STEP Canada / Canada Revenue Agency Roundtable (2022)

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The following is the author's summary of the verbal answers given by the Canada Revenue Agency ("CRA") representatives to the following questions (as provided by STEP Canada) at the STEP Canada 24th National Conference on June 15, 2022; official written answers will be published by the CRA in summer 2022, including a "bonus" question and answer not discussed during the Roundtable.

Unless otherwise stated, all legislative references hereafter are to the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (the "Act").

QUESTION 1. Interaction Between Subsection 104(21) and 104(21.2)

Subsection 104(21) permits a trust to designate, in respect of a beneficiary under the trust, a portion of its net taxable capital gains[1] ("NTCG"). Where the designation is made, the amount designated is deemed, for the purposes of sections 3 and 111 (except as they apply for the purposes of determining whether a beneficiary is entitled to claim a capital gains exemption under section 110.6[2]), to be a taxable capital gain ("TCG") for the year of the beneficiary from the disposition of capital property.

Given that a designation made pursuant to subsection 104(21) is not for the purposes of section 110.6, in order for a beneficiary under the trust to claim the lifetime capital gains exemption ("LCGE") in respect of the TCG designated to them under subsection 104(21), a separate designation pursuant to subsection 104(21.2) must be made.

Consider the following facts:

1) A trust (the "Trust") is an *inter vivos*, discretionary personal trust, resident in Canada;

2) There are 2 adult beneficiaries under the Trust ("Beneficiary A"; "Beneficiary B"), each of whom are resident in Canada;

3) Only Beneficiary B has access to their LCGE;

4) The Trust realizes two capital gains during the year, resulting in total NTCG to the Trust in the amount of $1,000,000, broken down as follows:

    a) a $300,000 "regular" TCG, from the disposition of the shares of a publicly traded corporation; and

    b) a $700,000 TCG resulting from the sale of qualified small business corporation shares[3] ("QSBCS"); and

5) The trust indenture permits the trustees to allocate and designate the NTCGs as follows:

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[1] Determined in subsection 104(21.3).

[2] The designation is also subject to paragraph 132(5.1)(b).

[3] Defined in subsection 110.6(1)

a) The $300,000 TCG to Beneficiary A; and

b) The $700,000 QSBCS TCG to Beneficiary B (so that Beneficiary B may use their LCGE to offset as much of the gain as possible[4]).

Does the formula in subsection 104(21.2) permit the trustees to allocate the NTCGs in the desired manner, or does the interaction of subsections 104(21) and 104(21.2) require a proration, such that the entire $700,000 QSBCS TCG cannot be designated to Beneficiary B?

ANSWER 1:

Subsection 104(21) provides that in order to designate NTCGs, the following conditions must be met:

1) The trust must be resident in Canada;

2) The designation must be made in the trust's return of income for the particular taxation year, in respect of a taxpayer who is a beneficiary under the trust in that taxation year and is resident in Canada;

3) The amount designated must have been included in computing the income of the beneficiary for that taxation year; and

4) The total of all amounts designated by the trust is not greater than the trust's NTCGs for the year.

In relation to the fact pattern above, the CRA confirmed that subsection 104(21) permits the Trust to designate $300,000 of TCGs to Beneficiary A and $700,000 of TCGs to Beneficiary B.

Where a designation is made under subsection 104(21), a separate designation under subsection 104(21.2) must be made in respect of its eligible TCGs. This allows a beneficiary to claim the LCGE under subsection 110.6 in respect of QSBCS (and other qualifying property) by deeming the beneficiary to have disposed of such property.

The CRA confirmed that a proportionate amount of the QSBCS TCG must be allocated to each beneficiary in respect of whom a designation was made under subsection 104(21), pursuant to the formula for eligible TCGs from QSBCS set out in clause 104(21.2)(b)(ii)(B):

$$\frac{(A \; x \; B \; x \; F)}{(D \; x \; E)}$$

In particular, elements B and D of the formula refer to the amount designated to each beneficiary under subsection 104(21) and the total of all amounts designated under subsection 104(21), respectively. The formula must be applied to each beneficiary to determine their proportionate amount of the trust's eligible TCGs.

Based on the allocations made under subsection 104(21) in relation to the fact pattern above, the equation for each beneficiary is as follows:

[4] Although amounts designated by a personal trust under subsection 104(21.2) are for the purpose of section 3 as it applies for the purposes of section 110.6; the LCGE available to an individual in a particular taxation year is determined pursuant to subsection 110.6(2), (2.1) and (2.2).

Beneficiary A:

$$\frac{(700{,}000\ x\ 300{,}000\ x\ 700{,}000)}{(1{,}000{,}000\ x\ 700{,}000)}$$

= $210,000

Beneficiary B:

$$\frac{(700{,}000\ x\ 700{,}000\ x\ 700{,}000)}{(1{,}000{,}000\ x\ 700{,}000)}$$

= $490,000

Accordingly, the Trust must designate $210,000 of the eligible TCGs to Beneficiary A and $490,000 of the eligible TCGs to Beneficiary B. Beneficiary B will be able to claim their LCGE to the extent permitted under section 110.6.

QUESTION 2. Subparagraph 104(4)(a)(ii.1) Election

In the 2021 STEP CRA Roundtable[5], it was noted that an alter ego trust can effectively elect to have the 21 year deemed disposition rule apply, rather than having the deemed disposition occur upon the death of the taxpayer who created the trust. To do so, the alter ego trust must make an election in its tax return for its first taxation year, pursuant to subparagraph 104(4)(a)(ii.1).

One consequence of the election is that the property transferred to the alter ego trust will be deemed to be disposed of by the taxpayer at fair market value and not the adjusted cost base pursuant to subparagraph 73(1)(a)(ii), because the condition in paragraph 73(1.02)(c) will not be satisfied.

Given the above, we have two questions:

A. Will CRA accept a late election under subparagraph 104(4)(a)(ii.1)?

B. Can this election be made by other trusts to which a subsection 73(1) rollover would otherwise apply, such as a spouse or common-law partner trust, or a joint spouse or common-law partner trust?[6]

ANSWER 2:

A. Late Election

To determine whether the CRA will accept a late election, one must look to the specific language of subparagraph 104(4)(a)(ii.1). The Act contains a number of provisions requiring elections to be filed with a return of income and others requiring elections to be filed by a specified filing-due date. Subparagraph 104(4)(a)(ii.1) requires that the election be made in the relevant trust's return of income under Part 1 for its first taxation year. The language is clear and unambiguous. Canadian courts have determined that this language requires that the election must be made in

[5] See 2021 question 13, CRA document 2021-0883051C6.

[6] For purposes of the transfer under subsection 73(1), these trusts are described in subsection 73(1.01)(c)(i), and (c)(iii)(A) and clause (c)(iii)(B).

the return of income, and therefore the election would not be considered late if the return is filed late (see *Rezek v. Canada*, 2005 FCA 227 at paragraphs 113 – 115).

The CRA confirmed that it will accept a subparagraph 104(4)(a)(ii.1) election that is made in the trust's return of income for its first taxation year, regardless of whether the return is filed on time. However, if the election is filed after the return, the election would be late and would not be accepted by the CRA. The Minister does not have discretion under subsection 220(3.2) and section 600 of the *Income Tax Regulations*, C.R.C., c. 945 ("Regulation 600") to accept a late-filed election under subparagraph 104(4)(a)(ii.1).

B. Application to Other Subsection 73(1) Trusts

No other trusts can make the subparagraph 104(4)(a)(ii.1) election. Subsection 248(1) defines an alter ego trust by reference to paragraph 104(4)(a) read without reference to the subparagraphs and clauses that describe these other types of trusts. As such, for these other types of trusts, the first deemed disposition occurs on date of the relevant death.

QUESTION 3. Electing Contributor and Electing Trust

a) Electing Contributor

The definition of "electing contributor" in subsection 94(1) is relevant in applying the rules in subsections 94(16) and 94(17). Subsection 94(16) provides rules for attributing the income of a trust that is deemed to be resident in Canada under subsection 94(3) to its electing contributors. The provision applies on an electing contributor-by-electing contributor basis. Subsection 94(17) provides rules regarding certain liabilities in respect of joint contributions where there is an electing contributor who is a joint contributor in respect of a contribution to the trust.

Can the election described in the definition of electing contributor in subsection 94(1) be late-filed?

b) Electing Trust

The definition of "electing trust" in subsection 94(1) is relevant in determining whether property held in the "non-resident portion", as defined in subsection 94(1), of a deemed resident trust is considered to be held in a separate trust.

Paragraph 94(3)(f) provides rules that generally have the effect, on an elective basis, of excluding from the taxable base of a deemed resident trust for Canadian tax purposes any income relating to property that has been contributed to the trust otherwise than by a "resident contributor" to the trust or, if there is a current "resident beneficiary" under the trust, a "connected contributor" to the trust (i.e., property that is part of the non-resident portion of the trust). Resident contributor, resident beneficiary, and connected contributor are all defined in subsection 94(1). In effect, this is accomplished by deeming there to be a second trust in addition to the electing trust. The additional trust is deemed to hold the property that forms the trust's non-resident portion. This has the effect of removing from the taxable base of the trust any income derived from that property.

Can the election described in the definition of electing trust in subsection 94(1) be late-filed?

ANSWER 3:

a) Electing Contributor

The definition of "electing contributor" in subsection 94(1) provides that in order for subsection 94(16) to apply in respect of the contributor and the trust for a particular taxation year of the contributor and for all subsequent taxation years, an election must be made in writing and filed on or before the contributor's filing due-date (i.e., the day the contributor's return of income is required to be filed under Part 1) for the first taxation year in which the election was to take effect. For example, the filing-due date for an individual's 2022 taxation year would be May 1, 2023 (since April 30, 2023 is a Sunday). The election must be filed on or before the relevant filing-due date even if the contributor's return of income for the particular year is not filed on time.

The Minister does not have discretion under subsection 220(3.2) and Regulation 600 to accept a late-filed election. However, the contributor could make the election for its next taxation year and all subsequent taxation years, provided the election is filed on time.

b) Electing Trust

The consequence of making an election under paragraph 94(3)(f) is that income of the non-resident portion will generally not be taxable in Canada, except for certain Canadian-source income. The definition of "electing trust" in subsection 94(1) provides that the trust must elect in writing to have paragraph 94(3)(f) apply to it and must file the election with the trust's return of income for its first taxation year throughout which it is deemed by subsection 94(3) to be resident in Canada and in which it holds property that is part of its non-resident portion.

Reference was made to the case law cited in Answer 2 above. As long as the election is filed with the relevant return, it is not considered late-filed, even if the return is late. Where the election is not included with the relevant return, the election is considered late, and the Minister does not have discretion under subsection 220(3.2) and Regulation 600 to accept a late-filed election in this case.

QUESTION 4. Death and Tax Payment over 10 Years

The tax payable by a deceased individual related to certain income and gains (rights and things per subsection 70(2), and deemed dispositions per subsections 70(5) and 70(5.2)) may be, pursuant to subsection 159(5), paid in 10 annual installments provided the taxpayer's legal representative so elects and furnishes the Minister with security acceptable to the Minister.

Can the CRA comment on what is acceptable security and what the recommended process should be to provide for such an arrangement?

ANSWER 4:

The process to elect to defer the payment of tax is to file Form T2075 at the appropriate Tax Services Office. A copy of the form should also be filed with the deceased taxpayer's terminal tax return. A collections officer will contact the taxpayer's legal representative to arrange for acceptable security.

See Information Circular: IC98-1R8 for a description of acceptable security. This includes bank letters of guarantee, standby letters of credit, or mortgages. This list is not exhaustive. Acceptability of other forms of security is determined on a case-by-case basis. Acceptable

security must be liquid (i.e., cash or cash-equivalent) and realizable on demand without defense or claim from third parties.

QUESTION 5. Trust and Debt Forgiveness

A Canadian resident trust makes a loan (the "Loan") to a beneficiary. The beneficiary uses the Loan proceeds for investment. Later the trust distributes the Loan as an in specie capital or income distribution to the beneficiary.

Is the distribution of the Loan to the beneficiary a settlement of debt? If so, do the debt forgiveness rules under section 80 apply to the beneficiary for the "forgiven amount"?

If the beneficiary used the loan proceeds for personal purposes (e.g. to buy a principal residence), is the answer different?

ANSWER 5:

Assumptions made by the CRA for the purposes of this answer:

1) The trust qualifies as a personal trust as defined in subsection 248(1);

2) Both the trust and the beneficiary's taxation year-end is December 31st and both are resident in Canada;

3) The trust instrument permits in specie capital or income distributions;

4) The Loan is a bona fide loan made in accordance with the trust instrument and is capital property of the trust; and

5) The adjusted cost base of the loan is equal to the principal amount thereof.

The determination of whether a loan is settled or extinguished, or if there is a forgiven amount, is a mixed question of fact and law and can only be determined on a case-by-case analysis. In this case, the Loan would be extinguished under the doctrine of merger, which would generally constitute a settlement of the debt. The result of the distribution of the Loan to the beneficiary is a settlement of the Loan which does not constitute a payment in satisfaction of the Loan.

It is necessary to determine whether the Loan is a commercial debt obligation, as defined in subsection 80(1) (i.e., whether it is a debt obligation where interest was deductible, or would have been deductible if interest had been paid or payable, in computing the debtor's taxable income). If the proceeds are used for investment purposes and meet the criteria for deductibility, the Loan would be a commercial debt obligation. If the debt is for personal use, the Loan would not be a commercial debt obligation, so the definition of forgiven amount in subsection 80(1) would not apply to that amount.

If the Loan is a commercial debt obligation, the settlement of the Loan gives rise to a forgiven amount, determined by the following formula:

$$A - B$$

where A is the principal amount of the Loan and B is, among other things which are not relevant here, any payment in satisfaction of the principal amount of the Loan. Since the CRA does not

consider an extinguishment of the Loan to constitute a payment, element B is nil. Therefore, the settlement would give rise to a forgiven amount.

The CRA noted that if there is in fact a repayment of the Loan, this should be clearly documented to show there is no forgiven amount.

QUESTION 6. Acquisition of Control

Assume a Canadian corporation is wholly owned by a trust. Assume also that the trust document provides that the trustees of the trust can exercise discretionary power in the distribution of income and capital from the trust such that paragraph 256(7)(i) will not apply to deem there not to have been an acquisition of control if there is change to the trustees of the trust. Is there an acquisition of control (giving rise to a loss restriction event for the Canadian corporation) in the following circumstances?

(a) The trust has one trustee, A, who resigns. B, who is related to A, takes over as trustee.

(b) The same circumstances as (a) except that A and B are not related.

(c) The trust has two trustees, D and E. The trust document requires unanimous decision making. E resigns and is replaced by F. E and F are related.

(d) The trust has two trustees, D and E. The trust document requires unanimous decision making. E resigns and is replaced by G. E is not related to G.

(e) The trust has three trustees, H, I and J. The trust requires majority decision making. J resigns and is replaced by K. Each of H, I, J and K are not related.

ANSWER 6:

Based on the Supreme Court's decision in *Minister of National Revenue v. Consolidated Holding Co.*, [1974] SCR 419, where a trust holds a majority of the voting shares of a corporation, the trustees of the trust control corporation. Where there are multiple trustees, control is determined by a review of all relevant facts, including the trust instrument. In absence of evidence to the contrary, all of the trustees would constitute a group that controls the corporation. Therefore, scenarios B, D, and E would result in an acquisition of control. For scenarios A and C, clause 256(7)(a)(i)(A) may apply to deem no acquisition of control, provided the new trustee is appointed concurrently with the resignation of the old trustee.

QUESTION 7. Paragraph 88(1)(d.3) "as a consequence of the death of an individual"

Paragraph 88(1)(d.3) states that "for the purposes of paragraphs 88(1)(c), (d) and (d.2), where at any time control of a corporation is last acquired by an acquirer because of an acquisition of shares of the capital stock of the corporation as a consequence of the death of an individual, the acquirer is deemed to have last acquired control of the corporation immediately after the death from a person who dealt at arm's length with the acquirer".

In 2010, the CRA issued an advance tax ruling described in document 2009-0350491R3 dealing with the availability of a section 88 bump to a series of transactions involving property owned by a subsidiary of an alter ego trust immediately after the death of the settlor. It was stated that among the reasons for granting the ruling was that the parent corporation seeking the bump, another subsidiary of the alter ego trust, acquired control of the subsidiary as a consequence of the death of the settlor of the alter ego trust because the shares of the subsidiary were acquired

by the parent corporation pursuant to the terms governing the alter ego trust which imposed an equitable obligation on the trustees to transfer the shares of the subsidiary to the parent on the death of the settlor.

1. Does this continue to be CRA's position and as a consequence the provisions of paragraph 88(1)(d.3) would apply to the parent in these circumstances?

2. Does the deemed reacquisition, pursuant to subsection 104(4), of the shares of a corporation wholly-owned by an alter ego trust on the death of the settlor of the alter ego trust result in an acquisition of control of the corporation by the alter ego trust as "*a consequence of the death of an individual*" for purposes of paragraph 88(1)(d.3)?

ANSWER 7:

1. The CRA's previous ruling would still apply in the circumstances described in the 2009 document—an acquisition of control occurred as a consequence of death because the transfer of shares was required by the terms of the alter ego trust.

2. Where subsection 104(4) results in a deemed disposition and deemed reacquisition, this would not automatically result in an acquisition of control, as the shares continue to be legally owned by the trust.

QUESTION 8. TOSI and Multiple Businesses

Suppose that husband and wife reside in Canada and own a number of corporations each of which has its own business and full-time staff. They work on a full-time basis for the various companies, but do not work for any particular company at least 20 hours a week. In this circumstance, would dividends above a reasonable amount be subject to tax on split income ("TOSI")? Assume the shares of the corporations do not qualify as excluded shares.

ANSWER 8:

Reference is made to the definitions set out in subsection 120.4(1). The CRA has assumed that these businesses are all related businesses.

If an individual has attained the age of 17 before the year, income from an excluded business is an excluded amount. This requires that the individual is actively engaged on a regular, continuous and substantial basis in the activities of the business in the relevant taxation year or any five previous taxation years. There is a bright line test which deems this requirement to be met where the individual works in the business at least an average of 20 hours per week during the portion of the year in which the business operates. The test applies on a business-by-business basis.

In this case, since neither spouse worked 20 hours per week in any of the businesses, they would not pass the bright line test. Each spouse would have to show that they were actively engaged on a regular, continuous and substantial basis in the activities of each business. Such a determination assesses various factors, including the nature of involvement and the roles each spouse holds. The more they are involved in a management role, the more likely they would be considered to be involved on a regular and substantial basis. The more their contributions are integral to the business, the more substantial their activities would be. Since the answer depends on the circumstances, the CRA is unable to make a determination in this particular case.

If the exemption for excluded businesses does not apply, TOSI may apply to the extent that distributions exceed a "reasonable return" based on the factors set out in that definition (i.e., work performed, property contributed, risk assumed, prior amounts received from the business, and any other relevant factors).

QUESTION 9. Section 43.1 – Life Estate

If a taxpayer transfers a remainder interest in real property to another person and retains a life estate in the property, subsection 43.1(1) will apply to the disposition as long as all conditions therein are satisfied. If, upon the death of an individual, the life estate to which subsection 43.1(1) applied is terminated:

- the holder of the life estate immediately before the death is, generally speaking, deemed pursuant to paragraph 43.1(2)(a) to have disposed of the life estate for proceeds of disposition ("POD") equal to the holder's adjusted cost base ("ACB"); and
- the ACB of the property to the holder of the remainder interest is increased pursuant to paragraph 43.1(2)(b), if the individual who held the life estate was not dealing at arm's length with the holder of the remainder interest in the real property.

Questions

a) What provisions of the Act apply if, rather than transferring a remainder interest in a principal residence (the "Residence") directly to an adult child (the "Child"), a parent ("Parent") transfers the remainder interest to a personal trust under which the Child is a beneficiary?

b) If Parent later moves out of the Residence to live in an assisted-living residence and the Residence is sold prior to the death of Parent what provisions of the Act then apply? Does the ACB of the life estate stay with Parent, with no adjustment available to the trust? Alternatively, is the life estate considered to be a gift from Parent to the trust at the time of Parent's relocation, thereby resulting in an increase in the ACB of the remainder interest to the trust?

Consider the following example:

- Parent transfers a remainder interest in the Residence to a personal, *inter vivos* trust (the "Trust") and retains a life estate in the property;
- The Child is the only beneficiary under the Trust;
- At the time of the transfer of the remainder interest:
    - the Residence has a fair market value ("FMV") of $250,000;
    - the life estate has a FMV of $50,000; and
    - the remainder interest has a FMV of $200,000;
- Assume all conditions in the definition of "principal residence" contained in subsection 54(1) are satisfied and that Parent has never claimed the principal residence exemption on any other property;

- Parent later moves out of the Residence and willingly disposes of the life estate to the Trust to enable the sale of the Residence to a third party;
- The Residence is immediately sold to an arm's length third party; and
- At the time of the sale, the Residence has a FMV of $400,000.

c) Does the answer change if Parent continues to live in the Residence while the remainder interest is held by the Trust and the Residence is not sold until after Parent's death? Is the trust considered not to deal at arm's length with Parent such that paragraph 43.1(2)(b) will apply?

ANSWER 9:

a) Remainder interest transferred to personal trust

The transfer of the remainder interest to the trust constitutes a disposition pursuant to paragraph (c) of the definition in subsection 248(1). Subsection 43.1(1) provides that notwithstanding any other provision of the Act (with limited exceptions not applicable here), where a taxpayer disposes of a remainder interest in real property and retains a life interest, the taxpayer is deemed to have disposed of and reacquired the life interest for POD equal to its FMV at that time. Parent and the Trust are deemed not to deal with each other at arm's length due to paragraph 251(1)(b), since Child is a beneficiary of the Trust and is deemed not to dealt with Parent at arm's length under paragraph 251(1)(a). If the remainder interest is transferred to the Trust for no proceeds or for proceeds less than FMV or by way of gift, Parent will be deemed to have received POD equal to FMV, pursuant to subparagraph 69(1)(b)(i) or (ii). If the transfer occurs by way of gift, the Trust will be deemed to have acquired the remainder interest at FMV pursuant to paragraph 69(1)(c). If Parent realizes a capital gain, they can claim the principal residence exemption, provided all relevant conditions are met.

b) Parent moves out of the Residence

Subsection 43.1(2) does not apply since the life interest is not terminated by death. When Parent disposes of the life interest to the Trust, they are deemed to have received POD equal to the FMV of the life estate at that time. As in scenario (a), subparagraph 69(1)(b)(i) or (ii) and paragraph 69(1)(c) may apply. Where the FMV of the life estate has increased since the initial transfer, Parent may realize a further capital gain. Where the FMV has decreased, Parent may realize a loss, which would be denied under subparagraph 40(2)(g)(iii), as a loss from the disposition of personal-use property.

c) Parent lives in the Residence until death

When Parent dies, they will be deemed to have disposed of the life estate immediately before death for POD equal to the Parent's ACB thereof, pursuant to paragraph 43.1(2)(a). Since Parent and the Trust are deemed not to deal with each other at arm's length, as noted above, paragraph 43.1(2)(b) will also apply to add to the Trust's ACB of the Residence the lesser of Parent's ACB of the life estate immediately before death and the amount, if any, by which the FMV of the Residence immediately after the death exceeds the ACB to the Trust of the remainder interest immediately before the death.

It should be noted that a personal trust's ability to claim the principal residence exemption is limited to the circumstances described in the definition of "principal residence" in section 54 and paragraphs 2.65 – 2.68 of Income Tax Folio S1-F3-C2.

QUESTION 10. Taxation Year-End of a Trust

When a trust winds up and ceases to exist, does the taxation year of the trust end at that time or does its taxation year continue until the time of its normal year-end? For an *inter vivos* trust the normal taxation year-end would be December 31 and for a graduated rate estate (GRE) (in its first 36 months) that year-end would be the end of the fiscal period adopted.

The Act is specific in certain provisions in deeming a year-end to arise (e.g. for alter ego, spousal and joint spousal trusts, a testamentary trust that ceases to be a GRE, and when a trust becomes or ceases to be resident in Canada). The Act is silent on this point in the general case.

The T3 Guide states that when a GRE winds up, a taxation year-end occurs on the date of the final distribution of its assets.

Can CRA explain the rationale for this?

ANSWER 10:

Subsection 249(1) defines "taxation year" for the purposes of the Act. Paragraph 249(1)(b) applies in the case of a GRE—the final taxation year ceases when the period for which the accounts of the estate are made up ends (i.e., upon the final distribution of trust property). Paragraph 249(1)(c) is relevant for trusts other than a GRE—the final taxation year coincides with the calendar year, since there is no provision that would cause the end of the taxation year to be anything other than the calendar year.

QUESTION 11. Joint Spousal or Common-Law Partner Trust

At the 2021 STEP CRA Roundtable, the CRA confirmed that a joint spousal or common-law partner trust may be created with a contribution of jointly-owned property by an individual and the individual's spouse or common-law partner.

We have two questions.

a) Once the joint spousal or common-law partner trust is created, can further contributions be made by the spouses or common-law partners at any time, in any form? For example, we assume the contributions are not limited to the initial settlement or to only jointly-owned property.

b) How is income computed in respect of the contributed property where subsection 75(2) is applicable? For example, assume that subsequent to the initial contribution by Spouse A and Spouse B, they contribute portfolios X and Y, respectively, to a joint spousal trust. Assume both Spouse A and Spouse B are discretionary capital beneficiaries such that subsection 75(2) applies to both of them.

ANSWER 11:

a) Further contributions

Where the trust is created by an initial contribution of jointly owned property, further contributions can be made by either spouse and are not limited to jointly owned property. Pursuant to subsection 73(1), transfers of property owned by one spouse or owned jointly would be eligible for rollover treatment.

b) Application of subsection 75(2)

Generally, where subsection 75(2) applies to property contributed to a trust, any income, loss, taxable capital gain, or allowable capital loss from the property, or property substituted therefor, is attributed to the contributor. The application of subsection 75(2) is determined in respect of each particular property or property substituted therefor. Accordingly, a transfer of two separate portfolios would result in attribution from each portfolio to the respective contributors. This would continue as long as the investments transferred, or property substituted therefor, continue to be held by the trust and the contributor is resident in Canada. Note, however, that subsection 75(2) does not apply to second generation income (i.e., income earned from reinvested income that is retained in the trust).

QUESTION 12. Sale to Alter Ego Trust

A transfer of capital property to an alter ego trust by the settlor occurs at cost absent an election for the transfer to occur at fair market value.

Given such, consider the following short fact pattern. A settlor settled an alter ego trust (the "Trust") a few years ago. The trust agreement provides that the settlor is not entitled to receive or otherwise obtain the use of any of the capital of the Trust during their lifetime. The Trust has cash. The settlor later transfers appreciated non-depreciable capital property (the "Transferred Property") to the Trust in exchange for cash. The acquisition of property by the Trust is consistent with the terms of the Trust. Does CRA agree that the Transferred Property will be deemed to have been disposed of by the settlor for proceeds equal to their adjusted cost base to the settlor (absent an election to the contrary) even though the settlor received payment?

If the settlor later gifts the cash, say to an adult child, does this alter the answer?

ANSWER 12:

Subsection 73(1) applies to *inter vivos* transfers to certain individuals, including an alter ego trust. Absent an election to have such transfers occur at fair market value, such transfers are deemed to have occurred at the transferor's adjusted cost base. Assuming all the requirements of subsection 73(1) are met and assuming the trust instrument allows for the sale described in the fact pattern, the settlor's proceeds of disposition for the Transferred Property would be deemed to be equal to the settlor's adjusted cost base thereof.

This answer would remain unchanged if the settlor later gifts the cash to an adult child.

QUESTION 13. Subsection 164(6) – Amending Deceased's Final T1 Return

Subsection 164(6) allows capital losses of a graduated rate estate in its first taxation year to be considered capital losses of the deceased, where all required conditions are met. Such conditions

include that the estate is a graduated rate estate ("GRE"), an election is filed, and the legal representative amends the deceased's final T1 return of income.

a) In amending the deceased's final T1 return of income, is the filing of a T1 Adjustment Request sufficient?

b) Assume a refund results from the application of the election under subsection 164(6). When does interest begin to accrue on the refund?

ANSWER 13:

a) Paragraph 164(6)(e) requires the legal representative to file an amended return of income for the deceased taxpayer for the taxpayer's taxation year in which the taxpayer died. The filing of a T1 Adjustment is not sufficient to satisfy this requirement. The amended return must be clearly identified as a subsection 164(6) election return. See the 2021 T3 Guide for information on the election from the perspective of both the GRE and the deceased taxpayer. Further, while the original terminal return can be filed via EFILE, elections and elective returns cannot.

b) Any refund resulting from the subsection 164(6) election is deemed to have arisen (and interest accrues from) the day that is 30 days after the latest of the dates specified in subsection164(5).

QUESTION 14. T3 Processing Update

Can the Canada Revenue Agency (CRA) provide us with additional information about their new service which allows users to file a T3 return via EFILE?

ANSWER 14:

The 2018 federal budget proposed new mandatory filing and disclosure rules for trusts. Additional proposals were released on February 4, 2022, generally applicable for the 2022 taxation year. As a result, the volume of T3 returns is expected to increase significantly next year, so the CRA is modifying its systems to allow for filing of T3s via EFILE. Supplementary information for tax preparers is available on the Government of Canada's website. The CRA is now accepting T3 returns via EFILE, along with a few other types of returns and forms, including Form T1135 Foreign Income Verification Statement.

The T3 EFILE page on the Government of Canada's website provides a list of certified software products. Refer to the "How to file a T3 return" page for additional information. T3 filers must have a trust account number before they can use EFILE.

Note that a T3 EFILE return includes an elections indicator to indicate if the trust is making an election at the time of filing the return. An indication does not constitute an election—it simply informs the CRA that an election is being submitted in paper format or through the Submit Documents online service, as applicable.

QUESTION 15. Meaning of Habitual Abode in Canadian Tax Treaties

As you know, Canada's extensive treaty network contains residency "tie-breaker" provisions – usually in Article IV:2 of most of the treaties. For example, in the Canada-US treaty, the residency "tie-breaker" rule is indeed in Article IV:2. Paragraph (b) of the provision states:

"…if the Contracting State in which he has his centre of vital interests cannot be determined, he shall be deemed to be a resident of the Contracting State in which he has an habitual abode;"

Can the CRA comment on its views of what an habitual abode is of an individual and what factors the CRA reviews to make a determination?

ANSWER 15:

Under Canadian common law, an individual may be a resident or deemed resident (see *Thomson v. Minister of National Revenue*, [1946] SCR 209). Residence depends upon the degree to which an individual settles their ordinary mode of living at the place in question. All relevant factors surrounding the individual's circumstances must be considered, including the length of time that the individual has resided in the country. Residential ties may be divided into several different categories, including significant ties (such as a home, a spouse, or dependants), secondary ties (such as personal property, social ties, and economic ties), and other ties.

An individual who is not a factual resident may still be deemed resident under subsection 250(1).

If an individual is a resident of Canada and of another country, there may be a tiebreaker provision in an applicable tax treaty, which generally provides that residence is determined by the following factors:

a) Where individual has a permanent home;

b) If the individual does not have a permanent home, or if the individual has a permanent home in both countries, the individual's centre of vital interests (i.e., personal and economic ties in each country); or

c) If the centre of vital interests cannot be determined, the individual's place of habitual abode (i.e., where the individual usually lives, based on time spent in each country and the nature of the individual's activities in each country, considered over a reasonable period of time).

For more detail, see Income Tax Folio S5-F1-C1 and paragraphs 19 and 20 of the official commentary to the OECD Model Tax Convention on Income and on Capital.

QUESTION 16. Foreign Entity Classification of a Foundation

In civil law countries a foundation is often used where the trust concept is not recognized. The foundation typically will have a founder who created the foundation (similar to a settlor), a foundation council with a role similar to that of trustees, and beneficiaries who may have a discretionary entitlement.

Does CRA have a view on how a foundation created under the laws of a country where civil law applies would be considered under the Act?

ANSWER 16:

The CRA adopts a two-step approach. First they will consider the characteristics of the foreign entity under the applicable foreign law and constating documents. Then they will compare the foreign entity to recognized categories under Canadian law.

This approach has been applied in previous rulings. Naturally, there are instances in which some characteristics do not have a Canadian law equivalent. The classification each foreign entity must be determined on a case-by-case basis. The CRA is willing to issue advance rulings, provided all relevant information is included in the ruling request to enable a determination to be made under this approach.

QUESTION 17. Deceased Taxpayer and Stock Options

On death, an individual holding stock option rights is deemed to have disposed of those rights immediately before death - pursuant to paragraph 7(1)(e) - at the value of those rights immediately after death.

CRA has stated in views 2009-0327221I7 and 2011-0423441E5 that the 50% deduction allowed under paragraph 110(1)(d) is not permitted to a deceased taxpayer.

Since providing the views above, paragraph 110(1)(d) has been amended to make specific reference to paragraph 7(1)(e) (see subparagraph 110(1)(d)(i)).

Does CRA agree that the 50% deduction is now allowed by a deceased pursuant to the amendment?

ANSWER 17:

As a result of the 2017 amendment to paragraph 110(1)(d), the deduction is now available to a deceased taxpayer, provided all relevant conditions are met.