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 – POST WIND-UP FILING OBLIGATIONS

The Act requires a taxpayer to file and pay tax based on the law that is currently in force. We do understand, however, that the Canada Revenue Agency ("CRA") will often encourage taxpayers to file income tax returns on the basis of proposed law.

This issue pertains to the obligations of taxpayers where income tax legislation, containing a retroactive provision is tabled, but has not as yet been proclaimed. The temporal application rules are not clear as to what happens when a corporation or a trust is wound-up subsequent to the legislation being tabled, but prior to its proclamation. The problem that is envisaged is the situation where a complete distribution has been made and the corporation has been wound-up or the trust has been officially terminated.

In such circumstances, what obligation would there be on the directors, shareholders, settlor, trustees, or beneficiaries (as the case may be), who received part or all of the distribution in the event that the proposed legislation was to be enacted and proclaimed into law, where the corporation or trust had not filed income tax returns on the basis of that law?

CRA Response

Proposed Legislation

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.

This practice is consistent with Parliamentary convention that establishes that tax proposals take effect as soon as the Minister of Finance tables the *Notice of Ways and Means Motion.*

Upon enactment of a particular amendment, any taxpayers who did not file based on the proposed amendment are expected to take immediate steps to put their affairs in order and, if applicable, pay any taxes and interest owing.

In the event that the Government announces that it will not proceed with these amendments, any taxpayers who have filed based on the proposed amendment are also expected to take immediate steps to put their affairs in order and, if applicable, pay any taxes owing. Where a taxpayer acted reasonably under the circumstances, took immediate steps to put their affairs in order and paid any taxes owing, the CRA will waive penalties and/or interest as appropriate.

Legislation Enacted with Retroactive Effect

Legislation only becomes binding and capable of producing legal effects upon commencement. In this regard, subsection 5(2) of the *Interpretation Act*[1] provides that,

> If no date of commencement is provided in an Act, the date of commencement of that Act is the date of assent to the Act.

The binding feature of retroactive provisions was addressed in *Gustavson Drilling (1964) Ltd. v. M.N.R.*,[2] where Dickson J. held that,

> The general rule is that statutes are not to be construed as having retrospective operation unless such construction is expressly or by necessary implication required by the language of the Act.[3]

For the purposes of this discussion, it is assumed that the retroactive legislative provision would, but for the fact that it has not as yet received assent, impose an additional tax burden on the taxpayer. The failure to heed the retroactive commencement date of legislation that has not as yet received assent is not without consequences.

Once the retroactive provision receives assent, it is binding and produces legal effects. There are specific provisions under the Act that address the failure to file income tax returns consistent with the provisions of the Act. The Minister may, pursuant to subsection 152(4), make an assessment, reassessment or additional assessment at any time, subject to such time bars[4] as may be applicable. Moreover, subsection 152(7) permits the Minister to assess tax payable notwithstanding that no return has been filed.

It should be noted that subsection 152(3) provides that liability for tax is not affected by the fact that no assessment has been made. In this regard, it was held in *The Queen v. Simard-Beaudry Inc.*[5] that a tax liability results from the Act, and is created as a result of taxable income, not by an assessment or re-assessment. The liability comes into existence the moment the income is earned. An assessment or reassessment does not create the liability, but is at most a confirmation of its existence.[6]

Accordingly, the retroactive commencement date gives rise to the liability prior to the wind-up of the corporation or trust notwithstanding that the assessment or reassessment is issued subsequent to the wind-up. Furthermore, the fact that a corporation or trust has

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1 R.S.C. 1985, c. I-21.
2 [1976] C.T.C. 1, 75 DTC 5451 (S.C.C.).
3 *Supra*, at pp. 6 & 5454 respectively.
4 See subsections 152(4) & (3.1).
5 71 DTC 5511 (F.C.T.D.).
6 *Supra*, at p. 5515.

been wound-up does not bar the issuance of a notice of assessment. The notice of assessment merely confirms the existence of the pre-existing liability. In the corporate context there is support for this position in the continuation of action provisions of the applicable corporate legislation. For instance, paragraph 226(2)(b) of the *Canada Business Corporations Act*[7] provides that,

> Notwithstanding the dissolution of a body corporate under this Act,
>
> …..
>
> (b) a civil, criminal or administrative action or proceeding may be brought against the body corporate within two years after its dissolution as if the body corporate had not been dissolved; …

Similar continuation of action provisions are contained in provincial company legislation.[8] In this respect, it should be noted that there are a number of cases where it has been held that the issuance of a notice of assessment is an administrative action or proceeding[9] albeit not a process to enforce a claim.[10] Accordingly, a notice of assessment can be issued without having to revive the corporation.

It should be noted that where the legal representative of a taxpayer has possession or control over the property of the taxpayer, the legal representative is required pursuant to subsection 159(2) to obtain a clearance certificate before distributing said property. The term "legal representative" is defined in subsection 248(1) to mean,

> a trustee in bankruptcy, and assignee, a liquidator, a curator, a receiver of any kind, a trustee, an heir, an administrator, an executor, a liquidator of a succession, a committee or any other like person administering, winding up, controlling or otherwise dealing in a representative or fiduciary capacity with the property that

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[7] R.S.C. 1985, c. C-44.

[8] See *Business Corporations Act*, S.B.C. 2002, c. 57, s. 346(1)(b); *Business Corporations Act*, R.S.A. 2000, c. B-9, s. 227(2)(b); *The Corporations Act*, C.C.S.M., c. 225, s. 219(2)(b); *An Act Respecting the Legal Publicity of Sole Proprietorships, Partnerships and Legal Persons*, R.S.Q., c. P-45, s. 50; *Business Corporations Act*, S.Q. 2009, c. 52, s. 306; *Business Corporations Act*, S.N.B. 1981, c. B-9.1, s. 152(2)(b); *Companies Act*, R.S.N.S. 1989, c. 81, s. 136(3); *Companies Act*, R.S.P.E.I. 1988, c. C-14, s. 74(3); *Corporations Act*, R.S.N.L. 1990, c. C-36, s. 355(2)(b); *Business Corporations Act*, R.S.Y. 2002, c. 20, s. 228(2)(b); *Business Corporations Act*, S.N.W.T. 1996, c. 19, s. 228(2)(b); and *Business Corporations Act*, S.N.W.T. 1996, c. 19, s. 228(2)(b), as duplicated for Nunavut by s. 29 of the *Nunavut Act*, S.C. 1993, c. 28; see also *Business Corporations Act*, R.S.S. 1978, c. B-10, s. 291; and *Business Corporations Act*, R.S.O. 1990, c. B.16, s. 242(1)(b).

[9] See *Dominion of Canada General Insurance Co. v. The Queen*, [1984] C.T.C. 190, 84 DTC 6197 (F.C.T.D.); *Manago v. M.N.R.*, [1990] 2 C.T.C. 2459, 90 DTC 1889 (T.C.C.); *Larocque v. M.N.R.*, [1991] 2 C.T.C. 2151, 91 DTC 899 (T.C.C.); *Osborne v. M.N.R.*, [1991] 2 C.T.C. 2756, 91 DTC 1283 (T.C.C.); *The Queen v. Leung*, [1993] 2 C.T.C. 284, 93 DTC 5467 (F.C.T.D.); *Pozzebon v. The Queen*, [1998] 3 C.T.C. 2902, 98 DTC 1940 (T.C.C.); and *Re Slater Steel Inc.* (2004), 6 C.B.R. (5th) 125 (Qc. S.C.).

[10] See *Pure Spring Co. v. M.N.R.*, 1946 C.T.C. 169, 2 DTC 844 (Ex. Ct.); *Léo Beauchesne Inc. v. The Queen*, [1977] C.T.C. 398, 77 DTC 5308 (F.C.T.D.); *H.J. Flemming Estate v. M.N.R.*, [1983] C.T.C. 321, 83 DTC 5329 (F.C.T.D.); and *Re Norris* (1988), 67 C.B.R. (N.S.) 246 (Ont. S.C. Reg.), aff'd in (1988), 67 C.B.R. (N.S.) 246 at 254 (Ont. S.C), rev'd on other grounds in [1989] 2 C.T.C. 185, 89 DTC 5493 (Ont. C.A.).

belongs or belonged to, or that is or was held for the benefit of, the taxpayer or taxpayer's estate.

Accordingly, before a corporation or a trust can be wound-up, the person who is responsible for the winding-up and distribution of the property is required to obtain a clearance certificate verifying that all amounts for which the corporation or trust is liable under the Act, and for which that person is or may be liable in the capacity of responsible representative, have been paid or that acceptable security for payment has been provided.

Where the legal representative, other than a trustee in bankruptcy, distributes the property without having obtained a clearance certificate, the legal representative is personally liable to pay under subsection 159(3), to the extent of the property distributed, the amounts which the corporation or trust can reasonably be expected to be liable under the Act at or before the time the distribution is made.

Furthermore, to the extent that the property were to be distributed to a person, who is not dealing at arm's length with the corporation or trust, that person can be held liable under subsection 160(1) for the lesser of the tax payable by the corporation or trust and the amount by which the fair market value of the property exceeds the consideration given for the property.[11] Section 251 provides the rules for determining whether or not persons deal with each other at arm's length.

In summary, where notice is given of proposed legislation having a retroactive effect date, and a legal representative:

(a) does not file in accordance with the proposed legislation;
(b) does not obtain a clearance certificate; and
(c) distributes the property of the taxpayer in the possession or control of the legal representative,

the provisions of subsection 159(3) apply.

[11] See *Montreuil v. The Queen*, [1996] 1 C.T.C. 2182, 95 DTC 138 (T.C.C.).

QUESTION #2 – TRUSTS AND PRINCIPAL RESIDENCE EXEMPTION

Assume the following facts:

1. **A personal trust has been settled *inter vivos*. The trust is not an alter ego or joint partner trust.**
2. **A cottage is contributed to the personal trust by "B", a Canadian resident individual who is one of the income and capital beneficiaries of the trust.**
3. **B triggers a capital gain as a result of contributing the cottage to the personal trust. As B occupied the cottage as his principal residence prior to contributing it to the trust, B uses his available principal residence exemption ("PRE") to reduce his tax exposure on the capital gain.**
4. **Subsection 75(2) applies to the trust, as B is both a contributor and is also a capital beneficiary of the trust.**
5. **The twenty-one year deemed realization rule under subsection 104(4) of the Act continues to loom over the trust. This rule presumably still applies even though any income is to be attributed under subsection 75(2) to B as contributor.**

Given the above facts, it would often be a "normal" plan to consider a rollout of the cottage to a capital beneficiary as an option to avoid the deemed disposition rules under subsection 104(4) and one would normally expect to achieve that as a tax deferred roll-out to a capital beneficiary (using the provisions of subsection 107(2)) but the normal rules will not apply if subsection 75(2) also applies in respect of any property of the trust.

Accordingly, our questions are as follows:

1. **Do the provisions of subsection 104(4) apply notwithstanding that income (or loss) and taxable capital gains (or allowable capital losses) will be attributed to the contributor pursuant to subsection 75(2)?**
2. **If the cottage is distributed to B prior to subsection 104(4) applying to the trust, will the provisions of paragraph 107(4.1)(c) apply so as to preclude the application of subsection 107(2) to the distribution such that subsection 107(2.1) will apply to the distribution?**
3. **If the cottage is distributed to "D", who is one of the other capital beneficiaries of the trust, and D has never contributed property to the trust, will the provisions of subsection 107(4.1) be applicable to such distribution?**
4. **Assuming our understanding under assumption 4 above is correct, will the amount of the capital gain realized on the distribution of the cottage to a capital beneficiary attribute to B pursuant to the provisions of subsection 75(2)?**

5. **If the answer to question 4 above is that the capital gain attributes to B pursuant to subsection 75(2), will B be able to utilize his PRE even though he will not be in receipt of the distributed property, namely the cottage?**

CRA Response

1. Yes, the 21-year rule in subsection 104(4) will apply regardless of the fact that income or loss or capital gains or losses may have been attributed pursuant to subsection 75(2).

2. Given that B is the person from whom the property was acquired by the trust, the condition in paragraph 107(4.1)(c) would not be met, and thus a subsection 107(2) rollover of the property would not be precluded pursuant to subsection 107(4.1).

3. On the assumption that B is still living at the time of the distribution to D and that subparagraph 107(4.1)(c)(ii) is not applicable, yes, the provisions of subsection 107(4.1) will apply. It should be noted that the fact that D has never contributed any property to the trust is not relevant in this case, as the property referred to in subparagraph 107(4.1)(c)(i) is the property referred to in paragraph 107(4.1)(b), which is the cottage that was contributed to the trust by B. This also assumes that the trust itself has not claimed the principal residence exemption and reduced the amount to be attributed to nil.

4. If B is alive and resident in Canada at the time of the gain, then subsection 75(2) will apply to deem the amount of the taxable capital gain, if any, to be a taxable capital gain of B.

5. The fact that the taxable capital gain will be attributed to B will not mean that B will have a principal residence exemption in respect of the property. As is noted in paragraph 4 of Interpretation Bulletin IT-120R6, *Principal Residence*, for a property to be a taxpayer's principal residence for a particular year, the taxpayer must own the property in the year. Thus, B could not have a principal residence exemption.

QUESTION #3 – UPDATE ON THE SOMMERER DECISION

Does the CRA plan to appeal the Tax Court of Canada decision in *Peter Sommerer v. The Queen*[12]?

CRA Response

On the question of subsection 75(2), the Income Tax Rulings Directorate recommended that the decision be appealed given that we believe that the wording of the provision is sufficiently broad to include transfers of property at fair market value where the transferor is one of the capital beneficiaries of the trust.

When you look back at the history of this provision, it has been fairly consistent since 1948. However, the predecessor of this provision in the *Income War Tax Act*[13] was quite different. There is no specific requirement in subsection 75(2) that the provision only applies where the trust received property from a donor whereas the earlier version in the *Income War Tax Act* clearly applied only to a donor of property to a trust. The Tax Court of Canada's interpretation in Sommerer is consistent with the earlier version (i.e. subsection 32(3) of the *Income War Tax Act*) but arguably, the use of different words shows that Parliament intended subsection 75(2) to apply to a broader set of transfers.

Getting back to the point of transfers at fair market value, we made this point at the 2006 STEP Annual Conference wherein we had noted that, as stated in the first paragraph of Interpretation Bulletin IT-369R, *Attribution of Trust Income to Settlor*, the application of subsection 75(2) does not depend on the manner in which the property was acquired, but on whether the property is held under one or more of the conditions set out in subsection 75(2). Thus, if a capital beneficiary of a trust transfers property to that trust pursuant to a conditional sales agreement, subsection 75(2) will apply to the income from that property on the basis that the property so transferred to the trust may revert to that capital beneficiary. If, however, a person other than a capital beneficiary were to sell property to the trust pursuant to a conditional sales agreement, subsection 75(2) would not apply solely by reason of the fact that the property may be returned to the vendor pursuant to foreclosure proceedings.

On the convention issue, the Court concluded that even if subsection 75(2) had applied to Peter Sommerer (Canadian resident), Article XIII(5) of the Canada-Austria Tax Convention would apply to preclude Canada from taxing Peter Sommerer on the gain on the disposition of the shares.

We recommended the decision be appealed regarding the application of the Convention as in our view:

[12] See *Sommerer v. The Queen*, 2011 DTC 1162.
[13] See *Income War Tax Act, 1917*, S.C. 1917, c. 28.

- There is an important distinction between juridical double taxation and economic double taxation.
- Article XIII of the Convention affords protection against juridical double taxation and not economic double taxation.
- This is supported by Article I of the Convention, which is applicable to persons who are residents of one or both of the Contracting States.
- Thus, the protections afforded by the treaty attach to persons who are residents of one or both states; they do not attach to income sources.
- The amount pursuant to subsection 75(2) is not the gain realized by the trust; it is an attribution of the gain.
- Canada, by agreeing to Article XIII(5) of the Canada-Austria Tax Convention, only ceded the right to tax certain capital gains realized by residents of Austria. It did not cede its right to tax Canadian residents on their Canadian income, however related to the gain realized by the Austrian resident.

On May 16, 2011 an appeal was filed to the Federal Court of Appeal.

In relation to the question of what will happen to cases involving the same or similar issues as in *Sommerer,* we understand that all such cases will be kept in abeyance pending the final resolution of the *Sommerer* case.

Will a taxpayer be able to request a refund based on the TCC decision in Sommerer?

Finally, as regards a taxpayer being able to request a refund based on the Court's decision in *Sommerer*, please note that pursuant to Information Circular IC75-7R3, *Reassessment of a Return of Income*, it is the policy of the CRA not to grant a request for a refund where the request is based solely on the successful appeal to the Courts by another taxpayer. If a taxpayer has an outstanding notice of objection for the same issues under appeal in the *Sommerer* decision, the resolution of that objection will be held in abeyance until the final resolution of the *Sommerer* case.

QUESTION #4 – TAXATION OF INCOME OF TESTAMENTARY SPOUSAL TRUST AFTER DEATH OF SPOUSE BENEFICIARY

Let's assume the following facts:

1. **Spouse A dies.**
2. **The will of Spouse A creates a spousal trust for the benefit of Spouse B upon the death of Spouse A. It has all the usual terms for rollover pursuant to subsection 70(6).**
3. **Spouse B then dies and the terms of the testamentary trust provide for all of the capital to be transferred to a residual charitable beneficiary. For tax purposes, of course, there would be a deemed disposition of the testamentary trust assets as of the date of the Spouse B's death pursuant to the provisions of subsection 104(4).**
4. **During the period of administration of the testamentary spousal trust after Spouse B's death, the trustee either allocates the trust income to the residual beneficiary or will make a designation under subsections 104(13.1) or 104(13.2) to not have the income taxed in the hands of the residual beneficiary.**

Given the above, we understand that the CRA has recently been taking the position that the residual charitable beneficiary is not entitled to the income of the testamentary trust after the death of Spouse B since the will of Spouse A does not clearly provide for the residual beneficiary to be an income beneficiary. Accordingly, all of the income of the testamentary trust from the date of Spouse B's death to the wind-up of the testamentary trust is apparently taxable in the testamentary trust as opposed to being allocated to the residual charitable beneficiary.

Assuming we correctly understand CRA's position, can you please explain your basis for the above position?

CRA Response

Paragraph 6 of Interpretation Bulletin IT-286R2, "*Trusts – Amount Payable*", discusses the notion of the "executor year" under common law for a testamentary trust. It is stated in this paragraph that where the initial taxation year of a testamentary trust coincides with the executor year and where the sole reason for the rights of a beneficiary being unenforceable is the existence of an executor's year, the CRA will consider the income of the trust for that year to be payable to the beneficiary or beneficiaries of the trust pursuant to subsection 104(24).

As stated in the T3 Trust Guide, "generally, you allocate income to the trust's beneficiaries according to the terms of the will or trust document". The T3 Trust Guide further points out that an amount can only be allocated to a beneficiary if one of the following applies:

- the beneficiary is entitled to the income in the year that it is earned by the trust, under the trust document;
- the trust makes a preferred beneficiary election to include the trust income in the beneficiary's income; or
- the beneficiary is paid income in the year that is earned by the trust, at the discretion of the trustee.

As noted in document 2007-0259841E5, "pursuant to subsection 104(6), there may be deducted in computing the income of an estate or trust for a taxation year, such amount as the estate or trust claims that would be its income for the year as became payable in the year to a beneficiary. Subsection 104(24) provides that, for the purposes of subsection 104(6), an amount is deemed not to have become payable to a beneficiary in the year for the purposes of subsection 104(6) unless the amount was actually paid to the beneficiary in the year, or the beneficiary was entitled in the year to enforce payment of it."

Therefore the determination as to whether income can be allocated to the residual beneficiary (and thus deducted by the trust in computing its income), in our view, will be a question of fact that will depend upon the terms of the trust.

It should be noted that if the income of the trust for tax purposes was comprised of items such as deemed dividends, capital gains or various phantom incomes, which were not specifically defined as income for trust purposes, then such amounts would not be deductible from the income of the trust, as they would not be payable as income to the beneficiary. Furthermore, subsection 104(6) does not allow for any of the gains deemed on the death of Spouse B to be allocated to the beneficiary.

QUESTION #5 - POST-MORTEM ESTATE PLANNING DEEMED DIVIDEND

In post-mortem estate planning, an important objective is to avoid double taxation. The Act allows three main methods whereby double taxation can be avoided, which are the loss carryback mechanism under subsection 164(6), the step-up approach using a wind-up (paragraph 88(1)(d) and the amalgamation equivalent); and the so-called "pipeline method". Our question concerns the pipeline method, which can be illustrated by the following sequence of transactions:

a) **A taxpayer, Mr. A, dies holding shares of a corporation, "ACo", which have appreciated in value. The shares have a cost of $100 and a fair market value of, say, $600,000. A capital gain of $599,900 results at death (assume no spousal rollover).**

b) **The estate, holding the shares of ACo, with an adjusted cost base of $600,000, transfers the shares of ACo to a holding company, AHoldco, taking back a promissory note of $600,000 (assume that in the intervening period, ACo has not appreciated in value).**

c) **A dividend of $600,000 is paid by ACo to AHoldco, which is received tax-free by AHoldco (the dividend is deducted in arriving at the taxable income of AHoldco under subsection 112(1)).**

d) **AHoldco repays the promissory note of $600,000 with a cash payment to the Estate.**

Our question concerns whether, in a sequence of transactions such as this, the promissory note issued by AHoldco to the estate, which represents the adjusted cost base of the shares of ACo to the estate, is a tax-free transaction. At the 2010 Canadian Tax Foundation CRA Roundtable (and we acknowledge other recent technical interpretations on point as well), the CRA stated that in certain circumstances this transaction could result in a dividend from AHoldco to the estate as a result of subsection 84(2). This would seem to be an unfair and inappropriate result, leading to double taxation, which the sequence of transactions seeks to avoid. The basis of this position seems to be the particular wording of subsection 84(2).

We wish to ask the CRA of the particular circumstances under which, in their view, the provisions of subsection 84(2) could apply.

CRA Response

As discussed in previously published CRA statements, the potential application of subsection 84(2) requires a thorough review of all of the facts and circumstances relating to a particular situation. In light of the limited facts provided to us, we are not able to confirm that subsection 84(2) would not apply in the context of the series of transactions described above.

Notwithstanding the above, we are prepared to offer the following comments on the matters raised in the foregoing question.

Post-mortem planning is an expression generally used to describe any planning that is undertaken principally to mitigate a form of double taxation exposure that can result when a person owns shares of the capital stock of a private corporation with an accrued gain at the time of death. In general terms, this double tax exposure would arise at the shareholder level where the deceased would be liable for tax on the capital gain triggered on the application of the subsection 70(5) "deemed disposition rules", and subsequently, the same value would be subject to tax when the corporation either distributes assets, or sells the assets and distributes the after-tax proceeds, to its shareholders (which may include the estate) by means of a winding-up or a share redemption, and the resulting capital loss is unavailable to offset the capital gain of the deceased.

Generally, there are two traditional post-mortem planning techniques to avoid this form of double taxation at the shareholder level. The first method is known as the "subsection 164(6) capital loss carryback strategy". Subsection 164(6) effectively provides the taxpayer's legal representative with the possibility of carrying back the estate's capital loss resulting from the winding-up or redemption of the shares of the capital stock of the private corporation to offset the deemed capital gain realized by the deceased. This strategy, which must be implemented within the first taxation year of the particular estate, essentially eliminates the capital gain of the deceased and allows the estate to be taxed once, as a deemed dividend on the winding-up or share redemption.

The second post-mortem strategy, which is illustrated in the hypothetical series of transactions described above, is commonly referred to as the "pipeline strategy." When correctly implemented, the result of the pipeline strategy is that the extraction of the corporation's surplus is subject to taxation as a capital gain as a consequence of the deemed disposition rules on death.

It is our understanding that the choice of post-mortem planning technique would generally depend upon, amongst other things, the applicable capital gains and eligible and ineligible dividend tax rates in the particular situation, in addition to the existence of certain beneficial corporate tax assets, such as the general rate income pool, the refundable dividend tax on hand account and the capital dividend account. Accordingly, where a corporation would not have any of the aforementioned beneficial tax accounts, and where the corporation would be in a jurisdiction in which capital gains are afforded more favourable tax treatment than dividends, the pipeline strategy may be the preferred method as previously described.

However, in undertaking a pipeline strategy, we would note that the anti-avoidance provisions of section 84.1 and subsection 84(2) must be examined. It is our view that these provisions, which have different requirements for application, target certain transactions that result in the extraction of corporate surplus otherwise than by way of a dividend treatment (otherwise known as "surplus stripping"). Furthermore, we believe that section 84.1 and subsection 84(2) are not in conflict and that the potential application of both provisions must be considered in the context of pipeline transactions.

To that end, we note that subsection 84(2) would apply where funds or property of a corporation resident in Canada have at any time after March 31, 1977 been distributed or otherwise appropriated in any manner whatever to or for the benefit of the shareholders of any class of shares in its capital stock, on the winding-up, discontinuance or reorganization of its business. The result of the application of subsection 84(2) is that the corporation shall be deemed to have paid at that time a dividend on the shares of that class equal to the amount described in the remainder of the provision.

Consequently, in the context of the pipeline strategy described above, some of the additional facts and circumstances that in our view could lead to the application of subsection 84(2) and warrant dividend treatment could include the following:

- The funds or property of ACo would be distributed to the estate in a short time frame following the death of Mr. A.

- The nature of the underlying assets of ACo would be cash and ACo would have no activities or business ("cash corporation").

Where such circumstances exist, resulting in the application of subsection 84(2) and dividend treatment on the distribution to the estate, we believe that double taxation at the shareholder level could still be avoided with the implementation of the subsection 164(6) capital loss carryback strategy, provided the conditions of that provision would apply in the particular facts and circumstances.

Finally, we note that we have issued several favourable rulings wherein we have concluded that subsection 84(2) would not apply to the proposed full or partial pipeline strategies.[14] These situations, in contrast to the examples noted above, did not involve cash corporations. Furthermore, in each case the taxpayers' proposed transactions contemplated, among other things, the continuation of the business for a period of at least one year, followed by a progressive distribution of the corporation's assets over an additional period of time. Consequently, one or more of the conditions of subsection 84(2) were not met in each case and the pipeline strategy was effectively implemented.

[14] See, for example, Documents F 2002-0154223, F 2005-0142111R3, F 2007-0237511R3, F 2009-0346351R3, F 2010-0377601R3, F 2010-0388591R3 and E 2011-0403031R3 (publication pending).

QUESTION #6 – TAX PAYABLE ON A DEEMED DISPOSITION PAYABLE IN INSTALMENTS

Under the Act, a deemed realization or a deemed disposition arises in respect of certain assets of a deceased taxpayer. The resulting tax payable may be remitted in up to ten equal annual instalments, plus interest, provided that the taxpayer's legal representative files an election in prescribed form, and furnishes acceptable security.

Our question concerns certain aspects of making payment under this basis.

(a) While the Act is specific regarding the payment of the tax, it is silent on the payment of interest. What is the CRA's administrative position on the payment of the interest?

(b) What is the nature of the security that the CRA would accept?

(c) Where the Will of the deceased provides for a distribution of assets to the beneficiaries over a relatively short period of time and does not explicitly create a trust under which the assets are to be held long-term, does CRA accept that the making of this election will result in a testamentary trust being created for up to ten years in order that funds be set aside for the making of these tax payments?

(d) Could the estate make payments earlier then specified if it chooses?

CRA Response

(a) The issue is not one of an administrative position; rather, subsection 159(7) provides that interest is to be computed at the prescribed rate in effect at the time the election was made.

(b) Security acceptable to the CRA would include a letter of credit, a bank guarantee, or a mortgage.

(c) It is not our view that this election will result in the creation of a testamentary trust. The definition of a "testamentary trust" in subsection 108(1) refers to a trust or estate that arose on and as a consequence of the death of an individual, and includes a trust referred to in subsection 248(9.1).

Subsection 248(9.1) deals with trusts created under the terms of the taxpayer's will, or by certain orders of the court in relation to the taxpayer's estate. Neither scenario would appear to apply in this instance. Nor does it appear to meet any of the scenarios contemplated as "occurrences as a consequence of death" as provided for in subsection 248(8).

Accordingly, we are of the view that the subsection 159(5) election by the representative will not, in and of itself, result in the creation of a testamentary trust.

(d) The estate could opt to make payments earlier than specified. If the legal representative files an election, the tax and the interest must be paid in no more than ten instalments; hence fewer than ten instalments could be made.

QUESTION #7 - INTESTACY

Assume that a taxpayer dies intestate and that, under applicable provincial law, the assets will be divided between a surviving spouse and, say, children, in accordance with a sharing ratio as defined by provincial law. Assume that all parties agree to a distribution of assets such that appreciated capital property and amounts in an RRSP or RRIF become property of the surviving spouse and other assets (say, cash) are left to children. Such an allocation of assets postpones the incidence of taxation at death, under various rollover provisions available on a transfer of assets to a spouse.

Does the CRA accept that such an allocation can be made for tax purposes, in order to maximize the benefit of the spousal rollover and defer tax?

CRA Response

When a taxpayer dies, certain provisions of the Act permit property of the deceased taxpayer to be transferred as a consequence of the death of the taxpayer to certain individuals on a tax-deferred (rollover) basis, e.g., a rollover under paragraph 60(l) of a refund of premiums as defined in subsection 146(1) or a rollover of capital property under subsection 70(6).

Generally, in a situation where a taxpayer dies intestate, subsection 248(8) provides that "a transfer, distribution or acquisition of property as a consequence of the law governing the intestacy of a taxpayer ... shall be considered to be a transfer, distribution or acquisition of the property as a consequence of the death of the taxpayer." Accordingly, provided property of the deceased taxpayer is distributed to the deceased's beneficiaries in accordance with the proportions or ratios specified under applicable provincial intestacy law, and there are not any agreements between beneficiaries that in any way alter the proportions or ratios of property distributed to the deceased's beneficiaries, the CRA will consider the property to be distributed as a consequence of the death of the taxpayer.

For example, assume the following facts:

- A taxpayer dies intestate and has a surviving spouse and one child.
- The taxpayer's net estate (after payment of estate expenses) comprises $500,000 of cash and $500,000 of RRSPs of which the taxpayer's estate is the beneficiary.
- Applicable provincial intestacy law requires 50% of the net estate to go to the taxpayer's surviving spouse and 50% to the taxpayer's only child.

Provided the total assets of the deceased taxpayer's net estate ($1,000,000 in the above example) are distributed in accordance with the applicable provincial intestacy law, i.e., 50% each to the surviving spouse and child ($500,000 of property each), and there exist no agreements that would alter the 50% ratio, in our view, the distribution would be as a consequence of the law governing the intestacy of the taxpayer for purposes of subsection

248(8). It is not our view that $250,000 of cash and $250,000 of RRSP property would each have to be distributed to the surviving spouse and child for the distribution to be as a consequence of the law governing the intestacy of the taxpayer.

QUESTION #8 – ACCESS TO INFORMATION

In the course of an audit, filing of a Notice of Objection, or filing of a Notice of Appeal to the Tax Court of Canada, a taxpayer or authorized representative may determine that it would be of benefit to obtain information in the possession of the CRA, such as the auditor's working papers, or the report of the Appeals Officer. In order to do so, a request can be made informally, or through an application under the *Privacy Act* ("PA") or under the *Access to Information Act* ("ATIA").

In a recent situation, an application was made under the *Privacy Act* to obtain the Appeals Officer's report in contemplation of filing a Notice of Appeal to the Tax Court of Canada. A period of 90 days is prescribed for the filing of a Notice of Appeal after confirmation of an assessment by the CRA Appeals Division. However, despite applying within days of receiving the confirmation, the CRA was unable to provide the information within the 90-day period. This can prejudice a taxpayer's position in filing a Notice of Appeal.

In such circumstances, what guidance can the CRA offer so that this information can be obtained on a timely basis, and what recourse does a taxpayer have if the information is not so provided?

CRA Response

The Access to Information and Privacy ("ATIP") Directorate promotes and encourages informal disclosure of documents by the CRA.

The ATIA and the PA were intended to complement and not replace existing procedures for access to government and personal information. The Act provides for the taxpayer to have access to their own information, including any actions or reports used by the CRA to assess them. Normally, this type of information should be given to the taxpayer without directing them to the ATIP Directorate to make a formal request under the ATIA or PA. Formally or informally, the information would only be disclosed if authorized under the applicable legislation (for example, section 241 of the Act).

The CRA's Publication P148, *Resolving Your Dispute: Objection and Appeal Rights Under the Income Tax Act*, explains to taxpayers what information is available to them and what information is not available to them.

The list of records available to a taxpayer include audit reports and working papers; scientific, appraisal and valuation reports that the CRA relied on or used to assess a taxpayer; records of discussions held between auditors and appeals officers; and others. In the case of an ongoing audit, a taxpayer can request an update to his or her audit by going directly to the auditor. It should be noted that, before releasing the records the the taxpayer, the CRA can protect and or sever the information that would be injurious to the CRA's enforcement and investigation activities, or that may contain third party or tax information that does not relate to the taxpayer.

The ATIP Directorate has processes in place to deal with requests that are made pursuant to the ATIA or the PA. Indeed, such requests are dealt with in the order in which they are received. The ATIP Directorate does not have authority to treat certain requests as having priority over others that are received. The ATIP Directorate makes every effort to achieve the deadlines set out in the legislation; however, there can be instances where such turnaround times cannot be met.

Where a taxpayer has made a formal request under the PA and has not received a response to such request within the prescribed time frame, the taxpayer has recourse to file a formal complaint with the Office of the Privacy Commissioner of Canada. It should be noted however that in normal circumstances, this would not expedite the amount of time it would take for the original materials to be supplied.

Our colleagues at the ATIP Directorate recommend that a taxpayer first request their records from the applicable Appeals or Audit office with which they are dealing. If the request is refused, and the taxpayer is told that they must make a formal request, the ATIP Directorate would be required to contact the program area to ask for the request to be handled informally. This is because: 1) the ATIP Directorate has a legal duty to assist requesters; 2) the ATIA and the PA are not intended to replace other means of obtaining access to government incorporation; and 3) an informal response would be faster than a formal one. In fact, in these cases, a formal request has no added value to the CRA or the requester. Although the ATIA and the PA include the right to complain to an oversight commissioner (i.e. the Information Commissioner of Canada of the ATIA or the Privacy Commissioner of Canada for the PA), a delay complaint would likely not be completed until the appeal deadline has passed.

QUESTION #9 – CONSEQUENTIAL ASSESSMENT

Subsection 152(4.3) permits the Minister to reassess a taxpayer beyond the normal reassessment period where the reassessment arises as a consequence of an assessment or a decision on an appeal either of which changed a taxpayer's balance in a particular year. The reassessment is allowed only to the extent that it can reasonably relate to the change in the balance in that year, and may be made only where the Act requires the inclusion, or allows the deduction, in computing a taxpayer's balance for the year of an amount relating to the deduction or inclusion that was adjusted for the other year. An example of this would be where there has been a change to the calculation of the carry forward of a loss occasioned by an adjustment to a balance of an earlier year.

Under subsection 152(4.4), the taxpayer's balance is the income, taxable income earned in Canada or any loss for the year, or the tax or any amount payable by, any amount refundable to, or any amount deemed to have been paid or overpaid by, the taxpayer for the year.

Questions:

(a) Must a request for an adjustment be made by filing an amended tax return or by a letter, including a T1 Adjustment Form, if the matter involves an individual?

(b) When is the effective interest date for a consequential adjustment?

(c) If the auditor does not make the consequential assessment as requested, when and how does one file a Notice of Objection, or seek other recourse?

(d) Does the CRA have any published guidelines concerning consequential assessments?

CRA Response

(a) A taxpayer (any taxpayer) who requests an adjustment must do so in writing, without the need to file any particular form.

(b) The effective interest date for arrears is the taxpayer's balance due date for the taxation year.

Once a notice of assessment is issued to a taxpayer, no additional interest is payable provided the taxpayer pays the amount in full within the period specified in the notice.

(c) A Notice of Objection may be filed in response to the issuance of an assessment; however, if no assessment is issued, an objection cannot be filed. If the auditor does not raise the assessment requested, the taxpayer could seek recourse from the auditor's superiors within the TSO.

(d) The CRA does not have any published guidelines on consequential assessments.

QUESTION #10 - PERSONAL USE PROPERTY

Where a taxpayer disposes of personal-use property, no loss may be claimed (with the exception of listed personal property where such a capital loss may be claimed against capital gains from listed personal property).

a) **Where an individual dies holding personal-use property which becomes property of the estate, does the property retain its nature as personal-use property, or does it then become capital property in the hands of the estate?**

b) **Does the answer depend on the use which is made of the property by a beneficiary of the estate?**

For example, suppose that an individual dies holding a cottage property. The property becomes property of the individual's estate and is not used by any of the beneficiaries. The property is held on the basis that it is to be disposed of when certain matters concerning the estate are resolved (the obtaining of probate, the settlement of possible legal issues, etc.). In the intervening period, the property declines in values. Does any resulting loss now become a capital loss from the disposition of a capital asset rather than personal-use property such that the capital loss is not denied and can be utilized by the estate?

CRA Response

The deceased person and his estate are distinct taxpayers. Therefore, the determination of whether the property, owned by an estate is inventory, depreciable capital property or non-depreciable capital property, must be made on its own merits and facts.

In the situation described, we are of the view that the real property would generally qualify as a non-depreciable capital property to the estate on the assumption that the property has not been rented or otherwise used to earn income.

The question that must then be answered is whether the property was used primarily for the personal use or enjoyment of the heirs of the deceased or persons related to them during the period following the death and before the sale. A cottage owned by an estate which has not been used by any of the estate's beneficiaries or any person related to the beneficiaries, would, in our view, not meet the requirements of subparagraph (a)(iii) of the definition of personal-use property as found in section 54. Therefore, provided that the cottage is not acquired by a person affiliated with the estate, a capital loss realized on the sale of the property by the estate would not be deemed to be nil pursuant to subparagraph 40(2)(g)(iii) and would be deductible against capital gains of the estate.

QUESTION #11 – PRINCIPAL RESIDENCE

Only one principal residence may be designated each year by an individual, his or her spouse, and, generally speaking, children under the age of 18. The choice of designation of a principal residence can be important where a family has two or more residences which might so qualify. The CRA has an administrative position outlined in Guide T4037, *Capital Gains*, that even though the Act requires a designation of a principal residence on disposition in order to claim the exemption, if the property has been used throughout the period of ownership as a principal residence such that the gain on the sale would be entirely exempt, no other property is designated for any year, and there is no excess land, the designation need not be made, and the disposition and resulting gain can be omitted entirely from the personal income tax return. This can lead to an unfortunate situation where an inappropriate selection is made as to a principal residence, precluding the subsequent selection of another property as a principal residence where a more beneficial designation could have been chosen.

In these circumstances, a taxpayer might wish to amend the designation of a principal residence, and our question concerns the circumstances under which this might be permitted.

a) **Suppose firstly that the first residence was sold at a loss rather than a gain, and omitted from a personal income tax return. Does this implicitly result in a designation of that property as a principal residence for the years of ownership, even though no gain has arisen?**

b) **Suppose that the property was disposed of at a gain and omitted from a personal income tax return under the CRA's administrative policy. Under what circumstances can a taxpayer amend the designation?**

CRA Response

General comment: The answers provided to question 11 address general circumstances where a particular property met the requirements of a principal residence and was not subject to change-in-use rules, election or subject to a previous designation in a prior event such as the death of a spouse.

a) Where a property which otherwise qualifies as a principal residence but is sold at a loss, there is no implicit assumption that the property was designated as a principal residence.

When a principal residence is sold at a loss, there is no requirement to file Form T2091(IND), *Designation of a Property as a principal residence by an Individual (Other Than a Personal Trust)*. The designation for the purposes of calculating the principal residence exemption under paragraph 40(2)(b) is only required in respect of gains on the sale of a principal residence.

An individual's principal residence is considered to be a personal-use property under the Act. Where a personal-use property (including a principal residence) is sold at a loss, paragraph 40(2)(g) of the Act deems the loss to be nil, thereby preventing a deduction for the loss against other capital gains.

b) In the scenario provided, the taxpayer had more than one property which could be designated as a principal residence for the periods in question. According to section 2301 of the *Income Tax Regulations*, a taxpayer's designation of a property as a principal residence for one or more taxation years for the purposes of calculating the exemption under paragraph 40(2)(b) is to be made in his or her income tax return for the taxation year in which he or she has disposed of the property or granted an option to another person to acquire the property.

If a taxpayer has not filed Form T2091(IND) with his or her return for the taxation year in which he or she disposed of the property, he or she is still considered to have designated the property as his or her principal residence (i.e., to have claimed the principal residence exemption for that property) for the years in question. The CRA presumes that the taxpayer made the proper designation at that time.

Although the law contains no provision for the late-filing or amendment of a principal residence designation, taxpayers may submit an adjustment request to the appropriate Taxation Centre for its review. The request should include an explanation for the change in designation and any supporting documentation.

In all cases, the decision to accept a late-filed or amended designation will be at the CRA's discretion, based upon the facts of the particular taxpayer's situation. Under no circumstances will the CRA accept a late-filed or amended principal residence designation if it involves retroactive tax planning, if it impacts the return of another individual (where property was jointly owned with another individual), or if it is necessary in order to give effect to the designation, to issue a notice of assessment or reassessment for a year that is statute-barred.

Where the taxpayer is within the time limits for filing a Notice of Objection for the taxation year in which he or she disposed of the other property, the taxpayer may file a Notice of Objection by using the My Account feature on the CRA Internet site or by writing to the Chief of Appeals at your Appeals Intake Centre.

QUESTION #12 – FOREIGN MUTUAL FUNDS

A taxpayer holds an interest in a foreign mutual fund, which is legally constituted as one of the following:

i) a foreign trust;

ii) a foreign corporation; or

iii) a US LLC.

No Canadian reporting is available, and no Canadian reporting slips are provided. Foreign reporting slips disclose that substantial capital gains were realized and distributed to the investors, including the Canadian investor.

Our question relates to how the Canadian investor is to report the income resulting in the mutual fund, and the distribution from the mutual fund.

For this purpose, it is assumed that section 94.1 is not applicable.

Our analysis indicates that there is no provision for capital gains of a foreign entity described above to be "flowed through" to a Canadian resident, and that the treatment of the distribution will depend on the nature of the entity itself. If the entity is a foreign trust, it would appear that the amount of the distribution would be considered income of a trust under subsection 104(13), and would be fully taxed, even though the source of the income is a capital gain. We reached this conclusion on the basis that the flow-through provisions dealing with the income of a trust apply only in the context of a trust which is Canadian resident and do not apply to a foreign trust. Alternatively, if the foreign mutual fund is constituted as a foreign corporation, including a US LLC, it seems that the amount should be reported as a dividend, which would be fully taxable, again because there is no provision which would allow a flow-through of the capital gain.

We ask that you confirm our understanding of this matter.

CRA Response

In order to determine how income from a foreign mutual fund is to be reported for Canadian tax purposes, one must determine what the fund qualifies as for Canadian tax purposes. It will be a question of fact whether, for example, a particular foreign fund constitutes a corporation or a trust for Canadian tax purposes.

As the CRA has previously stated, we generally employ a two-step approach in determining the status of a foreign entity for Canadian tax purposes:

1. the first step involves determining the characteristics of the foreign business association under the foreign commercial law; and then

2. the characteristics identified are then compared with those of recognized categories of business associations under the commercial law in order to classify the foreign business association under one of those categories.

The classification of the foreign entity will then determine the tax treatment of the distribution to the Canadian investor. There are limited provisions in the Income Tax Act that allow for the “flow through” of capital gains realized by an entity to the investors that hold an interest in the entity.

In general, subsection 104(21) allows a trust that is resident in Canada throughout its taxation year to designate its net taxable capital gains to its beneficiaries, where the conditions outlined therein are met. Where such designation is validly made, the amount designated is deemed for purposes of section 3 and 111 (with certain exceptions) to be a taxable capital gain of the beneficiary from the disposition of capital property.

No such provision exists in the Act for a trust that does not meet the residency requirement in 104(21). If a US mutual fund is a trust for Canadian tax purposes, paragraph 108(5)(a) will deem the distribution from the fund to be income of the beneficiary from a property that is an interest in the trust. Thus, there is no flow-through of the gains to the beneficiaries for Canadian tax purposes.

If a US mutual fund is a corporation for Canadian tax purposes, it will not qualify as a “mutual fund corporation”, as defined in subsection 131(8) of the Act. Thus, it cannot elect pursuant to subsection 131(1) to flow through a capital gains dividend to a Canadian shareholder, as the election is available only to a corporation that is a Canadian mutual fund corporation throughout the taxation year.

The capital gains distribution from such a fund will be included in the Canadian shareholder’s income as a dividend, in accordance with paragraph 12(1)(k) and section 90.

QUESTION #13 – HIGH NET WORTH INDIVIDUALS

It appears that CRA has recently embarked on a project to audit certain high net worth individuals. We understand that an extensive questionnaire has been sent to certain persons with detailed and probing questions.

Does CRA intend to audit all high net worth individuals in Canada or only certain persons? For this purpose, how does CRA determine the persons to whom this project will be directed (e.g., is the selection random, based on the level of assets, based on past compliance, and/or other criteria)?

What are the objectives of the project and why does CRA believe this action is necessary?

CRA Response

The Organisation for Economic Co-operation and Development formed a 14 country focus group to study the size and environment of high net worth individuals. This study produced a number of conclusions and recommendations on how a tax administration might deal with this segment of the population.

The CRA has a program to examine high net worth individuals and their related entities. The population that is under review includes:

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

The CRA's approach to high net worth individuals has been to reinforce our risk assessment by conducting a comprehensive review of the entities in the related group. We previously tended to examine the entities on a one-by-one basis.

Groups that are risk-assessed and deemed to be "high risk" are referred for audit by our Large Files program. This initiative is ongoing.

QUESTION #14 – VOLUNTARY DISCLOSURE

We understand that because the Fairness Provisions can be exercised only for a ten-year period following amendment to subsection 220(3.1), CRA in handling Voluntary Disclosures, may be precluded from waiving penalties which arise in respect of matters more than ten years old. For example, suppose that an individual had unreported income over a period of 15 years, and makes a voluntary disclosure. CRA may waive penalties and relieve interest in respect of the most recent ten years, but seems to be taking the position that nothing can be done with respect to the earlier years. Can you please clarify your guidelines in respect of Voluntary Disclosures and the levying of penalties in such circumstances?

(a) Does this mean, for example, that a Voluntary Disclosure will only cover ten years, being the period in respect of which CRA may waive penalties, or is there now an inherent limitation on the Voluntary Disclosure Program such that a taxpayer may be exposed to penalties and potentially prosecution in respect of matters more than ten years old?

(b) This would seem counter-intuitive and not conducive to promoting the Voluntary Disclosure Program. What, if anything, might be done about this?

CRA Response

A taxpayer must disclose the entire story surrounding the non-compliance. That is all years and all unreported income must be included as part of the initial disclosure. Only after reviewing the entire story can the CRA determine which years will require an (re)assessment. This can only be done on a case by case basis and taking into account the materiality of the amounts disclosed.

There are no legislative restrictions to assessing any year if the requirements in the applicable legislation are met. As a result, the CRA will not provide assurances that they will not assess beyond 10 years. We will apply the legislation as it relates to statute-barred years and assess income in the year it was earned.

If we identify that the disclosure is not complete then there are consequences. Don't come forward with half the information. If we suspect there is income which has not been disclosed, we will ask more questions, gather more information and possibly open additional years, with the possibility of penalties being added. We will also cross-reference amounts disclosed to third-party information at our disposal. If the disclosure is incomplete, it could be denied and referred to audit. Please ensure we get the complete story up front.

As the situation described in the question is a result of the proper application of the legislation there is little the CRA can do at this time. The Department of Finance is responsible for the content of the legislation and concerns may be addressed to them.

QUESTION #15 – CHARITABLE GIVING

The Act allows for a person in their year of death to donate an amount to registered charities equal to the amount of their income where they die in that year or the following year. Can the trustee determine the amount of the gift if the testator states in their will that they wish to give to the listed registered charity(ies) an amount that would reduce their tax to zero in the year of their death? The CRA has already stated that the trustee has the power to choose the charity(ies) if they are not named – may they also choose the amount of the gift if given proper instructions as to how to calculate it?

CRA Response

Subsection 118.1(5) provides that, subject to subsection 118.1(13), where an individual by the individual's will makes a gift, the gift is, for purposes of section 118.1, deemed to have been made by the individual immediately before the individual died.

Whether or not a gift to a qualified donee will qualify as a gift by will for the purposes of subsection 118.1(5) is a question of fact and depends upon the wording in the deceased individual's will and the discretion given to the executor of the estate with respect to the making of the gift to the qualified donee. For the purposes of this subsection, a gift is considered to have been made "by the individual's will" where the executor of the estate is required to transfer a specific property or amount (including a gift of residue or a specified portion of the residue) to a recipient that is a qualified donee.

Where an individual's will directs the executor to donate an amount to a qualified donee to minimize the amount of income tax liability on the deceased's final return, it is our view that the donation will generally qualify as a gift by will. A gift, the occurrence or quantum of which is subject to the discretion of the executor is not a gift by will.

As noted, it is the CRA's view that where an individual's will stipulates that a specific amount is to be gifted to charity and provides a list of charities but the executor has discretion as to the allocation of funds to each named charity, the donation would nevertheless qualify as a gift by will if the actions taken by the executor are reasonable and in accordance with the terms of the will and the donation is made to a charity that is a qualified donee.

QUESTION #16 - ACQUISITION OF CONTROL RULES AND TRUSTEES

Where control of a corporation is acquired by an unrelated person, certain rules apply which deem a year-end to occur, create certain write-downs for tax purposes, and limit loss carry forwards and loss carry backs. These acquisition of control rules are designed to restrict the portability of losses of a corporation between unrelated parties.

CRA has taken the position that an acquisition of control could occur where there is a change of the trustee of a trust. We would like to ask for further guidance as to CRA's position in this regard.

1. **In the following example, a Canadian corporation, CanCo, is owned by a trust (which may be an *inter vivos* or a testamentary trust). Would an acquisition of control occur in the following circumstances:**

    (a) **The trust has one trustee, Mr. A, who resigns and Mr. B takes over as trustee.**

    (b) **The same circumstances as (a), except that Mr. A and Mr. B are related persons.**

    (c) **The trust has two trustees, Mr. C and Mr. D. Mr. D retires in favour of Mr. E.**

    (d) **The trust has three trustees, Messrs. F, G, and H. The trust document requires unanimous decision-making. Mr. H retires in favour of Mr. I.**

    (e) **The trust has three trustees, Messrs. J, K, and L. The trust requires majority decision making. Mr. L retires in favour of Mr. M.**

2. **Does it make a difference if the trust is an *inter vivos* or a testamentary trust?**

3. **In the event that there are multiple changes in the trustee in the course of a year, does an acquisition of control occur each time there is a change of trustee?**

4. **If one of the trustees dies, does this result in the acquisition of control rules becoming applicable?**

5. **If your answer is that in most or all circumstances above an acquisition of control will occur, would you consider making a recommendation to the**

Department of Finance for an amendment to the Act in order to restrict the circumstances under which this matter may rise?

6. Is there an effective date as to the application of this policy, and what should taxpayers do who have failed to apply the acquisition of control rules?

CRA Response

1. Based on the decision in *M.N.R v. Consolidated Holding Company Limited*[15], where the majority of the voting shares of a corporation are held by a trust, it is the trustees of the trust who have the legal ownership of the shares, who have the right to vote those shares, and who, therefore, control the corporation. Where a trust has multiple trustees, the determination as to which trustee or group of trustees controls the corporation can only be made after a review of all the pertinent facts, including the terms of the trust document. However, in the absence of evidence to the contrary, we would consider there to be a presumption that all of the trustees would constitute a group that controls the corporation.

Given our position as summarized above, we would generally take the position that there would be an acquisition of control in each of the situations described in 1(a), (c), (d), and (e). With respect to 1(b), paragraph 256(7)(a) may apply, where shares are acquired by a person related to the former trustee, to deem that there be no acquisition of control.

2. Generally, no, except in the circumstances described in 4 below.

3. Yes, in the event that it is determined that an acquisition of control occurred in more than one occasion over the course of a year, there would be more than one acquisition of control in the year.

4. In the event one of the trustees dies, our position with respect to the change in a trustee, as outlined above, would apply in determining whether there is an acquisition of control. However, in the case of an estate, paragraph 10 of IT-302R3 indicates that where the executor, administrator, or trustee of the estate is replaced as a result of that person's death or inability to fulfill her or her functions, control of the corporation will be regarded as remaining unchanged. As indicated in Income Tax Technical News No. 34, the position outlined in Interpretation Bulletin IT-302R3, *Losses of a Corporation . The Effect that Acquisitions of Control, Amalgamations, and Windings-up have on Their Deductibility . After January 15, 1987,* was adopted when a previous version of paragraph 256(7)(a) provided a legal basis for the position. Consideration will have to be given to withdrawing the current position when the bulletin is next revised.

5. As indicated in Income Tax Technical News No. 34, we have raised the matter with the Department of Finance.

[15] See *M.N.R. v. Consolidated Holding Company Limited*, 72 DTC 6007.

6. There is no effective date as to the application of this policy. Each taxpayer who has failed to apply the acquisition of control rules will have to evaluate their particular circumstances to determine an appropriate course of action.

QUESTION #17 – RCA TRUSTS

We understand that the CRA has started to review RCA Trusts. Can you let us know the status of the review?

CRA Response

The number of RCAs registered in recent years has increased significantly. The refundable tax creates an enormous liability for the government that must be managed. Reviews of these trust arrangements are identifying issues that are of concern to the CRA, including whether a bona fide RCA even exists (versus a salary deferral arrangement for example). The CRA will continue to audit RCAs and any positions taken will be based on the facts of each case.

QUESTION #18 – COMPLIANCE ISSUES

Does the CRA have any new compliance issues that it would like to discuss with the STEP audience?

CRA Response

Dividend strips are an arrangement involving the use of a trust to funnel dividend income to beneficiaries.

The arrangements are structured to invoke subsection 75(2) in a manner which purports to insure that neither the trust nor the beneficiaries are taxable on the income.

A typical arrangement may involve a family operating company making a contribution to a family trust, which uses those contributed funds to acquire shares in a new corporation. The series of transactions is designed to culminate in the new corporation paying a large dividend to the trust, using funds stripped from the operating company, with the intent that the dividend be attributed back to the operating company.

The CRA is challenging these arrangements on the basis that the income is required pursuant to paragraph 12(1)(j) and in some cases, subsection 104(13), to be added to the income of the Trust and/or the beneficiaries, depending on the circumstances.

It appears that paragraph 10 of Interpretation Bulletin IT-369R, *Attribution of trust income to settlor*, is being relied upon to prevent taxation of the dividend in the trust, or in the hands of the beneficiaries. It should be noted, however, that paragraph 10 of the IT is a general administrative concession; it is not law. CRA is of the view that this concession does not apply to such schemes.

It is our alternative position that the GAAR applies to deny tax benefits arising from these arrangements.

QUESTION #19 – INSOLVENT ESTATES

1. **Where an estate is insolvent, does the Crown have priority over other creditors in relation to an outstanding tax liability of the deceased?**

2. **Where an estate is insolvent, and a bank has distributed the proceeds of a RRIF to the designated beneficiary, what is the liability of the legal representative in relation to any existing tax liability as well as to any taxes due on the RRIF?**

3. **Is the executor of an estate entitled to use estate assets to defray expenses, in particular, in order for the legal representative to object to income tax assessments?**

CRA Response

1. The Crown prerogative requires the executor of an estate to pay an income tax debt ahead of other debts of the estate, or alternatively, to provide security for the debt. It should be noted however, that the Crown prerogative is not absolute. For instance, where a creditor has a security interest in the estate property, then such interest would prevail over the Crown's claim.

   In the event that an estate does not have the capacity to pay all of its creditors in full, assigning the estate into bankruptcy presents an alternative solution, in which case the Crown's claim to priority over other creditors would cease, and the proceeds of disposition would be distributed rateably in accordance with the scheme of distribution set out in the Bankruptcy and Insolvency Act[16].

   It should be noted that trustees in bankruptcy are expressly excluded from the operation of subsections 159(2) and (3).

2. In relation to the registered retirement income fund ("RRIF"), where the last annuitant under a RRIF dies, the annuitant is deemed to have received, immediately before death, an amount under the fund equal to the fair market value of the property of the fund at the time of the death, pursuant to subsection 143.6(6). The amount is included in computing the income of the annuitant for income tax purposes by operation of subsection 146.3(5).

   Where a taxpayer receives a benefit under a RRIF, as a consequence of the death of the annuitant, subsection 160.2(2) provides that the taxpayer is jointly and severally liable with the annuitant for the income tax attributable to the amount received. Where more than one taxpayer receives a benefit under a RRIF, then such taxpayers

[16] See *Bankruptcy and Insolvency Act*, R.S.C., 1985, c. B-3

are jointly and severally liable to pay a portion of the annuitant's tax that is attributable to the amount received by the taxpayers.

In any event, the personal liability of a legal representative for a deceased's unpaid tax liability is limited to the value of the property over which the legal representative had possession or control and that he or she distributed.

3. Subsection 159(3) provides that where a clearance certificate under subsection 159(2) has not been obtained, the legal representative of a taxpayer is personally liable for the payment of amounts owing by a taxpayer under the Act to the extent of the value of the assets distributed. In short, an estate is required to pay any tax liability before assets can be distributed. However, allowance can be made for the payment of reasonable funeral, testamentary and administration costs.

   The decision as to whether or not to dispute the assessments should be made objectively. As such, this would rule out any person who stands to profit or gain from the outcome. Accordingly, there are three options available to the estate, namely:

   - The estate could make an assignment into bankruptcy, in which case the trustee in bankruptcy would make the decision as to whether an objection or appeal should be pursued;
   - The executor could personally fund the services of an accountant and in the event that there is a decrease in tax payable, consideration could be given to permitting the fees to be paid out of the assets of the estate; or
   - The executor could use estate assets to fund the services of an accountant, but would do so at the risk of being held liable under subsection 159(3).

   There are positive and negative aspects to each of these options which will require consideration from the legal representative.