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Alter Ego and Joint Partner Trusts: Some Issues – Part I

This article is based on a section of *Tax and Family Business Succession Planning*, 2nd Edition, by David Louis and Samantha Prasad, of Minden Gross LLP, to be published by CCH this fall.

Alter ego and joint partner trusts can have a number of advantages. Of course, the most wellknown is probate fee reduction. While Ontario weighs in with the highest rate (1.5%), the *Granovsky* [1] case sanctions multiple wills in that province; and the use of these will substitutes to protect a gainst dependant's relief claims are also problematic there. But alter ego and joint partner trusts may enjoy greater popularity in other provinces, such as British C olumbia, where probate taxes are only a smidgen lower (1.4%) than in O ntario. In addition, these trusts offer the advantage of confidentiality and can afford a certain degree of creditor and marital protection. Finally, they can offer administrative advantages and can be an effective alternative to a power of attorney.

However, the use of alter ego and joint partner trusts can also have some drawbacks. (An alter ego or joint partner trust will not circumvent the deemed disposition on death rules: an alter ego trust is deemed to dispose of its assets on the death of the individual who established it; likewise, a joint partner trust is deemed to dispose of its assets on the death of the last surviving spouse.) As time goes by, the list of technical issues has increased, as practitioners delve into the intricacies of these vehicles.

Amending Formulae

As discussed in Chapter 3, amending a trust may become problematic if the variation is such as to have the effect of resettling the trust. Some practitioners are concerned that this could be problematic even if the trust itself provides an amending formula. If this is indeed an issue, then this would interfere with the flexibility of alter ego and joint partner trusts, since an individual would usually desire the freedom to amend the trust – just like a will.

Inside

Also, as noted in Chapter 3, Doc. No. 2001-0111303,[2] involved a ruling pertaining to the addition of a beneficiary pursuant to an amending formula in the trust. While the CRA ruled that the amendment would not, in and of itself, result in a disposition of any property of the trust, it also indicated that the variation would result in the disposition of a portion of each b eneficiary's interest in the trust at the time the variation is made.[3]

If this is the CRA's view, one would think t hat a similar approach should therefore apply to an amendment adding a beneficiary to an alter ego or joint partner trust. Query, however, whether the CRA would be motivated to attack an alter ego or joint partner trust with fundamental amendments made pursuant to an amending clause. An alternative would be to distribute the assets out of the trust and set up a new trust; however, this could be cumbersome (for example, title would have to be re-registered).

Loss of Low Tax Brackets

Unlike an estate, it does not appear that these trusts will be eligible for graduated tax rates after death: it appears that both types of trusts would have to pay tax at high rates, unless the income is distributed to beneficiaries. This precludes the possibility of a will planning manoeuvre known as estate splitting – i.e., using low tax rates available to an estate to reduce taxes. What is interesting about this is that these trusts reduce provincial probate fees while increasing federal income tax.

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Capital Gains Exemption

Spouse and other testamentary trusts have access to the capital gains exemption by virtue of subsection 110.6(12) ; alter ego and joint partner trusts do not.

Registration "Formalities"

It is quite likely that assets should be re-registered to reflect the alter ego or joint partner trust as the owner. However, query whether there is a continuing requirement for such registration. This may also pose a problem if, for example, an individual simply opens a new bank account and then purports to transfer the bank account to the trust. This would seem to necessarily require the re-registration of the bank account in the name of trust; otherwise, the bank may well insist on a probated will in respect of the bank account. Similar issues will arise if an alter ego or joint partner trust is desired for creditor protection, failure to register assets in the name of the trustee may leave assets with greater vulnerability to creditor claims.

Reversionary Trust Rules/Interprovincial Planning

If a taxpayer wants to be a capital beneficiary of the trust, absent careful planning, any potential interprovincial tax planning opportunity (i.e., shifting assets to a trust in a lower tax rate province such that income and gains will be taxed in its ha nds) is likely to be unavailable.

The reason for the foregoing is that, for the most part, the taxation of alter ego and joint partner trusts is governed by the normal tax rules pertaining to trusts. In the above case, the property would normally be held by the trust on condition that it may revert to the transferor; thus subsection 75(2) would apply . For subsection 75(2) not to apply, the trust should be irrevocable and under no circumstances (other than by operation of law on the failure of the trust) should it be possible for the property to revert to the settlor. For reasons discussed above, this is a suboptimal feature which should be considered carefully.

Besides this, other constraints of subsection 75(2) would have to be met; for further discussion, reference should be made to Chapter 2. Of course, it would also be necessary to establish that the trust is resident in the province, which would presumably entail the appointment of local trustees and meeting other requirements in this respect .[4]Note: although a requirement of an alter ego/ joint partner trust is that the settlor/spouse must be entitled to all of the income, elections can be made under subsections 104(13.1) and (13.2) to tax the income at the trust l evel. If, however, the trust were resident in a low-tax province, in addition to benefits relating to ongoing income, tax may be reduced in respect of deemed dispositions on death.

Even though subsection 75(2) may apply to an alter ego or joint partner trust, it is the CRA's position that a T3 return must be filed, including schedule 9 (allocations) and T3 slips. This requirement was stated by the CRA in a Technical Interpretation released July 11, 2002, Doc. No. 20011-14045, which stated that:

> In order to ensure that the income is excluded from the computation of the trust's income, a T3 information slip should be prepared for the settlor and a statement showing the amount of income attributed to the settlor under subsection 75(2) should be submitted with schedule 9 of the T3 tax return as required when [75(2) applies to an alter ego or joint partner trust].[5]

Effect of Subsection 75(2) to the Individual

In most cases, income earned by an alter ego or joint partner trust will be taxable to th e settlor, rather than the trust i tself pursuant to subsection 75(2). This provision is very generally worded, requiring only that income or loss from the property (or substituted property), and taxable capital gains or allowable capital losses from the disposition of the property (or substituted property) are taxable to the settlor. However, this provision, in itself, provides little guidance to the intricacies of tax issues that may arise. In Technical Interpretation No. 2006-0216491E5, July 11, 2007, the CRA was asked how Regulation 1100(11), which restricts CCA to net rental income of the taxpayer, would apply where both the settlor and the alter ego trust earn rental income – i.e., would the settlor be able to aggregate the alter ego trust's net rental income with his or her own? The CRA indicated that the CCA limitation for computing the trust's income to be attributed to the individual is computed separately from the CCA limitation on property owned by the individual directly (Regulation 1100(15) would apply in a similar manner). Implicit in this interpretation is that the alter ego trust is a separate taxpayer, whose income is attributed to the settlor pursuant to subsection 75(2). If this is the case, query, for example, whether provisions such as restricted farm loss (section 31) would apply separately to the alter ego trust.

Acquisition of Control Issues – Transfer to Alter Ego or Joint Partner Trust

When control of a corporation is acquired by a trust, control will be considered to have been acquired by the trustees of the trust.[6] If control is transferred to or from an estate, special rules in p aragraph 256(7)(*a*) which specifically apply to estates may exempt the provisions that are triggered by an acquisition of control (loss streaming, deemed y ear end, etc.). These rules do not apply to alter ego or joint partner trusts; therefore, the transfer of control to such a trust could trigger such provisions. However, other exceptions in that paragraph pertaining to related person status may apply, e.g., where the trustee of an alter ego or joint partner trust is related to the transferor of a control block of shares. For further discussion, see Chapter 8. It therefore appears that these particular exceptions must be met when control of a corporation is transferred to an alter ego or joint partner trust.

Continued next month.

Notes:

[1] *Granovsky Estate v. Ontario* (1998), 156 DLR (4th) 557 (Ont. Gen. Div.).

[2] November 27, 2002.

[3] The CRA also indicated that the value of each beneficiary's interest in the trust at a particular point of time will approximate a proportionate share of the fair market value of the total of the trust property at the time.

[4] In addition, provincial anti-avoidance rules should be considered (Quebec has introduced anti-avoidance legislation). For the CRA's policies in respect of the residence of a trust, see Interpretation Bulletin IT-447.

[5] The position that a return is required was reiterated at the 2006 STEP Conference. See Technical Interpretation No. 2006-0185561C6, September 11, 2006. The APFF followed up on the above remarks at its 2006 CRA round table, asking the CRA to confirm this position, as well as asking how a loss of a trust can be allocated to the transferor, and whether the CRA could apply penalties for the non-filing of the T3 return when all of its income is subject to subsection 75(2). The CRA reiterated its long-standing position that a T3 return is both a return of income and an information return and confirmed the position expressed at the STEP round table (and that Document No. 95039335 no longer represented the CRA's position in this regard). The CRA indicated that the "presumptions outlined in subsection 75(2) . . . permit the transferor . . . to take advantage of any allowable capital loss in his/her return of income" indicating that in such situations the loss should be reported in parentheses in the appropriate box on the T3 slip. Finally, the CRA's view is that the obligation to file a T3 Return where subsection 75(2) applies as an information return per section 204 of the regulations, is legally supported by section 221. Consequently, "the CRA would be in a position to apply the subsection 162(7) penalty." [This is the $25-per-day penalty for failure to file an information return, with a maximum penalty of $2,500.] See Doc No. 2006-0196201C6, October 6, 2 006.

[6] See *M.N.R. v. Consolidated Holding Company Ltd.,* 72 DTC 6007 (SCC).

CRA Taxpayer Alert Re Tax Shelter Gifting Arrangements

Reproduced below is a CRA taxpayer alert, released August 13, 2007, regarding participation in tax shelter gifting arrangements.

Warning: Participating in tax shelter gifting arrangements is likely to result in a tax bill!

Despite numerous warnings and audit actions by the Canada Revenue Agency (CRA), taxpayers are still participating in tax shelter gifting arrangements. The CRA is urging taxpayers to avoid these schemes.

The CRA is auditing all gifting arrangements

Taxpayers should be aware that the CRA plans to audit all tax shelter gifting arrangements. Every audit completed to date has resulted in a reassessment of tax,

plus interest. In many cases the CRA has denied the "gift" completely. Penalties will be considered, especially where an investor was audited and reassessed for previously participating in a gifting arrangement.

Stats and Facts

- To date, the CRA has reassessed over 26,000 taxpayers who participated in these schemes, and denied about $1.4 billion in donations claimed.
- Audits of another 20,000 taxpayers involving $550 million in donation claims are just about complete.
- Audits on other arrangements involving over 50,000 taxpayers are about to begin.

Current Promotions

New schemes are being marketed that claim to be different from those for which the CRA has previously issued warnings. Taxpayers should avoid all schemes that promise donation receipts for 3 to 4 times the cash payment. It is the CRA's position that the proposed legislation, effective since 2003, will apply to reduce the donation credit to no more than the actual cash payment. Furthermore, as indicated above, completed audits have shown that there was effectively **no gift** being made in many cases, and as a result, the donation was reduced to zero.

Packages promoting these schemes sometimes include letters of commendation about the particular charity, which can give the impression of endorsing the scheme itself. These letters should not be interpreted as providing any assurance that these schemes do what they claim to be doing or that the promised tax benefits are in accordance with the *Income Tax Act*.

Get professional, independent advice

If you are still thinking about participating in a tax shelter gifting arrangement, it's very important that you get independent legal and tax advice. Independent advice means advice from a tax professional that is **not** connected to the scheme or promoter. If property is involved, you should also get independent advice on its true value. Packages from promoters will often claim to have legal or tax opinions from a law firm. You may find that these opinions contain very general comments and do not provide unconditional support for the scheme. Ask to see them, and have them reviewed by an independent professional.

In addition, participants who have been reassessed for previous participation in these schemes may also wish to obtain independent tax advice to determine their best options.

Tax shelter identification numbers

The CRA reminds taxpayers that tax shelter numbers are used for **identification purposes only**. These numbers identify both the schemes and those taxpayers who participate in them. They do not guarantee that taxpayers are entitled to receive the proposed tax benefits.

Not been contacted by the CRA yet?

The CRA generally has three years from the date of assessment to reassess taxpayers, and these audits can take over a year to complete. The fact that investors in these tax shelters have not been contacted and/or reassessed should not be interpreted as the CRA's acceptance of their claim.

Income Tax Technical News No. 36

On July 27, 2007, the CRA released Income Tax Technical News No. 36, which discusses the CRA's interpretation and application of paragraph 95(6)(*b*). Paragraph 95(6)(*b*) is an anti-avoidance rule that provides that where a person or partnership acquires or disposes of shares of a corporation or interests in a partnership, and it can reasonably be considered that the principal purpose for the acquisition or disposition is to permit a person to avoid, reduce or defer the payment of tax, the acquisition or disposition is deemed not to have taken place, and, where the shares or partnership interests were unissued by the corporation or partnership immediately before the acquisition, those shares or partnership interests are deemed not to have been issued. The application of paragraph 95(6)(*b*) was the subject of CRA Round table discussions at the Canadian Tax Foundation's Annual Conferences in 2004, 2005, and 2006. During those discussions, the CRA indicated that it was waiting for some cases to go through the courts, including *Univar* (2005 DTC 1478), and other issues to be addressed before releasing examples and guidelines for the application of this provision. Technical News No. 36 has been incorporated with this report.

Elections Available Under the Emigration Rules

The *Income Tax Act* (Canada) (the ITA) has had rules since 1971 taxing Canadian individuals that cease to be resident in Canada. The "departure tax" rules have undergone significant changes[1] over the years, which has added considerable complexity to this area. The rules pose many difficult problems for people considering emigration, including the ability to fund the tax payable and the avoidance of double taxation.[2]

This article will summarize the exit tax rules and, in particular, focus on certain helpful elections that may ameliorate the otherwise harsh impact of these rules.

Deemed Year-End

Where, at a particular time (the Particular Time), a corporation or a trust ceases to be a resident of Canada, its taxation year that would otherwise include the Particular Time is deemed to end immediately before the Particular Time. A new taxation year of the taxpayer is then deemed to begin at the Particular Time.

If the taxpayer is an individual (other than a trust) and carries on a business at the Particular Time, other than through a permanent establishment (as defined by Regulation) in Canada, the fiscal period of the business is deemed to end immediately before the Particular Time, and a new fiscal period of the business is deemed to begin at the Particular Time. For the purpose of determining the fiscal period of the business after the Particular Time, the taxpayer is deemed not to have established a fiscal period of the business before the Particular Time. Note, however, that there is no deemed taxation year-end for an individual (other than a trust).

Deemed Disposition of Property at Fair Market Value

The general rule is that at the time that is immediately before the foregoing deemed year-end (or, in the case of an individual, before the Particular Time), the taxpayer is deemed to dispose of each property owned by the taxpayer (subject to certain exceptions discussed below) for proceeds equal to its fair market value at the time of disposition. Those proceeds are deemed to have become receivable and to have been received by the taxpayer at the time of disposition. (Presumably this prevents any argument that a reserve is available.) The taxpayer is then deemed to reacquire, at the Particular Time, each property subject to the deemed disposition at a cost equal to the proceeds of disposition of the property.

Excepted Property

The deemed disposition does not apply to the following property (Excepted Property) owned by an individual:

(i) real property situated in Canada, a Canadian resource property, or a timber resource property;

(ii) capital property used in, eligible capital property in respect of, or property described in the inventory of, a business carried on by the taxpayer through a permanent establishment (as defined by Regulation) in Canada at the particular time;

(iii) an "excluded right or interest"[3] (as defined in the ITA) of the taxpayer;

(iv) if the taxpayer is not a trust and was not, during the 120-month period that ends at the time, resident in Canada for more than 60 months, property that was owned by the taxpayer at the time the taxpayer last became resident in Canada or that was acquired by the taxpayer by inheritance or bequest after the taxpayer last became resident in Canada; and

(v) if the taxpayer is an individual (other than a trust), was formerly resident in Canada, and subsequently becomes a resident again, any property in respect of which the taxpayer makes an election under paragraph 128.1(6)(*a*).

Excepted Property generally remains subject to tax under the ITA in the hands of the (now) non-resident taxpayer. Consequently, the individual will not incur tax under the ITA in respect of this property solely as a result of ceasing to be a resident of Canada.

Election Under Paragraph 128.1(4)(*d*) for an Individual (Other Than a Trust)

An individual (other than a trust) may elect in the prescribed form (T2061A) and manner in respect of a property described in (i) or (ii) above, which will deem the individual to have disposed of such property for proceeds equal to its fair market value at that time, and to have reacquired the property at the Particular Time at a cost equal to those proceeds. In effect, this election is only available for two types of taxable Canadian property, which will generally remain taxable under the ITA. Thus, this election provides an exception to the Excepted Property rule.

This election is attractive if the individual has a latent loss in respect of the property described in (i) or (ii) and can offset it against a gain resulting from the deemed disposition of other property.

This election should be filed in the year the individual ceases to be a resident. It is noted that Regulation 600(*c*) refers to the election under paragraph 128.1(4)(*d*) for purposes of "taxpayer relief" provisions in paragraphs 220(3.2)(*a*) and (*b*).

Election Under Subsection 128.1(8) – Relief for a Subsequent Loss

The eventual disposition of property subject to the deemed disposition may result in a reduced gain or a loss. Absent a specific provision, there would be no basis to recover the tax paid on the phantom gain recognized on departure. Fortunately, this situation is addressed, albeit with significant limitations.

An individual (other than a trust) that is deemed to have disposed of a capital property, and then actually disposes of that property at a later time when the property is a taxable Canadian property, may make an election and obtain relief. The individual elects in writing in the individual's return of income for the taxation year of the actual disposition.

The result of the election is that there is deducted from the individual's proceeds of disposition of the property at the time of ceasing to be a resident, and added to the individual's proceeds of disposition of the property at the

time of the actual disposition, an amount equal to the least of:

(a) the amount specified in respect of the property in the election;

(b) the amount that would, but for the election, be the individual's deemed departure gain; and

(c) the amount that would otherwise be the individual's loss from the disposition of the property at the later time, if the loss were determined having reference to every other provision of the ITA, including, for greater certainty, subsection 40(3.7) and section 112.

Note that the election does not reduce the proceeds of disposition of the property for purposes of determining the cost of the property pursuant to paragraph 128.1(4)(*c*). The requirement that the property is taxable Canadian property at the time of the actual disposition prevents this election being made for non-taxable Canadian property, including publicly traded securities. For example, an individual owning shares of GE prior to departure pays tax in respect of a deemed disposition. If the shares subsequently decline in value, and a loss is realized on an actual disposition of those shares, there is no recovery of the taxes paid on the deemed gain. This achieves the broad policy objective of the departure tax rules, but results in hardship unless the new home jurisdiction provides a step-up in the basis for the shares, and the loss can be utilized.

If there is no step-up for tax purposes, the individual should consider selling the shares at the time of departure and reacquiring them as a resident of the new jurisdiction. Under the prior legislation, the individual could elect to treat the non-taxable Canadian property as taxable Canadian property, and therefore not subject it to a deemed disposition. However, any future increase in value could be subject to tax under the ITA, subject to a tax treaty.

Election to Post Security for the Departure Tax

An individual that is deemed to have disposed of property pursuant to the departure rules in the year of emigration may make an election in a prescribed manner (Form T1244) on or before the individual's balance-due day for the emigration year, the effect of which is to defer tax in respect of the deemed disposition. This election must be filed and adequate security furnished to the Minister on or before the individual's balance-due-date for the emigration year. Note that the Minister does not have any authority pursuant to the "taxpayer relief" provision in subsection 220(3.2) to accept a late election. However, it should also be noted that if in the opinion of the Minister it would be just and equitable to do so, the Minister may *inter alia* at any time extend the time for making the election and the time for furnishing and accepting security pursuant to subsection 220(4.54).

If a valid election is made, interest and penalties do not commence until the secured amount in respect of the property becomes "unsecured". This is the balance-due day for the subsequent year in which the actual disposition occurred. The Minister cannot take any action to collect the tax while the amount is secured. The Minister's obligation to accept the security applies on a year-by-year basis. The Minister can determine annually whether the security will remain in place and in what amount.

Given concerns regarding the ability to give security, especially with respect to shares of private Canadian corporations, the Minister has discretion in the administration of security provisions. In the case of undue hardship, the Minister would be able to accept a lesser value of security or security of a different kind than what the Minister would normally find adequate. In making a determination with respect to undue hardship, the Minister will ignore any transaction that is a disposition, lease, encumbrance, mortgage, hypothec, or other voluntary restriction in respect of the property, if the transaction can reasonably be considered to have been entered into for the purpose of influencing the determination.

Collection of Taxes

A client may enquire as to the practical tax collection implications of reporting the deemed gain and the tax payable in the tax return for the year of departure, but not posting security or paying the tax due to lack of liquidity. In the case of an individual immigrating to the United States, Article XXVI A of the Canada–U.S. Tax Convention should not be overlooked. Paragraph 8 thereof only precludes collection against the former Canadian resident where the "revenue claim" relates to a taxable period in which the individual was a citizen of the United States. Consequently, an individual that is not a U.S. citizen in the taxable period will be dealing with the IRS in respect of his/her unpaid Canadian taxes.

– Ken Snider, Cassels Brock & Blackwell LLP

Notes:

[1] See Cindy Rajan, "Are You Sure You Want to Leave Canada? The New Taxpayer Migration Rules" in *Personal Tax Planning* (1999), vol. 47, n o. 5, *Canadian Tax Journal*, 1342-1366, for an excellent paper on the amendments.

[2] It is understood that the Department of Finance is attempting to have other countries accept measures in tax treaties with Canada that will prevent double taxation. For example, see Article 13(10) of the Canada–U.K. Tax Convention, and News Release No. 2000-068 from the Department of Finance, September 18, 2000, with respect to proposed changes to the Canada–U.S. Tax Convention.

[3] See subsection 128.1(10) for a long list of various types of rights and interests.

Recent Technical Interpretations

Distribution of Corporate Assets Prior to Divorce

The CRA ruled on a series of transactions designed to divide corporate assets prior to the divorce of the corporate shareholders. Shareholder A and Shareholder B each own equal portions of the Class A shares of Holdco. Holdco currently carries on an investment business and its assets consist of marketable securities, cash, and an investment in another private company, that owns land and a building leased to commercial tenants. Shareholder A and Shareholder B are currently husband and wife, living separate and apart and in the process of finalizing their divorce. The purpose of the transactions is to allow the property of Holdco to be divided equally between the shareholders.

The transactions to divide the property on a tax deferred basis are straightforward. Shareholder B will transfer her shares of Holdco to Newco, pursuant to subsection 85(1), in exchange for common shares with a paid-up capital equal to the paid-up capital of the Holdco Class A shares transferred. Holdco will then transfer a portion of its assets to Newco, pursuant to section 85, in exchange for preferred shares of Newco and the assumption of liabilities. The addition to the paid-up capital of the preferred shares issued by Newco will equal the cost amount of the properties transferred by Holdco, less the value of the liabilities assumed. Newco will then redeem the preferred shares and issue a promissory note to Holdco. Holdco will then purchase for cancellation the Class A shares held by Newco and issue a promissory note to Newco as consideration. The promissory notes will then be set off against each other.

Newco's first year-end will occur after the redemption of the preferred shares and before the purchase for cancellation of the Holdco Class A shares. This will avoid a circular Part IV tax issue with respect to the recovery of refundable tax by Holdco.

The CRA ruled that paragraph 85(1)(e.2) would not apply to the transfers of property pursuant to subsection 85(1). The redemption of shares by Newco and the purchase for cancellation of the Class A shares by Holdco will result in deemed dividends that will be deductible under subsection 112(1), will not be prohibited by any of subsections 112(2.1), (2.2), (2.3) or (2.4), will not be subject to tax under Part IV.1 or VI.1, and will be excluded from the proceeds of disposition of the shares under paragraph (*j*) of the definition of proceeds of disposition in section 54. The dividends will, however, reduce any loss on the shares pursuant to subsection 112(3). Subsection 55(2) will not apply to the dividends by virtue of paragraph 55(3)(*a*), provided there is no disposition or increase in interest described in any of subparagraphs 55(3)(*a*)(i) to (v). For greater certainty, the CRA ruled that the transactions would not result in a disposition or increase in interest described in subparagraphs 55(3)(*a*)(i) to (v) with respect to the deemed dividends received by Holdco or Newco. The set-off of the notes issued by Holdco and Newco will not result in a forgiven amount. Rulings were also given with respect to subsections 15(1), 56(2), 69(1), 245(2) and 246(1).

Document No. 2007-0226581R3, 2007

Capital Loss on Redemption of Shares Held by Estate

The stop-loss rule in subsection 112(3.2), applicable to a loss on a share held by a trust, is modified where the trust is an estate and the share is acquired as a consequence of an individual's death. Under subparagraph 112(3.2)(*a*)(iii), the loss under paragraph 112(3.2)(*a*) is reduced by 1/2 of the lesser of two amounts, the loss otherwise determined and the capital gain arising from the deemed disposition of the share on the individual's death. Effectively, therefore, capital dividends up to 1/2 of the capital gain realized on the decedent's death are ignored in the determination of the loss.

In a situation the CRA was asked to comment on, the decedent realized a gain on the disposition of Class A and Class E shares of a private company, as a result of the application of subsection 70(5). The Class A shares were subsequently converted to Class B and Class C shares under section 51. The Class E shares were converted to Class C shares. After the conversion, the corporation increased the paid-up capital and ACB of the Class C shares and elected that the deemed dividend (subsection 84(1)) be paid out of the corporation's capital dividend account.

It is the CRA's view that the capital gain on the Class A shares should, for the purposes of clause 112(3.2)(*a*)(iii)(B), be allocated "between the Class B and Class C shares based on relative adjusted cost base of the Class B shares and Class C shares received in exchange for the Class A shares immediately after the conversion". The approach is consistent with the CRA's approach to allocating dividends where there has been an exchange of shares and a loss has been realized (see paragraph 4 of IT-328R3).

Document No. 2007-0224371I7, May 30, 2007

Returns for Deceased Persons

In the guide to "Preparing Returns for Deceased Persons" (publication T4011), the CRA indicates that a copy of the death certificate and a copy of either the will, the letters of administration, or the grant of probate must be filed with the decedent's final return. These documents are required to ensure that the executor, who is filing the return, is the decedent's legal representative. If a copy of the will is not submitted with the final return, it will be required when requesting a clearance certificate.

With regard to whether the requirements affect the decedent's privacy rights:

> The Supreme Court of Canada has examined the issue of whether the authority conferred on the CRA violates an individual's rights and freedoms under the *Canadian Charter of Rights and Freedoms*. It was determined that such broad authority was necessary to maintain the integrity of the tax system and that the requirement for producing documents and records is the least intrusive means by which the CRA can effectively monitor compliance with the Act. The Supreme Court therefore concluded that the requirement to produce such documents does not infringe on an individual's statutory rights, including the right to privacy.

Document No. 2007-0237141M4, June 20, 2007

Utilization of Investment Tax Credits

In Supplement 1 of Information Circular 88-2, "General Anti-Avoidance Rule – Section 245 of the *Income Tax Act*", the CRA comments on the consolidation of profits and losses in a corporate group through the use of an inter-company loan. As indicated in the explanatory notes issued in connection with section 245, "the transfer of income between related corporations that is accomplished using transactions that are legally effective would not usually result in a misuse of the provisions of the Act or an abuse of the Act read as a whole". Numerous rulings have been issued by the CRA on transactions similar to the one discussed in the information circular that are designed to utilize losses within a corporate group. Shifting profits within a corporate group for other purposes such as the utilization of investment tax credits is also acceptable.

In a situation the CRA issued a ruling on, Canco has undeducted SR&ED expenditures and unclaimed investment tax credits. It is expected that Canco will have sufficient taxable income to utilize the undeducted SR&ED expenditures. Through wholly owned subsidiaries, Canco owns all of the issued and outstanding shares of Profitco.

The transactions to transfer income from Profitco to Canco are fairly standard. Canco will borrow on a daylight loan basis and lend the funds to Profitco at a commercial rate of interest (the Profitco Demand Loan). Profitco will use the loan proceeds to make an investment in preferred shares of Newco, a wholly owned subsidiary of Canco. Newco will lend the funds to Canco on an interest-free basis (the Canco Demand Loan). Newco is used to facilitate the transaction as Profitco is precluded from acquiring and holding shares in Canco under subsection 30(1) of the *Canada Business Corporations Act* ("CBCA"). To fund the dividends payable by Newco to Profitco, Canco will make capital contributions to Newco. Capital contributions are required so that the realizable value of Newco's assets (the Canco Demand Loan) after the payment of a dividend is not less than the aggregate of its liabilities and the stated capital of Newco's common shares and preferred shares (see section 42 of the CBCA).

To unwind the structure, the preferred shares held by Newco will be redeemed and Newco will assign the Canco Demand Loan as consideration for the shares. The Canco Demand Loan will be set off against the Profitco Demand Loan and then Newco will be wound up.

In addition to a GAAR ruling, the CRA ruled that subsections 112(2.1), (2.2), (2.3), and (2.4) would not apply to preclude the deduction of the dividends received by Profitco and that a dividend received by Profitco would be an excepted dividend as defined in section 187.1, which will not be subject to Part IV.1 tax under section 187.2. With regard to dividends paid by Newco, the CRA ruled that the dividends would be excluded dividends as defined in section 191, which will not be subject to Part VI.1 tax under section 191.1. Profitco will be entitled to a deduction under paragraph 20(1)(*c*), with respect to the interest on the Profitco Demand Loan, provided there is a legal obligation to pay interest, and Profitco continues to hold the Newco preferred shares. The setoff of the Canco Demand Loan and the Profitco Demand Loan will not result in a forgiven amount and subsection 88(1) will apply on the windup of Newco. Rulings were also given that subsections 15(1), 56(2), 69(1), and 246(1) would not be applied.

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