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THE TRUST IS DEAD, LONG LIVE THE TRUST[1]

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Wolters Kluwer regularly features Dentons Canada LLP articles examining cases and topics of special interest.

The Statute of Uses[2] enacted by the English Parliament in 1536 during the reign of King Henry VIII is one of the first known legislative attempts to prevent some perceived abusive planning techniques, taxation or otherwise, that were available to the citizenry through the use of trusts[3] in arranging one's property affairs.

More "recent"[4] legislative enactments aimed at curtailing the income tax benefits of using trusts include:

(1) The addition of subsection 107(4.1)[5] to the *Income Tax Act* for dispositions of property by trusts after 1988, without any grandfathering of existing trusts, denied the access to a tax-deferred rollout otherwise available under subsection 107(2) by a trust of its property to beneficiaries in a number of what were then very common situations.

Prior to the enactment of subsection 107(4.1), avoiding the attribution rule in subsection 75(2) was not of great concern where there was no plan to pay income to or realize capital gains in a trust prior to the wind-up of the trust relationship.[6] The enactment of this rule without grandfathering of existing trust relationships was particularly costly for trusts which subsequently became subject to the 21-year deemed disposition rule under subsection 104(4) and whose settlor or spouse thereof was then still alive and resident in Canada and not a capital beneficiary of such a trust.[7]

(2) The curtailment in 1996 of the trust relationships that could access the "preferred beneficiary election" in subsection 104(14) by restricting to disabled persons individuals who qualify as "preferred beneficiaries" as defined in subsection 108(1).[8]

In practice, the preferred beneficiary election could, for example, allow a trust to hold shares in a corporation operating a business which trust would receive dividends from its shareholdings. Thereafter, without ever having to pay the income to the preferred beneficiaries (usually minor children of the business owner), the trust would enter into an election with the children pursuant to which the children, and not the trust, would report the income on their returns, resulting in a deduction of the amount elected to the trust and little or no additional tax payable by the beneficiaries. Entering into a preferred beneficiary election did not result in an entitlement to the beneficiary in the income, which remained the property of the trust. After the end of the taxation year of the trust, the unpaid (but "taxed") income would take on the character of capital and could be allocated and paid as a tax-free capital distribution to the parents as capital beneficiaries.

In a real-life example in which the author was involved prior to 1997, a taxpayer with six minor children was able to remove approximately $150,000 from his corporation each year without any further income tax (after the corporation had paid approximately 25% tax on $200,000 of active business income subject to the small business deduction).

While the described situation is difficult to defend on a tax policy basis as not abusive, the amendments also resulted in unintended consequences. For example, a trustee who had every intention of using the income that was the subject of the preferred beneficiary election for the future benefit of a child who was not disabled would now have to ensure that the funds were payable to the minor child in order to get a paragraph 104(6)(*b*) income deduction in the trust.[9] Making the amount so payable could result in the funds having to be paid to the public trustee of the province in which the minor child resided. It would also result in the ability of the child to demand, at the age of majority, access to the full amount of the funds previously allocated and made payable to him or her.[10] Neither result was generally desirable. Accordingly, the tax planning community devised a more cumbersome structure involving the use of the provisions of subsection 104(18) in conjunction with "minor trusts", usually resulting in a multiple trust structure to achieve what was previously attainable through the use of one discretionary trust and the preferred beneficiary election.[11]

(3) The introduction of section 120.4, "Tax on Split Income", or the "kiddie tax", first announced in Budget 1999, for income earned after 1999, as subsequently amended to encompass more types of income than originally intended.

The tax, if applicable, is levied at the highest marginal rate applicable to the income in question and applies generally to dividend income and shareholder appropriations from private corporations along with taxable capital gains realized by a trust on a disposition of private corporation shares to a non-arm's length person. It also applies to income earned through a trust or partnership that is derived from property or services provided to, or in support of, a related person's business. The introduction of the kiddie tax effectively put to rest a number of structures in which income from a family business was paid through a trust to a minor.

One typical example involved the owner of a corporation undertaking an estate freeze transaction with his or her corporation and having the new, nominal value growth shares issued to a discretionary family trust. Thereafter, dividends paid on the trust's shares would be made payable to or for the benefit of a minor child and up to approximately $25,000 of dividends or more could be received by a minor with no other income, free from tax as, before the kiddie tax, the child's marginal tax rates would apply and funds that could be used for the benefit of the children could be removed from the corporation at a substantially reduced tax cost. With the introduction of the kiddie tax, the income-splitting advantage of such a structure was eliminated.

Another example involves a structure used by many professional partnerships. A professional partnership would restructure to create a management services limited partnership ("MSLP") to manage the affairs of the professional partnership. The limited partners of the MSLP would be trusts created for the benefit of the family members of the partnership. The MSLP would employ the administrative staff and purchase all supplies to be used in the professional partnership and resell these goods and services at a 15% markup. The resulting profit in the MSLP would be allocated to the trusts and thereafter to the minor children. Again, prior to the introduction of the kiddie tax, this income would be taxed at the marginal rates of the children to which the income is allocated. With the introduction of the kiddie tax, the income-splitting advantage of such a structure was eliminated.

On several occasions, after the introduction of such new rules, the popular media has (and, in the case of the author, several friends in the income tax planning community have) decried that the use of trusts for estate and tax planning was dead. To date, this has proven to be an overreaction to the various enactments; this is a testament to the great flexibility afforded by the use of trusts in estate planning.

The more recent proposals[12] (the "latest proposals"), however, may have a serious and long-lasting impact on two types of planning that have been prevalent in general estate planning: post-mortem income splitting and certain interprovincial income tax planning, and on one type of planning that was useful in some jurisdictions, such as Ontario, to minimize probate taxes: the use of multiple wills.

Post-Mortem Income Splitting

The latest proposals, if enacted as currently proposed, would deny, after 2015, access to the graduated income tax rates currently available to estates older than 36 months and to "testamentary trusts"[13] other than "qualified disability trusts",[14] and would impose on such trusts the top marginal tax rate on all of their income. An estate of a deceased that is less than 36 months in existence and that is the only estate designated as such in respect of the deceased would be subject to the graduated rates of tax and would now be called a "graduated rate estate".[15]

A typical tool used in will planning for high net worth individuals has included extending the time for the administration of an estate to extend, and using multiple testamentary trusts to multiply, access to the graduated tax rates currently applicable to such trusts.[16]

In a typical example, a high net worth couple, X and his spouse Y, reside in Alberta and have two adult children to whom they wish to leave the majority of their estate, which currently consists of substantial investment asset value. X and Y plan to fund their retirement with registered (RRSP/RRIF) savings and other pension income. The expectation is that their investment asset value will continue to grow during their retirement.

A possible estate plan for X and Y is as follows:

(1) They will currently separate the joint ownership investment assets (if any) into two separate accounts, one in the name of X and the other in the name of Y. There should be no current income tax implications to putting this in place.[17]

(2) The wills of X and Y will be structured such that when the first dies, his or her investment asset value will form part of that first deceased person's estate. If necessary, the surviving spouse will go through the probate process. The will shall provide that the investments of the first to die will be used to fund a qualifying testamentary spousal/common-law partner trust that is described in subsection 70(6) to ensure a rollover of any accrued gains. The use of such a testamentary trust here is to hold one-half of the investment asset value, as opposed to having all of the asset value held directly by the surviving spouse, which will generate an annual tax savings.

(3) The terms of the trust referred to in (2) above are such that on the death of the surviving spouse beneficiary, the value of this trust (subsequent to the realization of any gains as a result of the deemed disposition pursuant to subsection 104(4) on the death of the spouse beneficiary) will be transferred equally to two new testamentary trusts (Trust A and Trust B), one for the benefit of each of the children.

(4) Upon the death of the last of X and Y, the wealth (the one-half not transferred to the other upon the carving up of joint assets) maintained by them at death will be owned (after the impact of the section 70 deemed disposition) by two new testamentary trusts (Trust C and Trust D), again, one for each of the children.

(5) Any RRSP/RRIF asset value remaining at death should pass directly to the appropriate individual beneficiary and not into one of the trusts discussed above.

The result of such planning is that, on the death of the first of X and Y, there are two taxpayers to which marginal income tax rates will apply — the survivor of X and Y and the spousal trust for the benefit of the survivor of X and Y. Even better, on the death of the survivor of X and Y, there would be six taxpayers, each child of X and Y and Trusts A, B, C, and D. The income splitting ramifications of such a structure could be quite beneficial given an estate large enough to generate up to approximately $132,000 per taxpayer (or the start of the tax bracket with the highest marginal rate of taxation in most provinces and territories).

As each of the spousal trusts and Trusts A, B, C, and D will no longer have access to graduated tax rates after 2015, this common form of tax-efficient planning for death will no longer be effective for tax purposes, although there may be other important non-tax reasons for using testamentary trusts for the benefits of one's spouse and children.

Interprovincial Income Tax Planning

There are many suggested structures to take advantage of the diverse provincial income tax rates, with Alberta often being the target province of such planning. At the time of writing, the only jurisdictions remaining in which a corporation can pay a taxable dividend and receive a dividend refund of refundable dividend tax on hand ("RDTOH") greater than the top marginal income tax rate payable on non-eligible dividends are:

- Alberta (at 29.36%);
- Newfoundland and Labrador (at 32.08%);
- Yukon (at 32.04%);
- Northwest Territories (at 30.72%); and
- Nunavut (at 31.19%).

In a corporation that has substantial RDTOH currently or expects to generate investment income in the future and therefore create the RDTOH, there is an incentive to ensure that the taxable dividend that would have to be paid to recover the RDTOH is taxed at a rate lower than the 33$^{1}/_{3}$% dividend refund rate. In Alberta, the highest marginal income tax rate on non-eligible dividends in 2014 is 29.36%, resulting in almost 4% saving to "buy-down" the RDTOH.

In Alberta, there is an incentive to pay sufficient dividends to ensure a refund of the RDTOH on a yearly basis, even if the corporate funds are not required by the shareholders. In Manitoba, however, where the highest marginal income tax rate on non-eligible dividends in 2014 is 40.77%, there would be a substantial (7.34%) cost in removing the funds from the corporation. Unless funds are required by the shareholders of a corporation, there is a great disincentive in Manitoba to pay dividends to obtain a refund of the RDTOH.

Consider a situation where a husband and wife (each Manitoba residents and each having sufficient personal income such that their respective marginal income is taxed in the highest marginal tax bracket) each own one-half of the common shares of a Manitoba corporation. The corporation has $7 million of RDTOH from having earned substantial investment income over the years, including some substantial capital gains on a prior sale of property. The couple has been living on the shareholder loan created from the payment of the capital dividend account from the non-taxable portion of realized capital gains, but is now facing the need to remove funds from the corporation on a taxable basis.

A non-eligible dividend will result in a dividend refund to the corporation of 33⅓%, whereas the couple would pay 40.77% tax on the dividend versus 29.36% if they were resident in Alberta. Short of recommending that they take up residence in Alberta, an adviser may suggest that each settle a trust on an Alberta-resident trustee for the benefit of the other. The terms of the trust would be such that each spousal trust would qualify as one described in paragraph 73(1.01)(*c*) such that any transfer to such a trust would occur on a tax-deferred rollover pursuant to the provisions of subsection 73(1).

On the subsequent receipt of dividends by each trust, as the terms of the trust entitle the spouse beneficiary to all income, the income should be taxed in that spouse beneficiary's hands as it is payable to him or her[18] and then the provisions of subsection 74.1(1) would attribute such income back to the spouse settlor of the trust, resulting in taxation of such income in the taxpayer and province it would have been taxed had no planning taken place. In order to avoid this result, the trustee would designate, pursuant to subsection 104(13.1), that such income would instead be taxed in the trust. Provided that the trust is legally resident in Alberta, the dividend income would then be taxed at the highest marginal rate (29.36%) applicable in Alberta. Such planning, if effective, would result in an 11.41% tax saving to the Manitoba resident (or $2,396,100 on the $21 million taxable dividend required to obtain a full refund of the RDTOH). To an Ontario resident, the saving will be 6.8%; to a Quebec resident, 6.46%; and to a BC resident, 4.65%.

Proposed subsection 104(13.3) in the latest proposals jeopardizes this type of planning after 2015. It would have the effect of invalidating any designation made pursuant to subsection 104(13.1) (and its companion subsection 104(13.2), which permits taxable capital gains to be so designated) if, prior to the invalidation of the designation by the proposed subsection, the income of the trust would be greater than nil. In effect, if subsection 104(13.3) is enacted as currently written, after 2015, the designations under subsections 104(13.1) and (13.2) will only be available for use to retain income in a trust against which a loss in the trust can be claimed and not to result in taxable income in the trust to be taxed, in our example, in the jurisdiction of the residence of the trust.

Threats to the Use of Multiple Wills

In Ontario, the probate tax on the value of assets in excess of $50,000 that are the subject of an application for probate is 1.5%. Accordingly, in a $10 million estate, the tax will be almost $150,000 or an amount that makes it practical to consider a plan to avoid such tax. One method of avoiding such tax that has been accepted in Ontario is the use of multiple wills.[19] A testator can make two wills: (1) a will that must be probated as it includes assets, such as land, that cannot be transferred after death without probate; and (2) another will that includes all other assets that can be transferred without probate even if the probate fees in respect of the land can be avoided with certain planning.

Several proposed provisions contained in the latest proposals, while not affecting the efficacy of multiple wills as an Ontario probate tax avoidance technique, will adversely affect the income tax effects of multiple estates; this potential cost will have to be weighed against the probate tax savings from the use of multiple wills.[20]

As noted above, only graduated rate estates will be subject to the graduated rates of tax after 2015. As the proposed rules only allow that one estate can be designated as a graduated rate estate in respect of each deceased, assuming that each will results in a separate estate, only the income and gains from the assets in the will that is designated as a graduated rate estate will be eligible for the graduated rates of tax.

The tax cost of the loss of the graduated rates on one or more of the multiple wills will have to be weighed against the savings in probate tax resulting from their use.

Trusts after 2015

Although the latest provisions, insofar as they are discussed in this article, have dealt a serious blow to the use of testamentary trusts for post-mortem income splitting, there are still a number of useful applications, both tax and non-tax, for testamentary and *inter vivos* trusts.

The key tax and non-tax objectives often addressed when considering the establishment of a testamentary or *inter vivos* trust include:

- achieving income-splitting and estate planning benefits by using a trust to hold the growth shares of a corporation either from incorporation or after the original owners have undertaken an estate freeze;
- protecting assets from potential future creditors or unwanted future potential recipients (e.g., the spouse of a child) both with respect to asset value settled on the trust as well as value that may have accrued or been added;
- serving as a substitute for a will and avoiding the incidence of probate taxes (as discussed above in the BC probate avoidance structure);
- achieving a degree of confidentiality with respect to asset value within the trust and outside the will;[21]
- serving as a substitute for the enduring power of attorney; and
- potentially helping to avoid the application of provincial wills variation legislation. Such legislation can restrict an individual's ability to plan testamentary matters; this legislation can become an issue where, for example, an individual wants to effect a large bequest, or where children from a prior marriage are present.

Although they may no longer attract graduated rates of taxation, testamentary trusts and *inter vivos* trusts are still useful to achieve a number of estate planning goals, including:

- holding assets for minor beneficiaries without the involvement of the public trustee or public guardian, which would allow the settlor/testator to provide for a more ordered distribution of such minor's entitlement rather than in one lump sum when they reach age of majority, if a trust is not used;
- holding assets for disabled children, which will allow for the management of wealth on behalf of a person who may not have the ability or legal capacity to do so themselves; in some jurisdictions (e.g., Ontario, *The Henson Trust*) holding assets in a trust for disabled persons may allow them to continue to access provincial income-tested or asset-tested benefits;
- holding assets for spendthrift children, which will allow a parent to place wealth under the control of someone who is charged with ensuring that the funds last longer for the maintenance, betterment, and support of a child who might otherwise spend them foolishly; and
- providing for one's spouse during the spouse's lifetime while ensuring that the remainder interest, if any, devolves to the children of the settlor/testator (especially useful with second marriage scenarios where all of the children of the settlor/testator are from the first marriage).

A number of tax lawyers from Dentons Canada LLP write commentary for Wolters Kluwer's Canadian Tax Reporter *and sit on its Editorial Board as well as on the Editorial Board for Wolters Kluwer's* Income Tax Act with Regulations, Annotated. *Dentons Canada lawyers also write the commentary for Wolters Kluwer's* Federal Tax Practice *reporter and the summaries for Wolters Kluwer's* Window on Canadian Tax. *Dentons Canada lawyers wrote the commentary for* Canada–U.S. Tax Treaty: A Practical Interpretation *and have authored other books published by Wolters Kluwer:* Canadian Transfer Pricing *(2nd Edition, 2011);* Federal Tax Practice; Charities, Non-Profits, and Philanthropy under the Income Tax Act; *and* Corporation Capital Tax in Canada. *Tony Schweitzer, a Tax Partner with the Toronto office of Dentons Canada LLP and a member of the Editorial Board of Wolters Kluwer's* Canadian Tax Reporter*, is the editor of the firm's regular monthly feature articles appearing in* Tax Topics.

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Notes:

[1] With apologies to the French, "Le roi est mort, vive le roi!", which was first declared upon the accession to the French throne of Charles VII after the death of his father, Charles VI, in 1422. (Source: http://en.wikipedia.org/wiki/The_king_is_dead,_long_live_the_king!, accessed on November 2, 2014.)

[2] *The Statute of Uses*, 27 Hen 8 c. 10.

[3] The "use" was the then current term used to describe relationships where the registered owner agrees to hold the property to the "use" of (or, today, "in trust for") another.

[4] Since the author began practising law in 1987.

[5] Added by 1988, c. 55, s. 74(4), applicable with respect to distributions of properties by trusts after 1988.

[6] This has been referred to as an "estate freeze" trust, wherein the only goal of the trust is to trap the growth shares in a structure that would allow future growth to be distributed on a tax-deferred basis pursuant to subsection 107(2) in proportions to be determined at a future time.

[7] If subsection 107(4.1) applies, if the settlor is then alive and a resident of Canada, a subsection 107(2) rollout is denied to any beneficiary other than the settlor or the settlor's spouse.

[8] The definition "preferred beneficiary", amended by S.C. 1998, c. 19, s. 19, applicable to trust taxation years that end after 1996. Subsequent amendments relaxed the original definition to allow more disabled persons to qualify than under the original amendment.

[9] See the definition of "payable" in subsection 104(24), which requires that, as a general rule, to be payable in a year, the income was paid in the year to the beneficiary or the beneficiary was entitled in the year to enforce payment of it.

[10] This result was mitigated, although not perfectly, by the provisions of subsection 104(18), which provides for an amount to be payable to a minor in circumstances where it is not immediately payable and other, restrictive conditions exist.

[11] See, for example, Dale S. Meister, "Family Trusts and Associated Planning", *1996 Prairie Provinces Tax Conference*, (Toronto: Canadian Tax Foundation, 1996), 6:1–25.

[12] Originally introduced as conceptual proposals in a consultation paper issued by the Department of Finance on June 2, 2013 entitled "Consultation on Eliminating Graduated Rate Taxation of Trusts and Certain Estates" (the Department invited comments on proposed changes to the graduated tax applicable to testamentary trusts), then confirmed as policy in Budget 2014, followed by draft legislation released on August 29, 2014, and then included in Notice of Ways and Means Motions dated October 10 and 20, 2014 followed by inclusion in Bill C-43, *Economic Action Plan 2014 Act, No. 2* (October 23, 2014).

[13] Defined as follows in subsection 108(1): "means a trust that arose on and as a consequence of the death of an individual", but see that provision for important exceptions. This includes an estate.

[14] Defined in a proposed addition to subsection 122(3) as a testamentary trust resident in Canada for beneficiaries who are disabled and elect to be a qualified disability trust.

[15] In this article, the author does not attempt to discuss all of the provisions contained in the latest proposals. One notable provision that is absent from the discussion is proposed subsection 104(13.4), which would, *inter alia*, change the incidence of tax on the death of the person whose death otherwise would trigger the deemed disposition in an *alter ego* trust, joint spousal or common-law partner trust, spousal and common-law partner trust, self-benefit trust (subparagraph 73(1.02)(*b*)(i)), or a trust in which the settlor relied on the provisions of subsection 107.4(1) to obtain a tax-deferred rollover of property to the trust. Whereas, in most of these cases, the income resulting from the deemed disposition would be taxed in the trust, the new rules would, in effect, tax it in the terminal return of the person whose demise gave rise to the deemed disposition. In their submissions to the Department of Finance, both the joint CPA Canada-CBA committee and STEP Canada have criticized the provisions as drafted, outlining several practical scenarios where these provisions would result in unfair incidence of taxation.

[16] Compared to *inter vivos* trusts, which are taxed on all income at the highest marginal tax rate, testamentary trusts, like individuals generally, enjoy graduated tax rates.

[17] The provisions of subsection 104(20) should operate to deem there not to have been a disposition in respect of such separation of interests.

[18] Subsection 104(13) provides for this result.

[19] In Ontario, the use of multiple wills to avoid probate taxes on the will that was not the subject of a probate application was upheld in *Granowsky Estate v. Ontario*, 156 DLR (4th) 557 (Ont. S.C.).

[20] Using multiple wills is not the only planning method to avoid Ontario probate tax — a concerned individual may consider the use of an *alter ego* trust or joint spousal or common-law partner trust as a will substitute to avoid probate altogether. In a real-life situation in which the author was involved, $8 million of preferred shares issued to an individual on an estate freeze were transferred to an *alter ego* trust with his Alberta-resident children as trustees when the individual decided to retire to British Columbia. On his subsequent death, BC probate tax of $112,000 was avoided.

[21] For an example of a celebrity will that transferred assets to a trust outside the will document and the distribution of the assets away from public view, see http://hosted.ap.org/specials/interactives/_documents/jackson_will.pdf for the will of the late Michael Joseph Jackson.

INCOME TAX FOLIO S1-F3-C2, PRINCIPLE RESIDENCE

Effective November 14, 2014, the Canada Revenue Agency announced updates to Income Tax Folio S1-F3-C2, Principal Residence (the "Folio"). The focus of the updates is the Folio's section dealing with the "ordinarily inhabited rule", i.e., the requirement that a principle residence property must ordinarily be inhabited in a year by a taxpayer, a taxpayer's current or former spouse or common-law partner, or a taxpayer's child. Specific changes to ¶2.11 of the Folio clarify the situations in which a taxpayer's ordinarily inhabited housing unit may still qualify as a principal residence property, even if the taxpayer's main reason for owning that property is to gain or produce income from it.

MONEY PURCHASE LIMITS AND RRSP LIMITS

The Canada Revenue Agency has released the money purchase limit for 2015, which is relevant to registered pension plan contributions and corresponds to the RRSP limit for 2016. As such, for 2015 the money purchase limit is $25,370 ($24,930 in 2014), and the 2016 RRSP limit is $25,370 ($24,390 in 2015). The 2015 deferred profit sharing plan limit is $12,685 ($12,465 in 2014), and the 2015 defined benefit limit is $2,818.89 ($2,770 in 2014). As usual, an

individual's deferred profit sharing plan, RRSP, and money purchase limits are also restricted to 18% of earned income. As noted in *Tax Topics* No. 2227, the maximum pensionable earnings for 2015 are $53,600 ($52,500 in 2014).

CRA RELEASES 2015 INDEXING FACTORS

On November 20, 2014, the Canada Revenue Agency released the 100th edition of its T4127 guide, *Payroll Deductions Formulas for Computer Programs*. Effective January 1, 2015, the T4127 guide contains the formulas needed by payroll professionals to calculate federal, provincial, and territorial income taxes and CPP and EI deductions. The federal indexing factor for 2015 is 1.7%; therefore, to calculate the indexed income thresholds and personal amounts for 2015, the 2014 amounts should be multiplied by a 1.017 factor. The guide states that for 2015, the federal indexing factor of 1.7% also applies to New Brunswick, Northwest Territories, Nunavut, Saskatchewan, and Yukon thresholds and amounts. The indexing factors for the other provinces are as follows:

- Alberta, 2.4%;
- British Columbia, 0.7%;
- Newfoundland and Labrador, 2.2%; and
- Ontario, 2.0%.

There is no indexing applied to Manitoba, Nova Scotia, and Prince Edward Island thresholds and amounts.

RECENT TECHNICAL INTERPRETATIONS

Change of Method to Calculate Capital Gain

The issue the Canada Revenue Agency ("CRA") was asked to consider involved a taxpayer having realized a capital gain on a sale of shares subject to an earnout agreement (i.e., indexation of future benefits). At the time of the sale, the taxpayer decided not to use the "cost recovery method" to calculate his capital gain even if he met all the conditions listed in the second paragraph of IT-426R and would have been allowed by the CRA to use that method. Instead, he decided to calculate his capital gain on the basis of his best estimation of his anticipated proceeds of disposition. Since the amounts received under the earnout agreement were totally different from those estimated by the taxpayer at the time of the sale, he would like to retroactively change the method used to calculate his capital gain using the cost recovery method instead and, accordingly, correct his prior years' income tax returns.

The CRA confirmed that the taxpayer could not retroactively use the cost recovery method to calculate his capital gain on the sale of the shares. He could not amend his income tax returns filed previously to reflect the new calculation because there was no error to correct and the CRA did not have to reassess him. The only reason why he wanted to use another method to calculate his capital gain was because he did not properly estimate his future proceeds of disposition under the earnout agreement. Although the CRA was allowed by subsection 220(3.2) of the *Income Tax Act* (the "Act") to let an election be modified, cancelled, or filed late, this did not apply to this case since the cost recovery method and subsections 12(1) and 40(1) were not listed in Regulation 600. Only provisions listed in Regulation 600 may qualify for the above administrative concession. Note that the situation described in this case is not one described in subsection 152(4) of the Act and IC 75-7R3, for which the CRA would agree to issue a new assessment after the expiry of the statutory deadline.

— *External Technical Interpretation, Business and Employment Income Division, August 27, 2014, Document No. 2014-0529221E5*

Voluntary Disclosure for Failure to Prepare Form T1134 and Report FAPI

The situation considered by the CRA involved a taxpayer who had failed for many years to submit his form T1134 and to report the related foreign accrual property income ("FAPI") on his tax returns. Because subsection 220(3.1) of the *Income Tax Act* (the "Act") authorizes the CRA to waive interest and penalties, he decided to disclose those two reporting failures to the CRA under the Voluntary Disclosure Program ("VDP").

The CRA was asked:

- how many years of non-compliance had to be disclosed;
- how long they had to assess penalties for the taxpayer's reporting failures; and
- whether the foreign accrual property losses ("FAPLs") or foreign accrual capital losses ("FACLs") could be considered to calculate the foreign affiliate's FAPI.

The CRA confirmed that the taxpayer's disclosure would have to cover all the years for which the form was not prepared or the FAPI not reported. It could, otherwise, be ignored by the CRA. This interpretation is consistent with the voluntary disclosure principles outlined in Information Circular IC00-1R4. Regarding the penalty under subsection 162(7) of the Act for not producing a Form T1134, the CRA must reassess the taxpayer within the normal reassessment period under subsection 152(3.1) of the Act unless the period is extended under subsection 152(4) of the Act. Regarding the penalties under subsections 162(10), 162(10.1), or 163(2.4) of the Act, they may be assessed at any time. A taxpayer may also be liable to a penalty under section 163 of the Act, and interest on late balance under section 161. The rules on penalties are the same in case of voluntary disclosure except that they may be waived at the CRA's discretion (see subsection 220(3.1) of the Act). The FAPLs and FACLs could be claimed in the calculation of the foreign affiliate's FAPI (see items F and F.1 of the formula in the definition of FAPI in subsection 95(1) of the Act, Regulations 5903 and 5903.1, and the technical notes related to those provisions).

Internal Technical Interpretation, International Operations Division, July 14, 2014

Partnership to Sole Proprietorship

The CRA was asked if depreciable property owned by a family farm partnership could be transferred on a tax-deferred basis to one of the partners (i.e., a son) who will carry on the partnership's farming business as a sole proprietorship. Under subsection 98(5) of the *Income Tax Act* (the "Act"), which is a non-elective provision, property of a discontinued partnership can be transferred on a tax-deferred basis to one of the partners in certain circumstances. Within three months of a Canadian partnership ceasing to exist, one of the partners must continue the business of the partnership as a sole proprietorship using the partnership property that was received by him as proceeds of disposition of his partnership interest. A "Canadian partnership", as defined in subsection 102(1) of the Act, is a partnership, all the members of which at the relevant time are resident in Canada. Where the conditions of subsection 98(5) are met, the partnership is deemed to have disposed of each property for proceeds equal to the cost amount of the property. The continuing proprietor is deemed to have disposed of his partnership interest for proceeds equal to the greater of:

(1) the adjusted cost base of his partnership interest together with the cost of all partnership interests acquired by him from former partners on the termination of the old partnership; and

(2) the aggregate of the cost amount to the former partnership of each property received by the continuing proprietor plus any other proceeds of disposition realized on the disposition of the proprietor's partnership interest.

Where the amount in (1) is greater than (2), the excess may be added to the proprietor's cost base of capital properties other than depreciable property. Repealed paragraph 98(5)(*d*) of the Act has certain grandfathering rules for property that was acquired by the partnership before December 5, 1985, which may allow a bump on depreciable property and property other than capital property. A capital gain can result if the cost amount of partnership property transferred to the proprietor is greater than the aggregate cost base of his own partnership interest and any interests acquired on the partnership termination (i.e., (2) is greater than (1)). The CRA noted that since the situation described concerns of a farm partnership, the capital gains deduction under subsection 110.6(2) of the Act may be available. As well, in certain circumstances, subsections 73(4) and (4.1) of the Act allow capital gains arising on the transfer of an interest in a family farm partnership to a child to be deferred.

External Technical Interpretation, International Division, September 8, 2014

Meaning of "Gross Revenue" Follow-up

The CRA was asked if amounts received as volume discounts should be included in a corporation's gross revenue for purposes of s. 402(3) of the *Income Tax Regulations*. "Gross revenue" is defined in subsection 248(1) of the *Income Tax Act* (the "Act"), and, under paragraph (*a*) of that definition, includes "all amounts received in the year or receivable in the year . . . otherwise than as or on account of capital". Paragraph (*b*) of the definition also includes certain accrued amounts other than amounts already included in paragraph (*a*). Under Regulation 402(3), a corporation's gross revenue

is used in the formula to allocate taxable income in a taxation year where a corporation has a permanent establishment in a province and a permanent establishment outside that province. In Document No. 2010-0382161I7, "Discounts and Rebates — Application of IAS 2 and EIC-144" (October 27, 2011), the CRA had indicated that discounts and rebates received by a taxpayer after a purchase are included in the taxpayer's gross revenue.

The CRA commented that some may consider that the definition of gross revenue in subsection 248(1) is the same as a corporation's revenue as determined for financial statement purposes. However, the CRA cited instances where they can differ, and concluded that while they may be similar, there could be significant differences depending on the method of accounting used by the taxpayer. The CRA concluded that gross revenue for purposes of Part IV of the Regulations (including Regulation 402(3)) includes "all amounts received or receivable by a taxpayer other than on account of capital but does not include amounts received in respect of expenditures of the taxpayer". As well, the CRA noted that amounts such as unearned income or amounts receivable from property sold or services rendered are included in income under subsections 12(1)(*a*) or (*b*) of the Act, and are also part of gross revenue for Part IV of the Regulations. The CRA gave the following examples of what would not be included in gross revenue:

- amounts such as volume rebates that are received or receivable on account of the taxpayer's expenditures;
- government assistance received in respect of expenditures incurred or to be incurred by the taxpayer;
- amounts included in income from the disposition of capital property such as under sections 13, 14, or 38; and
- amounts that were included in gross revenue in a previous taxation year.

The CRA confirmed that this position on the definition of gross revenue for purposes of the provincial allocation differs from that described in Document No. 2010-0382161I7.

Internal Technical Interpretation, International Division, March 31, 2014

RECENT CASES

Dividend refund requirements are unambiguous: failure to file timely returns is fatal to claim

The taxpayer, a private corporation, declared and paid a total of $4.676 million in dividends to its shareholders from 1997 to 2004 but failed to file any corporate tax returns until 2008. The *Income Tax Act* is designed to achieve integration between corporations and shareholders. Corporations pay tax when dividends are declared, but once shareholders include the dividends in income and pay tax on them, there is a mechanism that entitles the corporation to a dividend refund. Private corporations are entitled to a dividend refund as long as corporate returns are filed within three years after the dividends are paid. The Minister denied the dividend refund, arguing that a failure to file returns within three years is fatal to the refund claim. The taxpayer was appealing the denial of the dividend refund on the basis that the tax provisions were ambiguous and failed to state a penalty for failing to file returns and that the filing deadlines were directory and not mandatory.

The appeal was dismissed subject to a concession by the respondent reducing the Part IV tax for 2003. The provisions relating to the dividend refund regime are clear and unambiguous. The preamble clearly sets out that the consequence for failing to file returns within three years is non-entitlement to the dividend refund. The French wording of the provisions reinforces the clarity of the steps that are needed to qualify for the refund. Taxpayers have an obligation to file returns, and deadlines are provided throughout the *Income Tax Act*. The deadline for filing the returns is mandatory and not directory. Reading the provisions as directory would make the filing deadlines meaningless and negate the fundamental obligation of the taxpayer to properly file tax returns.

1057513 Ontario Inc., 2014 DTC 1196

Taxpayer not entitled to raise new issues on appeal; relief request must be adequately described

The taxpayer, a large corporation, was formed from a number of amalgamations. Two predecessor companies made significant payments to employees in return for the employees surrendering share purchase options (the "Surrender Payments"). The predecessor companies deducted the Surrender Payments on current account, and the taxpayer was reassessed and denied the deduction. The taxpayer appealed the denial, arguing in its notice of appeal that the payments should be deductible as current expenses, and gave alternate arguments that the payments were eligible capital expenditures or deductible as financing expenses. The taxpayer argued that the overall issue was the deductibility of the payments, and three reasons were given to support the deductibility. The respondent was seeking to strike the two alternate arguments on the basis that they did not comply with the large corporation rules.

The appeal was allowed to strike the parts of the notice of appeal that dealt with the eligible capital expenditure argument. The taxpayer's notice of objection argued that the Surrender Payments were deductible on income account, but that does not preclude other reasons being raised in the notice of appeal. New issues may not be raised on appeal. The deductions were denied as the Minister treated them as being capital in nature, and paragraph 18(1)(*b*) of the *Income Tax Act* would preclude their deduction. The taxpayer's main argument was that paragraph 18(1)(*b*) did not apply as the Surrender Payments were on account of income. The financing expense argument is another exception to paragraph 18(1)(*b*) whereby certain types of financing expenses may be deducted even though they would otherwise be considered to be on capital account. The financing expense argument was just an alternate reason to allow the deduction, while the eligible capital expenditure argument raised a new issue. If that argument succeeded, the taxpayer would get deductions unrelated to the Surrender Payments and that argument could not be raised on appeal. The respondent contended that the relief requested was not specific enough. The taxpayer argued that the relief sought under the financing expense issue was less than that sought under the current expense issue and, as such, did not need to be separately articulated. The taxpayer argued it should be allowed to appeal on the basis of the eligible capital expenditure argument as well, as the Minister used that as a basis for confirming the denial of the deduction. If the Minister confirms a reassessment on a basis other than that which was objected to by the large corporation, it then may appeal to the Court on that basis. Although the Minister referred to the question of eligible capital expenditures in denying the deduction, the Minister never abandoned the original basis of assessment that the payments were on capital account and not deductible. The Minister did not substitute a new basis of assessment, and the taxpayer was unable to appeal based on the eligible capital expenditure argument.

Devon Canada Corporation, 2014 DTC 1192

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