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Is a Family Trust Vulnerable to the CRA? Some Warning Signs

It is not unusual for accountants or financial planners to have a bit of reluctance towards getting down and dirty with family trust structures. My guess is that this often stems from the convoluted legalese involved, be it the seemingly interminable provisions of the trust itself, or the often-picayune details of the financial structure of the trust arrangement. Trouble is, in recent months, structures involving trusts have received an unprecedented amount of attention, both from the CRA and our courts (see *The Trouble with Trusts*, TAX NOTES, No. 564, January 2010).

Once a structure has been implemented, and the lawyers have gone their (un)merry way, it is often the accountant or financial planner that stands in the line of fire between the client and a possible CRA challenge. In view of this scrutiny, it is more important than ever that a tax or estate plan involving a family trust should not be left on auto pilot – all the more so because family circumstances, as well as tax laws and policies, may change over the years.

It is often unreasonable for accountants or financial planners to be expected to roll up their sleeves and understand the arcane trust and tax law underpinnings of a structure involving a trust. However, experience shows that there are a number of warning signs that may mean it is time to take a more careful look at the structure.

In this article, I will talk about a number of these warning signs in respect of common estate freeze and income-splitting structures. Some of these stem from the ongoing operation of the trust structure; others may derive from the structuring of the trust arrangement itself.

Here are some signals that the structure could be vulnerable to CRA scrutiny.

Inside

Corporate Owner–Manager Denied Motor Vehicle and Home Office Expense Deductions . . . 3

Recent Technical Interpretations

Fair Market Value of Shares 5

Disposition of an Eligible Capital Property by a Trust 5

Gift by Will 5

Residence of a Proposed Family Trust 6

Personal Services Businesses – Information Technology 7

Death Benefit – Payment to the Director of a Corporation 7

Taxability of Monthly Payments Received by a Retiring Partner 8

- **"Homemade Amendments" to Trusts** In common law provinces, the general rule is that trusts must be amended by a court-ordered variation, unless the trust itself allows amendments to be made. From time to time, I have seen situations where terms of the trust are changed, e.g., by adding or deleting a beneficiary. Because these amendments are not valid, allocations and distributions of income or capital to the beneficiary are likewise invalid and could be challenged. Moreover, this could be a sign that those involved in these amendments may not be well versed in trust law, so that a review of the structure for other defects may be advisable. In some situations, it might be argued that the "amendments" are really clarification of the settlor's intention and are therefore part of the original trust; however, whether this argument is tenable may depend on the fact situation.

- **"Questionable Share Structures"** Where shares of a corporation are held by a family trust, sometimes deficiencies in the share structure itself may be a sign that the design itself is flawed. Perhaps the most telltale situation arises where the trust acquires valuable shares of the corporation for nominal or no consideration. As a simple example, a pre-existing shareholder may hold, say, one hundred common shares of a valuable corporation, but wishes to split dividends with other family members or perhaps multiply the capital gains exemption. So the trust subscribes to, say, 50 additional common shares for a nominal amount. Assuming that the corporation has at least some value, the result of this is that the trust has received a financial benefit. The CRA may assert that there has been a transfer (taxable disposition) of one-third of the shares to the family trust, based on their fair market value, so that a sizable capital gain will result. Alternatively, the CRA may tax the trust as a shareholder benefit (under subsection 15(1)) based on the value of the shares. But besides these issues, this could be a warning sign that the structure may have other warts.

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A similar warning sign relates to so-called exclusionary dividend structures. These are structures which involve more than one class of common-type shares, typically with shares of one class containing sufficient voting rights to control the corporation going to the founder of the business. The various classes of shares have so-called "exclusionary dividend" features – that is, dividends can be paid on one class to the exclusion of the others. I have mentioned these types of share structures on a number of occasions in recent months. These structures may be implemented in order to provide dividend or capital gain splitting. But the trouble with these structures is that it might be asserted that there is a significant "control premium" attaching to the voting shares, so that the non-voting (or limited voting) shares have a lower value. This may undermine an estate freeze or the multiplication of the capital gains exemption. In this context, if an exclusionary dividend structure has overlooked these issues, it could also be another warning sign that further review of the structure is in order – are there other deficiencies?

"Operational" Defects

In some cases, the structure itself may be fine, but the ongoing operation may be flawed or sloppy.

- **"Parents Scoop the Cash"** One of the most common situations arises where income is T3'd to children or other low-bracket family members, but the cash ends up in the hands of the parents – they simply "scoop the cash". This can be very problematic, and in fact is one of the deficiencies that the CRA is looking for in its review of trusts that it is currently undertaking. We generally recommend that, where income is to be allocated and distributed to a particular beneficiary, the cash payments should be paid from the trust's account to a separate bank account for that beneficiary. Payments out of the bank account should be for the benefit of the particular beneficiary, either for investments or personal expenditures for his or her benefit. In the former case, it should be clear that the investment is for the particular beneficiary, e.g., if the beneficiary is a child who is a minor, one alternative is for the account to be opened by the parent, "in trust" for the particular child. Receipts of personal expenditures for the particular beneficiary should be retained.

If payments are made directly from the trust for the benefit of the particular child, experience shows that, unless there is scrupulous record keeping, this can become quite messy; accordingly, the CRA might attack the arrangement as invalid. It is not sufficient to be able to show that the expenses were incurred for children in general, as opposed to the particular beneficiary.

- **Interest Rate is "Reset"** In most cases, income-splitting arrangements with a spouse or minor children will depend on the "prescribed rate loan" exception: the attribution rules will not apply to income earned on loans that bear the CRA's prescribed rate of interest. (The attribution rules will not apply to capital gains or losses of a minor, even if the investment is not funded by a prescribed rate loan.) In recent years, the prescribed rate has dropped, so that, at time of writing, the rate matches an all time low of 1%. In some cases, taxpayers may try to take advantage of this by lowering the rate on a loan to a family trust or low-bracket family members to match the prescribed rate. For example, the promissory note might be amended to lower the interest rate from, say, an original prescribed rate of 3%, to 1%. It is extremely doubtful that this manoeuvre works. In order to take advantage of the exception to the attribution rules, the interest rate must be based on the prescribed rate in effect when the loan was originally made. Accordingly, lowering the interest rate to below this amount would mean that the exceptions to the attribution rules no longer apply, so that the income from the proceeds of the income-splitting loan would be attributed back to the lender in the year in which the interest rate was lowered and subsequent years. The safest way to take advantage of the lower prescribed rates is to make a new loan, which typically involves selling the investment funded by the proceeds of the original loan (although this may of course involve capital gains or losses on the sold investment). When the recession was in full swing, this could be problematic because the sale might leave a shortfall; however, this is less of an issue than it would have been, say, a year ago.

Finally, a reminder: interest payable in respect of a particular year on a prescribed rate income-splitting loan must be paid no later than 30 days after year-end, or the attribution rules will apply for the year and future years. Hopefully, our high-tech diaries will help us not to lose sight of this requirement.

- **"No Paper?"** In my January article, I talked about deficiencies in trust documentation in the light of the CRA spotlight on trust structures (particularly, where income splitting is involved). Here is a reminder of some of the items:

  (i) If income is not actually paid to or on behalf of beneficiaries by year end, there should be evidence that the income was legally payable by that time, e.g., trustees' resolutions and/or promissory notes.

  (ii) There should be minutes or other evidence that trustees met and that they made decisions relating to the trust, including allocations to beneficiaries, investment management and/or delegation, and so on.

  (iii) The CRA is concerned that there be proper accounting records; the original settlement instrument can be located; promissory notes should not have "stale-dated" (i.e., due to applicable limitation periods).

In next month's article, I will continue my discussion of warning signs for family trust structures, focusing on one of the most dangerous traps in the *Income Tax Act*: the so-called "reversionary trust rules" in subsection 75(2), and a related provision, subsection 107(4.1), which can be even more damaging – jeopardizing the tax-free rollout of shares and other trust assets to beneficiaries.

– David Louis, tax partner, Minden Gross LLP, a member of MERITAS law firms worldwide. David's practice focuses on tax and estate planning for entrepreneurs and their corporations (dlouis@mindengross.com). These topic and others will be discussed in more detail in CCH Webinar on family trusts, to be presented on June 16.

Corporate Owner-Manager Denied Motor Vehicle and Home Office Expense Deductions

In *Morton Adler v. The Queen* (2010 DTC 1020) the Tax Court of Canada considered whether the owner–manager of a corporation was entitled to a deduction from employment income in respect of motor vehicle and home office expenses, and whether the Minister was permitted to raise an issue in his closing arguments that was not addressed in the pleadings.

The taxpayer, Morton Adler, was an employee of Island Ink-Jet Manitoba Ltd., a corporation that carried on the business of refilling printer cartridges. He was also the sole director, officer and shareholder of the corporation. During 2005 and 2006, the taxpayer incurred, and deducted from his employment income, expenses in relation to the use of his motor vehicle and a workspace in his home.

The Minister reassessed the taxpayer, denying these deductions, on the basis that the taxpayer was neither required to perform his employment duties away from his place of employment, nor required to pay for these expenses as required by paragraphs 8(1)(*h*.1) and (*i*) of the Act. The taxpayer appealed.

In his closing arguments at trial, counsel for the Minister also submitted that the deductions should be denied because the taxpayer failed to comply with subsection 8(10) of the Act, which provides that a taxpayer who claims a deduction under paragraph 8(1)(*h*.1) or subparagraph 8(1)(*i*)(ii) or (iii) must file form T2200, "Declaration of Conditions of Employment", with his income tax return. In support of this submission, counsel for the Minister argued that having generally cited section 8 in the Reply, he was entitled to raise an argument based on any subsection of that provision.

The Tax Court of Canada (per Justice Wyman W. Webb) dismissed the appeal without costs.

The Court first considered whether the Minister could raise subsection 8(10) as an additional ground for denying the taxpayer's deductions, notwithstanding the failure to comply with the obligation in subsection 6(1) of the *Tax Court of Canada Rules (Informal Procedure)* to identify the provision in the Reply. In answering this question in the negative, Webb, J. emphasized the importance of maintaining procedural fairness in proceedings governed by the Informal Procedure.

In the circumstances, the Court found that the Minister should have brought a motion to amend the Reply and that it could not rely on subsection 152(9) of the Act to advance an alternative argument at any time after the normal reassessment period. Citing the Federal Court of Appeal's commentary on subsection 152(9) in *Walsh v. The Queen* (2007 DTC 5441), the Court stressed, at paragraph 10, that the Minister should not be permitted to use this provision to dispense "with the procedural requirement of amending pleadings to include a new argument". Instead, submissions advanced pursuant to subsection 152(9) must comply with both the rules of the Court and procedural fairness.

Webb, J. posited that even if the Minister had brought a motion to amend the Reply, it would not necessarily have been granted. In fact, the statement on form T2200 that "[t]he *employee* does not have to file this form with his or her return, but must keep it in case we ask to see it" could be interpreted as an implied waiver by the Minister of the requirements in subsection 8(10). Given this uncertainty, the Court held that the Minister should not be placed in a more favourable position than would have been the case if a motion to amend the Reply had been made. Thus the taxpayer's failure to file form T2200 would not be considered.

Having disposed of the Minister's argument under subsection 8(10), the Court went on to consider whether the taxpayer was entitled, under paragraph 8(1)(*h*.1) and subparagraphs 8(1)(*i*)(ii) and (iii) of the Act, to deduct motor vehicle and workspace in the home expenses in computing his employment income. As each of these provisions provides for the deduction of an expense that the taxpayer was required to pay by or under a contract of employment, Webb, J. reframed the issue, asking whether the taxpayer was required by his contract of employment to incur the expenditures that he sought to deduct.

Following the decisions of the Federal Court of Appeal in *The Queen v. Cival* (83 DTC 5168) and *Hoedel v. Her Majesty the Queen* (86 DTC 6535), Webb, J. confirmed that a taxpayer will be considered to be required to incur expenses in the nature of paragraph 8(1)(*h*.1) and subparagraphs 8(1)(*i*)(ii) and (iii) only where he or she can demonstrate that the failure to do so would give rise to adverse consequences. As the taxpayer was not only an employee, but also the sole director, officer and shareholder of Island Ink-Jet Manitoba Ltd., the Court found that there was no basis upon which it could conclude that the taxpayer would be placed at a disadvantage as a result of failing to incur the motor vehicle or home office expenses. In fact, the Court stated, at paragraph 22, that "[o]ne cannot imagine the Appellant, as President of Island Ink-Jet Manitoba Ltd., seeking to have the company sue [him] for breach of contract, taking any disciplinary action, or writing a poor performance review . . .". The Court therefore concluded that the taxpayer was not required to pay the motor vehicle and home office expenses, but rather undertook to pay them personally. Consequently, he was not entitled to deduct these amounts in computing his income from employment.

The decision of the Court in *Adler* represents a very harsh application of paragraph 8(1)(*h*.1) and subparagraphs 8(1)(*i*)(ii) and (iii) of the Act that effectively prohibits an owner-manager of a corporation from claiming deductions from employment income in respect of motor vehicle and home office expenses. The outcome of this case may seem unfair given that such deductions would likely be allowed in the hands of a taxpayer who was employed by an unrelated corporation that required such costs to be paid or carried on business as a sole proprietor. However, there are many benefits and protections afforded by corporate status, and perhaps the inability of an owner-manager to claim these deductions from employment income is a reasonable price to pay, assuming that the Court's interpretation is correct in the owner-manager context.

– Julia Lombara, McCarthy Tétrault LLP

Recent Technical Interpretations

Fair Market Value of Shares

The CRA was asked to consider a hypothetical situation in which a taxpayer died a few years after completing an estate freeze. In the various scenarios put to the CRA, the taxpayer had, upon the freeze, exchanged his participating voting shares for either non-participating voting shares or a mix of non-participating non-voting shares and non-participating voting shares.

The CRA stated that, in such situations, the value that could be attributed to non-participating voting shares was a factual determination. The CRA's established position is that, in determining the fair market value of a class of shares, the CRA will establish the fair market value of the corporation "as a whole" and then allocate the value to each class of shares in isolation. The value of each class of shares depends on the rights, privileges, and restrictions of the class. One of those rights is voting control of the corporation.

The CRA accepts the estate freeze of participating shares to the extent that the freezor obtains freeze-preferred shares whose fair market value is equal to the fair market value of the participating shares at the time of the freeze. Where the freezor retains control of the corporation, the CRA does not take into account the premium that could be attributed to controlling shares for the purpose of subsection 70(5) upon the death of the taxpayer. In respect of the various hypothetical scenarios, the CRA stated that it would not attribute a premium to the voting shares for the purpose of subsection 70(5).

The CRA made similar comments in respect of the value of post-freeze voting shares at the 2009 Canadian Tax Foundation Conference (see Timothy Fitzsimmons, "2009 CTF: Wizards, Tiny Taxes and 'Evil' Kirk" TAX TOPICS, No. 1971-72, December 17, 2009). Additionally, one other unresolved issue is the value of the non-participating voting shares, if any, after the redemption by the corporation of all outstanding non-participating non-voting shares.

– Document No. 2009-0330211C6, October 9, 2009

Disposition of an Eligible Capital Property by a Trust

The CRA was asked for its views on the tax treatment of a distribution by a trust of the non-taxable portion of a capital gain realized by the trust.

X Co was the only beneficiary of ABC Trust, an *inter vivos* trust. X Co owned 100 per cent of the ABC Trust units, which had an adjusted cost base of nil. ABC Trust sold its business assets, including goodwill, to a third party for $100,000. The goodwill was the only asset that had any value. After the transfer, ABC distributed $100,000 to X Co. Of this amount, $50,000 was the non-taxable portion of the gain on the sale, and the other $50,000 was taxable to X Co. The distribution of the non-taxable portion of the gain was a capital distribution that, pursuant to subparagraph 53(2)(h)(i.1), reduced the adjusted cost base of the ABC Trust units held by X Co. The negative adjusted cost base triggered a capital gain of $50,000 for X Co pursuant to subsection 40(3).

The CRA agreed that this was the likely result, but noted two exceptions. First, paragraph 53(2)(*h*) does not apply to an interest in a personal trust that has never been acquired for consideration, or an interest in a trust that is described in any of paragraphs (*a*) to (*e*.1) of the definition of "trust" in subsection 108(1). Second, subparagraph 53(2)(*h*)(*i*.1) excludes the proceeds of disposition of the interest or a part thereof. If there is a disposition of the interest or part thereof in the trust, subsection 107(1) (disposition by a taxpayer of a capital interest) may apply rather than paragraph 53(2)(*h*).

– Document No. 2009-0330291C6, October 9, 2009

Gift by Will

The CRA was asked whether a gift by will may be claimed, where an individual died and the individual's will instructed that the residue of the estate be held in trust, with net income to be paid to registered charities.

Subsection 108(1) of the Act defines a testamentary trust as a trust or estate which arises on the death of an individual and as a consequence of that death, with certain exceptions. A testamentary trust can include a trust described in subsection 248(9.1), which is a trust created under the terms of a will or by an order of a court made pursuant to dependents' relief legislation.

Subsection 118.1(5) of the Act deems gifts made by an individual by will to have been made in the year of the individual's death. Accordingly, the donation can be claimed on the terminal year return, even though the transfer is made by the deceased's representatives rather than the deceased, and might not be made until a subsequent taxation year. Subsection 118.1(5) provides that, if a charitable gift is made in an individual's will, the gift is deemed to have been made by the individual immediately before the individual died. Accordingly, such charitable gift can be used to reduce the deceased's income in the year of death or in the preceding taxation year under subsection 118.1(4).

In this particular situation, the will in question appeared to be silent as to who would be the capital beneficiary of the trust. Since it was not clear who would receive the capital and at what time, the CRA did not see how any amount could be allowed as a gift by the individual's will pursuant to subsection 118.1(5) of the Act. The CRA also cited paragraph 6 of Interpretation Bulletin IT-226R, "Gift to a charity of a residual interest in real property or an equitable interest in a trust" (November 29, 1991), which states that in cases where the size of a residual or equitable interest at the time of its donation cannot reasonably be determined no deduction or tax credit in respect of the donation will be allowed.

– Document No. 2007-0259841E5, October 7, 2009

Residence of a Proposed Family Trust

The CRA was asked to determine whether a family trust that is to be established by a non-resident person is deemed resident for Canadian tax purposes. The non-resident is considering establishing a trust that will hold assets that are not situated in Canada, are not taxable Canadian property, and will not be acquired using assets that were generated in Canada.

If certain conditions are met, section 94 of the Act may deem a trust to be resident of Canada that would not otherwise be considered resident if certain conditions are met. Where the amount of income or capital of the trust to be distributed to any beneficiary depends on the exercise of, or failure to exercise, discretion by any person, paragraphs 94(1)(*a*) and (*b*) include conditions that, if met, will result in the trust being subject to Canadian tax. Furthermore, where the conditions in these two paragraphs are met but the amount distributed from the trust is not dependent upon the exercise of, or failure to exercise, discretion, paragraph 94(1)(*d*) may treat the trust in a manner that is similar to the manner in which non-resident corporations are treated for Canadian tax purposes. The non-resident trust is deemed to be a non-resident corporation having a capital stock of a single class divided into 100 issued shares, and each beneficiary under the trust is deemed to own a proportionate number of those shares based on the fair market value of his beneficial interest as a proportion of the fair market value of all beneficial interests in the trust. The non-resident, non-discretionary trust will thus be treated as a controlled foreign affiliate for the purposes of the attribution of foreign accrual property income in respect of each beneficiary of the trust whose beneficial interest has a fair market value of not less than 10 per cent of the beneficial interests.

The CRA notes that revisions to the rules relating to the taxation of non-resident trusts were proposed in Bill C-10. Pursuant to proposed subsection 94(3), which applies to a non-resident trust for taxation years after 2006, a trust that would not otherwise be considered resident in Canada will, unless it is an "exempt foreign trust", be deemed resident in Canada if the trust has either a "resident contributor" to the trust or a "resident beneficiary" under the trust. The CRA further states that a "connected contributor" at a particular time is an entity that is a contributor to the trust at the particular time, other than:

(a) an individual (other than a trust or an individual who was never non-resident before that time) who was, at or before that time, resident in Canada for an aggregate of not more than 60 months, or

(b) an entity all of whose contributions to the trust at or before that time were made at a "non-resident time" of the entity.

An entity will be a "resident contributor" unless it is an individual (other than a trust)

(a) who was non-resident at any time before that time, and at that time has been resident in Canada for an aggregate of not more than 60 months, or

(b) where the trust is an *inter vivos* trust created before 1960 by a person who was non-resident when the trust was created and the individual has not made a contribution to the trust after 1959.

There are specific exemptions for "exempt foreign trusts", which are defined to include certain widely held mutual fund trusts, charitable trusts, and trusts established for disabled and other children. The definitions of "resident contributor" and "resident beneficiary" also carve out the application of these deeming rules in respect of trusts, where the contributor has been resident in Canada for less than 60 months (commonly referred to as immigration trusts). In effect, other than "exempt foreign trusts", immigration trusts and non-resident trusts that have only received contributions from persons who are not resident in Canada and who meet the other requirements relating to "non-resident time", non-resident trusts will generally be "caught" by the proposed rules.

The proposed changes to the NRT Rules proposed in the 2010 Federal Budget in section 94 are more substantial. Since the 1999 Budget, the NRT Rules have been in a state of flux and have expanded the situations where non-resident trusts are deemed resident in Canada and therefore subject to Canadian tax. The major changes in the NRT Rules proposals relate to contributions by Canadians causing non-resident trusts to be deemed to be resident in Canada as well as the vastly expanded concept of a transfer in subsection 94(2) of the Act. The 2010 Budget indicates that the CRA has identified situations involving non-resident trusts, even after applying all of the proposed NRT Rules, that "frustrate the fundamental policy objectives of these rules". Accordingly, the 2010 NRT Rules proposals will further broaden the scope of non-resident trusts subject to Canadian tax. However, it is also recognized that the pre-2010 NRT proposals resulted in inappropriate results in certain cases where *bona fide* commercial transactions were involved.

– Document No. 2009-0334021E5, January 11, 2010

Personal Services Businesses – Information Technology

The situation the CRA was asked to comment on involved independent workers of the information technology sector who wanted to know the tax treatment applicable to personal services businesses. The CRA confirmed that a taxpayer carrying on a business could normally deduct any expenses incurred for the purpose of earning income from that business unless specifically prohibited (see various limitations listed in section 18 of the Act). However, this is not the case for a corporation carrying on a business through a "personal services business" as this term is defined in subsection 125(7) of the Act. If this is the case, paragraph 18(1)(*p*) of the Act would prevent such a corporation to deduct from their business income any expenses other than the following: (1) any remuneration, benefit, or allowance paid to an incorporated employee of the corporation during the year; (2) any amount spent for the sale of properties or negotiation of contracts by the corporation if the amount would have been deductible from the incorporated employee's employment income for the year if the amount had been spent by the incorporated employee under an employment contract requiring him/her to pay that amount; and (3) any amount paid in the year for legal expenses incurred for the collection of amounts owing on account of services rendered. A "personal services business" is a business providing services and having the following two characteristics: (1) the incorporated employee performing services for the corporation or a person that is related to that employee is a "specified shareholder" (see definition in subsection 248(1) of the Act) of the corporation; and (2) the incorporated employee would be considered an employee of the person to whom the services are rendered but for the existence of the corporation. The business will not be considered a "personal services business" if one of the following two conditions is met: (1) the corporation employs more than five full-time employees during the whole year; or (2) the amount paid in the year to the corporation for the services is received from a corporation with which it is associated in the year. A specified shareholder is one holding at any time in the year at least 10 per cent of any class of shares of the corporation. To determine if there is any employment relationship between the incorporated employee and the client to whom the corporation provides its services, three conditions are required: (1) performance of work by the worker; (2) remuneration paid for the work by the employer; and (3) existence of some subordination relationship between the worker and the employer (i.e., employer should have a power of direction and control over the worker). To determine if such a subordination relationship exists, the CRA would have to review several factors including the following: required presence of the worker at a work site, assignment of regular work to the worker, existence of some code of conduct applicable to the worker, and control of the quantity and quality of work done by the worker.

– Document No. 2009-0326681M4, December 14, 2009

Death Benefit – Payment to the Director of a Corporation

The CRA confirmed that an amount could be paid as a "death benefit", within the meaning of this term in subsection 248(1) of the Act, in respect of a deceased employee even though he/she was director of the corporation at the time of his/her death. As confirmed in paragraph 1 of IT-508R, the gross amount of a death benefit would include an amount received by any taxpayer in a taxation year upon or after the death of an employee or former employee in respect of his/her services in an office (including the directorship of a corporation) or an employment. Of course, the question of whether the amount was paid in recognition of services rendered is a question of fact. See paragraph 3 of IT-508R for examples of payments qualifying as death benefits, and paragraph 9 for a calculation of the death benefit if the recipient of the benefit is both the only person having received the benefit and the surviving spouse of the employee. As discussed in paragraph 2 of IT-508R, to the extent a payer of a death benefit does not have to be the employer, an amount received from a testamentary trust may qualify as a death benefit if it is received by the trust after the death of an employee in respect of his/her services from an office or employment. For additional information on this topic, see also Technical Interpretation No. 9129655.

– Document No. 2009-0347131E5, December 3, 2009

Taxability of Monthly Payments Received by a Retiring Partner

The issue considered by the CRA involved a member of a partnership having voluntarily retired from the partnership and to whom the partnership started making monthly payments. Under the original partnership agreement, the partnership would pay to the partner who died, became bankrupt or invalid, or retired, a benefit for the value of his work in process, goodwill, or other damages, that was equal to his average annual income for an undisclosed number of preceding years. In case of voluntary departure or retirement, the partner's benefit was cut in half. The CRA was asked if the monthly payments received by the partner would be treated as an income or as a right in the partnership's property.

The CRA confirmed that the income or capital nature of the monthly payments received by the retired partner would not be determined by the provisions of the original partnership agreement dealing with the compensatory benefit but by the verbal or written agreement that was entered into by the retiring partner and the remaining partners. The question of whether the provisions of subsection 96(1.1) or 98.1 of the Act would apply to the monthly payments could only be determined following a review of that latter agreement. The CRA noted that a partner leaving a partnership still kept all his/her rights in the property of the partnership by keeping a residual interest under paragraph 98.1(1)(*a*) of the Act. If the retiring partner could demonstrate that he/she contributed to the creation of goodwill for the partnership and received the payments in that respect, they could be deemed to be received as consideration for his/her right in the partnership property and be treated as capital not income payments. The payments would be taken into consideration to calculate the retiring partner's capital gain in respect of his/her partnership interest but could not be deducted from the income of the partnership or other partners. Note however that if all the remaining partners agreed to continue to allocate a portion of the partnership income to the retired partner, he/she would keep an interest in the income of the partnership under subsection 96(1.1) of the Act and that amount would have to be included in the income for his/her taxation year including the end of the partnership's fiscal period during which the allocation was made.

– Document No. 2009-0313121E5, December 18, 2009

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