1. **The Canada Revenue Agency ("CRA") has a position that an estate refreeze transaction in circumstances where the value of a corporation decreases after the implementation of an estate freeze transaction does not result in the conferral of a benefit on the common shareholder(s) or the preferred shareholder(s) provided that the decrease in value of the corporation is not the result of the stripping of corporate assets and the fair market value ("FMV") of the new preferred shares is equal to the FMV of the old preferred shares at the time of the refreeze.**

   a) **Could you please provide some further guidance with respect to what transactions might be considered to be the stripping of corporate assets.**

   b) **If the corporation initially increased in value after the first freeze, dividends were paid but the value of the corporation was still greater than the value of the preferred shares at that time and then subsequently, the value of the corporation declines below to lower than the initial freeze value, would the decrease in value be considered to be the result of the stripping of corporate assets?**

   c) **Could you please comment upon whether the payment of a bonus or salary to a beneficiary of the freeze who is active in the business would be viewed as the stripping of corporate assets.**

   d) **Would your position be different if the bonus or salary was paid to the beneficiary of the freeze in the ordinary course of the corporation's business or in connection with a post-freeze asset sale by the corporation?**

   e) **What is the effect on the shareholders involved in an estate refreeze if there has been a reduction in the corporation's value as a result of the stripping of corporate assets?**

CRA response to question 1 (a)

The stripping of corporate assets in the context referred to above could be achieved in several ways. While it is very difficult to describe all of them, we can give the following two examples which would preclude the application of the CRA's position in the context of a refreeze transaction:

- Dividends that would be paid by the corporation on the common shares of its capital stock and that would impair the value of the original freeze preferred shares;

- The payment by the corporation of a bonus or salary to the beneficiary of the freeze in connection with a post-freeze asset sale by the corporation, and such a bonus or salary is not commensurate with the value of the services performed and the responsibilities assumed by the beneficiary of the freeze.

CRA response to question 1 (b)

It is not possible to provide a definitive answer to this question as it would require an analysis of all the facts and circumstances related to a given situation. However, as a general comment, we would be inclined to consider that the payment of dividends by a corporation should not preclude the application of the CRA's position, provided that such dividends are paid out of the corporation's retained earnings and that they do not impair the value of the original freeze preferred shares.

However, where a dividend is paid and followed shortly thereafter by a decline in value, the CRA would need to examine, on a case-by-case basis, all the facts and circumstances relating to the particular transaction before taking a final position.

CRA response to question 1 (c)

Again, the answer to this question would require an analysis of all the facts and circumstances related to a given situation. However, as a general comment, the payment of a bonus or salary to a beneficiary of the freeze who is active in the business should not preclude the application of the CRA's position, provided that such a bonus or salary is commensurate with the value of the services performed and the responsibilities assumed by the beneficiary of the freeze.

CRA response to question 1 (d)

As mentioned above, the CRA's position should not apply where the payment by the corporation of a bonus or salary to the beneficiary of the freeze is in connection with a post-freeze asset sale by the corporation, and such a bonus or salary is not commensurate with the value of the services performed and the responsibilities assumed by the beneficiary of the freeze.

CRA response to question 1 (e)

In situations where the CRA's position in the context of a refreeze transaction would not apply, the CRA would examine the potential application of subsections 15(1), 56(2), 69(1), 246(1) and/or 245(2), among others. Furthermore, in cases where the refreeze transaction is not implemented on a FMV basis, the application of subsection 51(2), 86(2) or paragraph 85(1)(e.2) would also have to be considered. Of course, the potential application of these provisions would require an analysis of all the facts and circumstances of a given situation.

2. The CRA has recently taken the position that an amount of income is not payable to a beneficiary unless a promissory note is issued by the Trust to the beneficiaries and on this basis has denied or proposed to deny the deduction by the Trust of income payable to the beneficiary. We submit that it is not a requirement that a promissory note must be issued by the Trust in order for an amount to be payable to a beneficiary.

This appears to relate to a live file involving a discretionary trust which we are unable to comment on, except to say that each case must be based on its facts which must provide proof that "the person to whom it is payable is entitled in the year to enforce payment" (absent subsection 104(18)).

The CRA has published some commentary on this question. For example, in Interpretation Bulletin IT-342R, *Trusts – Income Payable to Beneficiaries*, the CRA explains the meaning of "amount payable" in paragraph 2. It is important to note that pursuant to subsection 104(24), an amount is not considered payable in a taxation year unless it is either paid in the year or the beneficiary is entitled to enforce payment of it in the year.

In Rulings document E9529647, which was issued on February 26, 1997, the CRA made the following comments regarding steps that may be taken to establish that an amount became payable to a beneficiary of a discretionary trust, in the year:

1. With respect to trustees exercising discretion before the end of the year:

    i. In order for the income of a discretionary trust to become payable in a taxation year to the beneficiaries of the trust, the trustees are required to exercise their discretion before the end of the trust's taxation year and the exercise of discretion must be irrevocable with no conditions attached to the beneficiaries' entitlement to enforce payment of the amount in the year. The apportionment of the trust's income to each beneficiary (e.g., all the income, a fixed percentage of the income, or a set amount) must also be established.

    ii. It is our view that the beneficiaries must be advised before the end of the trust's taxation year of the trustees' decision, including the apportionment of the trust's income to which the beneficiary is entitled in the year to enforce payment, even if the actual amount is not known. (In case of a minor beneficiary, the trustees may advise the legal guardian of the child's property of this right.) Although legal rights may exist without being in writing, in our opinion, the trustees' exercise of discretion and notification given to the beneficiaries of their decision should be in writing (e.g., a resolution signed by the trustees, minutes of the trustees' meeting) as failure to do so would result in the trustees and the beneficiaries having to provide the CRA with other satisfactory evidence to support their claim that amounts became payable to the beneficiaries in the year.

    iii. The fact that the actual amount of the income of a trust in a year cannot be ascertained until after the end of the trust's taxation year due to administrative delays in obtaining the necessary information will not, in and by itself, result in an amount apportioned to a beneficiary in the year based on that income not being payable to the beneficiary in the year (as supported by the case *Ginsburg v M.N.R.*, 92 D.T.C. 1774 (T.C.C.)). However, where the income of a trust is not ascertainable at the year end because the amount of such income is dependent on some contingency or event occurring after that time, then based on our response to Question 55 of the Revenue Canada Round Table in the 1981 Conference Report, it is our view that, depending on the circumstances, a beneficiary may not have an enforceable right to demand payment of such an amount in that year.

2. With respect to issuing a promissory note:

    i. Ordinarily, a promissory note is given and received as acknowledgement of the existence of and/or the conditional payment of a debt and does not create the debt.

    ii. A promissory note should only be issued by a trust to a beneficiary as evidence of an amount payable to the beneficiary where the trust indenture (or relevant provincial legislation where the indenture is silent on the issue) permits the trustees of the trust to do so.

    iii. Although a promissory note issued by a trust in respect of an amount payable to a beneficiary may be non-interest bearing, it must be payable on demand without restriction. Where the actual amount that is payable to a beneficiary is known before the end of the trust's taxation year, the promissory note should also be delivered to the beneficiary before the end of the year.

    iv. However, where it is not possible to determine the actual amount that is payable to a beneficiary until after the end of the trust's taxation year due to administrative delays in obtaining the necessary information, the promissory note should be delivered to the beneficiary as soon as the amount is quantified. (Where the beneficiary is a minor and the trust indenture so permits, the promissory note may be delivered to the legal guardian of the minor's property.)

3. It is possible for control of a corporation to be acquired and for an amalgamation of the acquired corporation with one or more corporations to occur on the same day. Both the acquisition of control and the amalgamation results in a year end being triggered and a new taxation year commencing. If no subsection 256(9) election is filed and the applicable amalgamation documents are silent as to the effective time of the amalgamation, would both the deemed year end resulting from the acquisition of control and the deemed year end resulting from the amalgamation occur at the same time being the commencement of the day on which these transactions occur.

This question is similar to one posed at the 2007 APFF Roundtable. At that time we were asked to consider a similar question in relation to the amalgamation of a Pubco with a Holdco to form Amalco, where the three persons who were shareholders of Holdco will control Amalco as the shareholders of Pubco will receive non-voting shares when the corporations amalgamate. We stated that:

> This amalgamation would technically generate two deemed taxation year-ends for Pubco. On the one hand, for purposes of the ITA, the taxation year of Pubco would be deemed to have ended immediately before the amalgamation of Pubco and Holdco pursuant to paragraph 87(2)(a) of the ITA. On the other hand, the group of three persons originally shareholders of Holdco would be deemed to have acquired, immediately before the amalgamation, control of Pubco pursuant to subparagraph 256(7)(b)(ii) of the ITA. Consequently, and in accordance with paragraph 249(4)(a) of the ITA (subject to paragraph 249(4)(c) of the ITA), the taxation year of Pubco that would, but for paragraph 249(4)(a) of the ITA, have included the time of the deemed acquisition of control pursuant to subparagraph 256(7)(b)(ii) of the ITA, would be deemed to have ended immediately before that time. In other words, the deemed acquisition of control of Pubco resulting from the amalgamation would technically generate a deemed taxation year-end with respect to Pubco immediately before the time that is immediately before the amalgamation.

This opinion is set out in Rulings document F2007-0243341C6, issued on October 5, 2007.

4. Proposed subsections 248(35) to (37) set out special rules for determining the FMV of a property that is subject to a charitable gift for purposes of determining the eligible amount of a gift under subsection 248(31). Proposed paragraph 248(35)(b) provides that the FMV of the gifted property is deemed to be the lesser of its FMV otherwise determined and its cost, or in the case of capital property, its adjusted cost base ("ACB") immediately before the gift is made, if one of two conditions are met:

(i) The taxpayer acquired the property that is the subject of the gift less than three years before the day that the gift is made (except if the gift is made as a consequence of death), or

(ii) The taxpayer acquired the property that is the subject of the gift less than ten years before the day that the gift is made (except if the gift is made as a consequence of death) and it is reasonable to conclude that, at the time the taxpayer acquired the gifted property, one of the main reasons for its acquisition was to make the gift.

Proposed subsection 248(37) excludes several types of gifts from the application of subsection 248(35). However, a gift of an interest in a life insurance policy is not excluded from the proposed application of subsection 248(35).

During the CLHIA Roundtable in May 2009, the CRA confirmed that proposed subsection 248(35) could apply to the gift of an interest in a life insurance policy such that the amount that may be receipted would be the lesser of policy's "cost" and its FMV.

Could the CRA provide further guidance as to what factors it would consider in determining the cost of an interest in a life insurance policy for purposes of proposed subsection 248(35)? For example, could the CRA comment on the transfer of an interest in a life insurance policy that is personally owned to a wholly-owned corporation, where the policy has a FMV of $300,000, and no cash surrender value ("CSV"). The deeming rule in subsection 148(7) provides that such a transfer between non-arm's length parties is deemed to occur at CSV or zero in this case. Therefore, where the deemed cost of the interest in the policy to the corporation is zero, but its FMV is $300,000 and subsection 248(35) applies, would the CRA allow the gift which occurs immediately after the transfer to take place at $300,000?

The FMV of an interest in a life insurance policy otherwise determined and the cost of that interest must be considered in applying proposed subsection 248(35) to a gift of an interest in a life insurance policy to a qualified donee.

As stated by the CRA at the CLHIA Roundtable in May 2009, we recognize that the *Income Tax Act (*the "Act") does not specifically define the cost of an interest in a life insurance policy and we have brought this to the attention of the Department of Finance for their consideration.

The "adjusted cost basis" to a policyholder of an interest in a life insurance policy is determined by a formula under subsection 148(9). In general terms, the adjusted cost basis to the original policyholder will be the amount by which the cash premiums paid by the policyholder (excluding premiums for accidental death benefits), and any income in respect of the interest in the policy that has previously been reported for tax purposes, exceeds the "net cost of pure insurance" under the policy.

It is our view that the adjusted cost basis of an interest in a life insurance policy, as defined in subsection 148(9), would generally be a reasonable proxy for the "cost" of an interest in a life insurance policy for purposes of the deemed FMV of a policy under proposed subsections 248(35) and 248(36).

Where subparagraph 248(35)(b)(i) or (ii) applies to the gift of an interest in a life insurance policy, the FMV of the interest in the policy to the donor is deemed to be its cost, and where a person dealing non-arm's length with the donor had acquired the same property within the relevant time, subsection 248(36) will apply to deem the cost of the interest in the life insurance policy for purposes of subsection 248(35) to be the lesser of the cost to the donor at the time of the gift or the cost to the non-arm's length person immediately before the interest in the policy was disposed of by that person.

Where subsection 148(7) applies to deem the cost of the interest in the policy held by the donor to be the CSV and the CSV of that policy is NIL, the deemed FMV of the interest gifted will be deemed to be the lowest of its cost to the donor at the time of the gift, which is NIL, or the cost to the non-arm's length person immediately before the interest in the policy was disposed of by that person. In the example provided, since the cost of the interest in the policy to the donor is deemed to be NIL, the deemed FMV of the gift of the interest in the life insurance policy will also be NIL.

5. In a prior Federal Auditor General Report, a recommendation was made to have financial statements be submitted with a trust's T3 return. We understand that this is something that the CRA has been working on. If you can comment, please provide us with an update of this AG proposal.

The CRA is still in the process of considering options to ensure proper reporting of income and analysing the impact of requiring trusts to include a statement of assets and liabilities with the T3, *Trust Income Tax and Information Return*. Consultations with internal stakeholders are in progress to assess the usefulness of a statement of assets and liabilities, the extent of the burden that this requirement would have on taxpayers and the CRA, and the value of imposing different requirements for different types of trusts. We will update you as additional information becomes available.

6. On February 26, 2010, the Department of Finance ("Finance") released new tax proposals to accommodate Employee Life and Health Trusts ("ELHT"). The proposals (which, if passed, will apply for 2010 forward) create a new type of taxable *inter vivos* trust that will enable funds to be accumulated within the ELHT by employer contributions for the benefit of employees' health benefits. It would appear that these proposals will replace the administrative material in Interpretation Bulletin IT-85R2, *Health and Welfare Trusts for Employees*. Can you please confirm the CRA's intent to withdraw IT-85R2 if the ELHT proposed legislation is passed.

The CRA is currently considering the impact of the proposed ELHT legislation on the administrative regime authorizing health and welfare trusts ("HWT") as set out in IT-85R2, dated July 31, 1986.

Over the years, the CRA has identified tax issues involving the use of HWTs, primarily in non-arms' length shareholder/employee situations. Examples include the use of offshore trusts and over-funding of benefits through lump sum payments by employers. Further information is contained in ITTN No. 25. We initially attempted to address these issues in a 2005 draft version of IT-85R3; however, the feedback received indicated the issues were more complex than they initially appeared and the draft was set aside. However, the CRA remains diligent in ensuring that HWTs fully comply with the administrative regime.

Finance has now released draft legislation on ELHTs which will give effect to the CRA's administrative position in IT-85R2 and deal with the tax issues previously identified by the CRA. As you know, Finance invited comments on the proposed legislation, to be submitted by April 30, 2010. These comments will be reviewed and considered and until that process is complete, it remains possible that the proposed legislation will be amended further. Any such amendments may have an impact on the factors relevant to the review of the interaction between the ELHT and the HWT regime. Given that the draft legislation on ELHTs only applies to trusts created after 2009, it appears there is still a need for the administrative guidance set out in the bulletin.

Consequently, at this point we are not in a position to comment definitively on the effect the ELHT legislation may have on HWTs and there are no plans to withdraw IT-85R2.

7. A recent Federal Auditor General Report was very critical of the significant delay in how federal income tax legislation is introduced into law. Assuming that Finance responds to this criticism and is able to get the significant back-log of technical amendments passed into law, can the CRA generally comment on how it intends to deal with the amendments that have a retroactive effect. For example, proposed section 56.4 (restrictive covenant draft legislation), very generally, will apply retroactive to October 7, 2003. Assuming that the subject matter is

not statute barred, will the CRA be actively reviewing prior transactions for compliance with newly enacted legislation that has retroactive effect?

It is the CRA's longstanding practice to ask taxpayers to file on the basis of proposed legislation. This practice eases both the compliance burden on taxpayers and the administrative burden on the CRA. If a taxpayer did not file on the basis of proposed legislation and the law has been enacted, the taxpayer would be expected to act promptly to bring his/her affairs into accordance with the law.

As part of its normal audit activities, the CRA may review prior transactions for compliance with the Act. Where a taxpayer did not comply, the CRA will reassess the taxpayer as authorized under the Act.

8. The *Garron* case looked at the concept of mind and management with respect to determining the residence of a trust. This was relevant in the context of a non-resident trust. Does the CRA confine these cases to their facts, or do they represent general principles? Does the CRA propose to apply a similar concept in dealing with Canadian resident trusts, which might, for example, have provincial tax implications? Has the CRA's audit methodologies or assessing practices changed for trusts in light of the *Garron* decision?

It has been the longstanding position of the CRA that, as is noted in Interpretation Bulletin IT-447, *Residence of a Trust or Estate*, the residence of a trust or estate in Canada, or in a particular province or territory within Canada, is a question of fact to be determined according to the circumstances in each case. This continues to reflect the current position of the Agency.

9. In the U.S., the Inland Revenue Service has made extensive use of disclosure of names from foreign banks about accounts of U.S. citizens (or residents) with foreign funds. It appears that in some cases such accounts have not been declared. Does Canada have an initiative to pursue these avenues, to obtain names of Canadian residents with offshore funds in similar circumstances? If so, what is the status of this initiative?

The CRA continues to pursue those taxpayers who have undisclosed income and assets hidden in offshore banks. A number of Unnamed Persons Requirements for information specifically linked to bank secrecy jurisdictions have been served on domestic financial institutions. More of such requirements are anticipated as the CRA gains a better understanding of the telltale signs left in the financial system by those who seek to hide assets offshore.

Beyond this, the CRA is making use of the Exchange of Information provisions of Canada's tax treaties to identify offshore accounts controlled by Canadians. The abusive use of bank secrecy jurisdictions is a challenge faced by many countries. Through the effective use of tax treaty information exchange provisions, countries can assist each other in addressing these abuses.

10. It seems that certain countries (Germany in particular) have obtained information on account holders in foreign jurisdictions. In one circumstance that we know of, it seems this information was stolen. Would the CRA under such circumstances make use of this information

- **a) If it was provided for free?**
- **b) If the CRA had to pay for the information?**

While we cannot comment on the specifics of any case, the CRA receives information from many sources that can result in enforcement activities to ensure taxpayers are in compliance with the tax laws. The CRA does not pay for information and does not tolerate non-compliance in the tax system.

Foreign banks are governed by legal structures within their own countries. Many of these foreign banks are not legally permitted to share information on their clients. This presents a significant challenge in the CRA's efforts to identify Canadians who are breaking the law and hiding income in offshore accounts.

A key to tackling the abusive use of tax havens is the exchange of tax information between countries. To that end, Canada is working to increase the flow of information through negotiations of tax information exchange agreements, renegotiations of existing treaties, and enhancing administrative arrangements with other countries. The CRA is using the knowledge gained from its audit work and treaty partners to identify taxpayers who have participated in the abusive use of tax havens.

11. Recently, the CRA has commenced an audit program of trust returns. Field auditors have explained that this has resulted from the Auditor General's findings that there has not been sufficient audit work done on trusts.

- **a) Is this a national initiative or region specific?**
- **b) What are the CRA's areas of concern in respect of trust taxation?**
- **c) Has the CRA noted in their examination any recurring problems in respect of tax compliance of trusts that STEP could report to its members, to improve trust tax compliance?**

CRA response to question 11 a)

The mandate of the CRA's national verification programs is to enhance compliance with the tax laws of Canada, including those related to trusts. Trust audits have been and continue to be conducted on a regular basis and a national project was initiated in 2005-2006 fiscal year to gather additional information to aid in the development of a comprehensive compliance strategy for trusts resident in Canada. The project was completed in 2007-2008 fiscal year.

CRA response to question 11 b)

One of the CRA's areas of concern in respect of trust taxation is the lack of information collected from trusts. Additional information would allow for a better evaluation of the relative tax at risk for the trust sector as a whole. As such, the CRA is currently determining what current and additional information will be required from trusts to balance the optimization of risk evaluation, utilization of information currently available to the CRA and reporting burden on the trust community.

CRA response to question 11 c)

Results of the project have indicated recurring issues in the following areas:

- Deduction of trustee fees and investment counsel fees not incurred in the earning of income.
- Transactions entered into to change the character of income to avoid tax on split income, also known as Kiddie Tax.
- The use of abusive transactions to take advantage of the capital gains exemption through the use of trusts.
- Settling of multiple trusts to lower provincial taxes payable.

- Allocations to minor beneficiaries, which do not qualify as paid or payable.
- Non-compliance with the attribution rules.

12. The CRA seems to be challenging plans which have the effect of withdrawing funds from Canadian corporations at capital gains tax rates, rather than through dividends. Under what circumstances would the CRA challenge such arrangements on the basis of GAAR?

If such an arrangement is challenged on the basis of GAAR, what is the treatment which the CRA would use to re-characterize the capital gain, and, under what circumstances would it be considered an eligible dividend.

In determining whether abusive tax avoidance exists where funds are extracted from Canadian corporations at capital gain rates rather than through dividends, the CRA will review the object, spirit and purpose of the provisions relied upon by the taxpayer together with other related provisions in light of their respective purposes and statutory schemes to allegedly strip a corporation of its surpluses, and determine whether the arrangement results in a breach of the legislative intent underlying the applicable provisions. Abusive tax avoidance may also result from an arrangement that circumvents the application of specific anti-avoidance provisions in a manner that frustrates or defeats the object, spirit and purpose of those provisions.

It is the CRA's view that the Act, read as a whole, provides that a distribution of corporate surplus is to be taxed as a taxable dividend on the basis of the legislative history of section 39, the object, spirit and purpose underlying specific anti-avoidance provisions such as subsection 84(2), sections 84.1 and 212.1 as well as former subsection 247(1), which was repealed further to the introduction of the GAAR.

If a capital gain arising from an arrangement is re-characterized as a dividend under subsection 245(5), the dividend will not qualify as an "eligible dividend" as the requirements listed in subsection 89(14) would not be satisfied.

13. Where a donation is made by will, it is considered to be a donation of the deceased. However, as a practical matter, sometimes the donations are not made by the due date for filing the terminal return. In these circumstances, what is the recommended practice? Does one submit the donation receipts made up to the time of filing, and then amend the return afterwards, or does one claim a donation equal to the amount stipulated in the will, and subsequently provide the receipts?

What would happen if the donation is stated to be a portion of the residue of the estate? How does one determine the amount of the donation? For example, suppose at the time of death the value of the properties that ultimately comprise the residue of the estate total, say, $500,000, but in the intervening period from death to the time when the property is delivered to the charity, the assets appreciate to $600,000, such that $600,000 is ultimately received by the charity. Is the donation to be recognized by the deceased $500,000 or $600,000? What happens if the assets depreciate in value?

Also, what happens if the assets to be donated are specified (e.g., 1,000 shares of Publicco)?

When a gift to a registered charity is made pursuant to an individual's will, subsection 118.1(5) deems the gift to have been made immediately before the individual's death for the purposes of section 118.1. These donations should be included in the individual's final return (or in the prior year's return). The requirements for supporting these donations can be found on page 16 of the guide, T4011, *Preparing Returns for Deceased Persons 2009*:

> You can also claim charitable donations made through the will, as long as you support the donations. The type of support you have to provide depends on when the registered charity or other qualified donee will receive the gift:
>
> - For gifts that will be received right away, provide an official receipt.
> - For gifts that will be received later, provide a copy of each of the following:
>   - the will;
>   - a letter from the estate to the charitable organization that will receive the gift, advising of the gift and its value; and
>   - a letter from the charitable organization acknowledging the gift and stating that it will accept the gift.

Please note that the CRA will accept this support on an administrative basis on the understanding that a receipt will be provided by the charity when the gift is actually transferred to the charity. Pursuant to subsection 118.1(2), a receipt in prescribed form is required in order to claim a donation tax credit.

With regard to the amount of the gift, the value that is to be used to determine the eligible amount of the gift for the purposes of proposed subsection 248(31) is the FMV at the time the gift is made, i.e., on the date of death. In situations where the value of the gift cannot reasonably be determined no gift will be allowed. This could be the case, for example, where a specific gift has been designated in the will, but it is unclear if the estate will have sufficient funds available to make the gift after the estate's liabilities have been paid. For additional comments, see Interpretation Bulletin IT-226R, *Gift to a charity of a residual interest in real property or an equitable interest in a trust*.

With regard to the specific examples you provided, in the first case, the value of the residue that is donated would be $500,000. In the second case, the value of the Publicco shares that are donated would be their FMV on the date of death.

14. Could you please provide an update on what people should be doing concerning the FIE rules. Should people be applying current section 94.1, or proposed section 94.1 and in what circumstances?

Budget 2010 has replaced the previously proposed amendments in respect of section 94.1, by returning to the existing provision with modifications. These most recent proposed amendments are subject to a public consultation process before being drafted and tabled in Parliament, but will be applicable for taxation years ending after March 4, 2010. For prior taxation years, the existing legislation applies.

Budget 2010 provides that a taxpayer who voluntarily complied with the previously outstanding proposals will have the option of having those years reassessed or of taking a deduction in its current fiscal year, in both cases considering whether it had reported more income than would have been the case under the existing rules. An individual or trust taxpayer choosing to make an adjustment to a previously filed year, should file a T1 or T3 Adjustment Request, as appropriate. A corporate taxpayer choosing to make an adjustment to a previously filed year should refile its T2 with a letter explaining the request and showing the deduction on its T2 Schedule 1 as an Other Deduction. Please see Information Circulars IC75-7R3, *Reassessment of a Return of Income* and IC07-1, *Taxpayer Relief Provisions* for further information.

An individual taxpayer who chooses to take a deduction in the 2010 taxation year should report the amount on the T1, *Income Tax and Benefit Return* as an Other Deduction on Line 232. A trust taxpayer who chooses to take a deduction in the 2010 taxation year should report the amount on the T3, *Trust Income Tax and Information Return* as an Other Deduction on Line 40. A corporate taxpayer who chooses to take a deduction in its taxation year ending between March 4, 2010 and March 4, 2011, should include the deduction on its T2 Schedule 1 as an Other Deduction.

15. The Act now contains a large number of "comfort letters", where Finance has indicated that amendments will be proposed. In some cases, these comfort letters go back several years. What is the CRA's assessing position with respect to these comfort letters? Will the CRA accept that tax returns can be filed based on these positions, or are they to be ignored until they are passed into law? It was noted that the Auditor General remarked on the delays in enacting legislation, generally of a technical nature, resulting from these comfort letters. Are you aware of any steps being taken to address this issue?

A comfort letter is not proposed legislation and usually only reflects Finance's views on a particular issue affecting a specific taxpayer. Given that our tax system is based on self-assessment, taxpayers may decide to file based on a comfort letter. Generally, the CRA will not reassess taxpayers who filed on the basis of a comfort letter provided they did so in conformity with the comfort letter.

The CRA administers and enforces the laws set out in the Act. Finance is responsible for tax policy and amending the Act. Any questions on when proposed legislation relating to comfort letters will be enacted should be addressed to Finance.

16. The next series of questions deal with foreign currency conversion. It is noted that over the last two years, the Canadian dollar has fluctuated in value considerably against the U.S. dollar, such that many people have large gains and losses from foreign currencies.

Suppose a person has an investment in a U.S. treasury bill. The Treasury Bill is purchased for $99, and matures at $100, yielding $1 of interest over a 90 day period. Further suppose that when the Treasury Bill was purchased, the Canadian dollar was at par, meaning that $99 Canadian was exchanged for $99 U.S. to purchase the Treasury Bill. When the Treasury Bill matures, the Canadian dollar is now at say $.80 U.S., meaning that the $100 on maturity is actually worth $125 Canadian. If the fact scenario involved a Canadian Treasury Bill (i.e., no foreign currency conversion), on maturity, $1 of interest income would be recognized. However, when converted into Canadian dollars, there is a total of $26 of economic gain. How would this gain be apportioned between interest and capital gains?

In our view, the economic gain of $26 should be apportioned as $1.25 in interest and $24.75 as a capital gain on the foreign exchange.

As you have noted and as the courts have held (see, for example, *O'Neill v. MNR*, 91 D.T.C. 692 and *Gestion Guy Menard Inc v MNR*, 93 D.T.C. 1058), the difference between the purchase price and the maturity value of Treasury Bills, that is, the discount, is interest income. Further, by virtue of subsection 16(1) of the Act, in the year of disposition, the amount that has been included in income as interest is deducted from the proceeds of disposition. Accordingly, in the example, at maturity, we have $1 of interest income and $99 proceeds of disposition, before the effects of the foreign currency conversion.

For purposes of subsection 39(2), the foreign exchange gain or loss will be computed by converting the proceeds of disposition to Canadian currency at the exchange rate in effect at the time of disposition and by converting the adjusted cost base to Canadian currency at the exchange rate in effect at the time of acquisition. This amounts to $99 US x $1.25 (conversion rate at disposition) - $99 US acquisition cost x 1.0 (conversion rate at acquisition) or $24.75 (capital gain on the foreign exchange). The interest amount is $1.25 calculated as $26 - $24.75.

(We refer you to *Gaynor v The Queen*, 1991 D.T.C. 5288 which discusses the correct method of calculating capital gains or losses realized on the disposition of securities which were purchased and sold using U.S. currency; this results in the translation of the foreign currency cost and the foreign currency proceeds into their Canadian dollar equivalent at the time of purchase and at the time of sale, respectively.)

17. Does the CRA accept that a foreign currency gain would always be a capital gain, assuming that the taxpayer is not a trader or dealer in securities and the property was not purchased as part of an adventure in the nature of trade?

Transactions that may result in a foreign exchange gain are diverse and varied. As stated in paragraph 1 of Interpretation Bulletin IT-95R, *Foreign exchange gains and losses* there are no provisions in the Act which specify whether a foreign exchange gain or loss is on account of income or capital. In determining whether such a gain or loss is on account of income, the basic principles of determining income from a business or property for purposes of subsection 9(1) must be applied. Thus the major problem in determining the income tax status of foreign exchange gains or losses is the identification of the transactions from which they resulted, or, in the case of funds borrowed in a foreign currency, the use of the funds.

From paragraph 6 of IT-95R, generally, a taxpayer who has transactions in foreign currency or foreign currency futures that do not form part of business operations, or are merely the result of sundry dispositions of foreign currency by an individual, will be accorded the same treatment as that of a "speculator" in commodity futures. It is acceptable for speculators to report all their gains and losses from transactions in commodity futures or in commodities as capital gains and losses with the result that only one-half the gain is taxable, and one-half the loss is allowable subject to certain restrictions, provided such reporting is followed consistently from year to year. However, if such a taxpayer has special "inside" information concerning foreign exchange, he or she will be required to report his or her gains and losses on income account.

18. If a U.S. Treasury Bill is "rolled over" on maturity by purchasing another U.S. Treasury Bill, does the CRA consider that there is a disposition, such that the foreign currency gain or loss is realized, even though economically the person still has the same overall position in U.S. dollars? What should be done if the taxpayer has never recorded currency gains and losses and this situation has gone on for many years?

Where a taxpayer holds the property as capital property and reports on capital account, further to paragraph 13 of IT-95R, the CRA considers that a taxpayer has "made a gain" or "sustained a loss" in a foreign currency only where there has been a transaction resulting in a gain or loss. The following are examples of the time when the Agency considers a transaction resulting in the application of subsection 39(2) to have taken place:

(a) at the time of conversion of funds in a foreign currency into another foreign currency or into Canadian dollars,
(b) at the time funds in a foreign currency are used to make a purchase or a payment (in such a case the gain or loss would be the difference between the value of the foreign currency

expressed in Canadian dollars when it arose and its value expressed in Canadian dollars when the purchase or payment was made), and

(c) at the time of repayment of part or all of a capital debt obligation.

Transactions in which foreign currency funds are invested in negotiable instruments such as notes, bonds, mortgages, debentures, U.S. government treasury bills and notes and U.S. commercial paper, will require a foreign exchange gain or loss calculation at the time the foreign currency funds are used to purchase these investments and as well, each time such investments mature or are otherwise disposed of, whether or not the funds are rolled over into like securities.

Therefore, it is our view that any foreign exchange gain realized upon maturity of the U.S. Treasury Bill would have to be calculated at that time and cannot be deferred until the U.S. funds are actually converted into Canadian dollars.

If the taxpayer has never recorded foreign currency gains and losses and this situation has gone on for many years, the taxpayer should send a request to have the tax returns in question amended. The taxpayer may also wish to consider making a voluntary disclosure of the unreported amounts in accordance with Information Circular IC00-1R2, *Voluntary Disclosures Program*.

19. If a loss results, could the loss be denied on the basis of the superficial loss rules? In other words, is the new U.S. Treasury Bill considered an identical property to the old U.S. Treasury Bill?

Subparagraph 40(2)(g)(i) deems a loss to be nil if it is a "superficial loss". The term "superficial loss" is defined in section 54 to be, essentially, a loss from the disposition of a property where the taxpayer or an affiliated person acquires the property or an identical property within the period that begins 30 days before and ends 30 days after the disposition and, at the end of that period, owns or has a right to acquire the property or an identical property. Where a loss is a superficial loss, the loss is denied, and is added to the cost of the property under paragraph 53(1)(f). Further, if the loss is deemed to be nil under section 40, then, for the purposes of subsection 39(2), the loss would be denied as the taxpayer has not "sustained a loss".

The general position of CRA with respect to the concept of "identical properties" for the purposes of applying the definition of 'superficial loss' is stated in paragraph 1 of Interpretation Bulletin IT-387R2, *Meaning of Identical Properties*, which provides, among others, that identical properties are properties which are the same in all material respects, so that a prospective buyer would not have a preference for one as opposed to another. Additionally, it states that to determine whether properties are identical, it is necessary to compare the inherent qualities or elements which give each property its identity and that such a determination is a question of fact which must be decided on the basis of the relevant details in each situation.

Subsection 248(12) specifically provides that 'for the purposes of the Act, one bond, debenture, bill, note or similar obligation issued by a debtor is identical to another such obligation issued by that debtor if both are identical in respect of all rights (in equity or otherwise, either immediately, or in the future, and either absolutely or contingently) attaching thereto, except as regards the principal amount thereof'.

Whether two U.S. Treasury Bills are identical properties is a question of fact to be resolved on the basis of the relevant details.

20. Under what circumstances do trusts have to make tax instalments?

Section 156 requires an individual to make instalment payments if certain conditions are met. Since trusts are taxed as individuals, generally, they are subject to these instalment payment provisions. For example, an *inter vivos* trust, including a mutual fund trust, may be required to make quarterly instalments during the year on account of its Part I tax payable for the year if the trust's net tax owing for the particular year, and for either of the 2 preceding taxation years, exceeds the trust's instalment threshold for that year. The terms "net tax owing" and "instalment threshold" are defined in subsection 156.1(1). For more information, please refer to Pamphlet P110, *Paying Your Income Tax by Instalments* under the heading "Who has to pay by instalments". Notwithstanding the above, we would note that under the current administrative policy, the CRA does not assess instalment interest and penalties where an *inter vivos* trust does not make instalment payments required under section 156.

A testamentary trust on the other hand, instead of making quarterly instalment payments, is allowed to pay its tax payable for the year within 90 days from the end of the taxation year by virtue of paragraph 104(23)(e).

21. A trust makes a distribution to its corporate beneficiary in respect of a capital dividend that was paid to the trust on a share of the capital stock of another corporation during a taxation year of the trust throughout which the trust was resident in Canada. The trust designates an amount under subsection 104(20) in respect of the corporate beneficiary and in respect of that dividend.

Paragraph (g) of the definition of "capital dividend account" ("CDA") in subsection 89(1) provides that the corporate beneficiary of the trust can add to its CDA an amount equal to the lesser of:

(i) the amount of the distribution, and
(ii) the amount designated under subsection 104(20) by the trust in respect of the corporation in respect of that dividend.

At what time will the corporate beneficiary of the trust add to its CDA the amount provided for in paragraph (g) of the definition of CDA in such a case?

The amount in respect of a distribution made by a trust to its corporate beneficiary in the period in respect of a dividend (other than a taxable dividend) paid on a share of the capital stock of another corporation resident in Canada to the trust during a taxation year of the trust throughout which that trust was resident in Canada will be added to the corporate beneficiary's CDA at the end of the trust's taxation year, provided that such amount was designated under subsection 104(20) by the trust in respect of the corporation in respect of that dividend and provided that the said amount was paid to the corporate beneficiary at or before the end of the trust's taxation year.

The corporation's capital dividend account cannot be increased before the end of the trust's taxation year because the designation under subsection 104(20) cannot be made before the end of the trust's taxation year and because the condition requiring that the trust be resident in Canada throughout the taxation year in which it receives the capital dividend will not be met until the end of the trust's taxation year.