.

Attribution pursuant to subsection 75(2):

In document 2010-0366301I7 we considered an audit in which a taxpayer who was the sole trustee and was a capital beneficiary of a trust, had transferred property to the trust by accepting undervalued freeze shares as consideration when growth shares were issued to the trust. It was our view that because the growth shares could revert back to the taxpayer, subparagraph 75(2)(a)(i) applied, and furthermore, because he was the sole trustee, both 75(2)(a)(ii) and 75(2)(b) were also applicable.

The stop-loss rule in subsection 112(3.2):

Our Directorate has provided advice on a number of audits where the issue of the potential application of the "stop-loss" rule in subsection 112(3.2) that can reduce the loss of a trust on the disposition of a share is in question. Document 2009-0310601I7 is an interesting example. In that case, in the first year of an estate, common shares held by the estate were redeemed and the aggregate capital loss realized was carried back to the final return pursuant to subsection 164(6).

The share redemption was done in two steps so as to allow the corporation to make a subsection 83(2) election to the extent of its capital dividend account. The first redemption resulted in a deemed dividend on which the corporation made the 83(2) election, and a capital loss to the estate. The second share redemption, the following day, resulted in a deemed taxable dividend and another capital loss to the estate. It was later realized that the tax result would have been more favourable if all of the shares had been redeemed in a single transaction.

The result was that the two redemptions were viewed as separate transactions for the purpose of applying the stop-loss rule in subsection 112(3.2).

Carrying charges:

In document 2013-0477561I7 we provided advice on the deductibility of carrying charges (specifically legal and accounting expenses), with respect to an individual's T1 final return and an estate trust return. Given the specific facts dealt with in that case, it was appropriate to disallow certain expenses claimed. However, the document clearly notes that such conclusions cannot be generalized, as the deductibility of an expense is fact specific and can only be determined on a case-by-case basis. The letter cites relevant case law that can provide guidance in making such determinations.

QUESTION 7. <u>Safe Income</u>

Under the provisions of subsection 55(2) of the Act, an intercorporate dividend can be re-characterized as proceeds of disposition to the extent that the amount of the dividend is attributable to anything other than income earned or realized (usually referred to as “safe income on hand”).

Suppose that the conditions for the rule in subsection 55(2) are met, and a dividend exceeds the amount of safe income on hand. The dividend would then be deemed to be proceeds of disposition or a gain, in its entirety (if no designation is made under paragraph 55(5)(f) of the Act for the dividend to constitute a series of separate dividends).

In this circumstance, is it permissible for the recipient of the dividend to self-assess the dividend as proceeds of disposition? It would appear that the structure of the Act requires this. Does CRA accept such a result, or would CRA attempt to apply the general anti-avoidance rule where it was clear that the arrangement was structured for tax planning reasons, to result in a capital gain?

CRA response

In the case of *The Queen v. Nassau Walnut Investments Inc.*, 97 DTC 5051 (FCA), in interpreting subsection 55(2) and paragraph 55(5)(f) of the Act, the Court found that:

- Subsection 55(2) applies if a dividend effects a significant reduction in a capital gain that could reasonably be considered to be attributable to anything other than safe income.
- Paragraph 55(5)(f) is not an election provision.
- The designation requirement of paragraph 55(5)(f) is, in some respects, no different than the deduction provided under subsection 112(1) of the Act.
- The intended purpose of paragraph 55(5)(f) is to prevent the conversion by subsection 55(2) of an entire dividend into taxable capital gain where a portion of that dividend might be attributable to safe income.

In that case, the Court concluded, among other things, that Nassau was obligated at the time of filing its income tax return for the taxation year in question to make a designation pursuant to paragraph 55(5)(f).

Moreover, courts have consistently held, in interpreting subsection 55(2) of the Act, that the safe income of a corporation should not be subject to double taxation when distributed as a dividend to another corporation. In that regard, we refer you to *The Queen v. Kruco Inc.*, 2003 FCA 284, *Lamont Management Ltd. v. The Queen*, [2000] 3 FC 508 (FCA) and *The Queen v. Brelco Drilling Ltd.*, [1999] 4 FC 35 (FCA).

CRA’s long standing practice is to apply subsection 55(2) only to the excess of the taxable dividend paid on a share over the safe income on hand attributable to that share, when issuing an assessment based on subsection 55(2).

In a situation where a recipient corporation would self-assess the entire amount of a dividend received on a share as a gain under paragraph 55(2)(c) of the Act or as proceeds of disposition under paragraph 55(2)(b) of the Act, regardless of the safe income on hand attributable to the share, CRA could reassess the recipient corporation and reduce the amount of the gain subject to paragraph 55(2)(c) by applying the purpose test provided under subsection 55(2), or, in other circumstances involving a surplus stripping scheme, by applying the general anti-avoidance rule provided under subsection 245(2) of the Act.

QUESTION 8. <u>Transfer of Property by a Personal Trust to a Beneficiary</u>

A Canadian-resident trust that meets the definition of a "personal trust" in subsection 248(1) of the Act holds property that has appreciated in value since its acquisition by the trust. The trust is to be wound up and the trustee wishes to transfer the property to a capital beneficiary. The trust has an outstanding amount that it owes to the capital beneficiary in respect of a loan that was previously extended to the trust. Can the transfer of property by the trust to the capital beneficiary settle the debt owing to the beneficiary and also constitute a rollover pursuant to subsection 107(2) of the Act?

CRA Response

For purposes of this response, it is assumed that:

1. the trust would not elect pursuant to subsection 107(2.001);
2. the trust is not subject to paragraph 104(4)(a);
3. subsection 107(4.1) is not applicable; and
4. the capital beneficiary is resident in Canada.

In general terms, subsection 107(2) of the Act applies to a distribution of property by a personal trust to a beneficiary in satisfaction of their capital interest in the trust. The term "capital interest" is defined in subsection 108(1) of the Act. The definition refers to the "rights of the taxpayer as a beneficiary under the trust".

The discussion by Justice Bonner of the Tax Court of what constitutes a "distribution" for purposes of subsection 107(2), in paragraph 13 of his decision in the case of *Chan v The Queen* (99 DTC 1215), is notable:

> The word "distribute" in the context of subsection 107(2) refers to an allotment of trust property to a beneficiary in accordance with his proportionate share. Such a distribution,

being an action taken by the trustee in response to fiduciary duty, is one for which consideration cannot be exacted except in accordance with a provision in the trust deed.

Under the law of equity, fiduciary duties are imposed on a trustee and are enforceable by the beneficiaries of a trust. In our view, the settlement of the debt owing by the trust to the beneficiary would not constitute a distribution undertaken by the trustee under a fiduciary duty to a beneficiary qua beneficiary, but rather, the fulfilment of requirements imposed on a debtor.

It cannot be said that a transfer that settles a debt can also constitute a distribution for purposes of subsection 107(2) of the Act. In order for both a distribution for purposes of subsection 107(2) and a settlement of debt to occur, it is our view that two transfers of property must occur. The settlement of the debt by the transfer of property to the creditor does not occur by virtue of rights of the holder of the interest as a beneficiary under the trust. It occurs by virtue of the rights held as a creditor.

QUESTION 9. <u>Interest and Penalties on Deficient Instalments of Inter Vivos Trusts</u>

In response to question 20 at the 2010 STEP Canada National Conference, the CRA noted that under the current administrative policy, the CRA does not assess installment interest and penalties where an inter vivos trust does not make installment payments required under section 156.

Can CRA confirm this is the current policy?

CRA Response

Under current administrative practices, the CRA does not assess penalties or interest where an inter vivos trust fails to make sufficient instalment payments. In preparation for the introduction of the new trust rules announced in Budget 2014, all associated administrative practices of the CRA are being examined. It is expected that any changes to these practices will be introduced in conjunction with the new rules and communicated in a clear and transparent manner.

Budget 2014 proposed, among other trust related measures, that testamentary trusts (other than estates for their first 36 months) and grandfathered inter vivos trusts will not benefit from the exemption from the tax instalment rules. This proposed measure will apply to the 2016 and subsequent years.

QUESTION 10. Cancellation of Immigrant Trust Exemption

The February 11, 2014 Federal Budget proposes to terminate the exemption in the non-resident trust rules (Section 94) for a contributor who has not been resident in Canada for 60 months. This exemption currently allows a Canadian resident individual to transfer property to a non-resident trust without that trust being deemed Canadian resident until such time as the individual had been a resident in Canada for 60 months in aggregate.

Both the previous version of Section 94 and the current version provide that a trust will be deemed resident as of the beginning of its taxation year, which for an inter vivos trust would be January 1.

To illustrate this, suppose that an individual, who was never previously Canadian resident, became resident on August 1, 2009. Assuming the individual remained Canadian resident thereafter, he or she would be resident for 60 months as of August 1, 2014. A non-resident trust to which the individual has made a contribution would be deemed resident under Section 94 in 2014, as of January 1.

Do you agree with this analysis?

CRA Response

The Department of Finance 2014 Budget Plan Annex 2 - Tax Measures: Supplementary Information provides the following statements:

> Budget 2014 proposes to eliminate the 60-month exemption from the deemed residence rules, including related rules that apply to non-resident trusts.
>
> This measure will apply in respect of trusts for taxation years:
>
> - that end after 2014 if (i) at any time that is after 2013 and before Budget Day the 60-month exemption applies in respect of the trust, and (ii) no contributions are made to the trust on or after Budget Day and before 2015; or
> - that end on or after Budget Day in any other case.

Paragraphs 28 & 29 of the Notices of Ways and Means Motions in Annex 2 of the Budget Plan detail the draft legislation in this regard. Provided the legislation is enacted as drafted we agree with your analysis as the 60 month exemption period would otherwise end in 2014, after the Budget Day.

To further illustrate, in a case where the 60 month exemption would otherwise expire in 2015 (i.e., same example as above except the individual became resident on August 1 of 2010) and no contributions were made to the trust on or after Budget day and before 2015, the measure would apply for the trust's taxation year beginning January 1, 2015 and ending December 31, 2015. If however, contributions were made to this trust on or after Budget Day, even though the 60-month time period would not expire until after 2014, the measure would be effective for the taxation year ending December 31, 2014 and this trust would be deemed resident in Canada pursuant to subsection 94(3) of the Act, for the purposes outlined therein, with effect from January 1, 2014.

QUESTION 11. **<u>Cancellation of Immigration Trust Exemption for New Immigrants</u>**

If the immigrant trust exemption is withdrawn, it would appear that a non-resident trust could be deemed to be resident in the year that an individual who is a contributor becomes resident, and as of January 1 of that current year.

Consider the case of the new immigrant to Canada, who, many years ago in his or her foreign jurisdiction established a trust. The individual becomes Canadian resident say as of August 1, 2015. As a result of the termination of the "immigrant trust" exemption, the foreign trust would be deemed Canadian resident as of January 1, 2015, which pre dates the person's actual arrival to Canada by 7 months.

Do you agree with this analysis?

CRA Response

As is noted in Annex 2 to the 2014 Budget Plan, the Department of Finance proposes to eliminate the 60-month exemption from the deemed residence rules, including related rules that apply to non-resident trusts. In the above-described situation, it will be a question of fact whether the foreign trust is a deemed resident trust pursuant to subsection 94(3) of the Act, or is determined to be factually resident in Canada, when the individual who established the trust immigrates to Canada. For purposes of our response, it is assumed that the trust has always been factually resident in the foreign jurisdiction and remains so following the immigration of the settlor.

Paragraph 94(3)(a) generally provides that if at a specified time in a non-resident trust's taxation year, there is a resident contributor to the trust, or a resident beneficiary under the trust, the trust is deemed resident in Canada throughout the taxation year for the purposes listed in subparagraphs (i) through (x). Note that paragraph 94(4)(d) provides that the application of paragraph 94(3)(a) does not deem the trust to be resident in Canada for the purpose of applying subsection 128.1(1).

Given that the immigrant settled property on the trust, he or she will be a "contributor" to the trust, as defined in subsection 94(1). Assuming that the trust was not created before 1960, upon becoming resident in Canada on August 1, 2015, the immigrant would be a "resident contributor" to the trust (pursuant to the proposed amendment to that definition in the 2014 Budget). Accordingly, the trust will be deemed resident in Canada from January 1, 2015.

QUESTION 12. Non-Resident Trusts and Section 94

A non-resident trust will be deemed to be resident in Canada for many purposes of the Act if it has a "resident beneficiary" or a "resident contributor" (as these terms are defined in section 94). The term "resident beneficiary" means a person (other than a successor beneficiary or exempt person) that is a beneficiary under the trust if at that time the person is resident in Canada and there is a connected contributor to the trust. The term "connected contributor" is also defined in the Act.

Suppose that an individual dies leaving a Will in which the deceased establishes a trust for the benefit of a US resident child and upon the death of the US resident child, a gift over to that deceased child's children (the deceased's grandchildren). The executor of the Will is a resident of Canada, and administers the Will in Canada by, for example, gathering the deceased's assets, discharging his liabilities and paying out specific bequests and legacies. The estate may continue in existence for some time after the child's trust is funded, dealing with tax matters and unadministered assets. However the trustee of the child's trust is resident in the US and central management and control of the trust will be (is) located in the US. There is no person (other than a successor beneficiary or exempt person) who is a beneficiary (i.e. beneficially interested) under the child's trust who is resident in Canada.

Although the deceased will be classified as a "connected contributor" to the trust for purposes of section 94, since there are no Canadian residents "beneficially interested" in the

Trust, there will not be a "resident beneficiary". Thus, the trust will not be deemed resident in Canada by virtue of the "resident beneficiary" test.

Despite this conclusion, for the purposes of section 94 it is possible to have multiple contributors to the same Trust. For example, paragraph 94(2)(n) provides that a contribution made at any time by a particular trust (which would include an estate) to another trust is deemed to have been made at that time jointly by the particular trust and by each person that is at that time a contributor to the particular trust.

Is the deceased's estate considered to be a contributor to the child's trust or is the only contributor the deceased himself?

CRA Response

Generally, by virtue of the definition of "trust" in subsection 248(1), an estate is a trust under the Act. For purposes of the non-resident trust rules in section 94, the "trust" definition in subsection 94(1) clarifies that, for greater certainty, a reference to a trust includes an estate. In order to determine if the deceased's estate in the given scenario is considered to be a contributor to the child's trust, one must consider the definitions of "contributor" and "contribution" in subsection 94(1) of the Act.

A "contributor" to a trust at any time means a person, other than an exempt person but including a person that has ceased to exist, that at or before that time has made a "contribution" (within the meaning assigned by subsections 94(1) and (2)) to the trust.

Pursuant to the definition of "contribution" in subsection 94(1), a contribution to a trust by a particular person or partnership includes a transfer or loan (other than an arm's length transfer) of property to the trust by the particular person or partnership.

Pursuant to paragraph 94(2)(g), when the child's trust acquires its interest in the deceased's estate, the estate will be deemed to have transferred the interest to the child's trust. Accordingly, the deceased's estate will be considered to be a contributor to the child's trust.

Furthermore, pursuant to paragraph 94(2)(n), "a contribution made at any time by a particular trust to another trust is deemed to have been made at that time jointly by the particular trust and by each person or partnership that is at that time a contributor to the particular trust…". Therefore, in the given instance, the deceased is also considered to be a contributor to the child's trust.

QUESTION 13. Voluntary Disclosures

We understand that voluntary disclosures that cover more than ten taxation years have been held in "limbo" as a result of the findings in *Bozzer v. The Queen* [2011 FCA 186]. We are told that the voluntary disclosures officers are awaiting direction from head office in Ottawa to determine how to deal with voluntary disclosures that exceed ten years. Can you please advise when CRA will make a determination on how to deal with these situations?

CRA Response

Voluntary disclosures that cover more than ten taxation years are currently being processed by the Voluntary Disclosure Programs (VDP) offices in accordance with the Federal Court of Appeals decision in *Bozzer v. Queen* (2011 FCA 186); the limitation period in subsection 220(3.1) of the Income Tax Act provides the Minister with the discretion to waive or cancel interest that accrued within the last ten calendar years, from the year the request was made, notwithstanding the taxation year from which the debt arose.

For more information on the VDP please consult the CRA's web page at www.cra-arc.gc.ca.

QUESTION 14. Registration of Tax Preparers

Question (a)

Recently, the United States government lost its appeal of the decision in *Sabina Loving et al v IRS et al*, which in essence, states that the IRS has no legal authority to regulate the tax preparation industry. Does the CRA have any comment on how this recent decision might impact the RTPP in Canada?

Question (b)

Can the CRA provide an update on its consultations on the RTPP?

CRA Response (a)

In 2010, the IRS launched the Tax Return Preparer Initiative. The initiative was designed to ensure that all preparers of individual income tax returns have a minimum level of competency and adhere to professional standards, with an overarching objective of better service to taxpayers and increased compliance.

Under the initiative, the IRS began phasing in a multipronged strategy. This strategy included requiring individuals to obtain a Preparer Tax Identification Number (PTIN) from the IRS if they prepare all, or a substantial portion of, any federal tax return or refund claim for compensation. The initiative also required all paid preparers of individual income tax returns who are not CPAs, attorneys or enrolled agents to pass a competency exam and complete annual continuing education requirements related to tax law and professional conduct. Preparers who passed the test, held a valid PTIN, and completed 15 hours of continuing education each year would be given a new designation – Registered Tax Return Preparer.

The phased implementation of the return preparer program stalled in January 2013 when the U.S. District Court for the District of Columbia issued an injunction in the case of Loving vs. IRS that prevented the agency from enforcing the regulatory requirements for competency testing and continuing education. The court said that the IRS lacked statutory authority to impose those requirements on return preparers. The court later clarified that the injunction did not apply to the requirement that all paid return preparers obtain a PTIN, acknowledging that the IRS has that authority under section 6109 of the Internal Revenue Code.

Further action in the case occurred on February 11, 2014, when the U.S. Court of Appeals for the District of Columbia Circuit upheld the lower court's decision. The IRS is continuing to assess the scope and impact of the Court's decision while consideration is given to options for appeal.[3]

The proposed Canadian program, referred to as the Registration of Tax Preparers Program (RTPP), will not introduce tax competency standards or professional development standards. What this means is that tax competency testing and continuing education requirements will not be applicable.

At this time, the CRA does not feel that it is necessary to introduce standards, especially, since some are already in place among the professional accounting associations. By registering tax preparers, the CRA will be able to fulfill the goal of the RTPP — to identify which tax preparers are making errors and to work with them to prevent these errors before the tax return is filed.

The CRA will also ensure that the necessary legislative or regulatory requirements are appropriately addressed prior to implementation of the RTPP.

CRA Response (b)

On January 17, 2014, Minister Kerry-Lynne Findlay announced the introduction of a new three-point plan to improve compliance and provide support to the small and medium-sized business

[3]Explanation taken from written testimony of John A Koskinen, Commissioner Internal Revenue Service before the Senate Finance Committee on Regulation of Tax Return Preparers April 8, 2014 with minor editing changes.

community. As part of this initiative, the Minister launched a consultation process with taxpayers and the tax preparer community on the proposed Registration of Tax Preparers Program (RTPP), an important component of the CRA's new and innovative approach to its compliance programs.

The RTPP focuses on working with tax preparers to prevent errors when tax returns are filed. Under the proposed RTPP, tax preparers who prepare individual and corporate income tax returns for a fee would be required to register with the CRA. Registration would allow the CRA to identify where errors are being made and work with the tax preparer, using a strategic compliance approach, to correct these errors before the tax return is filed.

The tax preparer community has been highly engaged in the consultations, offering extensive feedback and suggestions on the following nine key issues which are critical to the design of the RTPP:

1. The reasons why errors are found in income tax returns that are prepared by tax preparers.
2. Who would be required to register, and the challenges that may represent for the tax preparation industry.
3. The need for both a personal and entity identification number.
4. The publication of a list of registered tax preparers.
5. The strategic compliance approach.
6. Possible sanctions.
7. The redress process.
8. The types of services that would enhance the overall completeness and accuracy of tax returns.
9. The compliance burden for individual tax preparers and tax preparation businesses associated with the proposed registration program.

Feedback has been received through the seven in-person discussion sessions that were held in February 2014, the on-line feedback form, as well as written correspondence.

The consultation period continues until May 31, 2014 and all stakeholders are encouraged to provide input via the on-line feedback form or in writing. A final report on the results of the consultation process will be issued to the public in summer 2014.

QUESTION 15. <u>Restrictive Covenants</u>

In very general terms, the rules concerning restrictive covenants are divided into two categories, the first being where there is no consideration for the restrictive covenant, and the second being where there is consideration. The rules applicable to situations where there is no consideration are generally more widely applicable. However, a restrictive covenant is normally structured as a contract, and a contract requires that consideration be given by the parties. Accordingly, it would be common in drafting a restrictive covenant to state that the consideration is the sum of $1 and other valuable consideration etc. In these circumstances, does the fact that a contract of a restrictive covenant stipulates the amount of $1 mean that there is consideration, such that the elections, provided under subsection 56.4(7) are inapplicable? Is CRA prepared to accept that a nominal sum, merely to constitute a contract which is legally binding, does not constitute proceeds allocated to the restrictive covenant for this purpose?

CRA Response

While we understand that a nominal amount of consideration may be given by the parties in a contract relating to a restrictive covenant to ensure that the contract is legally binding, it is the CRA's view that this would still constitute an amount of proceeds received or receivable by the particular party for granting the RC. As such, the exceptions set out in subsections 56.4(6) and (7) could not apply because the respective conditions in paragraph 56.4(6)(e) and paragraph 56.4(7)(d) would not technically be met. In such cases, the amount of proceeds (or any additional amount deemed by paragraph 68(c)) received or receivable by the taxpayer for the RC would be taxable as ordinary income under subsection 56.4(2) unless one of the three exceptions in subsection 56.4(3) otherwise applies.

As such, taxpayers seeking relief in these circumstances may want to contact the Department of Finance Canada to outline their concerns on this issue.

QUESTION 16. <u>Stock Options at Death</u>

Paragraph 7(1)(e) provides that where an employee has died and the employee held unexercised stock options prior to their death, a benefit equal to the value of the stock options immediately after death minus any amount paid to acquire the options, is deemed to

be received by the employee in the year of death. Since the benefit is deemed to arise based on the value immediately before death, if these rights are unvested, such that after death they disappear, but before death they would have a value (ignoring a discount which might arise if death could be foreseen), what is the result that is obtained? Is it permissible to take the position that the unexercised and unvested stock option right, is disposed of by the taxpayer's legal representative, such that a loss carryback can result under the election contained in subsection 164(6.1), or is this provision inapplicable because the taxpayer's estate never obtains the unvested stock option right (it was extinguished at death), and therefore the estate never acquired it and cannot dispose of it?

CRA Response

Paragraph 7(1)(e) provides that where an employee has died and the employee owned unexercised stock options prior to their death, the employee is deemed to have received an employment benefit in the year of death. The employment benefit is equal to the value of the stock options immediately after death less any amount paid by the employee to acquire the options. Where the terms of the owned unexercised stock option provide that the stock options are automatically cancelled in the event of the employee's death, the value of the options immediately after death, and the paragraph 7(1)(e) benefit, will be nil. If the employee stock options are not vested prior to the employee's death, the employee would not own unexercised stock options prior to their death and paragraph 7(1)(e) would not apply.

Where an employee owns unexercised stock options prior to their death and the terms of the stock option provide that the deceased's estate may exercise the stock option during a limited period after the employee's death, the provisions of subsection 164(6.1) may apply. Subsection 164(6.1) is intended to provide relief where a stock option is exercised, expires, or is otherwise disposed of within the first taxation year of the deceased taxpayer's estate and the value of the stock option has declined since the employee's death, such that the benefit realized by the deceased's estate is less than the benefit deemed by paragraph 7(1)(e) to have been received by the deceased taxpayer. If the legal representative of the deceased elects in prescribed manner, an amount is deemed to be a loss from employment of the deceased taxpayer for the year of death. The amount of the loss is determined under paragraph 164(6.1)(a).

QUESTION 17. Capital Interest in a Trust – Is it "Eligible Property"?

A taxpayer holds a capital interest in a personal trust. The taxpayer is contemplating transferring the capital interest to a corporation if the transaction can be done by way of a section 85 rollover. Can the capital interest qualify as eligible property for purposes of the rollover rules in section 85 of the Income Tax Act?

CRA Response

For purposes of this response, it is assumed that the taxpayer holds a "capital interest", as defined in subsection 108(1) and that the trust is a "personal trust", as defined in subsection 248(1) of the Act.

Subsection 85(1.1) provides the definition of the term "eligible property" for the purposes of the rules under subsection 85(1) which allow a transfer on a tax-deferred basis of eligible property by a taxpayer to a taxable Canadian corporation. For the purposes of subsection 85(1), "eligible property" includes, *inter alia*, "a capital property (other than real property, or an interest in or an option in respect of real property, owned by a non-resident person)". Further, pursuant to paragraph (b) of the definition of "capital property" in subsection 54(1) of the Act, capital property means "any property (other than depreciable property), any gain or loss from the disposition of which would, if the property were disposed of, be a capital gain or a capital loss, as the case may be, of the taxpayer." The definition of property in subsection 248(1) includes a right of any kind whatever.

A "capital interest" in a trust is defined in subsection 108(1) to mean all rights of a taxpayer as a beneficiary under the trust other than an income interest in the trust. Subsection 107(1) of the Act contains special rules applicable to the disposition of a capital interest in a trust. Note that paragraph 107(1)(a) provides for the computation of a taxpayer's capital gain, if any, from the disposition of a capital interest in a personal trust. It will, however, be a question of fact whether a capital interest in a personal trust is a capital property of a taxpayer.

Accordingly, in our view, the capital interest in a personal trust will qualify as "eligible property" pursuant to subsection 85(1.1) and for the purposes of subsection 85(1), provided it is a capital property of the taxpayer.

QUESTION 18. <u>Electing to have Subsection 107(2.1) Apply</u>

Subsection 107(2) provides the rules for the "rollout" of the property of a personal trust to a beneficiary under the trust in full or partial satisfaction of the beneficiary's capital interest in the trust. In certain circumstances a trust resident in Canada may elect out of the rules in subsection 107(2) by filing an election under subsection 107(2.001) such that the rules in subsection 107(2.1) apply to the disposition. Subsection 107(2.11) provides that where a trust resident in Canada makes a distribution to a beneficiary to which subsection 107(2.1) applies, the trust can file an election for certain distributions with the result that the gains will be included in income of the trust rather than the beneficiary. As well, a beneficiary of a non-resident trust may elect out of the rules in subsection 107(2) by filing an election under subsection 107(2.002) such that the rules in subsection 107(2.1) apply to the disposition.

We have the following questions in respect of the subsection 107(2.001), (2.11), and (2.002) elections:

a) **Does the 107(2.001) election apply to all the property distributed to a beneficiary in full or partial satisfaction of the beneficiary's capital interest in a trust or can the trust make the election on a property by property basis?**

b) **Subsections 107(2.001), (2.11) and (2.002) each require an election to be made in prescribed form. As there are no prescribed forms available, how should each election be made?**

CRA Response (a):

Subsection 107(2.001) applies where a trust makes a distribution of a property to a beneficiary of the trust in full or partial satisfaction of the beneficiary's capital interest in the trust. Subsection 107(2.001) allows the trust to elect out of the rules in subsection 107(2) where:

(a) the trust is resident in Canada at the time of the distribution,

(b) the property is taxable Canadian property, or

(c) the property is capital property used in, eligible capital property in respect of, or property described in the inventory of a business carried on by the trust through a permanent establishment (as defined by regulation) in Canada immediately before the time of the distribution.

If the election under subsection 107(2.001) is made, the distribution is subject to the rules in subsection 107(2.1) of the Act. Where subsection 107(2.1) applies the trust is deemed to have disposed of the property for proceeds equal to fair market value. The beneficiary will be deemed to have acquired the property at a cost equal to those proceeds, and generally, the beneficiary will be treated as having disposed of the capital interest for an amount equal to the fair market value of the property less any capital gain realized by the trust.

Subsection 107(2.001) refers to a "distribution of a property to a beneficiary". The words "a property" refers to a singular property, such that the election can be used in respect of only one property of all the property distributed. For example, if the property being distributed is shares of a corporation, the trust may elect in respect of a single share out of all the shares being distributed to the beneficiary in settlement of his capital interest or part thereof to the extent that the conditions in subsection 107(2.001) are otherwise met. Note, however, that this election cannot be made in respect of a fraction of a share unless the share was legally subdivided prior to the distribution date.

CRA Response (b)

The filing requirements for each of the 107(2.001), (2.11), and (2.002) election is provided below:

Subsection 107(2.001) election

Subsection 107(2.001) requires the election to be made by the trust in prescribed form filed with the trust's return of income for the year in which the distribution occurred. As a prescribed form is not available for the election, a letter should be filed with the trust's T3 Trust Income Tax and Information Return for the year the distribution occurs, setting out all the pertinent information in respect of the distribution. A list of the information that should be included in the letter is provided on page 31 of the 2013 T3 Trust Guide which is available on the CRA website at http://www.cra-arc.gc.ca/E/pub/tg/t4013/t4013-13e.pdf. That information is reproduced below:

The letter should include the following information:

- a declaration to elect under subsection 107(2.001) of the Act;
- name of the trust;
- trust account number;
- type of trust;
- trust's tax year end date;
- residency status of the trust, (resident trust or non-resident trust);

- if applicable, the date the trust became a resident of Canada in the year;
- if applicable, the date the trust became a non-resident of Canada in the year; and
- name, address and signature of trustee making the election.

Subsection 107(2.11) election

Where a trust resident in Canada makes one or more distributions in the year to which subsection 107(2.1) applies the trust may elect under subsection 107(2.11) not to have subsections 104(6) and (13) apply to certain distributions (other than distributions of cash denominated in Canadian dollars).

The election filed under subsection 107(2.11) must be filed in prescribed form with the trust's return for the year or preceding taxation year. As a prescribed form is not available the trust should include the following information in a letter attached to the T3 Trust Income Tax and Information Return:

- a declaration to elect under subsection 107(2.11) of the Act;
- the name of the trust;
- the trust account number;
- the name of the beneficiary to whom the distribution is being made and whether the particular beneficiary is a resident or non-resident of Canada;
- a description of the property distributed to the beneficiary;
- the adjusted cost base of the property to the trust; and
- the fair market value of the property at the time of distribution.

Subsection 107(2.002) election

Where a non-resident trust makes a distribution of a property (other than property described in paragraphs 107(2.001)(b) and (c) of the Act) to a beneficiary in full or partial satisfaction of the beneficiary's capital interest in the trust, the beneficiary may make an election under subsection 107(2.002) to elect out of the rollover rules in subsection 107(2) such that the rules in subsection 107(2.1) apply.

Where the beneficiary makes the subsection 107(2.002) election, the election must be filed with the beneficiary's return of income for the taxation year in which the non-resident trust distributes the property. As there is no prescribed form available for the subsection 107(2.002) election, the beneficiary should attach a letter to their return of income for the year in which the non-resident trust distributes the property. Where the beneficiary files their return of income electronically, the election should be sent to the CRA separately. The letter should include the following information:

- a declaration to elect under subsection 107(2.002) of the Act;
- the name and address of the beneficiary;
- the beneficiary's CRA identification number (for example, social insurance number, business number etc.);
- the taxation year;
- a description of the property being distributed in satisfaction of the capital interest in the trust;
- the cost amount of the property to the trust;
- the fair market value of the property at the time of the distribution;
- the adjusted cost base of the beneficiary's capital interest in the trust;
- description and name of the trust;
- name and address of the trustee(s); and
- country of residence of the trust.

Under paragraph 107(2.002)(b), the cost amount of the capital interest to the beneficiary is deemed, for purposes of subparagraph 107(1)(a)(ii), to be nil. Generally, the beneficiary's proceeds of disposition in respect of the capital interest are calculated in accordance with paragraph 107(2.1)(d). The beneficiary will be treated as having disposed of the capital interest for an amount equal to the fair market value of the property, less the portion of the distribution that is a payment to which paragraph (h) or (i) of the definition of "disposition" in subsection 248(1) applies, and any eligible offset as defined in subsection 108(1). As a result, the beneficiary may realize a capital gain on the disposition of their capital interest in the trust.

QUESTION 19. <u>Multiple Assessments</u>

Suppose that a taxpayer carried out a series of transactions, where the tax consequences of each transaction are relevant to the next transaction. CRA believes that the transactions are

inappropriate, and constitute tax avoidance, and accordingly reassesses the transactions, either under specific principles or the general anti-avoidance rule. However, because the transactions depend on one another in a sequence, and there may be some uncertainty as to which transaction should be reassessed in the sequence, CRA reassesses each transaction independent of the other. The result is a series of tax reassessments which cannot all be correct. In addition, the tax involved may be greater than the value of the transaction in all, when viewed from beginning to end, so that it would be impossible for the taxpayer to pay the tax. In addition, of the various reassessments, it is arguable that only one of them, at most, could be correct.

It is noted that CRA may issue reassessments even though they may not be correct, and that these reassessments are not invalidated as a result. However, at the same time, the taxpayer cannot be expected to pay all of the assessments, because that may be impossible.

In these circumstances, what would CRA recommend in order to minimize interest expense? Would the impossibility of paying the full amount of the tax, combined with the fact that only one of the reassessments, at most, can be correct, give rise to a circumstance where a waiver of interest should be considered under the fairness provisions?

CRA Response:

In situations where the Agency believes a transaction or a series of transactions is designed to avoid, defer or reduce taxes and where the result of these strategies would provide a taxpayer with a tax benefit that is contrary to the object and spirit of the tax provisions, the Agency would challenge the result by issuing a reassessment for each relevant tax year. Such a reassessment would first be proposed to a taxpayer in a letter setting out the Agency's understanding of the facts and its views on the application of the Act to those facts and allow time for the taxpayer to provide representations in response.

A proposal may rely on a number of legal and tax provisions as secondary or alternative positions, including specific anti-avoidance provision or the general anti-avoidance rule (GAAR) as provision of last resort, however only one reassessment for a tax year would be issued.

Subsection 152(4) of the Act provides the time limits within which reassessments may be made. A reassessment of a tax year replaces any previous assessments or reassessment for that year and would not result in double or cumulative tax owing. In cases where a taxpayer is subsequently reassessed as a result of an objection or appeal to court, the amount of interest would accordingly be changed.

Subsection 220(3.1) of the Act gives the Minister the discretion to waive or cancel arrears interest, in whole or in part, that accrued within the last 10 calendar years before the year in which the request was made for any tax year debt. This provision also gives the Minister the discretion to waive or cancel any penalty for a tax year that ended within the last 10 calendar years before the year the request was made.

As discussed in Information Circular IC07-1, *Taxpayer Relief Provisions* (at paragraphs 27 and 28), the CRA may provide interest and penalty relief in situations where a taxpayer has a confirmed inability to pay or is experiencing financial hardship related to the balance owed to the CRA.

For an individual taxpayer, financial hardship refers to the financial difficulty that the payment of arrears would cause a taxpayer in being able to provide for reasonable basic living requirements, such as food, medical, shelter or transportation. For a corporate taxpayer, financial hardship refers to situations where the continuity of business operations, the continued employment of the employees, and welfare of the community as a whole would be in jeopardy.

Interest relief may also be provided in circumstances where a taxpayer has made bona fide efforts to pay the balance owed; however, substantial additional interest charges would absorb a significant portion of their payments making it extremely difficult, if not impossible, for a taxpayer to resolve their account within a reasonable amount of time.

A taxpayer is required to make full financial disclosure (with supporting documentation) when requesting interest and penalty relief, so that the CRA can determine a taxpayer's ability to pay the balance owing.

For more information on the Taxpayer Relief Provisions, including details on how to make a request and the types of supporting documentation required, go to www.cra.gc.ca/taxpayerrelief.