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TAXPAYER VICTORIES: COINCIDENCE OR TREND?

— David Louis, tax partner, Minden Gross LLP, a member of MERITAS law firms worldwide

It is relatively infrequent that most tax advisers, much less their clients, have close encounters with Canada's tax courts. But tax cases can ultimately permeate the environment that taxpayers face. If tax decisions go favourably for the CRA — as has often been the case recently, for upper-level courts, anyway — the CRA will ultimately be more aggressive in dealing with taxpayers. That's why I'm concerned about recent tax decisions, particularly those emanating from our top courts. Actually, it's not just that cases are going against taxpayers — it's that they deal with commonplace situations. The penultimate GAAR verdict from the Supreme Court struck down a simple "spousal flip", where a wife borrowed money to buy shares of a family company from her husband (*Lipson*). The most recent GAAR decision by the top court (*Copthorne*) isn't that much more complicated — it struck down a scheme that turned a vertical amalgamation into a horizontal merger, to preserve the tax attributes of pre-existing share capital. (OK, it was a double count, but hopefully you get my drift.)

Practitioners are left to ask, if these transaction are offensive, then what isn't — particularly in the eyes of the CRA? But in recent weeks, there's been (dare we say) a glimmer of hope, emerging from three Tax Court of Canada verdicts in which the Tax Court rejected CRA arguments and upheld taxpayers' claims.

MacDonald — Pipelines Trashed

The first case I will deal with, *MacDonald v. The Queen* (2012 TCC 123), involved a physician with a capital loss balance who was moving to the United States. The plan involved utilizing this balance by selling his shares in an investment-rich company to a relative for a promissory note. Although the actual facts were more complicated, in essence, the relative transferred the company to a Holdco for a back-to-back note, which allowed the taxpayer's former company to strip out cash by paying tax-free dividends to Holdco and, ultimately, the taxpayer to redeem his note without tax. If the structure rings a bell, it's very similar to a post-mortem "pipeline" transaction, which is commonly employed to utilize the cost base in shares of a private company occasioned by "death tax" to access assets from the company. And as with a pipeline, the CRA marshalled subsection 84(2) to attack the structure — an arcane provision which was brought in well over half a century ago, when the lack of a capital gains tax was used by aggressive taxpayers to avoid tax on dividends. (It potentially applies where funds or property of a corporation have been distributed or otherwise appropriated in any manner whatever to or for the benefit of shareholders of any class on the winding-up, discontinuance, or reorganization of its business.)

But Hershfield J was having none of it. The judge held that given the way the transaction was structured, Dr. MacDonald drew the money out as a creditor, not a shareholder as required by the provision, so that it did not apply. Hershfield J considered earlier cases on subsection 84(2) in light of post-1971 changes to the Act in respect of surplus strips

(section 247, replaced in 1988 by GAAR) and concluded that subsection 84(2) should be construed strictly (as the Tax Court of Canada had done in *McNichol* (97 DTC 111)).

As I said, the CRA has been trotting out this provision in post-mortem pipelines, which involve the estate of a decedent transferring shares of an Opco to a Holdco for debt in order to extract corporate-level assets equivalent to the cost base of the Opco shares, which is bumped up when the shares pass on death to another generation — i.e., by Opco paying the Holdco tax-free dividends and repaying the Holdco debt owing to the estate. Of course, the key benefit that attracts tax planners — and has provoked ire on the part of the CRA — is that corporate assets can be accessed at the lower rates applying to capital gains (i.e., due to the death tax) rather than dividends. In fact, the week the case came down, no fewer than two rulings by obviously intimidated taxpayers were released by the CRA.

But just as Obama poured cold water over the Keystone XL pipeline, the *MacDonald* case did much the same thing with the CRA's contention that subsection 84(2) applies to pipelines. The Court pointed out that the conditions imposed by the CRA for a favourable ruling were "clearly arbitrary" and "not invited by the express language in subsection 84(2)" (see paragraph 80). Where GAAR would not apply to recharacterize the legal effect of a series of transactions, other provisions should not be too readily stretched to give that result where a strict reading of them does not invite such a result (paragraph 82).

As for GAAR, the judge did not find the structure abusive (one of three prerequisites for the application of GAAR). The departure from Canada would have triggered the very same capital gain realized on the share sale, thereby ensuring reconciliation of his capital gains and losses. Therefore, "to deny a tax benefit to which he was entitled by an express provision of the Act because he achieved it by a different legally effective means is, frankly, bizarre"— although the judge shortly afterward conceded that "bizarre" might be putting it too strongly, as the real concern of the CRA is surplus strips (see paragraphs 121 and 122). In that regard, the judge later observed that the tax benefit is "systemic" (i.e., between pipeline-type methods relying on capital gains rather than dividend rates to extract corporate-level surplus); accordingly, neither GAAR nor subsection 84(2) can be used to fill a gap between the approaches and prevent a tax-planned approach to accessing retained earnings (see paragraph 132).

Personally, I'm glad I wasn't in the same room with CRA officials when the *MacDonald* case came out; I am quite sure they are not looking forward to the inevitable barrage of questions at the upcoming CRA round table sessions at various tax conferences.

McClarty: Transmogrification and Non-Tax Purpose

McClarty Family Trust (2012 DTC 1123) involved a scheme to transmogrify dividends from a family company, which would be subject to the "kiddie" tax, to capital gains, which at the time of the transactions were not (see below). The structure has long been high on the CRA's GAAR radar screen, because it has been all the rage, particularly with taxpayers in Western Canada. In its general incarnation, a high-low stock dividend would be declared on shares of a family company held by a family trust, to shift equity value to the stock dividend shares. Like in the standard plan, these shares were sold from the family trust to Mr. McClarty, resulting in a capital gain, which was then distributed to the trust's three minor beneficiaries. The stock dividend shares were sold to a holding company and subsequently redeemed tax-free. By virtue of the structure/variants, amounts owing by Mr. McClarty to the family trust were built up (along with amounts owing from the family trust to the minor beneficiaries). The judge rejected the application of GAAR (i.e., the recharacterization sought by the CRA of the trust's/beneficiaries' capital gains as dividends); given that the series transaction was motivated by creditor protection, he held that it wasn't an "avoidance transaction" (one of three GAAR prerequisites), voicing the view that every single transaction was made with a bona fide purpose other than to obtain a tax benefit (paragraph 52). (Based on precedent, the Court rejected the CRA's argument that the structure was an avoidance transaction because the creditor-proofing objective could be achieved in a less tax-efficient manner.) Although there was no need to determine whether the transaction was abusive — the final GAAR prerequisite — the Court noted that there was a gap in the kiddie tax for this sort of transaction, but it is inappropriate to use GAAR to fill a gap left by Parliament (paragraphs 54 and 55).

Indeed, taxpayers (other than those who are facing CRA scrutiny over similar structures) will find the actual tax strategies under review in this case mainly of historical significance. The 2011 federal Budget filled the gap — nixing this type of structure — by expanding the tax on split income (i.e., the kiddie tax) to encompass capital gains included in the income of a minor from a disposition (after March 21, 2011) of shares of a corporation to a non-arm's length person, if taxable dividends on such shares would have been subject to the tax on split income. But the case is relevant to tax planners because it shows that, when it comes to GAAR, a non-tax purpose can save the day.

Dhaliwal — What's an Election, Anyway?

The final case, *Dhaliwal* (2012 DTC 1122), involved a claim for an allowable business investment loss ("ABIL") on a bad debt. Needless to say, the CRA sent out its usual questionnaire; but although there were a few twists, they were ultimately not a problem.

The interesting issue centred on the requirement that, for ABIL treatment to apply to bad debts and shares of bankrupt corporations and the like, the legislation (subsection 50(1)) requires the taxpayer to elect in the taxpayer's tax return for the year. The CRA envisions a letter filed with the return (as the Court noted, there is no prescribed or recommended form). The trouble is, with electronic filing, this is not possible — i.e., *in* the return itself, as the *Income Tax Act* requires. So the issue was whether reporting the *tax results* of the ABIL (i.e., that the ABIL was deducted against ordinary income, etc.) meets the Act's requirement for an "election". Not only did Boyle J find that this was kosher,[1] but he trashed the CRA's submissions (among others, that e-filers should separately mail in an election or that the *Income Tax Act* simply does not allow an e-filer to make the election).

But at issue is how far the decision goes. It seems to me that although the judge was motivated by the constraints of e-filing, the decision may be interpreted to extend to paper filings as well (see paragraph 34 of the case — although the lawyer in me is screaming, "Do a letter"). But what about tax act sections with similar requirements? Although much of the case focuses on the history of ABIL claims in subsection 50(1) of the *Income Tax Act*, it is arguable that reasoning similar to that in *Dhaliwal* may apply to at least some similarly worded elections[2] (but see "screaming lawyer remark", above). But Boyle J stressed that the subsection 50(1) requirement is that the election be *in* the tax return, not *with* the tax return (see paragraph 30). A good example of the latter is the election not to have the capital gains attribution rules apply for separated spouses: paragraph 74.5(3)(*b*) not only requires that the election be filed "with" the return, but "jointly" by the former couple.

So are these three cases signs that the courts are giving the CRA pushback, or are they just a happy coincidence? Mind you, they are all lower-court cases. But I see a common thread to these cases: they do not involve fortunes, but the CRA was coming at the taxpayers with both barrels.[3] Maybe it's just my imagination, but could some tax court judges be a tad steamed at CRA aggressiveness?

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Notes:

[1] Per paragraph 34: "it is sufficient to communicate the taxpayer's election by clearly communicating in his or her tax return that he or she wants to be allowed an ABIL in respect of particular debt or shares disposed of in that year".

[2] Consider, for example, the elections referred to in subsection 14(1.01) and paragraph 249(4)(*c*) (the seven-day year-end extension upon an acquisition of control). However, the election to opt out of the subsection 73(1) rollover has ramifications to a spouse or common-law partner (e.g., see subsection 74.5(1)), but it may not be clear whether a results-based election has been made (e.g., if there has been no appreciation of the transferred property); consider also subsection 87(3.1) (tracking of paid-up capital through an amalgamation) and the various replacement property rules. Subsection 256(9) provides that control is deemed to be acquired at the beginning of the day unless the corporation elects otherwise. I am not persuaded that provisions with similar wording to that considered in *Dhaliwal* should necessarily give rise to that same result.

[3] For example, besides the *MacDonald* subsection 84(2) argument, in *McClarty*, an "abutting" provision (subsection 84(3)) was argued by the CRA with a similar outcome.

INFORMATION CIRCULAR IC-100 — GST/HST COMPLIANCE REFUND HOLDS

The Canada Revenue Agency (the "CRA") issued Information Circular IC-100, GST/HST Compliance Refund Holds (the "Circular"), dated May 18, 2012. This Information Circular describes circumstances where an insolvency practitioner (e.g., a trustee in bankruptcy, a receiver, or a liquidator) may request relief where refunds or rebates under the *Excise Tax Act* for an insolvent corporation are not being released. Under section 77 and subsections 229(2), 230(2), and 296(7) of the *Excise Tax Act*, the CRA cannot release a refund or rebate to a taxpayer unless all returns under the *Excise Tax Act*, the *Excise Act, 2001*, the *Air Travellers Security Charge Act*, and the *Income Tax Act* have been filed. This includes an insolvent corporation's corporate tax returns from the pre-insolvency period. The Circular states that under subsection 220(2.1) of the *Income Tax Act*, an insolvency practitioner can file form RC342 to request that the Minister waive the requirement that the T2s for pre-insolvency periods must be filed before the post-insolvency GST/HST refunds for the corporation can be released. The Circular does not apply where the insolvency practitioner controls only part and not all of the personal property of the insolvent corporation. The Circular indicates that generally, the request for a waiver from the filing requirement will be approved where "because of circumstances beyond the insolvency practitioner's control, insufficient books and records are available to prepare the corporate income tax return(s) that are required from the taxpayer". The CRA will consider the insolvent corporation's history of compliance, whether it continued not to file returns in spite of being contacted by the CRA, whether there are indications that there are sufficient financial records to file the tax returns, and any other issues noted in the submission by the insolvency

practitioner. If the request for a waiver is denied, the usual forms of redress are available to the insolvency practitioner in terms of a request to have a second review of the original decision or a request for judicial review.

MANDATORY EFILE FOR TAX PREPARERS

— Maureen Vance C.A., Consultant, CCH Tax Software

The tax provisions from the Notice of Ways and Means Motion tabled on April 23, 2012 (CCH *Special Report* 065H) are included in Bill C-38, which received first reading in the House of Commons on April 26, 2012. Most of the tax provisions were from proposals in the 2012 federal Budget. However, one of the tax provisions in Bill C-38 that was not mentioned in the 2012 federal Budget came as a surprise to many in the accounting community.

Bill C-38 proposes to add subsection 150.1(2.3) of the *Income Tax Act*, which states the following:

> **Electronic filing — tax preparer:** A tax preparer shall file any return of income prepared by the tax preparer for consideration by way of electronic filing, except that 10 of the returns of corporations and 10 of the returns of individuals may be filed other than by way of electronic filing.

This subsection would apply in respect of returns of income for the 2012 and subsequent taxation years that are filed after 2012.

The term "tax preparer" is defined in new subsection 150.1(2.2):

> **Definition of "tax preparer":** In this section and subsection 162(7.3), "tax preparer", for a calendar year, means a person or partnership who, in the year, accepts consideration to prepare more than 10 returns of income of corporations or more than 10 returns of income of individuals (other than trusts), but does not include an employee who prepares returns of income in the course of performing his or her duties of employment.

The requirement is also subject to the following exceptions set out in new subsection 150.1(2.4):

- The Canada Revenue Agency may deny a tax preparer the authority to file electronically for the year because the tax preparer does not meet the criteria for filing referred to in subsection 150.1(2). This exception would apply if a tax preparer's application for the authority to file electronically has been denied or if the authority has been revoked for the year.
- Returns of income of corporations prescribed under paragraphs 205.1(2)(*a*) to (*c*) of the *Income Tax Regulations* will not be required to be filed electronically by a tax preparer. These corporations are not currently subject to the mandatory electronic filing requirement for corporations under subsection 150.1(2.1).
- The Canada Revenue Agency may specify that it does not accept certain types of returns in electronic format.

Presumably any return that is not currently eligible to be electronically filed (e.g. a multi-jurisdiction T1 return) would be exempt from this requirement.

Penalty for Failure to EFILE

Bill C-38 also proposes an amendment to section 162 by adding subsection (7.3) as follows:

> **Failure to file in appropriate manner — tax preparer:** Every tax preparer who fails to file a return of income as required by subsection 150.1(2.3) is liable to a penalty equal to
>
> (*a*) $25 for each such failure in respect of a return of an individual; and
>
> (*b*) $100 for each such failure in respect of a return of a corporation.

This section would impose a penalty on a tax preparer that failed to electronically file a return that was not subject to one of the exceptions indicated above. The penalties would be $25 for each failure to file an individual return in electronic format, and $100 for each failure to file a corporate return in electronic format.

This penalty provision will come into force on January 1, 2013.

In effect, these proposals would impose a penalty on any individual or firm that prepares more than 10 T1 returns **or** 10 T2 returns for remuneration and paper-files more than 10 T1 returns or 10 T2 returns that are otherwise eligible to be electronically filed.

It would be effective for all returns filed in 2013 or later relating to a 2012 return of income (e.g., all 2012 T1 returns).

Note that unlike the current mandatory EFILE for prescribed corporations with gross revenue greater than $1 million, this penalty would be assessed on the tax preparer, not the tax filer. The penalty would not, however, apply to an employee that files returns, such as a comptroller or tax director in a corporation.

CURRENT CASES

SCC confirms: A trust is resident where its central management and control is exercised

St. Michael Trust Corp. v. The Queen, 2012 DTC 5063 (Supreme Court of Canada)

The Supreme Court of Canada in *St. Michael Trust Corp.* (also known as *Fundy Settlement* and *Garron*) considered how the residency of a trust for purposes of the *Income Tax Act* (the "Act") is to be determined.

The appellant, St. Michael Trust Corp., was a licensed trust company resident in Barbados and the trustee of two trusts, Fundy Settlement and Summersby Settlement. The trusts were settled in Barbados by an individual resident in the Caribbean. The beneficiaries of both trusts were resident in Canada. The trusts had owned shares in two Canadian-resident holding corporations. When the trusts sold the shares, St. Michael Trust Corp. claimed refunds of the portion of the purchase prices withheld and remitted by the purchaser to the Minister pursuant to section 116 of the Act on the basis that (1) the trusts were resident in Barbados because St. Michael Trust Corp. was resident in Barbados, and (2) the capital gains realized by the trusts on the disposition of the shares were exempt from Canadian tax under the Canada–Barbados tax treaty since the treaty provides that tax is payable only in the country in which the trusts were resident. The Minister reassessed the appellant, in its capacity as trustee, and denied the refunds on the basis that the trusts were resident in Canada.

St. Michael Trust Corp.'s appeals from the Minister's reassessments were dismissed by the Tax Court of Canada (2009 DTC 1287) and the Federal Court of Appeal (2010 DTC 5189). Both courts found that the trusts were resident in Canada for the purposes of the Act as the central management and control of the trusts was located in Canada. The Tax Court concluded on the facts of the case that all of the substantive decisions in relation to the trusts were always intended to be made, and were in fact made, in Canada by the beneficiaries and not in Barbados by the trustee, which exercised a limited role in an administrative capacity. The Federal Court of Appeal held that the Tax Court made no palpable and overriding error in reaching this conclusion.

The Tax Court and the Federal Court of Appeal also considered, in *obiter*, whether (1) subsection 94(1) of the Act deemed the trusts to be resident in Canada and, if so, whether the trusts would be resident in Barbados for purposes of the treaty and thus entitled to the benefit of the exemption from Canadian tax, and (2) whether the general anti-avoidance rule ("GAAR") would apply. With respect to whether the trusts would be deemed to be resident in Canada under subsection 94(1), the Tax Court decided that the trusts did not acquire property "directly or indirectly in any manner whatever" from the Canadian-resident beneficiaries or persons related to the beneficiaries and held that the deeming rule in subsection 94(1) would not apply. The Federal Court of Appeal disagreed with the Tax Court on this point but determined that the trusts would be resident in Barbados for treaty purposes; since the deemed residence rule in section 94 does not make a foreign trust liable for tax on its worldwide income from all sources, the trusts would not be residents in Canada for treaty purposes and would be entitled to the benefits of the treaty. Both the Tax Court and the Federal Court of Appeal decided that the GAAR did not apply as the trusts did not misuse or abuse the treaty.

The primary issue considered by the Supreme Court was whether the trusts were resident in Barbados, as was argued by the appellant, or in Canada, as was argued by the Minister. The appellant submitted that the residence of a trust must be the residence of the trustee based on two propositions: (1) since a trust is not a legal person like a corporation, the central management and control test for determining residency of a corporation is inapplicable to trusts, and (2) subsection 104(1) of the Act links the trustee to the trust for all attributes of the trust, including residency. The Minister submitted that the trusts were resident in Canada because the central management and control of the trusts was carried out in Canada by the beneficiaries. If the trusts were found not to be resident in Canada under the common-law principles, the Minister submitted two alternative arguments: (1) the trusts were deemed to be resident in Canada under subsection 94(1), and (2) the GAAR applied to deny treaty benefits to the appellant.

In a relatively short judgment issued in the name of "the Court", the Supreme Court dismissed St. Michael Trust Corp.'s appeals and agreed with the lower courts that the trusts were resident in Canada for purposes of the Act because the beneficiaries exercised the central management and control of the trusts in Canada.

In respect of the first proposition submitted by the appellant, the Supreme Court held that while a trust is not a person at common law, subsection 104(2) deems a trust to be an individual under the Act. The Court added that the reference to a "person" in subsection 2(1), which provides that an income tax is to be paid on the taxable income for each taxation year of every person resident in Canada at any time in the year, must be read as a reference to the taxpayer whose taxable income is subject to income tax which, in the present case, is the trust, not the trustee. In respect of the appellant's second proposition, the Court held that although subsection 104(1) provides that a reference to a trust in the Act must be read to include a reference to the trustee, there is no provision in the Act that links the trust and the trustee for purposes of determining the residency of the trust or that requires that the residence of a trust must be the residence of the trustee.

The Court concluded that the test for determining the residency of a corporation, which looks at where the exercise of central management and control actually takes place, is to be used in determining the residency of a trust. The Court provided two key reasons for its conclusion. First, the Court observed that there are many similarities between a trust and a corporation that justify treating trusts and corporations the same way for determining residence, including that (1) both hold assets that are required to be managed; (2) both involve the acquisition and disposition of assets; (3) both may require the management of a business; (4) both require banking and financial arrangements; (5) both may require the instruction or advice of lawyers, accountants, and other advisers; and (6) both may distribute income. Second, the adoption of the central management and control test for determining the residency of a trust promotes consistency, predictability, and fairness. The Court held:

> As with corporations, residence of a trust should be determined by the principle that a trust resides for the purposes of the Act where "its real business is carried on" (*De Beers*, at p. 458), which is where the central management and control of the trust actually takes place. As indicated, the Tax Court judge found as a fact that the main beneficiaries exercised the central management and control of the trusts in Canada. She found that St. Michael had only a limited role — to provide administrative services — and little or no responsibility beyond that (paras. 189-90). Therefore, on this test, the trusts must be found to be resident in Canada. This is not to say that the residence of a trust can never be the residence of the trustee. The residence of the trustee will also be the residence of the trust where the trustee carries out the central management and control of the trust, and these duties are performed where the trustee is resident. These, however, were not the facts in this case.

Since the Supreme Court held that the trusts were resident in Canada under common-law principles, it did not consider the Minister's arguments about section 94 or the GAAR. However, the Court noted that it "should not be understood as endorsing the reasons of the Federal Court of Appeal on those matters". It therefore remains unclear whether the Supreme Court would, in a similar case, apply the GAAR or agree with the Federal Court of Appeal as to applicability of section 94 or that, despite the application of subsection 94(1), the trusts would be entitled to the benefits of the treaty. Nevertheless, proposed section 4.3 of the *Income Tax Conventions Interpretation Act* provides that, notwithstanding the provisions of a treaty, a trust that is deemed resident in Canada under section 94 of the Act will be a resident of Canada and not a resident of the other contracting state for the purposes of applying the treaty.

Based on the Supreme Court's conclusion in *St. Michael Trust Corp.*, advisers should ensure trustees actually exercise their powers and discretions under the trust (i.e., carry out the central management and control of the trust) in the appropriate jurisdiction. In *St. Michael Trust Corp.*, for example, the residence of the trustee would have been the residence of the trusts had St. Michael Trust Corp. carried out the central management and control of the trusts and had its duties been performed in Barbados. As another example, where trustees are resident in Alberta, if the facts reveal that the central management and control of the trust is exercised by a third party (e.g., a beneficiary) who is resident and making decisions in Ontario, the trust will be found to be resident in Ontario.

Lastly, it is interesting that the judgment in *St. Michael Trust Corp.* was issued in the name of "the Court" rather than indicating a particular judge who drafted the decision. Such *per curiam* judgments are rare and are usually issued in very controversial cases, such as the *Reference re Secession of Quebec*. Although the *St. Michael Trust Corp.* case arguably was not controversial, following the Supreme Court's split judgment in *Lipson* (2009 DTC 5015), it is a welcome sign that the Court in *Copthorne* (2012 DTC 5007) and in this case has issued a tax judgment with a unified voice.

— V. Daniel Jankovic, McCarthy Tétrault LLP

Beneficiary liable for gains accruing prior to distribution of property

Green v. The Queen, 2012 DTC 1061 (Tax Court of Canada — Informal Procedure)

This informal procedure decision of the Tax Court of Canada dealt with the computation of the taxpayer's gain on the disposition of property he received as a beneficiary under his grandmother's estate. In particular, the issue was whether the gain from the sale of the property should include the portion that accrued while the property was held by the grandmother's estate. A straightforward application of subsection 107(2) of the *Income Tax Act* (the "Act"), which deemed the taxpayer to have acquired the property at the estate's cost, led the Tax Court to dismiss the appeal on the basis that the taxpayer's gain was to be computed using the estate's cost of the property. However, it is unclear whether the Tax Court appreciated that the reassessment it upheld was inconsistent with the reasons for judgment and, in particular, the tax consequences of the application of the 21-year deemed disposition rule to the grandmother's estate.

The property that was the subject of the appeal was real property that the taxpayer held with his three siblings as tenants-in-common. The property was originally owned by the taxpayer's grandmother who died in 1967. Her will granted a life estate over the property to the taxpayer's mother with the remaining interests in the property going to the taxpayer and his siblings upon their mother's death. The mother died in June 2007, at which time the property passed to the taxpayer and his siblings. The property was then sold by the four children in March 2008 for $395,000.

It appears that the taxpayer took the position that his tax cost for his one-quarter interest in the property should be based on its value at the time of his mother's death or its value when it was sold in March 2008. There were some selling costs associated with the transaction which resulted in the taxpayer claiming a small capital loss of $2,750 on the sale in his 2008 tax return reporting the transaction.

The Minister reassessed the taxpayer to delete the capital loss and substitute a capital gain of $68,250, representing one-quarter of the capital gain between the March 2008 sale price for the property and the estate's historical cost for the property on V-day (i.e., December 31, 1971) — which the parties accepted as $100,000 — less a one-quarter share of the $22,000 of selling costs associated with the March 2008 sale.

The taxpayer appealed the reassessment, arguing that the trust was responsible for paying the capital gains tax, and since he only became an owner of the property upon his mother's death in 2007, the value of the property at the time of his mother's death should be used to calculate any capital gain.

Not surprisingly, the Tax Court directed its attention to subsection 107(2) of the Act, which generally provides for a "rollover" of property (i.e., a transfer deemed to occur at the transferor's cost) from a trust to a beneficiary when property is distributed by the trust to the beneficiary in satisfaction of all or part of the beneficiary's capital interest in the trust. Subsection 107(2.001) of the Act allows a trust to elect not to have subsection 107(2) of the Act to apply, such that a fair market value disposition of the property would occur in the hands of the estate on the distribution, but no election was made by the trust in this case. Accordingly, Angers J determined that subsection 107(2) applied to effect the rollover of the accrued capital gain to the beneficiaries and the taxpayer's appeal was dismissed on that basis.

In response to the taxpayer's complaint that the estate should be responsible for paying the tax on the portion of the gain that accrued while the property was held by the estate, the Tax Court noted that a deemed disposition of the property for its fair market value should have occurred on January 1, 1999 in the estate pursuant to the 21-year deemed disposition rule in subsection 104(4). (The deemed disposition would normally have occurred pursuant to that provision in 1993, but the estate was able to defer the event to 1999 pursuant to an election under subsection 104(5.3).) However, the Tax Court went on to observe that the estate did not follow up on the election by reporting the deemed disposition of its property in its 1999 tax return and, therefore, the estate did not pay tax on gains that accrued to 1999 even though the Minister would have been entitled to reassess the estate for such tax as a consequence of that event. Presumably, the Tax Court made reference to the tax implications to the estate from the 1999 deemed disposition to show that no tax had been paid by the estate on any of the post-V-day gain on the property and, therefore, the taxpayer's complaint was without merit.

By dismissing the taxpayer's appeal, the Tax Court essentially upheld the Minister's reassessment that made the taxpayer liable for tax on the entire post-1971 (i.e., since V-day) gain that accrued on the property while in the estate. However, having identified (as noted above) that the estate would have had a deemed disposition of all its property on January 1, 1999, the Tax Court perhaps should have allowed the taxpayer's appeal and required the Minister to compute the taxpayer's gain using a cost for the property based on its value on the January 1, 1999 deemed disposition date. This is because one of the tax consequences from a fair market value disposition pursuant to the 21-year disposition rule is that the trust is deemed to have reacquired the property on that day for a cost equal to its fair market value at that time. In other words, following the 21-year deemed disposition, the tax cost of the estate's

property is stepped up to its value at that time (by virtue of the preamble in subsection 104(4)), and if the estate transfers property to a beneficiary thereafter, the cost for the property that the beneficiary inherits pursuant to subsection 107(2) should be the stepped-up cost and not the estate's historical cost prior to the 21-year deemed disposition. Immediately preceding its analysis of how subsection 107(2) applies to transfer the accrued gain on the property from the estate to the taxpayer, the Tax Court made the statement that "[s]ince 1999, in my opinion, capital gains have been accruing in the trust". So, it may be that the Tax Court was intending for the taxpayer to only be liable for the portion of the capital gain that accrued after 1999, even though dismissing the appeal resulted in the taxpayer's gain being computed in accordance with the reassessment, which reflected the gain on the property since V-day. It is to be noted that this case was decided under the Tax Court's informal procedure and the taxpayer was self-represented; this may explain why the cost implications of the application of the 21-year deemed disposition rule to the estate did not make its way into the Tax Court's analysis of the case.

It was not evident from the reported decision whether any evidence was introduced by the taxpayer or the Minister on the value of the property at the time of the deemed disposition on January 1, 1999. So it is unclear the extent to which the computation of the gain would have been reduced, if any, if using a January 1, 1999 value for the taxpayer's cost of his one-quarter interest in the property rather than the $100,000 V-day value. However, it is unfortunate that the CRA did not explore the topic with the taxpayer in the course of its audit of the matter, as it is clear from the evidence that the auditor purported to have a discussion with the taxpayer about the implications of the deemed disposition of the property by the estate. According to the evidence, the auditor proposed to the taxpayer that the parties ignore the deemed disposition rule; if this was an attempt by the auditor to amicably resolve the matter, it was a curious proposal to make since the deemed disposition would have resulted in the taxpayer inheriting a stepped-up cost on the rollout of the property by the estate in 2007 and, therefore, a lesser capital gain than what the CRA reassessed and the Tax Court ultimately upheld.

— *Alison Minard and John Yuan, McCarthy Tétrault LLP*

TAX NOTES

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For CCH Canadian Limited

Susan Peart, C.A., LL.M.
(416) 224-2224, ext. 6434
email: Susan.Peart@wolterskluwer.com

Natasha Menon, Content Product Manager
Tax, Accounting and Financial Planning
(416) 224-2224, ext. 6360
email: Natasha.Menon@wolterskluwer.com

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CCH Canadian Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
416 224 2248 · 1 800 268 4522 tel
416 224 2243 · 1 800 461 4131 fax
www.cch.ca

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