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Curiosities and Anomalies in The Federal Income Taxation of Trusts and Estates, 4th Ed.

**1350+ Commonwealth Tax Case Analysis/Citations for
The Canada Income Tax Act
Treatment of Common-law Trusts and Estates**

By: Lyndon Maither, CFE, B.Comm

Written for Kim

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For Kimberley Edith, who gave a mere B.Comm something to write about, work on, polish...
... the 'star' who she was and continues to be, who earned and owns New York better than
Liza M. And Washington DC, too!

And who never slowed down "with her chrome heart shining in the sun".

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Kim Scott Neufeld JD's "Book".

This "book" came from someone. It came more from Kim Scott Neufeld, JD than from me. Kim Scott Neufeld is the only "thing" I had when I wrote it. I just did the "play" iz all...

And if you don't think it's one of two things that will cause a writer in the late 80's/early 90's to spend all his time in the library following the legal Amazon "upstream", waiting for a yes, get it right, mere 16 megahertz computer to spell check an estimated 650 pgs of Wordperfect DOS, replete with case names – that will slow you right down, to think - (garnered the old fashion way of photocopying in the library and marking for the series of typists, some of who were really proficient) then you're not too intelligent. By the way, being "crazy", the other one, isn't it. (*I had to try to catch up to a Close-Encounters-Of-The-Third-Kind "spaceship", starting with a mere Chevy Chevette...knowing I was completely "certain".*)

So while you read this (in areas slightly outdated now unfortunately) I hope you can appreciate who it actually came from, and what caused it. *After all, I could only do my best, for the best.* Kim Neufeld, JD, solely, prepared my mind for everything I encountered in my life, as the journey of a thousand miles started with one, with frantic complete abandon, step...

Of "Tax";

"Love isn't "commanded" or "earned", like respect. It simply arises when so so many things are perfect. It doesn't depend on "what you do" but "who you are" instead. It's "particular" in its detail and completely, permanently, opens the senses. It arises not because the person wants it to happen, but because nothing else can. It weathers slur, mockery, bold-faced contempt and when that's all that's wanted, then nothing else in the entire World matters: it's one sided. It happens without condition and it blindly doesn't even look for imperfections, demanding "So what!". It causes tears of happiness, when no one is looking, and when the person arises in the morning it only asks how they can honour more who they have found, sometimes "turning whole libraries upside down". It causes the most rational of mind to talk out loud to itself. With it you cannot "live more" and without it, well, I don't remember the time it didn't exist. It's a domain of deep sighs and endless thoughts... It doesn't ask needless questions. Mere matters of the flesh aren't remembered "yesterday" since form is never enough, but love will allow you to "fall down an elevator shaft and enjoy all the bumps". When the entire World turns cold, its elements, its hardships, its reputations, its history, it will still keep a person going. And in the meantime it proves to you on a daily basis "what a wonderful World it is" as it takes it over. It will cause Sinead O'Conner to state that "nothing compares" as well as getting Willie Nelson to "always have it on his mind". It's always a celebration replete with regalia and pageantry. It brings out 'the crazy' in any person "infected" and if left to run its course completely morphizes them to ends not foreseen. It will compel you to forever feel "23" and it prevents your compassion from limiting your passion. It carries with it all the virtues, selectively applied, that benefit the World and none that take, purposively, from it. Infatuation is fickle, until the next novelty, but love lasts and lasts decades, even in absence making that a true test and the latter can cause miracles while the former can cause catastrophes. And these are words and meanings which you will not find in sequence in a library, or, in a movie/TV show."

~ Some dude who used to "peel up" Peel, in Montreal, and "blow down" Redpath, with "chicken legs" on a dexterous mountain bike ~

Foreword

This research results from not being able to get enough. (... I'm sometimes like that with people.)

Humans try and are rational throughout most of their lives. Economists speak of it and when most awake in their morning they have their day "planned" because of their version of "certainty" they have come to understand. This research was the result of not being able to, effectively, get enough certainty.¹

And finitely measured "certainty" is what our civilizations are founded on. I tried to get as much as possible by reading as much as possible since our World is measured in our court-rooms. This topic happened to be the Canadian income taxation of trusts, estates and testamentary planning spoken of, to various qualities, in a few tons of paper photocopied and speed-reading many irrelevant head-notes and in some cases feet of unindexed case reporters, as well as, as of course, relevant cases (it's amazing how things "collide..."). I chose trusts because of Lloyd Raphael's 1982 *"Taxation of Trusts"* that was out of date by the time I read it in 1987 (I was consuming everything I could get on income tax at that time: "if I could be like that, just for one day, I'd do anything...") and that trusts by their nature are, in my opinion, the most flexible legal 'creatures', if I can ascribe a personality to them, that our ITA has to attend to. The same was being started for partnerships and joint ventures when I stopped in early 1993. This is the updated work to the Office Consolidation of our ITA as at December 2013 with what I think are "substantially all" the directly relevant cases from the chosen Commonwealth countries of Canada, the U.K., Australia and New Zealand. I chose these countries to examine since they all have an English common-law heritage and consequently their tax law must attend to it, like ours. This also contains new footnoted material in the form of Dept. of Finance pronouncements ('non-descript' as they may be) on the introduction of the legislation, references to numerous periodical pieces (principally from the Canadian Tax Journal – mostly available on-line, and Estates, Trusts and Pensions Journal), as well as cases that have occurred in the cited Commonwealth since last printing (March 2011) (generally approx. 117 not previously commented on, Secretariat on the quarter-lap) and, more analysis of the principles spoken of in the 3rd edition. Somehow it has been lengthened by approx. 190 pages so I must have done something. A hard-copy is not available for sale so download at will for free from Google Books.

Unfortunately, this compendium speaks only of the income taxation of common-law trusts, estates and beneficiaries and though there may be some incidental application to the Quebec civil law environment I didn't try and capture that World as well. I thus encourage driven, knowledgeable and capable researchers to provide their own "copyrightable" opinion to the public forum (Google Books) on how our ITA applies to their environment.

Our Income Tax Act is a back-bone of how our government of the day provides a finite amount of benefits to our population to ensure that the cruel dark World spoken of by the actor Russell Crowe in "Gladiator" does not imperil the standards of our lives. We don't go to witch-doctors on dirt paths, unprotected, with chicken in hand after a neighbouring marauder has inflicted harm on us.²

We tax because we care – about, ourselves as a community, and it is that simple.

We used to hear about "loop-holes" an awful lot. I have a phrase "Just because you can doesn't mean you should" that reflects a lot on what Revenue Quebec also tried to pronounce in attaching an ethical obligation to its reporting compliance television ads in the mid-90's. (I was once amused in a small Vancouver convenience store when I read a landed immigrant owner's note to his customers in a nook-in-the-wall convenience store, attended to religiously by both parties (on Carrol Street – you may find the same on the counter in same across from Dominion Square on Peel in Mtl.), which was to the effect that "Everyone Fears the Police, No one Fears God.") I hardly remember any of a particular professor's course that he taught at Concordia University in the early 90's when he spoke of "trying to obey the Ten Commandments": it was a pleasure to watch a B.Comm teacher speak of a religion, in a business law class, since there are always

¹ Some do find "certainty" only once in a lifetime as was described in The Bridges of Madison County.

² ...unless they've harmed your chicken

several levels of rules in any society. But, income tax is a positivism strain of law. And when money is the blood of modern life, while our heart tells us where to put it, counting on ever cell is important. And laws with their peculiarities must apply to “the rich”, like “the poor”.

With this in mind, this is why this research takes such an offensive approach: it tries to find loop-holes (tactical – “Tarzan swinging on vines”, and substantive: “mismatches” between underlying and tax), and it’s not shy. Like a blood-hound looking for the skunk it sometimes tries to introduce cases that have bearing that have not come to light in Canada. I purposefully took the approach of staying off the beaten path of regular planning where the industry is flooded with so-called summarized “editorial comment” etc. and only wanted to know of how our ITA broke down. This is certainly not a “how-to” book for juniors replete with check lists and other “filler” generally available on the internet etc. but instead seeks to introduce cases and issues that have not been examined in detail for those who can appreciate the balance of what they are reading – read that other material generally available on the topic first: read this last, and hopefully you’ll remember me and this as the one who told you “stuff” the others didn’t. You’ll thus understand that I have no interest in what CRA Rulings has stated here and there except to elaborate on their general opinion embodied in their ITs/ICs/ATRs/TNs: I concerned myself only with what the judges have said.

I did this because arguments don’t happen when there is clarity/certainty, nor do Acts evolve until there has been systematic or material testing of their possible deficiencies (either in the hands of legislators or the population). Rulings is but one side of the issue, a judge’s opinion always ranks. I once said to a Manager in CRA Rulings that **“Problems don’t go away just because you ignore them.”** So, like Nathan Bedford Forrest, the Confederate Commander, who I later came to understand, “get there first, with the most [thought]”: find the flaws, pronounce them, and like pesky Jack Nicholson said of absolutely fabulous works-of-wonder called “women” in “The Witches of Eastwick”, ask **“was it intentional, or was it a mistake, because if it was a mistake, maybe we can do something about it!”** Jump the gun, analyze/show the argument before it happens and let the legislators hopefully evolve the universe. Provisions crack on commas, words are missed, misused or poorly added, judges try and give us certainty when so little of it exists in Canada on this subject and for a brief period of a few years I initially enjoyed the 4:00 AM silence of tossing handfuls of the finite universe of common-law trust and estate variables at the dance of our Act to see if it would falter. Many times it didn’t; many times it did.

And maybe if I find enough of them first, I too will be the first to close that many of them....which is the primary purpose of my research, from “the outside”.³

R.E. Lee was once bothered by the conundrum of being a good commander: “In order to save the ones you love, you have to sometimes cause the death of the ones you love.” I choose not to actually practice this particular sport since it would bother my conscience. (I enjoy a considerable freedom in my opinion, choosing to “put myself out-there, to be proven wrong” and practice as “an artist” rather than “a painter..”) Some would say that I’m the one who *“builds the snow-balls that are thrown”*: I think, would you rather hear it from me, or someone who gets into an argument with CRA/Justice over actual facts and presents it to a Judge. Is it not better to “prove” the battle without having to have it? Is it not better to “point out The Emperor’s new clothes” before “it happens”? Is it not in the interest of everyone to acutely scrutinize our fiscal laws to make them better? Finance counsel do “drink coffee at the same Tim Hortons” as us: they too, take breaks. And with regard to this superficial argument of “snow-balls”, I hope you can accept that I don’t write the statute law and I don’t judge its contested application to a fact situation: this is the way it is and this is what others have said about it. And I’d find it unethical to advise and charge a client for this given the public money I enjoyed to compose it in the form of: sidewalks, a well-stocked string of university and court-house libraries, a Montreal General Hospital doctor over a bike accident, cheap photocopies all over the place, sometimes EI – and of course earnings spent on typists, and all those other minute incidents of public finance Canadians may not understand how they come to them: I never did like “big cars or long cigars” as “a hillbilly” song called

³ No one likes to see an Act fail: **it insults the integrity of all those who hope it applies to them equally**, as well as those technically-and non-technically-inclined who brought it into existence. Our Acts, of which this is one, **must apply to those wealthy enough to pay those to “professionally” look for \$320 M problems, as well, equally**. I’m not sure of the cost of building the hospital and staffing it, where I was born, but I’m pretty sure that it was less than \$320 M, as they’ve handled their share of substance abuse victims.

“Was I Right or Wrong?” would rhyme. I just want to make our ITA better by questioning it. And rather than stumble over a Sec. 85(1) filing extension problem as I’ve seen some do, on his way to his version of rock and roll fame, why not question it all. And, maybe after a few hours, I do have a properly qualified one 35,000,000th opinion of how it can be weak.

Unfortunately, this is a rather superficial study of how our ITA applies since to do otherwise would certainly cause extensive lengthened elaboration. There was a trade-off between trying to cut in-depth to the core of the issues that I wanted to address, and the coverage of the numerous other issues that others may speak about. This is a study of curiosities: where the law is clear there is nothing to talk about but where the law can or does create unexpected results is where I chose to dwell. I have thus made multiple references to other researchers’ articles for your review, generally. And it has also tested my resolve to adapt a work that I started in 1987, while our Act “grew up”, so I’m sorry if my particular statutory references are not completely technically accurate at times – while provisions may shift around the policy behind them basically doesn’t so I do apologize: a detailed study of all the provisions related may undermine some issues I comment on.

I don’t believe I’ve even thoroughly scratched the surface here since each one of the jurisprudential issues could take a small book by itself before all the various outcomes could be covered, but I’ve tried to get into the material far more than what a normal “reference manual” would. I’ve also tried to focus on only the principal issues in testamentary planning (estate and trust planning and use) and the use of private trusts and not estate planning *per se* the latter including *inter vivos* issues that are prepared for in advance. This area of income tax has also become extremely complex with the issue of “beneficial ownership” and while Finance has advanced the work to refine our Act since this project started in 1987 there are still numerous mis-steps and short-comings where the Act doesn’t meet the environment perfectly. This compendium analyzes the basic structure of how the environment is attended to and how previous issues regarding it have been spoken of by our Judges (principally in Canada but also from the other English law tradition countries of the UK, Australia and New Zealand.) I choose to adopt case law from the foreign commonwealth environments as well since there is so little actual case law in Canada on this sport: importing judicial reasoning on specific issues, while not binding, illustrates how similar provisions (with similar objectives) have been scrutinized in the face of very similar trust/testamentary environments. Equally unfortunately, I cannot say that I have included every single meaningful case applicable to this environment but at 1350+ I don’t know how many more there are. I stopped counting at that number.⁴ With respect to all these cases I have copied the salient judicial pronouncement or have tried to paraphrase what the case was about in the context in which it is cited: you’re definitely encouraged to read the full case. Even still, this is a finite arena where the inter-lock of statutory provisions must work all of the time to all of the possible situations and in this case I am grateful for the holdings of various law faculty and court-house libraries that allowed me to think of a substantial number of the variables that our Act has to attend to, and in many cases, our Act is still rudimentary.⁵

A CRA Rulings Official once said to me that “no law is perfect”: that is rather repulsive statement from someone who is supposed to serve in a last line in defending our tax-revenue. But unfortunately, they only have to work with what they have. And I thought “If one gets by ‘Mother T’, (a cross between Mother Theresa and Mister T), by the time you turn around and amend, with approx. 247,000 people dying in Canada every year when I last checked, you’ll lose a lot more.⁶ Maybe instead you should have the desire of the Canadian Olympic Women’s Volley-ball team: the ball never touches the ground!” (Maybe we’d live in a different World when Rulings employees, with guidance, directly earn their salaries by saving us money from very “crafty” counsel who earn theirs by being exactly so. Having spent time in the CRA Head Library/National Archives

⁴ There is certainly one on mere control of trust property, without status of trustee, attracting filing obligation as it appeared in Australia that I was not able to rediscover at time of printing, on a provision very much like Sec. 104(1).

⁵ When I describe why I like this “labour of love” activity to those who ask I simply explain that it is like the present condition of the Pyramids in Egypt: there are sharp steps up their sides when they initially were smooth. Any human language, in dealing with codifying the treatment of the inter-lock of “smooth creatures” in testamentary/trust taxation, is limited to how precise you can be, and in many instances as you will note, the “steps” in our Act are “juttery” – they are not “smooth”. **What I hope to try and do here is also develop this sense in you.**

⁶ The ITA can only be interpreted as a positivism strain of law: the end-game isn’t taxpayers saying “this is sort of what I pay” when they file their returns and remit their proceeds.

in Ottawa, and the McGill CDH/Nahum Gelber, U. of T. Bora Laskin and U.B.C. Law Faculty Libraries and listening to the “ping” of internal databases I can conclude that they are best equipped for it. Or, have mere B.Comms and others continue to get ‘fatal’ “\$320 M opinions” from them, as has happened in our history.) When I started this project the McGill Library contained copies of “the Act” (IWTA and ITA) all the way back to its origin: it was a pretty thin document when it started out – now it’s evolved a great deal more – so the above logic doesn’t work when one merely considers how it has “grown into the taxpayer’s life like a tree to light”: is it full-grown, or only half way there?⁷

An Act is only as good as the carefully polished thought you put into it considering all relevant issues in the domain including past successes and failures: statutorily and jurisprudentially, in all relevant forums. Unfortunately, Finance seems to only want to make amendments when the need arises instead of projecting out that need before it arises. While some sympathy does reside for Finance counsel we do govern ourselves by our Acts and perhaps one day our federal employees will sense out needs before they arise and be more concise with their syllables. Should a fiscal Act respond to the “ebb and flow” of the underlying law or project out and make provision for that “ebb and flow”, in advance, considering all evolving streams of precedents that are developing that can affect before a tax case “happens”? This project was started in 1987 and a huge amount of now very historic case still has massive impact to this day, though like a river-bed changing it can be predicted where it will be going and with what I find in other jurisdictions we certainly have not seen ‘the end of it’. And in the case of the testamentary/trust environment you’ll sometimes get a grasp of how mismatched our ITA with underlying possible law can be through what you’ll find here. Or, is this issue (any in tax-interpretation), some joke where some judge inevitably should be sought for some opinion!? ...we govern ourselves certainly, with what is and can only be, our Acts meeting our facts and resulting evolving precedents.

But, any and all steps are better than nothing (since the underlying environment is relatively finite and static), and as “Col. Kilgore” of the movie “Apocalypse Now” would state “Someday all this will be over.” and we’ll have a ridiculously air-tight Act, significant evolution of which was started by Paul Martin in the 90’s. Until then, “Agitate, Agitate, Agitate” like an instigator once helped make “those United States” “the United States” and while “Nothing is Achieved Through Unanimous Consent” as ol’Chris Columbus mused, “the frontier” is getting, thankfully, harder to find. (Who knows, maybe we will not have huge amounts of litigation over “taxes” in our future...because more will know of *In Re: Weston's Settlements* where it was said “The avoidance of Tax may be lawful, but it is not yet a *virtue*.” and more will understand day-to-day, simple, “privilege”. [Star Track eliminated money in the 23rd century..])

In this study you will find amongst other things, like in any “Dr. Seuss-like” compilation, issues that may change the way you look at the Act such as:

- the inconsistent use of the statutory terms “trust created” and “contributions to a trust” in the face of considerable case law that states various interpretations for differing purposes (when is an existing trust agreement augmented with additional after-received property, as compared to the creation of an identical trust anew through adoption of another existent’s terms), dangerous in the absence of proper referencing if you want your provisions to apply to THAT trust, or,
- the case for the statutorily recognized “*splintered trust*” that opens up multiple instances for assessment of income tax incidences of the trust’s *individual properties*, as well as allowing for resident taxation where a majority of the “trustees” or other “owning or controlling” parties in respect of the property are resident outside of Canada, though one is resident, or,
- leaving an unqualified “expenditure” be a direct off-set against a Sec. 69(1.1)(b)-70(2)-(3) inclusion for a knit-in, against full income inclusion of a right or thing, of otherwise non-deductible executor fees/probate et cetera, (which can also be used to give an *inter vivos* trust income interest tax-free deductible cost, and possibly even recoup cost previously deducted, tax-free), or,
- the poor statutory coverage of trust income interests going through a death that causes problems vis-à-vis their cost deductibility (and possible double taxation of their “value”, as rights

⁷ Has anyone seen the “thickness” of the US IRC?

- or things) and the resulting need to always assent to their transfer as expeditiously as possible, prompting the Sec. 70(3) roll-through, or,
- the need to have 4 ownership bases (testator to estate to trust to beneficiary) through which title devolves in the ITA, instead of the quasi-3 (testator to estate/trust to beneficiary) now to disallow mis-matching on such issues as:
 - transfers of property to the general estate “ahead” of trusts that arise out of it
 - transactions with nebulously based estate/trust interests which can avoid capital gains therein
 - timing of creation of trusts out of estates to take too much advantage of recognition deferrals
 - recognition of income of the estate vs. trust by the beneficiary
 - poor mechanics on tainted spousal trust cleansing, etc., or,
 - the poor interaction between Sec.164(6) and the section 107 trust-property roll-out mechanics that allow carry-back of non-spousal beneficiary-recipient-generated estate executor’s-year losses to the testatrix’s terminal return (why the disparity with those of spousal beneficiary-recipients), (generally applicable to transfer and other fees to affect an actual tax-consequence section 107 distribution that is a Sec. 164(6) “disposition” – did you think there were no tax consequences here?), as well as beneficial carry-back when transfer of assets to holding in enduring testamentary trusts by the executrix allow such a “disposition” cited in s. 164(6) to occur, or,
 - the possibility that the underlying law of residuary estates, at any time in the process of administration of an estate always causes its income to be taxed in the hands of the estate (thus subjecting it to possibly lower testamentary trust tax rates, changing it to tax capital), *even when immediately paid out, and even when administration comes to an end*, regardless of how long the administration of the residuary estate takes to legitimately finalize, and in the face of the Sec. 104(6)-(13) mechanics which only work on “income” payable, due to the relation-back principle and ownership of the income as such (unless upset by a statute), or,
 - the fact that the Sec. 104(13.1)-(13.2) trust-beneficiary income recognition carve-back option is not properly qualified to be available only when the trust has, in fact, tax loss carry-forwards, for which it was enacted, which can be used to reduce absolute tax payable amounts in cases of testamentary trusts for instance and plan for the avoidance of income attribution instances for those *inter vivos*, or,
 - the possibility that the spouse under the famous subsection 73(1) or 70(6) spousal trust does NOT have to recognize any, nor all, of the taxable income of the trust given Sec. 108(3) and the consequential disparity with the income recognition mechanics applicable to non-spousal trust income beneficiaries (I guess spousal recipients *really are* favoured), or,
 - just what are you trying to NOT have happen with those “tainted spousal trust” rules given how porous they are (what “debt assumed” and what “property transferred”), or,
 - failing to see a need for the syllables “immediately before that time” to sever the disposition (and not the cost amount: compare the “when” against a Sec. 70(5) or (6) disposition) cited in a Sec. 107(2) roll-out of trust property to make it not a disposition against which executor/probate fees can be, again, deducted as “outlays or expenses” (exactly on-point as a McGill HL told me - 26’ of unindexed Simons reporters to find that jewel, plus exactly what was said in Pappas Estate) (sorry, you’ll have to read this in its entirety to find the other ways to deduct trustee fees as such: directly against income in many respects), or,
 - the doubling of property and capital losses through a differently-evolved income attribution provision applicable to “reversionary trusts”, Sec. 75(2), or,
 - there is no danger at all vis-à-vis all-too-crazy-an-impact of powers of appointment (as some privately have noted the lethargy in respect of when even the USA/UK/Aust. recognizes their distinct characters for estate and other tax purposes - attending to these creatures is going to

take considerable amendment all over the place – they’re just “rights” with a fancy name), such as the direct undermining of Sec. 70(5.3) (testamentary insurance valuation implications if CRA continues to not recognize them as “property”, “per se”, for tainted spousal trust listing consideration), or the ability to resettle trusts through a special power that are not actual variations upon which at least one provision is based (I see *no need to not follow* ‘arcane’ and highly evolved property law jurisprudence here, giving credence to the power-grantor’s opinion, in what is, already, a measured World, – can our legislative thought not be so infantile(?), especially when the USA/UK/Aust. recognizes their classes in their Acts/case), or,

- the poor linkage of tax aspects of floating trust debt, that can be reassigned to a selection of beneficiaries, gaining from the “equitable off-set” mechanics under s. 107(2) distributions that can cause unintended tax consequences, or,
- hey, why even bother targeting Sec. 105(1) ‘in-direct’ trust benefits for non-resident Part XIII withholding tax rates, *maybe no one will notice* (imagine how many different ways that dangerous *purportedly all-encompassing stop-loss failure* can be knit in all over the place), et cetera,

then I hope you find the attached worthy of a sound read. The author is also of the strong opinion that there should be **4** full ownership bases through which legal title of property flows in the ITA in the testamentary setting (testator-estate-trust-beneficiary), not the hodge-podge **quasi-3** now (testator-estate/trust-beneficiary, non-spousal; in spousal cases it’s only 2) linked up fully to the provincial estate-devolution and trust statutory and common-law environments (with adjustment for certain instances of provincial quirks when they are not homogenous) eliminating quite a few instances where mis-matches cause anomalies and taking away some possibility of mis-interpretation/application. I’m also strongly of the opinion that Canada should adopt the Australian basis of trust-beneficiary income recognition – “proportionality” – and/or at least reform Sec. 104(24) to allow **notional income to be deemed payable** (in accompany to proportionality and some stat. adjustment for better targeting) to a beneficiary thus modernizing the use of commercially-oriented testamentary and, in particular, *inter vivos* trusts for situations where notional “tax income” is higher than actual income in-hand and payable in specie through a court order.⁸

The intent here is the mockery of the repulsiveness of the “Emperor’s New Clothes” since that sometimes works to the better and, that’s exactly what I want with this research: **the statutory obsolescence of the above issues at least.** *I sincerely encourage anyone to please correct what I’ve written here if my interpretations are in error since I dislike the legal conclusions I’ve reached with how the case law cited, hopefully exhaustively, allows our ITA to be looked at, in my opinion.* (If your conscience allows you to see fit to put an issue in-front of a judge, fire-at-will, and regardless of the outcome, at the end of the day, the environment will be enriched.) I’ve also fallen in love with Aussies, actually in particular, their jurisprudence since it tends to be more *refined* than in Canada on this subject (I think of Masterman-Macfarlane’s “constructive trust” that finally broke the mould, and their reasoned “testamentary options” to “buy and sell” testamentary property in a roll-over context that our less-well-argued cases have missed, even “the proportionality” of their income recognition process, et cetera). And the diversity of their case law is far wider. It is probably because trusts are better understood and are more pervasively used in their society than ours... must be something to do with the kangaroos...

The numerous people who gave me the drive to promulgate the intricacies and deficiencies I found through this study are too lengthy to list but those who I can name and like to thank include, two professionals who I met at the start of this work: one didn’t know I could start, and the other who didn’t even want to read it even when I could. Both unknowingly started it all off. It would definitely include Catherine Brown of the U. of Calgary (who I read in the start of this project, back in ’87 to ’93, - as well as now - when she had authored *only 5-6”* thick of periodical explanations about our World *then*), Maurice Cullity, the late Wolfe Goodman of the firm Goodman Carr, Vern Krishna of the U. of Ottawa, the slew of other researchers, whose heady concentrated pronouncements in “the spectrum of periodicals” were the wind beneath my wings, Guy Fortin

⁸ due to non-deductibility of numerous trust expenses that, while having bearing in trust law, have none in tax law

formerly of McGill, of civil heritage, who allowed me into his *Estate Planning* Course at McGill so long ago in '93, Adam Parachin of the U. of Western Ontario for his sincere kindness in "the rekindling", Lawrence Jacobson CA MBA of CRA/Concordia U. (for "holding the line, year after year after year" as the Best Tax Professor I ever had as a student, smiling at the 1 hr. final, and, "those non-paying rock and roll bands" (trust me Larry, the band *does pay*)), Teresa Tettraelt, Manager of the CRA 305 Rene Levesque, Montreal, Library for "drying my ears" and allowing me access to the photocopy machine when that Library was open to the public and the late Harold Porter of the McGill University Old CDH Library-Circulation for "keeping the lights on 15 minutes longer" on basically every one of those nights in 1989 to 1993 as I learned about the importance of "words in an Act", unable to close a book (and, of course, the rest of the McGill old CDH now Nahum Gelber / U. of T. Bora Laskin / U.B.C. Law Library staff, past and present), when "I didn't have an office". In this regard, I was truly blessed with this purity, these "Dreamers" as an Apple computer "Think Different" tv advertisement would say, and am eternally grateful.

I'd also like to Thank Yin Vallaincourt, of Montreal, for her own dedication during 1988-1993, for churning out 1st and 2nd drafts based on my case photocopies (before jurisdictions' judgment web-sites existed and the World went electronically searchable⁹) and "chicken scrawl", as well as the 4 other typists who were paid somehow "as the diamond was recut".

I'd also definitely like to Thank Laura Shevchenko of the Montreal company of The Bookbinders Daughter (www.bookbindersdaughter.com) for binding my material facilitating this "indie" expression.

If you would like to be kept timely abreast of cases that pop up in Canada, the UK, Australia and New Zealand that I feel impact this environment, on a quarterly basis, please feel free to contact me at the number below: I'll add you to my free email broadcast list.

Hope you like.

LM

⁹ And, of course, I'd like to Thank the compilers/administrators/supporters behind the Australian AUSTLII.org, New Zealand NZLII.org, UK BAILII.org and the Canadian CANLII.org/S.C.C.-Fed.Ct. databases for easing my play-load.

Recommendations to Improve the ITA vis-a-vis Trusts and Estates: A Start

February 2nd, 2014.

2013FIN398819

April 16th, 2014

**The Honourable Joe Oliver, P.C., M.P.
Minister of Finance
Department of Finance Canada
140 O'Connor Street
Ottawa, ON
K1A 0G5**

Ref: Submission of Specific Points on Common-law Estate/Trust ITA provisions

Dear Honourable Sir.

I was greatly saddened by the passing of James M. Flaherty, P.C., M.P. and I hope that with the PM's eulogy at his recent Funeral the country will remember him very well like I do.

I initially tried to point out technical problems with the ITA via submission of my research to Finance in 2002. The research started in 1987/8.

I have previously submitted the attached via the your Finance email on your web-page but thought that I'd also submit a written copy to both you and CRA Rulings to possibly sensitize you to deficiencies I feel exist within the ITA.

I have attached some thoughts that I think could improve the ITA with respect to the list of points I mentioned in the Foreword of the work I submitted in CD form late last year. While I have not had the opportunity to cover them all - some take considerable study to attend to! - I have attached what I think could better our ITA.

I do not know the statistics behind the effect the attached would have - I do not know how material they are in relation to what kind of scenarios CRA is encountering in their Rulings Division, generally, so the attached is submitted only as ideas to "tidy up some loose ends" which I feel exist.

The ITA can only be made better, technically, as time goes by, as well as reacting to new underlying law as well as to new argument that gains favour of the day.

While seemingly insignificant, technical points in a fiscal law could and should aim to give certainty without any room for possible misinterpretation even in the instance of GAAR so I thought I'd "jump the gun" in trying to formulate some legalese that could cure any of these problems that I feel exist.

Thanking you I remain,

Yours truly,

Lyndon Maither

Cc: Mrs. Theresa Murphy, CGA
Director CRA
320 Queen St.
Ottawa, Ontario
K1A 0L5

The three are:

1. Whether there is a legal argument to bring another trust residency instance back to the SCC and this time argue extensively on the enlarged scope of how a trust/estate is actually targeted for assessment in the ITA (S. 104(1)) thus making the POEM ineffective as a poor test. Words count.
2. The law on residuary estates and income recognition mechanics that can be perhaps successfully argued to prevent s. 104(13)-(24) from transferring recognition until and even when the residuary estate is finalized.
3. Possible wording for powers of appointment over trust/estate property, which cannot be ignored, that can prevent abuse.

(There are other specific points that I will be submitting comments on.)

Creation of, or Contribution to Existing, Trusts

There are numerous instances in the ITA which state "contributions" to a trust and yet there are also some which state trusts "created". As recently as 2011 below there has been a TCC that noted it in passing. Given the foundation structure of numerous provisions in the ITA on this differentiation clarity could be added by explicitly stating what these terms mean.

For purposes of this Act,

- (a) a contribution to a trust is deemed to have been made when there is a transfer or loan of property to an existing trustee or executor to be held on the same terms of an existing trust whereby the property is subject to the same capital and income interests,
- (b) a trust is deemed to have been created when a transfer or loan is made to a person to be held on conditions of a trust and as a result new capital or income interests in a trust are created.

Counters start of drift in TCC thought (contained in Peter Sommerer and Her Majesty The Queen, 2011 TCC 212) that contributions to an existing trust could be recognizable as creation of identical trusts anew.

Unrestricted "Expenditures" deduction against Right or Thing (s. 70(3)-69(1.1)(b)) as well as unwarranted reintroduction of "cost" to be deducted (income interest in trust)

"Idem, where s. 70(3) applies - Sec. 69(1.1)"

(1.1) Where a taxpayer has acquired property that is a right or thing to which subsection 70(3) applies, the following rules apply:

- (a) paragraph 69(1)(c) is not applicable to that property; and
- (b) the taxpayer shall be deemed to have acquired the property at a cost equal to the total of
 - (i) such part, if any, of the cost thereof to the taxpayer who has died as had been capable of being deducted by the taxpayer in computing the taxpayer's income for the year, and
 - (ii) any qualified expenditures made or incurred by the taxpayer to acquire the property.

S. 69(1.2) - Qualified expenditures

For purposes of subparagraph 69(1.1)(b)(ii) a qualified expenditure means:

- (a) funeral expenses of the deceased to whom subsection 70(3) applies,
- (b) transfer costs related to the right or thing, or
- (c) *optional*

and shall not include

- (d) estate or trust fees or expenses, and,
- (e) conditional bequests to any party as a consequence of death
- (f) *optional*.

Focuses the unqualified expenditures that a taxpayer can incur to be off-set against a full income inclusion such as executor fees, testamentary conditional payments to relatives of the deceased, etc. By qualifying the nature of the expenditure to narrow it down the "expenditure" is much more exact.

"Capable of being" deducted disconnects the flow through of historic cost of an income interest in a trust going through death as a right or thing. The way the provision now reads (*even if in conjunction with the definition of "cost amount" in s. 248*) a taxpayer could bequeath an income interest in a trust and if she hadn't have taken maximum allowable deductible cost under s. 106 against it that "cost", though lost to her, would now be deductible by the right or thing beneficiary since they have inherited the "cost": *not deductible cost*. Merely by changing the designation to "cost amount" still doesn't cure the problem since the s. 248 definition thereof (below¹¹) still allows build-up and transfer of undeducted cost to another generation.

¹¹S. 248 "cost amount"

(f) in any other case, the cost to the taxpayer of the property as determined for the purpose of computing the taxpayer's income, except to the extent that that cost has been deducted in computing the taxpayer's income for any taxation year ending before that time;

"Income interest in trust - Sec. 106(1)"

(1) Where an amount in respect of a taxpayer's income interest in a trust has been included in computing the taxpayer's income for a taxation year by reason of subsection 106(2) or 104(13), except to the extent that an amount in respect of that income interest has been deducted in computing the taxpayer's taxable income pursuant to subsection 112(1) or 138(6), there may be deducted in computing the taxpayer's income for the year the lesser of

- (a) the amount so included in computing the taxpayer's income for the year, and

(b) the amount, if any, by which the cost to the taxpayer of the income interest exceeds the total of all amounts in respect of the interest that were deductible under this subsection in computing the taxpayer's income for previous taxation years.

Preventing Shifting of Tax Incidences when Executor Assents to Dispositions of Estate Property to Enduring Trusts Etc. within Executors' Year

"Where disposition of property by legal representative of deceased taxpayer - Sec. 164(6)"

(6) Where in the course of administering the estate of a deceased taxpayer, the taxpayer's legal representative has, within the first taxation year of the estate,

(a) disposed of capital property of the estate to a qualified recipient so that the total of all amounts each of which is a capital loss from the disposition of a property exceeds the total of all amounts each of which is a capital gain from the disposition of a property, or

(b) disposed of all of the depreciable property of a prescribed class of the estate to a qualified recipient so that the undepreciated capital cost to the estate of property of that class at the end of the first taxation year of the estate is, by virtue of subsection 20(16) or any regulation made under paragraph 20(1)(a), deductible in computing the income of the estate for that year,

notwithstanding any other provision of this Act, the following rules apply:

(c) such parts of one or more capital losses of the estate from the disposition of properties in the year (the total of which is not to exceed the excess referred to in paragraph 164(6)(a)) as the legal representative so elects, in prescribed manner and within a prescribed time, are deemed (except for the purpose of subsection 112(3) and this paragraph) to be capital losses of the deceased taxpayer from the disposition of the properties by the taxpayer in the taxpayer's last taxation year and not to be capital losses of the estate from the disposition of those properties,

(d) such part of the amount of any deduction described in paragraph 16(6)(b) (not exceeding the amount that, but for this subsection, would be the total of the non-capital loss and the farm loss of the estate for its first taxation year) as the legal representative so elects, in prescribed manner and within a prescribed time, shall be deductible in computing the income of the taxpayer for the taxpayer's taxation year in which the taxpayer died and shall not be an amount deductible in computing any loss of the estate for its first taxation year,

(e) the legal representative shall, at or before the time prescribed for filing the election referred to in paragraphs 164(6)(c) and 164(6)(d), file an amended return of income for the deceased taxpayer for the taxpayer's taxation year in which the taxpayer died to give effect to the rules in those paragraphs, and

(f) in computing the taxable income of the deceased taxpayer for a taxation year preceding the year in which the taxpayer died, no amount may be deducted in respect of an amount referred to in paragraph 164(6)(c) or 164(6)(d).

S. 164(6.1)- Qualified Recipients

For purposes of subsection 164(6) qualified recipients are deemed not to include

(a) trusts arising as a consequence of death of the deceased taxpayer,

(b) taxpayers and partnerships related to the deceased taxpayer immediately before death,

(c) *optional*.

There is no qualification on to whom the estate can dispose of property during the executor year and still have the provision apply: the way it is worded presently this could easily be interpreted to include a trust that the deceased taxpayer creates and since both are recognizable as different beings outside of subdivision k the loss/gain would be recognizable and there could be statutorily unintended transfer of said results. The same applies to taxpayers formerly related to the deceased which would, again, force "artificial" recognition that would not otherwise occur in normal instances when property would otherwise exit the taxpayer's arena of related parties. By taking out these two parties there is some restriction on the possibility of creating "artificial" tax consequences with parties related to the deceased taxpayer and the property stays in the same relative hands.

Ensuring All Benefits Conferred on Non-Residents in Relation to Trusts or Estates are Taxable

Presently per S. 212(1)(c) there is no Part XIII tax imposed on s. 105 (property upkeep, and, abnormal benefits) benefits realized by non-residents in respect of a trust or estate. While per the above it is possible to eliminate artificial cost charge-up on trust income interests going through a death, there is still a possibility when the trust imposes an "eligible off-set" obligation¹⁰ in the form of a conditional bequest to make a payment to a non-resident. In this case the eligible off-set

¹⁰ S. 108(1) "eligible offset" « *montant de réduction admissible* »

"eligible offset" at any time of a taxpayer in respect of all or part of the taxpayer's capital interest in a trust is the portion of any debt or obligation that is assumed by the taxpayer and that can reasonably be considered to be applicable to property distributed at that time in satisfaction of the interest or part of the interest, as the case may be, if the distribution is conditional upon the assumption by the taxpayer of the portion of the debt or obligation;

tax affects a distribution by the trust/estate with consequences, but the actual payment is not captured for tax effect to the non-resident: by referencing it below there are tax consequences when this is attempted.

S. 212(1)(c) - Estate or trust income

- (c) income or benefit of or from an estate or a trust to the extent that the amount
 - (a) is included in computing the income of the non-resident person under subsection 104(13) or section 105, except to the extent that the amount is deemed by subsection 104(21) to be a taxable capital gain of the non-resident person, or
 - (b) can reasonably be considered (having regard to all the circumstances including the terms and conditions of the estate or trust arrangement) to be a distribution of, or derived from, an amount received by the estate or trust as, on account of, in lieu of payment of or in satisfaction of, a dividend on a share of the capital stock of a corporation resident in Canada, other than a taxable dividend;

Ensuring Spouse under Spousal Trust Recognizes All of Trust's Taxable Income

"Where transfer or distribution to spouse or spouse trust- Sec. 70(6)"

(6) Where any property of a taxpayer who was resident in Canada immediately before the taxpayer's death that is a property to which subsection 70(5) would otherwise apply is, as a consequence of the death, transferred or distributed to

- (a) the taxpayer's spouse or common-law partner who was resident in Canada immediately before the taxpayer's death, or
- (b) a trust, created by the taxpayer's will, that was resident in Canada immediately after the time the property vested indefeasibly in the trust and under which
 - (i) the taxpayer's spouse or common-law partner is entitled to receive all of the income of the trust that arises before the spouse's or common-law partner's death, and

(ii) the taxpayer's spouse or common-law partner is entitled to have all of the taxable income of the trust immediately payable to the spouse or common-law partner, and

- (iii) no person except the spouse or common-law partner may, before the spouse's or common-law partner's death, receive or otherwise obtain the use of any of the income or capital of the trust,

if it can be shown, within the period ending 36 months after the death of the taxpayer or, where written application therefor has been made to the Minister by the taxpayer's legal representative within that period, within such longer period as the Minister considers reasonable in the circumstances, that the property has become vested indefeasibly in the spouse or common-law partner or trust, as the case may be, the following rules apply:

- (c) paragraphs 70(5)(a) and 70(5)(b) do not apply in respect of the property,
 - (d) subject to paragraph 70(6)(d.1), the taxpayer shall be deemed to have, immediately before the taxpayer's death, disposed of the property and received proceeds of disposition therefor equal to
 - (i) where the property was depreciable property of a prescribed class, the lesser of the capital cost and the cost amount to the taxpayer of the property immediately before the death, and
 - (ii) in any other case, its adjusted cost base to the taxpayer immediately before the death,
- and the spouse or common-law partner or trust, as the case may be, shall be deemed to have acquired the property at the time of the death at a cost equal to those proceeds,

(d.1) where the property is an interest in a partnership (other than an interest in a partnership to which subsection 100(3) applies),

- (i) the taxpayer shall, except for the purposes of paragraph 98(5)(g), be deemed not to have disposed of the property as a consequence of the taxpayer's death,
- (ii) the spouse or common-law partner or the trust, as the case may be, shall be deemed to have acquired the property at the time of the death at a cost equal to its cost to the taxpayer, and
- (iii) each amount added or deducted in computing the adjusted cost base to the taxpayer of the property shall be deemed to be required by subsection 53(1) or 53(2) to be added or deducted, as the case may be, in computing the adjusted cost base to the spouse or common-law partner or the trust, as the case may be, of the property; and
- (e) where the property was depreciable property of the taxpayer of a prescribed class, paragraph (5)(c) applies as if the references therein to "paragraph 70(6)(a)" and to "paragraph 70(6)(b)" were read as references to "paragraph 70(6)(d)".

"Income of a trust in certain provisions - Sec. 108(3)"

(3) For the purposes of the definition "income interest" in subsection (1), the income of a trust is its income computed without reference to the provisions of this Act and, for the purposes of the definition "pre-1972 spousal trust" in subsection (1) and paragraphs 70(6)(b) and (6.1)(b), 73(1.01)(c) and 104(4)(a), the income of a trust is its income computed without reference to the provisions of this Act, minus any dividends included in that income

- (a) that are amounts not included by reason of section 83 in computing the income of the trust for the purposes of the

other provisions of this Act;
(b) that are described in subsection 131(1); or
(c) to which subsection 131(1) applies by reason of subsection 130(2).

CRA is of the opinion, ostensibly (per past rulings), that subpara. 70(6)(b)(i) causes the spouse to recognize all of the taxable income of the trust as payable to them however it is very possible for a Ct. to misinterpret this to mean only deferred entitlements :

- 1....Is the provision still available when the trust is phrased to capitalize the income through deferred payment and make it payable every 3 years? It could be said to be.
- 2....If the income to which the spouse is entitled is measured as trust law income you have an immediate problem in transferring recognition *of all that tax income* in that trust law expenses may be deductible against that stream of revenue, legally per the terms of the will, and that reduces shadow tax law income payable since there is an immediate divergence when those expenses/adjustments are not allowable per the ITA causing the trust to recognize in its hands some of the taxable income.

This being said is it not prudent to force recognition of all taxable income in the hands of the spouse so that there is never a problem in the issue of divergence on trust law vs. tax law deductible expenses or deferral/shifting of recognition?

Sec. 104(13.1)-(13.2) Trust-Beneficiary Income Recognition Carve-back, illegitimately Used

In Jeannette Lussier v. Her Majesty The Queen, 97-1928-IT-G, the TCC considered not irreprehensible that S. 104(13.1) could be used to split income as one of the primary purposes of the taxpayer group (beneficiary-trust). It's obvious to most that this set of provisions were enacted to legitimately allow for loss absorption by the trust though this is now how at least the TCC is interpreting their use (as well as in some estate-planning commercial prints). There should be some qualification on the claw-back of recognition to be available only when the trust does in fact have those loss carry-forwards: otherwise it's simply handing on a silver platter the ability of a taxpayer group to reduce its absolute tax payable between trust and beneficiary.

Amounts deemed not paid - 104(13.1)

(13.1) Where a trust, in its return of income under this Part for a taxation year throughout which it was resident in Canada and not exempt from tax under Part I by reason of subsection 149(1), designates an amount in respect of a beneficiary under the trust, not exceeding the amount determined by the formula

$$A/B \times C$$

where

A is the beneficiary's share of the income of the trust for the year computed without reference to this Act,
B is the total of all amounts each of which is a beneficiary's share of the income of the trust for the year computed without reference to this Act,

C is the amount for the year of the trust described in subparagraph 111(1)(a), the amount so designated shall be deemed, for the purposes of subsections 104(13) and 105(2), not to have been paid or to have become payable in the year to or for the benefit of the beneficiary or out of income of the trust.

Idem - 104(13.2)

(13.2) Where a trust, in its return of income under this Part for a taxation year throughout which it was resident in Canada and not exempt from tax under Part I by reason of subsection 149(1), designates an amount in respect of a beneficiary under the trust, not exceeding the amount determined by the formula

$$A/B \times C$$

where

A is the amount designated by the trust for the year in respect of the beneficiary under subsection 104(21),
B is the total of all amounts each of which has been designated for the year in respect of a beneficiary of the trust under subsection 104(21), and

C is the amount for the year of the trust described in subparagraph 111(1)(b), the amount so designated shall

(a) for the purposes of subsections (13) and 105(2) (except in the application of subsection (13) for the purposes of subsection (21)), be deemed not to have been paid or to have become payable in the year to or for the benefit of the beneficiary or out of income of the trust; and

(b) except for the purposes of subsection 104(21) as it applies for the purposes of subsections 104(21.1) and 104(21.2), reduce the amount of the taxable capital gains of the beneficiary otherwise included in computing the beneficiary's income for the year by reason of subsection 104(21).

This considerably simplifies the equations obviously and *directly considers the tax loss balances* of the trust in determining what amount can be clawed back for trust recognition to absorb them. There is a need to also have accompanying loss

account adjustments to reflect the fact that these discretionary elections do have effect on the balances, during the periods, even if not taken, in the subpara. 111(8) definitions.

Severing The Disposition in a Trust Distribution to Disallow Expenses and Outlays to be Considered Creating Tax Non-Zero Affect

"Distribution by personal trust - Sec. 107(2)"

(2) Subject to subsections (2.001), (2.002) and (4) to (5), if at any time a property of a personal trust or a prescribed trust is distributed (otherwise than as a SIFT trust wind-up event) by the trust to a taxpayer who was a beneficiary under the trust and there is a resulting disposition of all or any part of the taxpayer's capital interest in the trust,

- (a) the trust shall be deemed to have disposed of the property **immediately before that time** for proceeds of disposition equal to its cost amount to the trust immediately before that time;

Can there be argument in Canada that a deemed disposition that *directly coincides with an actual disposition* allows expenses and outlays to be considered to determine a capital gain/loss on an otherwise taxable non-event? If there is, and that's not what was legislatively thought of, the above additional 4 words would prevent it [applied to all trust capital distribution and income provisions]. Note: the second "immediately before that time" can only be interpreted to apply to the cost amount, not the time of disposition. (Please refer to jurisp. on prevention of expense deduction against a s. 70(5) deemed disposition. "Immediately before that time")

Aligning Reversionary Trust Income/Loss Attribution Specifics to be the Same as Other Income Attribution Provisions

Without rewriting everything I composed about how this provision could be very dangerously interpreted, especially with regard to the fact that in the recent FCA case of Her Majesty The Queen v. Peter Sommerer¹¹ the Crown attempted to argue that there could be double recognition between attributee and beneficiary. Through the evolution of the other general attribution provisions this, I consider to be, the most dangerous provision in the ITA that I know of: it artificially doubles losses and through the court's evaluation of the evolution of the provisions they too could come to this conclusion. While it has some penalizing value now which could prompt for double recognition of income, once argued, it opens up for double loss, *so it can only penalize once*.

"Trusts - Sec. 75(2)"

(2) Where, by a trust created in any manner whatever since 1934, property is held on condition

- (a) that it or property substituted therefor may

- (i) revert to the person from whom the property or property for which it was substituted was directly or indirectly received (in this subsection referred to as "the person"), or

- (ii) pass to persons to be determined by the person at a time subsequent to the creation of the trust, or

- (b) that, during the existence of the person, the property shall not be disposed of except with the person's consent or in accordance with the person's direction,

any income or loss from the property or from property substituted for the property, and any taxable capital gain or allowable capital loss from the disposition of the property or of property substituted for the property, shall, during the existence of the person while the person is resident in Canada, be deemed to be income or a loss, as the case may be, or a taxable capital gain or allowable capital loss, as the case may be, of the person **and not of the trust**.

Technical Cleanliness of Untainting Tainted Spouse Trusts

Special rules applicable in respect of trust for benefit of spouse - s. 70(7)

(7) Where a trust created by a taxpayer's will would, but for the payment of, or provision for payment of, any particular testamentary debts in respect of the taxpayer, be a trust to which subsection 70(6) or 70(6.1) applies,

- (a) for the purpose of determining the day on or before which a return (in this subsection referred to as the "taxpayer's return") of the taxpayer's income for the taxation year in which the taxpayer died is required to be filed by the taxpayer's legal representatives, subsection 150(1) shall be read without reference to paragraph 150(1)(b) and as if paragraph 150(1)(d) read as follows:

¹¹ 2011 TCC 212. Appealed : 2012 FCA 207

"150(1)(d) in the case of any other person, by the person's legal representative within 18 months after the person's death; or;" and

(b) where the taxpayer's legal representative so elects in the taxpayer's return (other than a return of income filed under subsection 70(2) or 104(23), paragraph 128(2)(e) or subsection 150(4)) and lists therein one or more properties (other than a net income stabilization account) **to which subsection 70(6) would otherwise apply** that, **as were previously owned by the taxpayer**, on or after the taxpayer's death and as a consequence thereof, transferred or distributed to the trust, the total fair market value of which properties immediately after the taxpayer's death was not less than the total of the non-qualifying debts in respect of the taxpayer,

(i) subsection 70(6) does not apply in respect of the properties so listed, and

(ii) notwithstanding the payment of, or provision for payment of, any such particular testamentary debts, the trust shall be deemed to be a trust described in subsection 70(6),

except that, where the fair market value, immediately after the taxpayer's death, of all of the properties **to which subsection 70(6) would otherwise apply** so listed exceeds the total of the non-qualifying debts in respect of the taxpayer (the amount of which excess is referred to in this subsection as the "listed value excess") and the taxpayer's legal representative designates in the taxpayer's return one property so listed (other than money) that is capital property other than depreciable property,

(iii) the amount of the taxpayer's capital gain or capital loss, as the case may be, from the disposition of that property deemed by subsection 70(5) to have been made by the taxpayer is that proportion of that capital gain or capital loss otherwise determined that

1. the amount, if any, by which the fair market value of that property immediately after the taxpayer's death exceeds the listed value excess, is of
2. the fair market value of that property immediately after the taxpayer's death, and

(iv) the cost to the trust of that property is

(A) where the taxpayer has a capital gain from the disposition of that property deemed by subsection 70(5) to have been made by the taxpayer, the total of

(I) its adjusted cost base to the taxpayer immediately before the taxpayer's death, and

(II) the amount determined under subparagraph 70(7)(b)(iii) to be the taxpayer's capital gain from the disposition of that property, or

(B) where the taxpayer has a capital loss from the disposition of that property deemed by subsection 70(5) to have been made by the taxpayer, the amount by which

(I) its adjusted cost base to the taxpayer immediately before the taxpayer's death exceeds

(II) the amount determined under subparagraph 70(7)(b)(iii) to be the taxpayer's capital loss from the disposition of that property.

Meaning of certain expressions in s. (7) - Sec. 70(8)

(8) In subsection 70(7),

(a) the "fair market value" at any time of any property subject to a mortgage or hypothec is the amount, if any, by which the fair market value at that time of the property otherwise determined exceeds the amount outstanding at that time of the debt secured by the mortgage or hypothec, as the case may be;

(b) "non-qualifying debt" in respect of a taxpayer who has died and by whose will any trust has been created that would, but for the payment of, or provision for payment of, any particular testamentary debts in respect of the taxpayer, be a trust described in subsection 70(6), means any such particular testamentary debt in respect of the taxpayer other than

(i) any estate, legacy, succession or inheritance duty payable, in consequence of the taxpayer's death, in respect of any property of, or interest in, the trust, or

(ii) any debt secured by a mortgage or hypothec **not existing immediately before the time of death** on property owned by the taxpayer immediately before the taxpayer's death;

and

(c) "testamentary debt", in respect of a taxpayer who has died, means

(i) any debt owing by the taxpayer, or any other obligation of the taxpayer to pay an amount, that was outstanding immediately before the taxpayer's death, and

(ii) any amount payable (other than any amount payable to any person as a beneficiary of the taxpayer's estate) by the taxpayer's estate in consequence of the taxpayer's death, including any income or profits tax payable by or in respect of the taxpayer for the taxation year in which the taxpayer died or for any previous taxation year, and any estate, legacy, succession or inheritance duty payable in consequence of the taxpayer's death.

Ensuring only the Deceased's Property Can be Listed

For purposes of the ITA, outside of subd. k, which is s. 70(7)-(8) in this case, estates are not recognized as trusts that arise

out of them: that can be the only reason both terms of redundantly used throughout these subsections. That being said it is possible for a taxpayer estate to be a recipient of a gratuitous or FMV sale of property from an "outside" party, and, in this case, there is no restriction on whether that property can then be used to be considered on a listing since the provision simply doesn't say that it applies to only property previously owned by the deceased taxpayer.

What Type of Property can be Listed

Other than a net income stabilization accounts cannot be listed, as specified, however this tax creature is afforded treatment other than under the s. 70(5)-(6) regular channels anyhow so by mentioning them here the argument is opened that property other than that described in s. 70(5)-(6) can be listed. And that includes s. 70(2) rights or things.

The only non-depreciable capital property that need be listed is one to act as a sink for the gain/loss recognition through disallowance of s 70(6), the rest apparently need not be subject to s. 70(6) since no where does the provision require it.

Capping the Incurrence of Mortgages as Non-Qualifying Debt

Non-qualifying debt causes tax consequences and it is based on testamentary debt part of which is that debt which is

(i) *any amount payable (other than any amount payable to any person as a beneficiary of the taxpayer's estate) by the taxpayer's estate in consequence of the taxpayer's death,*

If the executor faces a will that compels that property of the testator be mortgaged to secure funds to make ancillary payments then that mortgage is compellable by the vigour and effect of the will and can be argued to be in consequence of the taxpayer's death. That latently arising mortgage then becomes a testamentary debt.

When considering what kind of debt to be listed against to withhold beneficial tax consequences under s. 70(6) - non-qualifying debt - the phrase that "jumps" that mortgage over the targeting is

"other than

(ii) any debt secured by a mortgage or hypothec on property owned by the taxpayer immediately before the taxpayer's death"

and seeing how there is no qualification in the definition of non-qualifying debt on when that mortgage can be obtained a taxpayer can simply have his spousal trust sustain it after compelling the executors to contract for it to obtain more liquidity for the estate and it produces no tax consequences when assumed by the trust. By qualifying mortgages to exist with "other than ...not existing immediately before the time of death" only those mortgages that exist prior to death will be exempt, which I believe is the objective

Estates and Trusts... A Difference.

Fiscal Targeting.

The Canadian Income Tax Act provides definitions of both "estate" and "trust" in subsection 248(1) both of which have "the meaning assigned by subsection 104(1)" while that subsection provides:

"Reference to trust or estate – Sec. 104(1)"

Sec. 104. (1) In this Act, a reference to a trust or estate (in this subdivision referred to as a "trust") shall, unless the context otherwise requires, be read to include a reference to the trustee, executor, administrator, liquidator of a succession, heir or other legal representative having ownership or control of the trust property, but, except for the purposes of this subsection, subsection (1.1), subparagraph (b)(v) of the definition "disposition" in subsection 248(1) and paragraph (k) of that definition, a trust is deemed not to include an arrangement under which the trust can reasonably be considered to act as agent for all the beneficiaries under the trust with respect to all dealings with all of the trust's property unless the trust is described in any of paragraphs (a) to (e.1) of the definition "trust" in subsection 108(1).¹²

"Restricted meaning of "beneficiary" – Sec. 104(1.1)"

(1.1) Notwithstanding subsection 248(25.1) and for the purposes of subsection (1), paragraph (4)(a.4), subparagraph 73(1.02)(b)(ii) and paragraph 107.4(1)(e), a person or partnership is deemed not to be a beneficiary under a trust at a particular time where the person or partnership is beneficially interested in the trust at the particular time solely because of

(a) a right that may arise as a consequence of the terms of the will or other testamentary instrument of an individual who, at the particular time, is a beneficiary under the trust;

(b) a right that may arise as a consequence of the law governing the intestacy of an individual who, at that time, is a beneficiary under the trust;

(c) a right as a shareholder under the terms of the shares of the capital stock of a corporation that, at the particular time, is a beneficiary under the trust;

12 March 2001 FINANCE TECHNICAL NOTES: Subsection 104(1) provides a rule under which a reference to a trust or estate is read in the Act as a reference to the trustee or the executor, administrator, heir or other legal representative having ownership or control over trust property.

Subsection 104(1) is amended to include a "liquidator of the succession" to the list of persons to which a trust or estate refers for the Purposes of the Act. This amendment is made to ensure that the Act appropriately reflects both the civil law of the province of Quebec and the law of other provinces.

Subsection 104(1) is amended so that this rule does not apply where the context otherwise requires and to clarify that this rule is meant to be a convenient way of linking the trustees and others described in the subsection with a trust for the purposes of the Act. This amendment recognizes that there are references to "trust" in the Act that are meant to indicate a trust arrangement, rather than the persons who are responsible for the operation of the arrangement. The latter references include those found in subsections 74.4(4), 104(5.3) and (5.5), 108(6) and 127(7).

Subsection 104(1) is amended, in conjunction with 104(1.1), so that, except for the purposes of those two subsections, subparagraph (b)(v) of the definition "disposition" in subsection 248(1) and paragraph (k) of that definition, references in the Act to trusts are considered not to include an arrangement where a trust can reasonably be considered to act as agent for its beneficiaries with respect to all dealings in the trust's property. These arrangements are generally known as "bare trusts". Trusts described in paragraphs (a) to (e.1) of the definition "trust" in subsection 108(1) are expressly not affected by the amendment.

These amendments generally apply to the 1998 and subsequent taxation years. However, in order to co-ordinate this, amendment with changes to the replacement of the definition "disposition" in section 54 with the new definition of the same expression in subsection 248(1), it does not apply in connection with transfers of property that occurred before December 24, 1998.

(d) a right as a member of a partnership under the terms of the partnership agreement, where, at the particular time, the partnership is a beneficiary under the trust; or
(e) any combination of rights described in paragraphs (a) to (d).¹³

alter ego trust

"alter ego trust" means a trust to which paragraph 104(4)(a) would apply if that paragraph were read without reference to subparagraph 104(4)(a)(iii) and clauses 104(4)(a)(iv)(B) and (C);¹⁴

estate

"estate" has the meaning assigned by subsection 104(1);

inter vivos trust

"inter vivos trust" has the meaning assigned by subsection 108(1);

testamentary trust

"testamentary trust" has the meaning assigned by subsection 108(1);

trust

"trust" has the meaning assigned by subsection 104(1);

and thus one is left with the conclusion that that provision operates only to assign the tax liability of the trust or estate against the person having the ownership or control of the property subject to it.¹⁵

The applicable tax liabilities can be applied against **two** parties and not just one since the provision refers to those having **ownership or control** over the property however the subsection 248(1) definition and subsection 104(1) target are of absolutely no help in ascertaining whether a trust or estate exists for purposes of our Act. The taxpayer must rely on historic common law principles or relevant statute law in order to ascertain what reporting responsibilities she has and which provisions of our Act he can benefit

¹³ July 2010 FINANCE TECHNICAL NOTES (Part 1 -technical): Subsection 104(1.1) applies for the purpose of identifying beneficiaries under a trust for the purposes of subsection 104(1), subparagraph 73(1.02)(b)(ii) and paragraphs 104(4)(a.4) and 107.4(1)(e).

Subsection 104(1.1) is amended to clarify that it applies notwithstanding subsection 248(25). Subsection 248(25) describes, for other purposes of the Act, the circumstances in which a person or partnership is considered to be "beneficially interested" in a trust.

This amendment applies to the 1998 and subsequent taxation years.

March 2001 FINANCE TECHNICAL NOTES: New subsection 104(1.1) applies for the purpose of identifying beneficiaries under a trust for the purpose of subsection 104(1), as well as for the purposes of subparagraph 73(1.02)(b)(ii) and paragraphs 104(4)(a.4) and 107.4(1)(e). A person or partnership is deemed not to be a beneficiary under a trust at a particular time for these purposes where the person or partnership is beneficially interested in the trust at the particular time solely because of any one, or a combination of, the following:

- a right that may arise as a consequence of the terms of the will or other testamentary instrument of an individual who, at the particular time, is a beneficiary under the trust;
- a right that may arise as a consequence of the law governing the intestacy of an individual who, at the particular time, is a beneficiary under the trust;
- a right as a shareholder under the terms of the shares of the, capital stock of a corporation that, at the particular time, is a beneficiary under the trust; or
- a right as a member of a partnership under, the terms of the partnership agreement, where, at the particular time, the partnership is a beneficiary under the trust.

These amendments generally apply to the 1998 and subsequent taxation years. However, in order to co-ordinate this amendment with changes to the replacement of the definition "disposition" in section 54 with the new definition of the same expression in subsection 248(1), it does not apply in connection with transfers of property that occurred before December 24, 1998.

¹⁴ See article in *Estates, Trusts and Pensions*, Vol. 24 Pg. 346 "Alter Ego, Joint Conjugal, and Self-benefit Trusts Revisited: Some Troubling Tax Issues and A Search for Better Alternatives" by Catherine Brown

¹⁵ See *FCT v. Prestige Motors Pty Ltd*, 114 A.L.R. 507 FC Aust where a taxpayer attempted to argue a mis-targeting of an assessment notice.

from or suffer.^{16 17 18}

16 For an excellent discussion of the fiduciary environment see "Demystifying the Fiduciary Mystique", R. Maurice Gautreau, C.B.R. Vol. 68 March #1.

17 Dec. 23, 1998 Press Release: TRUST TAXATION — PROPOSED NEW RULES

The proposals on the taxation of trusts and their beneficiaries relate to measures on trust taxation announced in the October 2, 1996 Notice of Ways and Means Motion. In addition, these amendments respond to gaps, inconsistencies and uncertainties in the existing law. These issues are, or can become, relevant in the context of:

- the taxation of emigrants;
- the distribution of property from Canadian trusts to non-resident beneficiaries; and
- the distribution of property from non-resident trusts to Canadian beneficiaries.

The proposed amendments are summarized below, with attention drawn in particular to those amendments that are proposed to be effective from today.

Changes to the rules governing the distribution of trust property to beneficiaries

There are currently five sets of taxation rules for distributions from trusts to beneficiaries contained in subsections 107(2) to (5). The rules in subsection 107(2.1), which generally apply to distributions by commercial trusts, are problematic because they do not provide a clear mechanism to avoid double taxation of gains. The existing rules in subsection 107(5), which apply to dispositions of property to non-resident beneficiaries in satisfaction of a trust interest, are problematic because they provide that there is no gain or loss associated with the disposition of the interest.

Proposed amendments address these problems and eliminate a number of inconsistencies, effective with regard to distributions made after 1999. The taxation of trust distributions will now be governed by either roll-over rules under amended subsection 107(2) or fair market value realization rules* under subsection 107(2.1). In accordance with the October 2, 1996 press release, there will now generally be a deemed disposition at fair market value where a Canadian trust distributes taxable Canadian property to a non-resident beneficiary.

Rules governing the tax treatment of bare, protective and similar trusts

Under the existing law, there is uncertainty with respect to the tax treatment of bare trusts, protective trusts- and other trust vehicles into which property can be transferred without any change in its beneficial ownership. The existing law generally provides that a transfer of capital property to a trust that does not result in any change in the beneficial ownership of the property is not treated as a 'disposition', but does not provide for an explicit cost for the transferee.

The proposed amendments are generally intended to preserve Revenue Canada's administrative position with regard to bare trusts, which is essentially that such trusts are treated as agents for their beneficiaries for income tax purposes. However, in the event that a Canadian resident transfers property to a non-resident bare trust after today, that transfer will be treated as a "disposition" and the bare trust will be treated as an ordinary trust for income tax purposes.

Where bare trusts are not involved, transfers of property which do not result in any change in the beneficial ownership of the property will now generally be treated as dispositions of the property. In these circumstances, a special set of "roll-over" rules in new section 107.4 is proposed. Consequential to these changes, the existing definitions of 'disposition' in subsection 13(21), section 54 and subsections 59(5) and 66.4(5) have been replaced by a new definition of that term in subsection 248(1). These amendments also apply after today.

In addition, new subsection 107.4(4) provides for special rules after today in the event that all or part of a trust interest created on a "rollover" transaction to which new subsection 107.4(3) applies is subsequently disposed of. In these circumstances, the trust interest is considered to have been disposed of for proceeds of disposition that are not less than an amount based on the fair market value of the net trust assets associated with the interest.

Application of the 21-year rule

The proposed amendments ensure that a non-resident trust is not deemed to dispose of and reacquire, a property pursuant to the 21-year deemed disposition rule unless the proceeds of disposition are taken into account in determining the non-resident trust's Canadian tax position. This ensures that, after today, the 21-year rule cannot be used as a mechanism for non-resident trusts to distribute property to Canadian residents at an artificially high cost amount. In addition, the proposed amendments ensure that the 21-year rule applies, as intended, for the 1999 and subsequent taxation years to non-resident discretionary trusts to which paragraph 94(1)(c) applies.

The proposed amendments also restrict, after today, the exemption from the 21-year rule for trusts in which all interests have vested indefeasibly to cases where the beneficiaries are all resident in Canada. This exemption is contained in paragraph (g) of the definition 'trust' in subsection 108(1). A related relieving amendment to subsection 104(5.8) provides that the date of the 21-year anniversary for such a trust is determined without reference to the special transfer rules for trusts in subsection 104(5.8), if the transfer occurred on or before today.

Oct. 1, 1987 Press Release: The Minister noted that the increasing use of trusts in commercial arrangements has emphasized the need for several other amendments to the Act, including changes to the special rules which were intended for testamentary and family trusts in which none of the interests was purchased from the trust or a settlor of the trust. These changes include:

- withdrawing the rules that allow a trust to allocate capital cost allowances and depletion to beneficiaries,
- restricting the preferential flow-through of trust income and the character, of certain of its sources to trusts that are resident in Canada,
- permitting a trust, in computing its income, to deduct an amount in respect of its income distributions to beneficiaries which is less than the amount of the actual distributions,
- amending the adjusted cost base rules to require amounts received from the trust to reduce the adjusted cost base of the beneficiary's interest in the trust except to the extent such amounts are included in the beneficiary's income,
- limiting the preferential treatment accorded dispositions of capital interests to interests in testamentary and family trusts, and

- excluding from the "21 year"-deemed disposition rule, those trusts under which all beneficiaries' rights are vested indefeasibly in possession.

Income Flow-through Rules

Under the existing rules, the income of a trust for a taxation year - determined in accordance with the provisions of Part I but before deducting any amount in respect of capital cost allowance or terminal loss - that becomes payable in the year to the beneficiaries of the trust is normally taxable in the hands of the beneficiaries. If the trust would otherwise be entitled to claim capital cost allowance or depletion allowance in computing its income for the year, the existing rules permit beneficiaries under the trust to deduct their shares of such allowances against the trust income which has become payable to them. Under these rules, a trust may be unable to deduct its losses from a prior year if in accordance with the terms of the trust, all trust income is required to be distributed to the beneficiaries under the trust. This results from the mandatory deduction of trust income distributions (under the existing rules).

Under the proposals, the income distributions of a trust will only be taxable in the beneficiary's hands to the extent of the trust's income otherwise determined under Part I - after deducting capital cost allowance and terminal loss amounts - and to the extent the trust deducts such amounts in computing its income. These changes allow for the repeal of the rules dealing with the trust allocations of capital cost allowance and depletion allowance and will generally resolve the problem for trusts in utilizing loss carry-forwards.

Under the proposals, the rules providing for the flow-through of the trust income and certain of its sources will be restricted to beneficiaries of resident trusts. Beneficiaries of non-resident trusts will include in their income all distributions which they become entitled to receive from the trust other than distributions or payments of capital by a testamentary trust or an inter-vivos trust in which none of the interests has been purchased from the trust or a settlor thereof.

Adjusted Cost Base Rules

Under the existing rules, certain amounts distributed by a trust to its beneficiaries out of trust income may be neither taxable in their hands nor regarded as payments of capital. Such amounts may not reduce the adjusted cost base of the capital interests of the beneficiaries under the trust.

Under the proposals, the rules governing the computation of the adjusted cost base of a capital interest in a trust will be revised to require that all trust distributions other than amounts which are required to be included in income by the beneficiaries will reduce the beneficiary's adjusted cost base. An exception to this rule will permit a resident trust to distribute in a year the non-taxable portion of its capital gains for the year without causing a reduction in the adjusted cost base of its capital interests. These rules will not apply in respect of capital interests in testamentary trusts or inter-vivos trusts in which none of the interests is purchased from the trust or a settlor of the trust, unless such interest has been purchased by the beneficiary.

Capital Interest Rules

Under the existing rules, beneficiaries under commercial trusts, other than unit trusts, are entitled to the benefits of the special rules that apply on the disposition of capital interests in the trust. These rules provide that where the trust property is distributed to the beneficiary in satisfaction of his rights as a capital beneficiary,, the property may be rolled over to the beneficiary at its cost amount to the trust. In addition, on the disposition of a capital interest, the capital gain that would otherwise occur may be reduced where the cost amount of the trust property attributable to the interest is greater than the beneficiary's adjusted cost base.

Under the proposals, these rules would be limited in their application to testamentary trusts and inter-vivos trusts in which none of the interests has been purchased from the trust or a settlor of the trust.

Deemed Disposition Rules

Under the existing rules, the capital properties, land inventories and resource properties owned by trusts other than unit trusts and trusts governed by certain deferred income plans are deemed to have been disposed of and subsequently reacquired by the trust on certain dates. In the case of commercial trusts other than unit trusts, the first application of this rule would occur on January 1 1993. This rule was intended to prevent the use of trusts in estate planning arrangements to defer indefinitely the recognition of capital gains which would otherwise occur on the death of the individual or on his ceasing to reside in Canada.

It is proposed to exclude from the deemed disposition rules those trusts in which every interest in the trust is vested absolutely in possession in the holder thereof or which will so vest upon the death of the settlor or his spouse (or former spouse). Such trust arrangements do not permit the deferral of capital gains beyond the lifetime of the holders of such vested interests.

1971 TR: Under the present tax system, all taxable trusts or estates are subject to the same set of rules, the most important of which are as follows:

- (1) generally income received by the trust and payable to beneficiaries in the year received is taxable to the beneficiary, not the trust;
- (2) income that is not so payable is taxable to the trust, and for this purpose the trust uses the personal rate schedule (although it is not entitled to a personal exemption); and
- (3) once the trust has paid income tax on an amount, the balance can usually be distributed in subsequent years without further tax.

The new legislation continues the present tax treatment for the first category of income. This income will be taxed in the hands of the beneficiaries, and deducted in computing the income of the trust.

For trusts which accumulate income, the new bill distinguishes between estates (trusts created by a will) and personal trusts (trusts created by a living person).

In the case of an estate, income not payable to beneficiaries in the year received is taxed to the estate under the same system as at present. The estate uses the personal rate schedule, but is not entitled to personal exemptions.

In the case of a personal trust, income not payable to beneficiaries in the year received is taxed to the trust at the higher of 50% or the personal rate schedule.

For another jurisdiction's apparatus on how the trust-estate is to be referenced in tax legislation see *Leighton v. Commissioner of Taxation*¹⁹ where the Aust. Federal Ct. of Appeal looked to their Income Tax Assessment Act's reference and held:

"Was Mr Leighton a "trustee"?"

42. First, I consider that Mr Leighton did satisfy paragraph (b) of the definition of "trustee" in s 6 of the 1936 Act. He had, and took upon himself, "the administration or control of income affected by [a] ... trust". That conclusion requires explanation.

43. It was common ground that the share trading in Australia was conducted in the name of Salina and Kolton and that the various broking accounts were in their individual names "c/ Leighton & Leighton 4 rue des Orchidees MC98000 Monaco" or words to similar effect. The invoices issued by the various brokers confirming a buy or sell trade were addressed to Kolton or Salina. Settlement of those invoices was subject to two recorded instructions in the following general terms. First, that the registration details for the shares was "Westpac Custodian Nominees" and, secondly, that payment was to be effected along the following lines:

Unless we hear from you before the settlement day we will be settling direct with Westpac Custodian Nominees Limited on the settlement day.

Of course, the relevant Westpac Custodian Account was in the name of Mr Leighton: see [7] above. But that is not the only connection.

44. Critically, Mr Leighton administered and controlled the share trading (and, as will become apparent, administered and controlled the income arising from the share trading

The new bill also provides that the minimum 50% tax on investment income of personal trusts will not apply to trusts in existence on budget day 1971 unless that trust receives additional contributions or borrows any money from a non-arm's-length lender after that date.

The new bill also provides that the preferred beneficiaries of a personal trust or estate may elect to include in their income the income of the trust that is being accumulated for their benefit. If this election is made the income is not taxed to the trust. This election may be made by any or all of the preferred beneficiaries, but the election by each is limited to his share of the trust income. Preferred beneficiaries are defined as the spouse or children of the person who established the trust. When the beneficiaries or their "shares" cannot be ascertained, the bill provides rules based on reasonable but generous assumptions, to determine each beneficiary's share of income. This election will also permit capital gains realized by a trust and otherwise included in its income to be taxed in the hands of lower-rate beneficiaries.

With the introduction of a tax on capital gains a number of special rules are needed to cover trusts. These rules are somewhat complex because of the extreme complexity of trusts, and the following summary is intended to give a general understanding of these rules.

When property is transferred to a trust this will generally be regarded as a sale at fair market value and accordingly a capital gain or loss will result. The cost of the property to the trust will be the fair market value of the property at the date of transfer.

When property is transferred to a special trust under which a spouse is a beneficiary⁷, the capital gain on the transfer can be deferred under certain circumstances. In these cases the trust will take over the property at the cost of the person establishing the trust. On the death of the spouse the trust will be considered to have sold the property at its fair market value and accordingly a capital gain or loss will result. The cost of the property to the trust for tax purposes will then be increased to the fair market value of the property.

For trusts in existence at the start of the new system, the cost of the trust property will be original cost or fair market value on Valuation Day.

When trust transfers property to its capital beneficiaries, the beneficiaries will take over the property at the trust's cost. This tax-free transfer recognizes the fact that a trust is, in a sense, the agent of its beneficiaries.

If a beneficiary sells or otherwise disposes of an income interest in a trust, all of the proceeds received will be treated as ordinary income but the purchaser will be able to deduct his cost from trust income received. If a beneficiary sells or otherwise disposes of a capital interest in a trust, the capital gain or loss will be measured against his pro rata share of the cost of the trust property to the trust at the time of sale.

The property of a trust, other than a special trust for a spouse, will be revalued every 21 years for capital gains tax purposes. This provision is necessary to prevent the indefinite postponement of capital gains taxes through the use of long-term trusts.

¹⁸ See "The Taxation of Trusts: Reconciling Some Fundamental Principals" by Catherine Brown in *Estates, Trusts and Pensions*, Vol. 21, Pg. 1 for a review of some key-points in what a trust is and how the ITA attends to its more rudimentary attributes.

¹⁹ [2010] FCA 1086 (6 October 2010)

conducted through the share broking accounts) pursuant to the administrative and management services he provided to each of Salina and Kolton under the Directors and Management Services Agreement (see [9] and [11] above) he had with each of them. These “basic” services (for which he was paid a fee based on a percentage of sales proceeds from the sale of shares) were defined in each agreement as:

Leighton will provide the following basic services or any part thereof (together with any ancillary, additional or other services provided by Leighton on behalf of SALINA, “the Services”) to SALINA as and when SALINA may reasonably require:

- 1.2.1 management services, including the opening of bank accounts, and the purchase, sale, settlement and safekeeping of securities and other assets and property;
- 1.2.2 accounting services;
- 1.2.3 corporate services;
- 1.2.4 provision of director(s) and secretary (as applicable);
- 1.2.5 provision of office facilities; and
- 1.2.6 provision of Board Room facilities upon notice ...

...

45. Put simply, Mr Leighton was contracted by each of Salina and Kolton to administer and control “the purchase, sale, settlement and safekeeping of securities”, which in this case included the 676 share trades the subject of the dispute: see [15] above. In that direct sense, Mr Leighton controlled the income of Salina and Kolton. He controlled, by direction, which shares were purchased and which shares were sold. He also controlled, by direction, settlement of those share trades through the Westpac Bank Account which had a number of important characteristics.

46. In relation to the Westpac Custodian Agreement:

1. it was signed by Mr Leighton in his own name;
2. Mr Leighton held an equitable interest in the shares the subject of the Custodian Agreement, the legal title to which was vested in Westpac. Mr Leighton held that equitable interest not for his own benefit but on trust for the benefit of Salina or Kolton; and
3. Mr Leighton’s obligations under the Westpac Custodian Agreement and in relation to the shares were of a fiduciary nature: see [33], [43] – [44] above and [51] below.

47. Similarly, in relation to Mr Leighton’s Westpac Bank Account:

1. it was opened and operated by Mr Leighton in his own name;
2. there was a debtor / creditor relationship between Mr Leighton and Westpac in relation to the moneys standing to the credit of the account;
3. the source of the moneys standing to the credit of the account was from Salina, from Kolton or from the sale of securities purchased with their money;
4. the rights Mr Leighton held as creditor against Westpac were held not for his own use and benefit but for the benefit of Salina and Kolton. Mr Leighton had a fiduciary obligation (see [33], [43] – [44] above and [51] below) to apply those funds to purchase shares (registered in the name of Westpac Custodian) on behalf of Salina and Kolton; and
5. when proceeds from the sale of shares were paid into Mr Leighton’s Westpac Bank Account, he did not receive those proceeds of sale for his own benefit but for the benefit of Salina and Kolton. The proceeds were marked with a fiduciary obligation to apply the proceeds for the benefit of Salina and Kolton: see [33], [43] – [44] above and [51] below. The proceeds were not retained in Mr Leighton’s Westpac Bank Account. They were used for further share purchases on behalf of Salina or Kolton or transferred

to CLC's account with HSBC and CLC then distributed the proceeds to Salina and Kolton's respective bank accounts with HSBC.

48. By making the arrangements between Mr Leighton, on the one part, and Kolton or Salina, on the other part, as recorded in the Directors and Management Services Agreement (see [44] – [45] above) it was intended that the moneys received by Mr Leighton be kept separate from his personal moneys and be accounted for separately, consistent with a fiduciary obligation: see [33], [43] – [44] above and [51] below. That was not only the intention but what was in fact achieved.

49. As the Commissioner submitted, applying the reasoning of Wilcox and Lee JJ in *Harmer* 24 FCR 237 at 247-248:

1. Legal title to Salina and Kolton's money was given to Mr Leighton to enable him to invest the moneys and earn income therefrom;
2. There was more than a mere grant by Salina or Kolton of enjoyment of possession of their money by Mr Leighton pending demand for redelivery to them coupled with a right to collect any income accruing to the owner; and
3. The object of the arrangements between Salina and Kolton and Mr Leighton was to deliver the funds to Mr Leighton for him to hold for the eventual benefit and use of Salina and Kolton.

50. It was common ground that where, as here, a taxpayer (namely Salina or Kolton) is trading in stock, including shares, income is earned on a sale when a recoverable debt comes into existence, even though the debt may be payable at a later date: *J Rowe & Son Pty Ltd v Federal Commissioner of Taxation* [1971] HCA 80; (1971) 124 CLR 421 at 450. Mr Leighton conceded (as he had to) that in relation to each purchase, the debt was discharged by payment into the Westpac Bank Account *at the direction of Salina or Kolton*. This statement of the position is accurate, so far as it goes. However, contrary to Mr Leighton's submissions, that is not the end of the enquiry which Div 6 (and in particular, the definition of "trustee") requires you to make. The statement, *at the direction of Salina or Kolton* – invites the further question – how was the debt discharged? Here, it was discharged through the Westpac Bank Account which could only be, and was only, operated and conducted by Mr Leighton. Whether the brokers had rights against Salina or Kolton is not conclusive. The question is the proper characterisation of the role of Mr Leighton. If the income was earned on a sale when a recoverable debt came into existence, then the capacity and manner in which Mr Leighton administered or controlled that income was under the Directors and Management Services Agreement which included his capacity as a director of Salina or Kolton and the management services of opening bank accounts etc under cl 1.2.1. If, however, the timing of the earning of income by Salina or Kolton was not until settlement through Westpac, then the capacity and manner in which Mr Leighton administered or controlled that income again was under the Director and Management Services Agreement and included his capacity as a director of Salina or Kolton and the management services of opening bank accounts etc under cl 1.2.1.

51. Consistent with earlier authority (see [33] above), for each of Salina and Kolton, Mr Leighton stood in some relation to the proprietary right by virtue of which the income exists (*Howey* at 293) and he owed a fiduciary obligation towards them which included a liability to account to them: *Manning* at 509; *Hospital Products Ltd v United States Surgical Corporation* [1984] HCA 64; (1984) 156 CLR 41 at 96-97 and 142. That is sufficient to make him a "trustee" within the meaning of the term in s 6 of the 1936 Act having the administration and control of income from the share trading affected by a trust in favour Salina and Kolton.

Existence of a "trust estate"

52. The conclusion that Mr Leighton was a "trustee" within the meaning of the term in s 6 of the 1936 Act having the administration and control of income from the share trading

affected by a trust in favour of Salina and Kolton requires further explanation. One of the tests of s 98(3) is not only that Mr Leighton be a "trustee" but a "trustee of the trust estate". In my view, on either construction of the role of Mr Leighton (see [50] above), the "trust estate" included the shares held and the income earned from the share trading. The corpus of the trust estate changed over time consistent with the share trading. And for the reasons earlier identified, the "income" of that "trust estate" was "affected by an ... express or implied trust" in favour of Salina and Kolton. Mr Leighton was not administering or controlling the shares and the income derived from the share trading for his own benefit. He was doing it for Salina and Kolton under the terms of their respective Director and Management Services Agreement. In both instances, those Agreements expressly stated that he was an independent contractor: cl 7.2. That is not determinative: cf *New Zealand Netherlands Society "Oranje" Inc v Kuys* [1973] 2 All ER 1222 at 1229-1230 and *Noranda Australia Ltd v Lachlan Resources NL* (1988) 14 NSWLR 1. The management services he undertook included responsibility for the "purchase, sale, settlement and safekeeping of securities" for the benefit of Kolton or Salina, as the case may be. Put another way, the "trust estate" was synonymous with the trust property – the shares and the income which was under his direct administration and control: see [34] – [35] above. It was that trust property which gave rise to the income derived by the trustee, the trustee having satisfied all of the tests in s 98(3) of the 1936 Act.²⁰

Subsection 248(1) provides that the definition of trust in Sec. 104(1) while apply for purposes of the Act while subparagraph 108(1)(j) provides that a trust will include an *inter vivos* trust and a testamentary trust except in certain instances related to commercial, deferred income plan and unit trusts.

Since subsection 108(1) is in subdivision k it is relevant in adding body to Sec. 104(1) while "testamentary trust" is defined in Sec. 108(1)(i) to include both trusts and estates of a certain character while "*inter vivos* trust" is defined in Sec. 108(1)(f) to mean any trust other than a testamentary trust. For purposes of the Act then it could be argued that the term "trust" if used alone includes estates while if the term estate is used a trust is not included. If the term testamentary trust is used only those arrangements described in Sec. 108(1)(i) will be targeted.

By virtue of the fact that an estate appears to be provided for in the definition of trust for purposes of the Act all of the provisions which provide favorable or unfavorable treatment for trusts and property held under them could also apply to estates. If certain provisions are targeted exclusively at estates, trusts are not captured²¹. The consistency of the legislative thought on what "a trust" includes for purposes of the Act would not be the best however if this were the case. Both are used in Sec. 70(3) when only "trust" would have been sufficient, subsections 70(7)-(8) use both terms, most likely due to the fact that both are significantly needed in the particular instance, subparagraph 212(1)(c) also uses both and so does Sec. 128(2)(b), apparently without reason if the statutory logic above is valid, while Sec. 164(6) cites only estates, expressly disqualifying trusts. If the cascading of the trust definition in Sec. 108(1)(j) for purposes of the Act is relevant there would appear to be minor redundancy in Sec. 70(3) and 212(1)(c). There could be an argument against the above when one considers that the term "estate" as defined in Sec. 248(1) is that in the definition in Sec. 104(1) as well. Equally ambiguous is the fact that the definition of "trust" in Sec. 248(1) does not refer to the Sec. 108(1)(j) definition directly while the latter is to apply only for certain purposes of subdivision k. This argument represents the more valid statutory operation: that Sec. 108(1)(j) does not apply for purposes of the Act and it has no bearing on the Sec. 104(1) targeting as that provision relates to the Act as a whole since ITA convention is that if such subdivisional definitions are to be valid for purposes of the whole Act Sec. 248(1), (or some other bridging provision), must provide for such.

²⁰ See also the Aust. case of *Nekon Pty Ltd v Commissioner of State Revenue* [2010] TASSC 2 (16 February 2010) for an instance of litigation over an Act that seemingly did not differentiate between types of ownership.

²¹ See an example of exactly this reasoning in *Paul Hess and Her Majesty The Queen*, 2011 TCC 360, whereby the Tax Court considered the difference in terminology used for filing purposes, exempting the taxpayer.

Under numerous Estate Administration/Trustee Acts the definition of "trust" includes duties incidental to the office of personal representative of a deceased person however the Ontario provincial Trustees Act from which this reference was drawn was enacted in 1970 where prior to that time, and after, the ITA used both the terms "estate" and "trust" for eons in various provisions. The same holds true with respect to section 2 of the Ontario Estates Administration Act where property devolves to and becomes vested in the legal representative "as trustee for the persons by law beneficially entitled thereto". If the two terms are to be treated as the same tax entity why would subdivision k, Sec. 70(6)-(7)-(8), 164(6), or 212(1)(c) and virtually every tax treaty Canada has entered in to make specific reference to one, the other, or both in certain provisions and not others? Clearly one, the other, or both are to be expressly captured in the particular instance and the legislators recognized consistently their difference and lack of equivalence under the Act.

An "estate", in the context in which our Act refers to it, is not equivalent to a trust and unless the Act provides so²² favorable provisions expressly targeted at trusts may not be available to incompletely administered estates while by the same principle unfavorable provisions will be avoided.

This is one of the most important technical deficiencies in the Act concerning the taxation of property passing on death or being held under trust for and although the Act's "official commentators" may be quite quick to point out that "an estate" and a "trust" are "almost" the same tax entity, they are not nor have they been recognized as equivalent under the Act by the use of the terms "estate" and "trust".

It's important since, while there has not been extensive litigation on the issue, taxpayers may choose to transact with the two different entities in arranging affairs, in a testamentary situation, that can cause "abnormal" consequences such as:

- ... Transferring interests in estates with their nebulous rights thereto rather than in the trusts where their interests are more codified,
- ... Transferring property to a general estate, even for consideration, upstream of a trust that will result out of its administration,
- ... Disclaiming interests in estates that do not affect their possible interests in any trusts that arise,
- ... The possibility of a string of differing tax years for trusts that arise out of one estate depending on when the executrix assents to title apportionment and trust creation,
- ... The creation and/or assignment of estate debt that alters pre-assented-to-creation trust interest values post transfer of the interests thereunder,

to name five.

"Person acting for another – Sec. 159(1)"

(1) For the purposes of this Act, where a person is a legal representative of a taxpayer at any time,

(a) the legal representative is jointly and severally liable with the taxpayer

(i) to pay each amount payable under this Act by the taxpayer at or before that time and that remains unpaid, to the extent that the legal representative is at that time in possession or control, in the capacity of legal representative, of property that belongs or belonged to, or that is or was held for the benefit of, the taxpayer or the taxpayer's estate, and

(ii) to perform any obligation or duty imposed under this Act on the taxpayer at or before that time and that remains outstanding, to the extent that the obligation or duty can reasonably be considered to relate to the responsibilities of the legal representative acting in that capacity; and

(b) any action or proceeding in respect of the taxpayer taken under this Act at or after that time by the Minister may be so taken in the name of the legal representative acting in that capacity and, when so taken, has the same effect as if it had been taken directly against the taxpayer and, if the taxpayer no longer exists, as if the taxpayer continued to exist.

²² which it does in one certain instance: the "testamentary trust"

Subsection 159(1) previously, charges the trustee with joint and several liability with her trust for the payment of any taxes under the Act. For an interesting case dealing with the equivalent provision in the Australian Income Tax Assessment Act see *Barkworth Olives Management Ltd v. Deputy Commissioner of Taxation*²³ where the trustee attempted to state that he was not personally responsible for a \$81 M tax liability of a trust. The Supreme Court Of Queensland found, after an examination of considerable jurisprudence, that:

[8] Section 254 provides:

“Agents and trustees

(1) With respect to every agent and with respect also to every trustee, the following provisions shall apply:

(a) He shall be answerable as taxpayer for the doing of all such things as are required to be done by virtue of this Act in respect of the income, or any profits or gains of a capital nature, derived by him in his representative capacity, or derived by the principal by virtue of his agency, and for the payment of tax thereon.

(b) He shall in respect of that income, or those profits or gains, make the returns and be assessed thereon, but in his representative capacity only, and each return and assessment shall, except as otherwise provided by this Act, be separate and distinct from any other.

(c) If he is a trustee of the estate of a deceased person, the returns shall be the same as far as practicable as the deceased person, if living, would have been liable to make.

(d) He is hereby authorized and required to retain from time to time out of any money which comes to him in his representative capacity so much as is sufficient to pay tax which is or will become due in respect of the income, profits or gains.

(e) He is hereby made personally liable for the tax payable in respect of the income, profits or gains to the extent of any amount that he has retained, or should have retained, under paragraph (d); but he shall not be otherwise personally liable for the tax.

(f) He is hereby indemnified for all payments which he makes in pursuance of this Act or of any requirement of the Commissioner.

(g) Where as one of 2 or more joint agents or trustees he pays any amount for which they are jointly liable, the other or others shall be liable to pay him each his equal share of the amount so paid.

(h) For the purpose of insuring the payment of tax the Commissioner shall have the same remedies against attachable property of any kind vested in or under the control or management or in the possession of any agent or trustee, as he would have against the property of any other taxpayer in respect of tax.

(2) In subsection (1), **tax** includes the general interest charge under section 163AA, former section 170AA, subsection 204(3), former subsection 221AZMAA(1), former subsection 221AZP(1), former subsection 221YD(3) or former section 221YDB, additional tax under former Part VII and shortfall interest charge.”

[13] Each notice of assessment was issued to the appellant as trustee of a described trust, it identified the relevant income year, it specified the relevant taxable income (described as “Your Taxable Income”) and relevant penalties, and it asserted the amount payable and the date upon which the amount payable fell due for payment. Objections against the assessments, amended assessments and penalty assessments were lodged but those objections remained unresolved.

[14] Section 255-45 of TAA 1953 provides that a certificate signed by the Commissioner, a Second Commissioner or a Deputy Commissioner covering one of the matters stated by s 255-45(2) or (3) is prima facie evidence of the matter in a proceeding to recover an amount of tax-related liability.

23 [2010] QCA 80 (9 April 2010)

The respondent relied upon such a certificate. It verified that each of the notices of assessment and amended assessment was made and served upon the appellant and certified that \$81,425,884.83 was due by the appellant to the Commonwealth.

[15] The appellant's defence admitted that at all relevant times it was the trustee of the trusts as described in the notices of assessment, that it received the notices of assessment and amended assessment as alleged by the respondent, and that it had not paid any amount of income tax for any of the tax years in accordance with the notices of assessment nor any amount of the administrative penalties and general interest charges assessed by the Commissioner. The appellant pleaded that it was not liable because it had not received the money which constituted the assessed taxable income. In opposition to summary judgment the appellant adduced affidavit evidence from its director, Mr Pollard, to this effect: the appellant was at the relevant times and it remained a trustee of the trusts described in the various notices of assessment and amended assessment; each notice of assessment and notice of amended assessment was issued to the identified trust; and in each case the income assessed to tax was money that did not come to the appellant in its representative capacity or at all.

...

[20] On the other hand, if s 254(1)(e) does operate, its operation could not be limited to execution after a judgment for a tax debt has been obtained. A judgment for a tax debt incurred by a trustee as trustee does not limit the respondent's rights to execution in the way proposed by the respondent and it also does not authorise direct recourse to the trust assets.[6] The judgment in this case was given in the form appropriate for a debt: "...the Defendant pay to the Plaintiff the amount of \$81,425,884.83...". Under that form of judgment the respondent is entitled to seek recourse to the appellant's assets to recover the full amount of the judgment and as the respondent's senior counsel acknowledged in argument, the respondent is entitled to apply to wind up the appellant if the judgment debt is not paid. Furthermore, whatever remedies may be given by s 254(1)(h) the operation of that provision is not expressed to be conditional upon the existence of a judgment against the trustee (or agent);[7] and even if the remedy given by that provision were predicated upon the existence of a judgment for a tax debt, that would provide no ground for implying that a judgment may be ordered against a trustee (or agent) for an amount which (on the present hypothesis) s 254(1)(e) provides that the trustee (or agent) is not liable to pay.

[21] But although I would reject that aspect of the respondent's argument, I would uphold the respondent's argument that an analysis of the relevant statutory provisions and their interrelationship with each other demonstrates that it was entitled to summary judgment.

[22] It must be acknowledged that the question of statutory construction is not straightforward. So much is sufficiently indicated by the tentative remarks about the relation between s 89 of the Income Tax Assessment Act 1922-1928 (Cth) (the predecessor of s 254) and s 31 of that Act (the predecessor of Div 6 of Pt III) in the joint judgment of Rich and Dixon JJ in *Howey v Federal Commissioner of Taxation*, [1930] HCA 45; (1930) 44 CLR 289 in the course of which their Honours observed that s 89 enables the Commissioner to assess a trustee, "but it is not easy to say precisely in respect of what income."

[23] The taxation of the income of trust estates is dealt with in Div 6 of Pt III of ITAA 1936. Broadly speaking, the "net income" of a trust estate is equivalent to the amount which would be the taxable income if the trust estate were an Australian resident taxpayer. (For ease of reference, I will refer to the net income of the trust estate by the abbreviation "trust income".) In Div 6 of Pt III, s 96 states the general rule: a trustee is not liable as trustee to pay income tax upon the trust income except where the Act so provides. Accordingly, where tax is payable upon the trust income it is the beneficiary who is assessed and is liable to pay the tax unless some provision exceptionally renders the trustee liable to be assessed and to pay the tax. For present purposes it is sufficient to summarise the scheme of Div 6 of Pt III in the following very broad (therefore inevitably imprecise) terms: where a beneficiary not under a legal disability is presently entitled to the trust income then (subject to some qualifications not presently relevant) the trustee will not be liable to pay tax on the trust income and

the beneficiary or beneficiaries will be assessed and liable to pay that tax: s 97; if beneficiaries are presently entitled to all or part of the trust income but one or more of the beneficiaries is under a legal disability, the trustee is to be assessed and is liable to pay tax on all or a corresponding proportion of the trust income: s 98; and if no beneficiary is presently entitled to part of the trust income the trustee is to be assessed and is liable to pay tax in respect of a corresponding part of the trust income: ss 99, 99A.

[24] There are other provisions dealing with different scenarios, but the point which is relevant here is that, in specified cases, instead of a beneficiary or beneficiaries being assessed and liable to pay tax on the trust income the trustee must be assessed and is liable to pay the tax. This is such a case. We were informed by the appellant's senior counsel that the assessments were made under s 99A. It is convenient therefore to refer to some of its provisions, by way of example of the manner in which particular provisions in Div 6 of Pt III render trustees liable to tax as an exception to the general rule that beneficiaries are liable to pay the tax assessed upon the trust income. Section 99A(4) provides that in specified circumstances "the trustee shall be assessed and is liable to pay tax on the net income of the trust estate...". A different form of words is used in s 99A(4A), which provides that in the different circumstances it specifies "the trustee shall be assessed and is liable to pay tax on...part of the net income of the trust estate." These expressions are used throughout Div 6 of Pt III where liability to tax on trust income is imposed upon a trustee in lieu of the beneficiary.

[25] Section 161(1) provides that "every person" must, if required by the Commissioner by notice published in the Gazette, give to the Commissioner a return for a year of income within the period specified in the notice. Section 166 then provides that from the returns and any other information in the Commissioner's possession he shall make an assessment of the amount of the taxable income of any taxpayer and of the tax payable thereon. That provision may apply in relation to the assessment of trustees under Div 6 of Pt III, but if it does not then s 169 applies. Section 169 provides that where under the Act any person is liable to pay tax the Commissioner may make an assessment of the amount of such tax. That an assessment is to be made in relation to a trustee rendered liable to pay tax on trust income under Div 6 of Pt III is also made clear by the relevant sections in Div 6 of Pt III themselves (including s 99A) and so much is yet again confirmed by the definition of "assessment" as meaning, where the taxpayer is the trustee of a trust estate, "the ascertainment of so much of the net income of the trust estate as is net income in respect of which the trustee is liable to pay tax (or that there is no income in respect of which the trustee is so liable) and of the tax payable on that net income (or that no tax is payable)...". It follows from these provisions that the amount shown on each notice of assessment in this case as "Your Taxable Income" must be understood as a reference to so much of the net income of the trust estate in respect of which the trustee is made liable to pay tax by s 99A, or other relevant provision in Div 6 of Pt III.^[9]

[26] Section 174 of ITAA 1936 provides that the Commissioner is obliged to serve a notice of an assessment in writing upon the person liable to pay tax. Section 175 provides that the validity of any assessment shall not be affected by reason that any of the provisions of the Act have not been complied with. Section 175A provides that a taxpayer who is dissatisfied with an assessment made in relation to the taxpayer may object against it in the manner set out in Part IVC of TAA 1953. Section 177(1) provides that the production of a notice of assessment or of duly signed copies shall be "conclusive evidence of the due making of the assessment and, except in proceedings under Part IVC of [TAA 1953] on a review or appeal relating to the assessment, that the amount and all the particulars of the assessment are correct." As was common ground in this appeal, these provisions apply in relation to the subject assessments. As was also common ground, the effect of reading s 175 with ss 175A and 177(1) is that the validity of an assessment is not affected by a failure to comply with any provision of the Act but a taxpayer may object to the assessment in the manner set out in Part IVC of TAA 1953.^[10]

[27] As the appellant argued, it is s 204 of ITAA 1936 which creates the legal consequence that the income tax specified as being payable in a notice of assessment becomes due and payable by the person liable to pay the tax to the Commissioner at a particular time.^[11] The liability of the taxpayer

to pay tax prior to assessment is “conditional” upon assessment and objection^[12] or “inchoate”.^[13] Service of the notice of assessment “crystallises the taxpayer’s liability under the Act and makes the tax assessed due and payable at a certain date (s 204)”.^[14] Section 204 relevantly provides that, subject to other provisions of Part VI, where the taxpayer’s return was lodged on or before the due date for lodgement, the tax payable by a taxpayer for a year of income becomes due and payable on the later of 21 days after the due date for lodgement of that return specified in the Gazette under section 161 for the year of income or 21 days after a notice of assessment is given to the taxpayer; otherwise the tax becomes due and payable 21 days after the due date for lodgement. ^[15] That is supplemented by s 255-5 of TAA 1953, which provides that an amount of a tax-related liability that is due and payable is a debt due to the Commonwealth, payable to the Commissioner, and may be sued for by the Commissioner, a Second Commissioner or a Deputy Commissioner. Accordingly, in circumstances in which s 99A rendered the appellant trustee liable to be assessed and to pay tax upon the trust income, the combined effect of s 204 of ITAA 1936 and s 255-5 of TAA 1953 was that the amount described in each notice of assessment as the amount payable became due and payable by the appellant as a debt due to the Commonwealth and payable to the Commissioner on the date specified in the notice as the due date for payment. Again, so much was common ground, subject to any operation of s 254(1)(e).

[28] The ground upon which the appellant contended that s 254(1)(e) excluded liability was, as sworn to by the appellant’s director, that the income assessed for tax was “money that did not come to the [appellant] in its representative capacity, or at all.” To treat that evidence as throwing doubt either on the amount of the tax payable by the appellant or on the amount of the trust income would be contrary to s 177(1) of ITAA 1936 (under which both amounts were conclusively established for the purposes of these proceedings by each notice of assessment) and s 204 of ITAA 1936 and s 255-5 of TAA 1953 (which rendered the amount of tax specified in each notice of assessment a debt due and payable by the appellant to the Commonwealth at the time specified in the notice of assessment). On any view there is a substantial conflict between s 254(1)(e) and those statutory provisions summarised earlier which render trustees liable for tax in accordance with s 99A and similar provisions in Div 6 of Pt III. That conflict must be alleviated, as far as possible, “by adjusting the meaning of the competing provisions to achieve that result which will best give effect to the purpose and language of those provisions while maintaining the unity of all the statutory provisions”, a process which may require the Court to determine which is the “leading provision”, which is the “subordinate provision”, and “which must give way to the other.”^[16]

[29] The better construction of s 254(1)(e), at least when it is read in isolation from the other provisions I have discussed, appears to be that it imposes and qualifies personal liability only where the agent or trustee retains or fails to retain money which comes to the agent or trustee after the making of an assessment under s 254(1)(b). That accords with the terms and structure of s 254(1) as a whole and it is suggested by the expression in s 254(1)(d) “tax which is or will become due”, an expression that postulates a degree of certainty about the fact and amount of the tax liability which might not be present before a notice of assessment is served.^[17] Section 254(1)(e) would therefore ordinarily limit the liability of an agent or trustee to any amount of money received by the agent or trustee after the due date for lodging a return^[18] and thus after the derivation of the income with reference to which the tax was assessed. On this construction of s 254(1)(e), the appellant’s argument would produce quite remarkable results in the case of a trustee who, unlike other trustees, and unlike agents generally, is made liable under Div 6 of Pt III. Tax assessed to the trustee upon trust income, which otherwise would become due and payable shortly after issue of the notice of assessment, would not become due or payable unless and until the trustee, in that capacity, subsequently received more income in the form of money sufficient to pay the tax. That would be so even if the trust income with reference to which the tax was assessed was derived in the form of the receipt of money by the trustee and even though no beneficiary was presently entitled to any of the trust income or potentially liable for the tax. These are such surprising results as to cast doubt upon the construction which produces them.

[30] Other constructions of s 254(1)(e) may also be open, but on any construction which produces the limitation of liability for which the appellant contends there is a substantial conflict between it and those provisions which render trustees liable for tax with reference to s 99A and similar provisions in Div 6 of Pt III. In my opinion, the limitation of liability in the general provision in s 254(1)(e) must give way to those specific provisions in Div 6 of Pt III which impose liability to tax upon the trustee as an exception to the general rule that the beneficiaries are liable. Whilst s 254(1)(e) qualifies the personal liability s 254 creates, it should not be construed as qualifying the trustee's personal liability created by operation of s 204 and the other provisions mentioned earlier where, as in this case, a trustee is expressed to be liable to tax under a provision of Div 6 of Pt III; that is so, at least where, as in this case, the trustee was trustee during the period in which the trust income was derived and up to the time when the liability accrued under s 204. [19]

[31] In support of a contrary construction the appellant's counsel referred to the following passage in *Federal Commissioner of Taxation v Prestige Motors Pty Ltd* [1994] HCA 39; (1994) 181 CLR 1:

"By virtue of s 254(1)(b), the trustee was obliged to make a return in respect of any income derived by him in a representative capacity. Although s 254(1)(b) provides that the trustee is to be assessed on the return, the trustee is not liable to pay tax on any of that income save in respect of so much of the net income of the trust as is brought to tax by s 98, s 99 or s 99A. Where the trustee is liable to pay tax which is or will become due, the trustee is authorized and required to retain sufficient funds to meet that payment out of "any money which comes to him in his representative capacity"(s 254(1)(d)) and, to that extent but only to that extent, the trustee is personally liable for that tax (s 254(1)(e)). The trustee is not liable to be assessed to tax or to pay tax in respect of any share of the net income of a trust estate which is included in the assessable income of a beneficiary under s 97. But, where the trustee is liable to be assessed to tax, the assessment imposes a debt to be borne by the estate [*Deputy Federal Commissioner of Taxation v Brown* [1958] HCA 2; (1958) 100 CLR 32, at p 42]. Section 254(1)(b) directs that "each return and assessment shall, except as otherwise provided by this Act, be separate and distinct from any other".

[32] That passage supports the appellant's argument in so far as it conveys that s 254(1) comprehensively deals with the personal liability of trustees for tax. Considerable weight must be given to this considered statement by the High Court, but in my respectful opinion it does not foreclose the present question in the appellant's favour. The High Court was not called upon to decide and it did not decide whether or not trustees might be liable to make returns under s 161(1), to be assessed on such returns, and to pay tax under the statutory provisions discussed earlier in these reasons; and the Court did not decide whether or not s 254(1)(e) applied to limit the trustee's liability for tax in a case of this kind. Reference to the question in issue in *Federal Commissioner of Taxation v Prestige Motors Pty Ltd* and the authority cited in the quoted passage suggests that it should not be read as requiring the conclusion that s 254(1)(e) applies in a case such as this.

[33] The question was whether a notice of assessment was effective where the notice did not name the trustee. At first instance the Federal Court declared that the income tax assessed to the trustee was due and payable by the trustee to the Commissioner pursuant to s 204 of ITAA 1936.[21] The Full Federal Court reversed that decision [1993] FCA 580; (1993) 47 FCR 138, but the High Court set aside the decision of the Full Court. That case therefore did not define the relationship between s 254 and the statutory provisions which give conclusive effect to notices of assessment. The effect of ss 174, 177 and 204 of ITAA 1936 was, however, discussed in subsequent observations in the joint judgment [1994] HCA 39; (1994) 181 CLR 1:

"Service of the notice of assessment brings to an end the process of assessment"

As Kitto J explained in *Batagol v Federal Commissioner of Taxation* [(1963) [1963] HCA 51; 109 CLR 243], service of the notice of assessment on the taxpayer fixes the ascertainment of the amount of the taxable income and the amount of the tax payable by the taxpayer and brings to an end the process of assessment. His Honour said [ibid, at pp 251-252]:

"[I]f the Commissioner, having gone through the process of calculation, serves on the taxpayer

a notice that he has assessed the taxable income and the tax at specified amounts, the tax becomes by force of the Act due and payable on the date specified in the notice or (if no date is specified) on the thirtieth day after the service of the notice: s 204. Thus, and thus only, there is brought about an 'ascertainment' of the taxable income and of the tax ... The word 'ascertainment' being understood in this sense, the definition of 'assessment' means, in my opinion, the completion of the process by which the provisions of the Act relating to liability to tax are given concrete application in a particular case with the consequence that a specified amount of money will become due and payable as the proper tax in that case."

Service of the notice on the taxpayer brings the process of assessment to an end in the sense that, in conformity with s 174(1), the notice, which necessarily reflects the requisite elements of the calculation that has been made, is served after the making of that assessment.

In *Batagol*, Kitto J was directing his comments to an assessment of a taxpayer to tax on his own taxable income. In applying the provisions of the Act to an assessment of a trustee to tax in respect of the net income of the trust estate, it is necessary to take into account the definition of "assessment" in s 6(1) as it relates to an assessment of a trustee to tax in respect of such income. Hence the process of assessment in such a case – and the notice – must specify, not the taxable income, but "so much of the net income of the trust estate as is net income in respect of which the trustee is liable to pay tax".

[34] The notice of assessment in that case was addressed to the "Prestige Toyota Trust" and, like the notices of assessment here, it included a statement that:

"Your taxable income is ..."

[35] The High Court concluded that "the recipient of the notice...would have understood it as a notice of assessment directed to the trustee of the Prestige Toyota Trust, and that the notice relates to the assessment of the trustee to tax in respect of a share of the net income of that trust";[24] and that, "the notice purported to define the tax liability of the trustee to be met out of money in the trust estate" and that the notice of assessment was therefore "a notice of assessment of the respondent to tax".[25]

[36] As to the liability being met out of money in the trust estate, the authority cited in the passage quoted in paragraph 31 of these reasons was *Deputy Commissioner of Taxation v Brown* [1958] HCA 2; (1958) 100 CLR 32. Significantly, that case did not concern a trustee who was rendered liable to pay tax on income of a trust estate derived by the trustee during the relevant year of income. The question in *Brown* was whether the Commissioner could recover from a person entitled in a distribution of a deceased's estate amounts she had received from the executors which were sufficient to cover the tax which had been assessed upon the executors by assessments and amended assessments made after they had fully administered the estate. The dictum of Dixon CJ in *Brown* cited in *Prestige Motors Pty Ltd* concerned the combined effect of ss 216, 217 and 254 of the Income Tax and Social Services Contribution Assessment Act 1936-1952 (Cth). Section 216 applied where a taxpayer escaped full taxation in his lifetime by reason of not having duly made full, complete and accurate returns: in that event the Commissioner was given the same powers and remedies against the trustees of the estate of the taxpayer in respect of the taxable income of the taxpayer as the Commissioner would have had against the taxpayer if he was still living, and consequential provisions (including the creation of a first charge on all the taxpayer's estate in the hands of the trustees for the amount of the tax) were provided for that purpose. Section 217 provided that, where at the time of a person's death, tax had not been assessed and paid on the whole of the income derived by that person up to the date of his death, the Commissioner should have the same powers and remedies for the assessment and recovery of tax from the trustees of that person's estate as he would have had against that person if that person was alive: again consequential provisions were made to give effect to that purpose. Importantly for present purposes then, the taxing provisions operated in relation to income derived by the deceased taxpayer rather than by the trustee.

[37] It was in that context that Dixon CJ observed:[27]

“The provisions of ss 216, 217 and 254 are specific: they do not in terms extend beyond the “trustees”. They are interpreted as imposing a liability upon the executors only *quoad* assets and as meaning by assessment to impose a debt owing by the estate: see *Stapleton v Federal Commissioner of Taxation* [(1955) [1955] HCA 58; 93 CLR 603, at p 618].”

[38] In *Stapleton v Federal Commissioner of Taxation* [1955] HCA 58; (1955) 93 CLR 603, the relevant provision in issue was again s 216 of the Income Tax and Social Services Contribution Assessment Act 1936-1953 (Cth). The question was whether the Commissioner was entitled to claim a first charge on the assets of a bankrupt vested in the Official Receiver in Bankruptcy to secure payment of the amount of amended assessments to tax issued after the bankruptcy and after the appointment of the Official Receiver or, alternatively, whether the Commissioner was entitled to prove against the estate in the same amount in priority to most of the secured creditors. Dixon CJ, McTiernan, Williams, Webb and Taylor JJ[29] construed s 216 as authorising the Commissioner to assess the trustees of the estate and proceed against them for recovery of the tax, “though he could not, of course, recover from them anything in excess of the value of the assets in their hands at the time of the assessment or coming to their hands thereafter (cf *Patterson v Federal Commissioner of Taxation* [(1936) [1936] HCA 57; 56 CLR 507 at pp 518, 519]).”

[39] *Patterson v Federal Commissioner of Taxation* [1936] HCA 57; (1936) 56 CLR 507, concerned s 62 of the Income Tax Assessment Act 1922-1932 (Cth), which gave the Commissioner the same powers and remedies for the assessment and recovery of tax from the executors and administrators as the Commissioner would have against the deceased person if that person were alive. In the context of that section, which rendered a representative liable to pay tax in respect of income derived by a taxpayer before the representative was appointed, it seems unsurprising that the Court concluded that the executors and administrators’ liability was “as representatives and extends only to the assets of the deceased coming to their hands or which ought to come to their hands.”[31]

[40] In summary, *Brown*, *Stapleton* and *Patterson* concerned taxing provisions which imposed a liability to tax upon a person who was appointed as a representative after the relevant income had been derived and who therefore had no opportunity during the period when that income was derived to make provision for any tax liability. Whilst s 254 might well have a similar operation in a similar case, there is no similar rationale for construing s 254(1)(e) as qualifying the ordinary operation of s 204 in its application to those sections in Div 6 of Pt III which expressly contemplate that a trustee will be made personally liable for tax as an exception to the general liability of beneficiaries.

Our subsection 159(1) has a broader scope since applies to not just the trust property itself but also beneficiaries for whom the trustee acts as well, as the trustee personally: the collection alternatives are 3 fold when considering the above case though there would be of course argument that once the income has been paid/payable to a beneficiary the trust’s tax liability in respect of it disappears.

The “Splintered 4 Quadrant” “Multi-faceted” Trust/Estate: What Our Act Actually Says and Why You Should Be Cautious in your Dealings with its Property

While a vast majority of trusts are recognizable and assessed based on the stated trustees or executors it should be noted that these are not the only parties who can be subject to assessment in respect of its property. The “targeting” provision that gives the trust its identity for purposes of the Act and turns it into “a taxpayer”, s. 104(1), opens up the parties against which an assessment can be based to those that are:

*...unless the context otherwise requires, be read to **include** a reference to the trustee, executor, administrator, liquidator of a succession, heir **or other legal representative having ownership or control of the trust property...***

and thus there are 4 quadrants of recognition who can deal with trust property who can attract assessment:

1. the trustee, executor, administrator, liquidator, succession heir or legal representative having ownership of **any of** the trust property
2. the trustee, executor, administrator, liquidator, succession heir or legal representative having control of **any of** the trust property

3. those not actual such parties since the provision refers to **only include**, not “mean”, having ownership of **any of** the trust property
4. those not actual such parties since the provision refers to **only include**, not “mean”, having control of **any of** the trust property.

Equally, unlike the rest of the subsection, **such a party need not have such characteristics in respect of all of the trust property** since when reading further in the subsection Finance has made specific provision for other types of trusts that:

*...a trust is deemed not to include an arrangement under which the trust can reasonably be considered to act as agent for all the beneficiaries under the trust with respect to **all dealings with all of the trust's property**...*

Such specifically allows for the valid argument that Finance sought to cast as wide as possible a net, especially given its opening identification process to a very broad cast of possible parties to capture any instance where any party has **any control or ownership of any of the trust's property**: the ITA does not seek to dwell on inter-“trustee” legal obligations but only seeks to capture any and all economic incidents of **any** the trust's property and **it doesn't differentiate who owns or controls it but instead identifies, for assessment purposes, anyone who “comes near it”, for tax realization.**

These primary 4 quadrants of trust identity can then be easily seen to open up, on a multiple faceted basis, to be, ownership or control by any party, on a trust property by property basis. “Ownership” or “control” were undoubtedly chosen to target since some trusts are created only *with loaned property without title transfer* and thus “control” captures such: but, it's interesting that the definition hasn't evolved to narrowing the discretion to identify to between the two, which, *presently it allows for both*²⁴.

So Finance has cast a “diamond” multi-faceted definition of “trust” (or “estate” for that matter) for purposes of the Act²⁵.

In other words, if the party fits within 1 to 4 above, then they can be subject to an assessment if they have dealings with **any** of the trust's property.

While under the ITA the shareholders and their corporation are maintained completely “opaque” through the corporate shell, and in the case of partnerships the same holds equally true to certain extents though attribute immediately gains from the property to the partners, in the case of trusts/estates the fact that ownership/control of the trust property is referenced statutorily, the constituting document, the trust deed, or named trustees/executors thereunder, are not the assessment target as such: those parties, **looking through the trust deed to who has ownership or control of the trust's actual property(ies), are.** Simply put, s. 104(1) isn't narrowed down to apply only to the trust document as a global item and named trustees/executors stated therein: it looks through it to the underlying property(ies) and who owns them, individually through the trust deed, or controls them. And, s. 104(1) further splits that ownership/control down to multiple parties and multiple properties since to do otherwise would disallow the broadness of the “ownership or control” referencing to allow some property to avoid capture. In short, even if you're not a named trustee, though have control over a particular property owned by it, you can be assessed since that is the targeting of identification for assessment under s. 104(1)²⁶.

24 And by ensuring both seem to apply *equally* the argument that one party either owns or controls property, while another does, precludes the argument from exempting that party from assessment.

25 Clearly there must be a trust in respect of it being subject to ownership/control by one party for the measured benefit of another, allowing the 3 certainties to exist.

26 This is further reinforced with the wording in s. 104(2) referring to multiple trustees, multiple trusts and multiple specified properties.

“Taxed as individual – Sec. 104(2)”

(2) A trust shall, for the purposes of this Act, and without affecting the liability of the trustee or legal representative for that person's own income tax, be deemed to be in respect of the trust property an individual, but where there is more than one trust and

**(a) substantially all of the property of the various trusts has been received from one person, and
(b) the various trusts are conditioned so that the income thereof accrues or will ultimately accrue to the same beneficiary, or group or class of beneficiaries,**

The SCC seems to have interpreted **differently** in detail, in the author's opinion, the actual wording of the liability provision, s. 104(1) in two of its pronouncements on trust identity and coverage in the ITA: Consolidated Holdings and Fundy Trust. In Consolidated²⁷ the SCC drilled down to the *individual executor* as a related party and **thus looked through the trust deed** to establish who, **individually**, controlled the trust property - being corporate shares - for vote casting purposes and thus *control purposes* - the subject of the litigation²⁸. In terms of *establishing residency* the SCC has looked to a **global party test** looking for the centrality of management of the actors and residency thereof, **on a global basis. In the author's opinion, the former is a correct perspective of the simple application of s. 104(1) and the latter isn't.**

This argument is **very important** in the face of recent SCC jurisprudence concerning issues of trust residency that *state that the residency of the trust must be determined as the residency of the centrality of point of effective management (POEM) of an indivisible taxpayer*, when, upon proper reading of the "identifying provision" - s. 104(1), *the alternative has clearly been provided for*²⁹.

While CRA will undoubtedly assess, *based on convention*, the named trustees/executors, that is not who they are limited to.

Estates

An "estate" within the context of the ITA provisions³⁰ consists of the property of the testator, within its widest definition, that passes to the legal representative on death pursuant to statutory authority or the will. The estate includes any property to which the testator was beneficially entitled before his death and pursuant to the death his legal representatives, be they executors or administrators, are compelled to deal with either pursuant to intestate law or the will in distributing it to parties entitled thereto.³¹ Certain forms of rights may arise to parties designated by the testator in his will that allow them to receive property not from or through the estate but pursuant to contractual/fiduciary situations in which the testator was formerly entitled and the distinction between such and those arising under a will/intestate law arises from the contractual arrangement in which the testator was involved. Such was the case in *Baltzan Estate v. Canada*³² where a testator stated in his will that his spouse would be entitled to the benefit of his R.R.S.P. if she survived him for thirty days and the Minister of National Revenue contended that the benefits flowed through the estate first then to her causing the R.R.S.P.s to be taxable in the hands of the estate. The relevant R.R.S.P. plans allowed the testator to designate a beneficiary if a designation was signed and delivered to the bank administering the plan and was acceptable by it before any payment was made whereby payment to the testator (or more accurately his estate) would not occur. The will designated the spousal beneficiary and she gained rights to the plan **directly from the agreement and not from the estate or the will** and the proceeds did not pass through the estate to be taxed.³³ As will be discussed, it's important to note the difference in the origin of the rights one creates when

such of the trustees as the Minister may designate shall, for the purposes of this Act, be deemed to be in respect of all the trusts an individual whose property is the property of all the trusts and whose income is the income of all the trusts.

This provision is needed for several reasons which include to disallow accessing marginal rates through creation of multiple trusts as well as amalgamating for assessment purposes. **Note that the draftsman felt it necessary to refer to all properties and provides the discretion to the Minister to amalgamate: until she does then s. 104(1) applies by default to follow ownership or control issues across multiple instances to the mass of possible parties specified therein.**

²⁷ [1974] S.C.R. 419

²⁸ See a subsequent subchapter on "the drunken trustee"

²⁹ At least in respect of the subject property

³⁰ related to those instances other than bankruptcy

³¹ See *Stapleton v. F.C.T.*, 93 C.L.R. 603, Halsbury's Laws of England, 4th Ed. Vol 17 para. 61-612. See also *In re: Estate of McKeena*, 51 D.T.C. 533.

³² 1990 2 C.T.C. 232, Sur. Ct. of Sask.. See also the recent UK case of *Fryer & Ors v Revenue & Customs* [2010] UKFTT 87 (TC) (17 February 2010) for instances where pension fund balances did "hit" an estate or tax purposes.

³³ See a similar situation in *Baird v. Baird*, 1990 2 W.L.R. 1412 (PC), where *Re: MacInnes*, 1935 1 D.L.R. 401 (SCC), and *Re: Shirley*, 1965 49 D.L.R. (2d) 474, were discussed as jurisprudence concerning the source of nominated beneficiaries' entitlements under pension plans while *In re Danish Bacon Ltd. Staff Pension Fund Trusts*, 1971 1 W.L.R. 248 also was commented on wherein it was held with respect to a nomination:

"First, although the nomination had certain testamentary characteristics, and not least that of being ambulatory, it

tax planning - very different consequences can result depending on their source.

A will may give an absolute gift but cut it down and impose a trust of varying duration in respect of it but the testator's intention must be clear³⁴. Superadded words may express wish/expectation but nothing more does not create a trust³⁵. The person named in the will or codicil upon which the responsibility is placed to ensure that the testamentary instructions are enforced is commonly referred to as the executor since habitually the bare legal title of the estate will vest in him by statutory authority and thus he must fulfill the duties of the office and execute the appropriate distributions. Since he has assumed the obligation of dealing with the legal title to the assets of the deceased a charging of the tax liabilities in respect of the estate, no matter how long it lasts in its form, against the executor is rational since it will only be he who is in the position to deal with the estate property. If the will doesn't provide that a certain person should be executor, or if there isn't any valid will applicable (intestacy) then the Courts (Surrogate) will appoint "an administrator" of the estate and once done he assumes the same responsibilities as the executor with respect to the estate property.

It is not here where you will find a rendition of the mechanics of the provincial estate administration/property devolution acts: they can be found generally now on-line for your inspection.

An executor or administrator of an estate may be deemed by provincial statute law relating to the devolution of property that in respect of certain types of property they are "trustees". **In a loose sense** an executor or administrator may be regarded as a trustee regardless since in effect they are holding legal title of property that is not their own that will be distributed to those beneficially interested, however, they are not obliged in the role of an executor/administrator to distribute legal title until the debts of the deceased have been extinguished and only then can they be described as "trustees".³⁶ If the property is specifically bequeathed to an executor upon a trust then he becomes a trustee of it when he has executed a declaration of this in respect of it or has severed it from the estate, thus sheltering it from estate claims. In *Pagels v. MacDonald*³⁷ the Court held:

"When the executor has performed all his executorial functions he may become a trustee in various ways: he may become a trustee by merely continuing to hold property after his functions as executor have been performed. When the executor becomes a trustee of **ascertained** property, the beneficiaries then become owners of equitable interests in **that property**. Thus a beneficiary under a will does not, by reason of the will alone, obtain any title, legal or equitable, **to any asset forming part of the testator's estate. When he does obtain such a title, he obtains it as a result of the administration of the estate of the testator according to law and in accordance with the dispositions of the will.**"

In *Re: Cockburn Danckwert*³⁸ J. held that:

"Whether persons are executors or administrators, once they have completed the administration in due course, they become trustees holding for the beneficiaries, either on an intestacy or under the terms of

took effect as a contractual arrangement and not as a disposition by the deceased. The contributions and interest did not come to the deceased and then pass on from him by force of his will or the nomination: they went directly from the fund to the nominee, and formed no part of the estate of the deceased.

.....
Despite certain testamentary characteristics, the nomination takes effect under the trust deed and rules, and the nominee in no way claims through the deceased."

The court in *Baird* held:

"Contracts and trusts are not mutually exclusive concepts and it does follow that, because a member has a right (whether in terms contractual or fiduciary) to have a payment made to his estate after his death in certain events in default or on failure of prior interests limited by the terms of the contract, the designation of those prior interests in accordance with the terms of the contract necessarily constitutes a testamentary disposition of trust property which is freely disposable by him during his lifetime."

The terms of the arrangement must be examined to ascertain whether it allows the testator the power to dispose of the amount standing to his credit under the scheme **during his lifetime** in that a disposition of the interest therein upon death will be testamentary: the testator can exercise effective control over the funds *inter vivos*.

34 *Re: Fraser*, 1942 2 W.W.R. 497.

35 *Re: Richardson Estate*, 1949 1 W.W.R. 1075, *Re: Iversen Estate*, 1956 19 W.W.R. 524, *Re: Fletcher Estate*, 1953 9 W.W.R. 566, *Re: Duncan*, 1953 10 W.W.R. 289, *Brice v. Brice & Public Trustee for Alberta*, 1971 1 W.W.R. 481, and *Re: Quinn*, 1984 52 B.C.L.R. 273.

36 See *Wellington Harness Racing Club Inc. v. Hutt City Council* [2004] 1 N.Z.L.R. 82 NZHC where the mere use of the term in a national Act was not enough to create a trust in the equity sense. The term's use was, essentially, found to be for limited statutory scheme.

37 1936 54 C.L.R. 519 at 526.

38 [1957] 2 All E.R. 522, at pg. 524.

the will..."

An executor is not to be equated with a trustee until all of the debts and liabilities of the deceased and estate are discharged or provided for and the residue has been ascertained. It is this residue that can then become the property of a trust accepted by the executor however, it is not until the estate has been administered that a trust in respect of its residue can come into existence.³⁹

Trusts Arising out of Estates

"A trust" is an equitable obligation binding a person to deal with the legal title of property over which he has control though most generally also legal ownership, for the benefit of persons described in the trust agreement or will by the settlor/testator. Trusts are a means by which the legal title to property may be held by one person while the benefits, ultimate or interim, accrue to or are currently realized by those persons equitably entitled to them. From this definition, one can clearly see the similarity between a trust arising out of a will and the unadministered estate which is subject to that will however there are some very fundamental differences. The executors or administrators of estates are not compelled in equity to be concerned with the proportionality of benefits, realized through their activities or spontaneously, inuring to the income or capital beneficiaries of the estate. They are instead simply concerned with the legal title to property in the estate and how it becomes vested, after the debts and liabilities have been extinguished, in the proper parties as per the will.

Until the residue of the estate is ascertained the subject matter, being the property of the trust which results, cannot be ascertained. In winding-up the estate, the executor/administrator must ascertain all of the liabilities of the estate of the deceased and extinguish or make provision for them, in many cases pursuant to the will. They may include trade accounts, credit card balances, income tax liabilities, mortgage liabilities and lease obligations etc.. It is only after the liabilities against the estate of the deceased have been extinguished or provided for that property can be considered clear of implicit encumbrances and transferred to beneficiaries or trustees named in the will upon the implicit/explicit assent of the executor.

It is also quite common for the testator's beneficiaries to have to assume estate debt as a consequence of receiving property. When and to what extent particular beneficiaries are to assume this debt have repercussions on the integration of tax-costs of property under the section 107 mechanics and on transfers of their estate/trust interests if such is to be the case.

One of the most classic instances where an unadministered estate was recognized as separate and distinct from a residuary trust that could arise on the completion of the administering of an estate was that of the Commissioner of Stamp Duties (Queensland) v. Livingston.⁴⁰ The Privy Council provided in is often quoted case, concerning whether a deceased taxpayer had formerly held a choice in action enforceable against the executors or a beneficial interest enforceable against trustees at the time of death, that:

"The testator's assets consisted of real and personal estate in New South Wales and real and personal estate in Queensland. Mrs. Coulson died on July 8th, 1950, intestate, having married her second husband on June 22nd, 1950. She thus survived her first husband by less than two years, and at the date of her death, his estate was still in the course of administration, no clear residue had been ascertained, and, consequently, no final balance payable or attributable to the shares of residuary beneficiaries had been determined. It is essential to the decision of this case that Mrs. Coulson's rights at her death were the rights of a person interested in a dead man's **unadministered** estate.

What, then could be the "beneficial interest in property" that was charged by this Act as the subject of a succession on Mrs. Coulson's death?... One way or the other then, if there is to be a taxable succession, it must be because she died owning a beneficiary interest in real property in Queensland or had beneficial personal property interests locally situate in Queensland. This is the way in which the issue has been posed in the judgments of the High Court of Australia, and in their Lordship's view it is the correct formulation of the problem.

When Mrs. Coulson died, she had the interest of a **residuary** legatee in the testator's unadministered

39 Re: Ponder, 1921 2 Ch. 59, Palmer v. Simmonds, 1854 2 Drew 221.

40. (1965) A.C. 694 (H.L.), as referred to in The Queen v. Eide Estate, 74 D.T.C. 6286.

estate. The nature of that interest has been conclusively defined by decisions of long-established authority, and its definition no doubt depends upon the peculiar status which the law accorded to an executor for the purposes of carrying out his duties of administration. There were special rules which long prevailed about the devolution of freehold land and its liability for the debts of a deceased, **but subject to the working of these rules whatever property came to the executor virtue official came to him in full ownership, without distinction between legal and equitable interests. The whole property was his. He held it for the purpose of carrying out the functions and duties of administration**, not for his own benefit; and these duties would be enforced upon him by the Court of Chancery, if application had to be made for that purpose by a creditor or beneficiary interested in the estate. Certainly, therefore, he was in a fiduciary position with regard to the assets that came to him in the right of his office, and for certain purposes and in some aspects he was treated by the court as a trustee. "An executor," said Kay J. in *In re: Marsden*, "is personally liable in equity for all breaches of the ordinary trusts which in Courts of Equity are considered to arise from his office." He is a trustee "in this sense." **It may not be possible to state exhaustively what those trusts are at any one moment. Essentially, they are trusts to preserve the assets, to deal properly with them, and to apply them in a due course of administration for the benefit of those interested according to that course, creditors, the death duty authority, legatees of various sorts, and the residuary beneficiaries. They might just as well have been termed "duties in respect of the assets" as trusts. What equity did not do was recognize or create for residuary legatees a beneficial interest in the assets in the executor's hands during the course of administration. Conceivably, this could have been done, in the sense that the assets, whatever they might be from time to time, could have been treated as a present, though fluctuating, trust fund held for the benefit of all those interested in the estate according to the measures of their respective interests. But it never was done. It would have been a clumsy and unsatisfactory device from a practical point of view; and, indeed, it would have been in plain conflict with the basic conception of equity that to impose the fetters of a trust upon property, with the resulting creation of equitable interests in that property, there had to be specific subjects identifiable as the trust fund. An unadministered estate was incapable of satisfying this requirement. The assets as a whole were in the hands of the executor, his property; and until administration was complete no one was in a position to say what items of property would need to be realized for the purposes of that administration or of what the residue, when ascertained, would consist or what its value would be. Even in modern economies, when the ready marketability of many forms of property can almost be assumed, valuation and realization are very far from being interchangeable terms. At the date of Mrs. Coulson's death, therefore, there was no trust fund consisting of Mr. Livingston's residuary estate in which she could be said to give any beneficial interests, because no trust had as yet come into existence to affect the assets of his estate...**

... The law as they were stated it was reaffirmed by the House in the same terms in *Dr. Barnardo's Homes v. Special Income Tax Commissioners*. It is sufficient to quote two short passages from speeches in that case. Viscount Finlay said: "... the legatee of a share in the residue has no interest in any of the property of the testator until the residue has been ascertained. His right is to have the estate properly administered and applied for his benefit when the administration is complete"; while Viscount Cave says: "When the personal estate of a testator has been fully administered by his executors and the net residue ascertained the residuary legatee is entitled to have the residue, as so ascertained, with any accrued income, transferred and paid to him; but until that time he has no property in any specific investment forming part of the estate or in the income from any such investment, and both corpus and income are the property of the executors and are applicable by them as a mixed fund for the purposes of administration."...

"It is idle to use such phrases as... that she had an 'interest' in his estate." If the present appeal is tried by this test, which they accept as the correct one, their Lordships regarded as clearly established that Mrs. Coulson was that entitled to any beneficial interests in any property in Queensland at the date of her death. What she was entitled to in respect of her rights under her deceased husband's will was a choice in action, capable of being invoked for any purpose connected with the proper administration of his estate;

and the local situation of this asset, as much under Queensland law as any other law, was in New South Wales, where the testator had been domiciled and his executors resided and which constituted the proper form of administration of his estate. For these reasons their Lordships agree with the view of the law that is expressed in the opinion of those members of the High Court, Fullagar, Kitto and Menzies J.J., who formed the majority on this appeal. They have studied, too, the reasoning of The Supreme Court of Canada on a similar issue in *In re: Steed and Raeburn Estates; Minister of National Revenue v. Fitzgerald* (1949 S.C.R. 453), and they note that the views that they have expressed in this opinion coincide with the judgments delivered by four out of five of the members of that court."⁴¹

While certain provincial devolution Acts statutorily provide that "trust" come into existence in respect of the deceased's property it's the author's opinion that this is mere codification of common law principles above enunciated. Whether the codification can be relied upon for purposes of the CITA is questionable: the legislators ostensibly did not wish to incorporate the diversity of provincial codifications into their Federal Act thus the sometimes concurrent usage of both terms "estate" and "trust" and specific usage of one, the other, or both in various provisions previously commented upon.⁴²

Besides the trusts created by statute for the purposes of and under the provincial Devolution of Estate Acts and Trustee Acts, technically, in order for a trust to be constituted there must be three certainties in the arrangement which may be created by way of transfer of legal title to another party⁴³ or by way of unilateral declaration.⁴⁴ The three certainties are that the intent or wish to create a trust can be ascertained, the property which is to be subject to the trust can be ascertained and the parties who are to be beneficiaries, and the extent of their interest, under the trust can be ascertained. Obviously, trusts may be directly created under a will by providing for these three certainties in the language used however until the debts and liabilities of the estate are netted out against the property to be held the arrangement suffers from a lack of certainty of the property to be held and thus cannot constitute a trust in the form of a residuary estate.⁴⁵ In the case of *inter vivos* trusts valuable consideration must be contributed to the trust and there must arise the existence of a fiduciary relationship between the ultimate parties to benefit and the holder of the property. The property subject to the trust must be ascertainable in order for the trust to be constituted: it is not enough that a description of property that might exist, the extent of the property must be ascertainable so as to lay the foundation of the beneficiaries' rights and the trustees' duties.⁴⁶ There need not be an overly meticulous description of the property: a description of the steps to be taken in ascertaining the property would be enough to allow the courts to establish the extent of interests and trustee duties if such is required.⁴⁷

The legal title to property⁴⁸ need not vest in a trustee in order for the trust to arise but instead the legal title

41 See also *Robertson v. F.C.T.* 1941, 65 C.L.R. 338, when properly held in an unadministered estate was held by the Australian High Court not to be held in a trust for purposes of the Australian Land Tax Assessment Act as well as *Re: Beardmore Trusts*, 1951 O.W.N. 728, and *Ogilvie-Five Roses Sales Ltd. v. Hawkins et al.*, 1979 4 E.T.R. 163, as well as *Smith v. Layh*, 90 C.L.R. 102, and *New Zealand Insurance Co. Ltd. v. Commr. of Probate Duty*, 1973 V.R. 659, *Re: Leigh's Will Trusts*, 1970 Ch. 277, *Re: Ponder*, 1921 2 Ch. 59, *Re: Cockburn's Will Trusts*, 1957 Ch. 438 (severed property), *Re: Edward's Will Trusts*, 1982 Ch. 30, *Wise v. Whitburn*, 1924 1 Ch. 460, *Attenborough v. Solomon*, 1913 A.C. 76 (H.L.), *Bromley et al. v. Tyron et al.*, 1952 A.C. 265 (H.L.), *Richardson v. Watson*, 1833 4 B & Ad. 787, Off. Rec. in *Bankruptcy v. Schultz*, 1990 64 A.L.J.R. 651, *Winter v. Grady*, 1921 21 S.R. (N.S.W.) 686, *Re: Ferguson*, 1957 V.R. 635, *Lords Atkinson, Wrenbury, and Carson in Baker v. Archer-Shee*, 1927 A.C. 844 *Corbett v. I.R.C.* 1938 1 K.B. 567, *Eastbourne Mutual B.S. v. Hastings*, 1965 1 W.L.R. 861, *Barclay v. Barclay*, 1970 3 W.L.R. 82, and *Halsbury's Laws of England*, 4th Ed. Vol. 17, para. 1355-56.

42 See *Duggan v. Gov. of Full Sutton Prison and Anor.*, [2003] 2 All E.R. 678 ChD, where the statutory reference to "a trust" did not recognize one to be created for the purposes of private law, while in *Registrar of the Accident Compensation Tribunal v. Comm. Of Tax. Of Aust.*, [1993] 178 C.L.R. 145 HC Aust., where a statutory body was recognized as a trust for purposes of the imposition of the taxing statute.

43 which is the case in all will trusts and some *inter vivos* trusts.

44 which should be, but need not be, in writing except in the case of land.

45 *Bromley v. Tyron*, 1952 A.C. 265 (H.L.), *Re: Ferguson*, 1975 V.R. 635, *Eaton v. Paines*, 1894 W.N. 32. See also *Re: IBL Industries Ltd*, 1991 76 D.L.R. (4d) 439, and *B.C. v. Henfrey Samson Belair Ltd.*, 1989 2 S.C.R. 24, where the vagueness of property purportedly held in trust did not allow one to be recognized in an *inter vivos* situation.

46 *Re: Beardmore Trusts*, 1951 O.W.N. 728.

47 If the subject matter isn't accurately defined the trust may fail, as was the case in *F.C.T. v. Clarke*, 40 C.L.R. 246, where a taxpayer tried to divert income into a supposed trust.

48 being its legal ownership

to the right to the use of the property may be the object that is conveyed as valuable consideration. This distinguishes the "transfer, assignment or disposition" of property to the trust from the lending of the legal title of the property to the trust under the agreement that in return for the use of the property the trust may pay rent for it to the "contributor". On the termination of the agreement the property is "returned" to the lender and the trust either continues to maintain the excess income realized from the property for the benefit of the stated beneficiaries, or dissolves following a distribution of that excess accumulated income. The valuable consideration is obviously the right to the excess income and it is only generated through a loan of property to the trust.⁴⁹

A testamentary general or special power of appointment granted to the executors that will allow them to appoint property from the residuary estate to unspecified or certain parties automatically doesn't, in the author's opinion, cause the trust to be void due to lack of certainty of object nor does it offend the rule against delegation of testamentary power.⁵⁰ This was the case in *Re: Nicholls*⁵¹ where broad and successive general powers of appointment were given to executors exercisable in respect of residuary property. This case is illustrative of jurisprudence concerning the topic and the Court of Appeal found that the residuary trust was created notwithstanding the lacking of specific beneficiaries. No contemporary or societal interest would be prejudiced by the general power of appointment in a testamentary situation and the issue should be decided on principle and policy in each individual case.⁵²

A trust is an equitable obligation imposed upon the acceptor of the office of trustee which causes him to fulfill the terms of the agreement, (i.e. holding of legal title, distribution of property, carrying on business, etc.). It is the beneficiaries as expressed in the agreement, for whom such action will benefit, who have recourse to the trustee in the event of a breach of the equitable obligation that compels him to act. A settlor acting only in that capacity doesn't have recourse against the trustee in instances of breach though he may reserve the power to revoke the trust or remove the trustee and appoint another. This is often a good tax planning point even with Sec. 75(2). A trust can easily be equated with being a structured arrangement whereby the legal title to the subject property is to ultimately vest in a beneficiary, (who may be the trustee) or be made available for his use. The property in this case may be the original property that the settlor of the trust transferred to the trustee or it may be property such as income that accrues in respect of the original property. Beneficiaries may be absolutely entitled to receive the legal title of the property at some time or they may be contingently entitled being their beneficial rights are enforceable only upon the occurrence of an event that is described in the trust deed and in cases where the event doesn't occur there may be a gift over to the other beneficiaries or a reversion to the settlor. Their rights, as given in the beneficial title, may be enforceable in the future or immediately.

Unlike the unsettled estate a trust agreement compels the trustee to deal with property in a manner that is impartial to the beneficiaries named in respect of the trust and thus he must exercise his powers and obligations in an "even-handed" way so as not to cause the beneficiaries entitled to capital and income

49 See *Dunkelman v. M.N.R.*, 59 D.T.C. 1242, and *C.I.R. v. Levy*, 56 T.C. 68, for the classic example as well as *Chamberlain v. C.I.R.*, 25 T.C. 317, and *C.I.R. v. Plummer*, 1979 3 All E.R. 775.

50 A power of appointment is imply the legal ability to grant legal or beneficial ownership or interests in property it is expressed in respect of. They will be commented upon in depth subsequently in relation to disclaimers and are another other flexible tool.

51 34 D.L.R. (4d) 321 (O.C.A.)

52 See *Re: McEwen*, 1955 N.Z.L.R. 575, *Blausten v. I.R.C.*, [1972] 1 All E.R. 41 (C.A.), *Chichester Diocesan Fund & Bd. of Fin. Inc. v. Simpson*, [1944] 2 All E.R. 60 (H.L.), *Re: Leek*, 1967 2 All E.R. 1160, *Re: Manisty's Settlement*, 1974 Ch. 17, *Re: Abraham's Will Trusts*, 1969 1 Ch. 463, *Klassen Estate v. Klassen*, 1986 5 W.W.R. 746, and *Hatfield Estate*, 12 B.C.L.R. (2d) 162 (S.C.). See *Horan v. James*, 1982 2 N.S.W.L.R. 376, for historic analysis of 33 relevant cases and *E. & T.Q.* 1988 Vol. 9 pg. 1. As provided in *Re: Beatty's Will Trusts*, 1990 3 All E.R. 844 (Ch), citing *Re: Nicholls* with concurrence, the rule of uncertainty has often been the basis for holding a testamentary power invalid, not the rule against testamentary delegation. It was also held by the Chancery Court justice that the question of what would constitute sufficient guidance to the executors (as well as the courts) is so much a matter of degree that predicting a rule on powers would be impossible and that the rule against delegation was a "shadow cast by the rule of uncertainty, having no independent existence". *Tatham v. Huxtable* and *Horan v. James* were expressly not concurred with while it was pointed out that it would be additionally disruptive to individuals if such a rule was found to exist given their reliance on liberal jurisprudence in arranging wills additionally reinforced by examples of such powers to avoid inheritance taxes in the popular source books.

therefrom unequal hardship, loss, or benefit, other than that allowed as per the trust provisions.⁵³ This is often a difficult consideration in the taxation environment.

A bequest of a specific property through the will is quite different from a general bequest of a value of the estate after it has been fully administered in that the beneficiary under the former receives immediate beneficial ownership of the property and it vests indefeasibly in him, (subject to possible subsequent estate debt application), while under the latter his rights to the estate may be negated by excessive creditor claims. The legal representative still maintains a lien against the former specific bequest. Since the property is specified and ascertained to a greater extent than the balance of the estate it can be concluded that a trust in respect of it has arose while it continues to suffer from being subject to creditors' claims.⁵⁴

In *Scott Davis et al. v. Her Majesty the Queen*⁵⁵ the TCC had to establish whether an inter vivos trust had been established in respect of founding employees of a corporation with regard to its shares. It held:

[30] I must now review the evidence and jurisprudence to determine whether a Trust existed in this situation.

[31] Counsel for the Appellants referred to the text by Professor Donovan Waters – *The Law of Trusts in Canada*, Chapter 5. Counsel for the Appellants quoted from page 107:

For a trust to come into existence, it must have three essential characteristics. As Lord Langdale M.R. remarked in *Knight v. Knight*, in words adopted by Barker J. in *Renahan v. Malone* and considered fundamental in common law Canada, first, the language of the alleged settlor must be imperative; second, the subject matter or trust property must be certain; third, the objects of the trust must be certain. This means that the alleged settlor, whether he is giving the property on the terms of a trust or is transferring property on trust in exchange for consideration, must employ language which clearly shows his intention that the recipient should hold on trust. No trust exists if the recipient is to take absolutely, but he is merely put under a moral obligation as to what is to be done with the property. If such imperative language exists, it must, secondly, be shown that the settlor has so clearly described the property which is to be subject to the trust that it can be definitively ascertained. Third, the objects of the trust must be equally clearly delineated. There must be no uncertainty as to whether a person is, in fact, a beneficiary. If any one of these three certainties does not exist, the trust fails to come into existence or, to put it differently, is void.

I. Certainty of Intention to Create a Trust

[32] Counsel for the Appellants referred to the characteristics specified to by Professor Waters and said:

Dealing with the first certainty, certainty of intention, simply put, this means there has to be some evidence a settlor had in mind to give another person the benefit of some property that is owned by the settlor.

[33] Counsel for the Appellants again quoted from the text by Professor Waters at page 108:

There is no need for any technical words or expressions for the creation of a trust.

[34] Counsel for the Appellants noted that the evidence indicates that there was an intention that a certain percentage of the shares of Canfish were to benefit Canfish employees. Counsel for the Appellants said that the intention to hold the shares for Canfish employees is satisfied by the evidence which established that each principal took the position that they were holding 5% of the shares in Trust for employees or future employees.

[35] Counsel for the Appellants also noted that further evidence of the intention to create a trust is the Trust Declaration (Exhibit A-2).

II. The Subject Matter of the Trust Property must be Certain

[36] Counsel for the Appellants said that the subject matter of the Trust property was 5% of the

⁵³ See *Re: Haye's Will Trusts*, 1971 1 W.L.R. 758, and *Halsbury's Laws of England*, 4th Ed., Vol. 48, para. 827.

⁵⁴ Is there thus a fundamental dichotomy here then? See *Re: West*, 1909 2 Ch. 180.

⁵⁵ 2008TCC31

issued and outstanding shares of Canfish.

[37] Counsel for the Appellants also noted that the fact that the amount paid for the 5% of Canfish shares flowed through SKD Holdings is an indication that there was Certainty of Property concerning the Canfish employees.

III. Certainty of Objects

[38] Counsel for the Appellants said that the "Certainty of Objects" is to be regarded to mean certainty as to who is a beneficiary of the Trust.

[39] Counsel for the Appellants said that the "objects" of the Trust have to be either existing employees of Canfish or may include former employees of Canfish.

[40] Counsel for the Appellants said that "it is sufficient to name a class or category of persons as beneficiaries, as long as it is possible to ascertain that a particular person is a member of the class" (Transcript p. 49).

[41] Counsel for the Appellants said that in this situation it is sufficient that the Trust was established for the benefit of employees of Canfish, i.e. an ascertainable class.

[42] Counsel for the Appellants admitted that while Davis, Beagrie and Ramsay looked at all of the employees of Canfish (or former employees) and only selected some, this does not change the situation from the point of view of the trust law.

[43] Counsel for the Respondent said that the Crown's position is that there was not a valid Trust.

[44] Counsel for the Respondent agreed with counsel for the Appellants on the three "Certainties". **However, counsel for the Respondent maintains that when we consider clause 1 of the Trust Declaration, the description of the beneficiaries of the Trust is too vague to meet the test of certainty.**

[45] Counsel for the Respondent maintains that the cash and the NQL shares were received by the Canfish employees because of their employment with Canfish. Counsel for the Respondent said that the cash and the value of the NQL shares are taxable as a benefit under paragraph 6(1)(a) of the Act.

A. Creation of a Trust

[46] Both parties agree that three certainties must exist for a trust to be established.

[47] Counsel for the Respondent argued that there was an additional requirement for the effective creation of a trust that being the "constitution of the trust" which is the title transfer of property to the trustees. According to counsel for the Respondent, without this transfer of property a trust would simply be declared but not created.[1]

[48] The certainty of intention to create a Trust was spelled out in Exhibit A-1 which established that from the onset of the creation of Canfish, shares were to be held in Trust for the employees of the company. This intention was further evidenced by the execution of a Trust Declaration in favour of the future Canfish employees (Exhibit A-2). Collectively, these documents and the testimony of Mr. Davis and Mr. Mullen support the certainty that the founders of Canfish intended to establish a Trust on behalf of the Canfish employees.

[49] In the present appeal, the certainty of subject matter is achieved through a review of the Trust Declaration (Exhibit A-2), which states that 5% of the shareholdings of Canfish would be held in Trust. Although a specific number of shares were not provided in the Trust Declaration it is the discretionary power given to the trustees that prevents this certainty from failing.[2]

[50] The certainty of objects requires that the beneficiaries of the trust are described in clear terms such that the trustees can perform their duties when distributing property of the trust.

[51] In the context of a discretionary trust there is no need to individually identify all of the members of the group. However, this certainty will fail if "the definition of beneficiaries is so hopelessly wide as not to form 'anything like a class', so that the trust is administratively unworkable".[3]

[52] In the present appeal a discretionary Trust was established and the beneficiaries of the Trust were referred to as the employee pool of Canfish, i.e. an identifiable group easily ascertained.

[53] As discussed above, constitution of a trust occurs when there is a transfer of property to the trustee after a declaration has been prepared. This particular requirement for the creation of trust is

contained in section 1260 of the *Civil Code of Québec*^[4] and as such would have no application in the present appeal.^[5]

[54] Since the three certainties have been established by the Appellants and the constitution of the Trust has application only in a civil law context, I have concluded that a Trust was legally established to hold a 5% share interest in Canfish, on behalf of Canfish employees.⁵⁶

The Act consistently refers to either trust or estate or both in its subsections and when reading it you should forever be sensitive to which tax creature the provision is applying to. This difference in character was pronounced quite well in the TCC of Howard Lipson, *Harriet Lipson v. Her Majesty The Queen*⁵⁷ where the Tax Court had to consider whether the definition of “taxable Canadian property” attended properly to trusts or, estates as well, in a Quebec succession environment (similar to an unadministered estate in common-law provinces). It held, appropriately with respect to the targeting provisions in the Act:

[15] The respondent says that the appellants disposed of capital interests in a trust and, accordingly, had the obligation to send notices pursuant to subsection 116(3).

[16] The respondent can only be correct if a Québec succession is a trust for the purposes of the definition of “taxable Canadian property”.

[17] Under the *Civil Code of Québec* there is no question that a succession is not a trust.^[2]

[18] The respondent argues that a succession is treated as a trust under the Act. She relies upon subsection 248(1) of the Act which provides that:

“trust” has the meaning assigned by subsection 104(1);

and upon subsection 104(1) which provides that:

In this Act, a reference to a trust or estate (in this subdivision referred to as a “trust”) shall, unless the context otherwise requires, be read to include a reference to the trustee, executor, administrator, liquidator of a succession, heir or other legal representative having ownership or control of the trust property, but, except for . . .

The French language text of subsection 104(1) reads as follows:

Dans la présente loi, la mention d’une fiducie ou d’une succession (appelées « fiducie » à la présente sous-section) vaut également mention, sauf indication contraire du contexte, du fiduciaire, de l’exécuteur testamentaire, de l’administrateur successoral, du liquidateur de succession, de l’héritier ou d’un autre représentant légal ayant la propriété ou le contrôle des biens de la fiducie. Toutefois, [...]

[19] The appellants disagree, take the position that subsection 104(1) does not define the term “trust” and submit that providing that a trust or estate is to be referred to as a “trust” is a matter of labelling rather than definition. Consequently, it is wrong to conclude that an estate is to be considered as a trust for all purposes of the Act.

[20] I agree with the appellants’ conclusion. I think it is helpful to take the analysis through some additional steps.

[21] The terminology “the meaning assigned by” is used in a number of statutes and subsection 248(1) also provides that:

“estate” has the meaning assigned by subsection 104(1);

[22] When I first considered the appellants’ argument on this point, I was troubled by the question: What is the effect of the definition of “trust” in subsection 248(1)? Parliament puts in particular language for a purpose and, if the language of the statute is susceptible of a reasonable meaning, that meaning should be given effect.

[23] At first, it seemed unclear what the point of the definition in subsection 248(1) combined with subsection 104(1) was. Could it be that the two subsections constituted a surprisingly worded attempt to treat estates as trusts and trusts as estates?^[3]

⁵⁶ See also *Arthur Stern and Her Majesty the Queen*, 2004TCC461, where the TCC did not recognize the creation of a trust in respect of ownership of property when documentary evidence simply didn’t “go far enough” to provide such.

⁵⁷ 2012 TCC 20

[24] **Clearly not.** Not only is subsection 104(1) worded in a way that is not suited to such a purpose, but if one had wanted to equate trusts and estates, one would have written something much more straightforward.

[25] The words “‘trust’ has the meaning assigned by subsection 104(1)” have to be understood as meaning that throughout the *Act* a reference to “trust” shall be read to include a reference to a “trustee, executor, administrator, liquidator . . .” as the case may be.

[26] The words do not import into the *Act* as a whole a rule that the use of the word “trust” means “trust or estate”.^[4] This becomes clear when one examines the purpose of the subsection.

[27] When one considers the text of subsection 104(1) and that estates, successions and trusts are not legal persons, it becomes apparent that the purpose of the subsection is to simplify the drafting.

[28] In the absence of this provision, in some places where one is describing how to compute income, the text of the law would have to refer to the trust or estate, which is not a legal person, but in other places where one is placing an obligation to do something such as filing a return, one would have to refer to the person charged with carrying out that obligation, for example the trustee.

[29] What this drafting technique does is avoid the necessity of distinguishing between the trust or estate and the person charged with doing something; one has to read each section referring to “trust or estate” as referring either to the trust or estate or to the person given an obligation in relation to the trust or estate. The technique also avoids the necessity of repeating a series of alternative persons who may be the person who has the obligation.

[30] That is the effect of the attribution of meaning provided for in subsection 248(1); it is not to treat an estate as a trust.

[31] Consequently, there was no disposition of property described in paragraph (h) of the definition of “taxable Canadian property” and accordingly there was no obligation on the appellants to file a notice pursuant to subsection 116(3) of the *Act*.

When the Unadministered Estate becomes a Trust and Why It's Important for Tax Aspects: Should There Be 4 Testamentary Ownership Base's and Not 3?

The time at which an estate, which is undergoing administration, becomes a trust for purposes of the *Act* is very much a question of fact which must be evaluated in each individual case while the importance of the difference in the two can be quickly inferred from the expressed targeting of “trusts” and “estates” throughout the *Act*. As previously submitted a trust, in the form of the residuary estate, cannot come into existence⁵⁸ until the debt/obligations of the testator have been ascertained. Until that time, as a consequence, the value of the property subject to the beneficiaries trust rights cannot be ascertained.

The issue is extremely important since the *Act* *does recognize* a difference between the estate and a trust that arises out of it through its use of the terms both **inside and outside subdivision k**.

That point of time is an extremely important event that determines when:

1. income can be paid as such to residuary beneficiaries as capital rather than income to be taxed as income in the hands of the estate at potentially lower rates, directly undermining the application of the Sec. 104(6)-(13) income recognition transfer mechanics⁵⁹,
2. slightly technical though poorly drafted tainted spousal trust rules that allow for accessing of tax-free roll-overs to a spousal trust, in Sec. 70(7)-(8)⁶⁰,

⁵⁸ failing the expressed severing of property therefrom.

⁵⁹ See the subchapter in Income Payable Mechanics regarding Executors Year and Unadministered Estates

⁶⁰ Here, you can have your cake and eat it too, since it seems that you can donate property to the general estate and have it listed for purposes of the rules since they do not state that the property listed must be owned by the deceased

3. accessing carry-back of a common-law and ITA recognized executor's year estate losses in Sec. 164(6) to the testator's terminal return (which may be prevented if the estate crystallizes to a trust),
4. the avoidance of Part XIII withholding tax on "income" payments, which are actually tax capital payments per very material historic principles, to non-residents since Sec. 212(1)(c) targets Sec. 104(13) inclusions,
5. the enforceability of rights to income otherwise, when an estate takes extended periods of time to administer to the point of being a trust,
6. the *numerous of provisions* in the Act which apply to either specified "trusts", or, "estates", or both.

The facts of the instance determine how the ITA applies to it. And that's why it's extremely important to know in which "New York state of mind" you're in.

On the issue of how the property makes its way through the chain of ownership from testator to ultimate recipient [Sec. 70(5)/(6) "testator"-Sec. 104(1) "trust" - Section 107 "beneficiary", existing principally]⁶¹ and the non-capital property applications [Sec. 70(1)/(2)/(3)] the author's opinion is that there should be 4 ownership bases through which property flows in a testamentary tax setting: **testator to, estate, to crystallized trust (if but for an infinitesimally small amount of time) then to, ultimate beneficiary as opposed to in many instances what exists now which is the 3, of, testator to, estate or trust, to ultimate beneficiary, or 2 in the case of spousal recipients.** We see both the general estate and arising trust upon its administration, even for an instant, considered in the Sec. 70(7)-(8) tainted spousal trust mechanics, and the recognition of the *executor's year*, purely of an estate law perspective, in Sec. 164(6) **but the difference in state of environment allows for considerable flexibility when one targets what transactions can occur between any trust arising out of the estate itself.**⁶² Estate law is one aspect of the testamentary process, trust law applicable to creatures arising out of a crystallized estate in the testamentary setting is another. The provinces, with their command of property rights, have systemtically recognized the difference in the environment with both estate devolution *and* trustee acts where one or the other applies.⁶³ Here, the underlying law is not fully established save for a reasonable volume of non-tax precedents, while our ITA doesn't "think like that" at all. Why **partially** recognize a difference in the legal environments with their ramifications and then draw out inherent flaws via the **absence** of equally attendant provisions?

An important distinction to be made in this process of subject ascertainment is the recognition and accounting for debts/obligations of the testator that must be met out of the property in the estate and the actual extinguishment of those debts. In order for the executor/administrator to be considered to have fulfilled his function, through the normal process of advertising for creditors, fulfilling the deceased obligations etc., the estate must have been administered to the extent at which the beneficiaries' equitable rights become ascertainable in respect of property held. It is only at this time, at which property can be recognized *not* to be potentially subject to latently arising or identifiable claims that a trust in respect of it occurs, either informally or formally. Assent to the then operative instructions of the will, the second necessity, may also be evidenced by the executor's conduct.⁶⁴

This is not to say that debts will always be extinguished for often the testator directs that such debt is to be assumed by the beneficiaries as a condition of the distribution of the estate property, (or of the gift itself). Here the issue is debt not indicated in the will or debt in respect of which there are no directions given, how it is

taxpayer. That property then can be streamed back to the donator through the will's/trust's provisions.

61 Though in the case of spousal recipients the property is deemed transferred directly to the spousal beneficiary.

62 Here there can be inter-estate/trust transactions involving such things as interest transactions/income recognitions/debt transactions, etc. Even more interesting is the instance where a spouse under a to-be testamentary spousal trust, who in common law has an interest in the general estate until the trust is created, transfers his interest. Is the scope of the interest limited to the spousal trust or to the estate as it is administered? Is there not a difference in their value? There is numerous case in the UK where the law is more refined in this area.

63 Though there may be instances where both apply to a given situation, but the primary objective of these **two** sets of statutes is the respect of genres of the historic common-law in their regard.

64 In Re: Perry, 1950 N.Z.L.R. 530, Attenborough v. Solomon, 1913 A.C. 76, Re: Claremont, 1923 2 K.B. 718, Gudgeon v. Pub. Trustee, 1960 N.Z.L.R. 233, In the Estate of Dunn, 1963 V.R. 165, Blake v. Bayne, 1908 A.C. 371, Re: Ponder, 1921 2 Ch. 59, Re: Rowe, 1926 V.L.R. 452, and Re: Yerburch, 1928 W.N. 208.

ascertained, extinguished or assumed, and the effect it has on the scope of the beneficiaries' rights. In *C.I.R. v. Sir Aubrey Smith*,⁶⁵ the question of whether or not an estate had been administered to the extent at which it could be seen as a trust arose with respect to payments received by a beneficiary while the beneficiary contended that since a singular, albeit substantial, mortgage remained to be extinguished out of the estate property "a trust" could not be recognizable. At the heart of the case was the fact that under the rule in *Rex (The King) v. Special Commissioners of Income Tax (ex parte Dr. Barnardo's)*⁶⁶ payments received by the beneficiary which were in substance income of the executor's were not recognizable as income in the hands of the beneficiary unless the estate could be shown to be fully administered thus allowing for the recognition of the beneficiary's distinctive income rights. Essentially in *Smith* the estate had been fully administered save for the extinguishment of the mortgage and when the beneficiary contended that due to the debt the residuary estate could not be ascertained Lord Hanworth, M.R. provided:

"... There were, as I say, mortgage debt due from the estate. There is still a sum of £10,000 due on mortgage. Emphasis has been laid upon that, and it is said that it has been attempted in some case, and in this case, to rely upon the fact that there was an outstanding mortgage unpaid as connoting that there could not be an estimation or ascertainment of the residuary estate because the estate was still fluid as the direction to pay debts has not yet been carried out. For my own part, I think this question of a mortgage debt, or any other debt, must take its proper place in perspective. It may be in some cases that there is a factor from which a strong inference may be drawn. It may be, on the other hand, that the device of leaving a debt unpaid is resorted to in order to pretend that the residue of the estate has not been ascertained and is not ascertainable. If such a device were resorted to in any case it ought to be held ineffective. In other words, there may be in this, or in any other case, features which point in one direction or another, and largely those features are questions of degree and so of fact."

"... all the relevant matters must be taken into consideration and, as Mr. Justice Rowlatt quite neatly says in his judgment in the present case, you may have an assent by conduct: 'When it is said that the executor 'assents to a bequest' what is meant is not that he assents to the disposition of the testator but that he assents to its taking effect upon the specific property if the bequest is specific, upon a sum of money if it is pecuniary, or upon the residue brought out by the executor at the end of the administration if it is a residuary bequest.'" Lord Haldane's exposition in *Attenborough v. Solomon* makes this clear. **The assent of the executor, it is important to add, may be inferred when there is clearly nothing more to be done by way of administration. "The question is, in all cases: Has the administration of the estate reached a point of ripeness at which you can infer an assent, at which you can infer that the residuary estate has been ascertained and that it is outstanding and not handed over merely for some other reason.""**

"The property which on the death of the testator vests in the executor does not remain vested in him forever. So soon as he assents to the dispositions of the will becoming operative and the trusts taking effect, the estate vested in him as executor is divested and vests under the dispositions of the will in the trustees of the will. **The assent of an executor may be given formally and may be inferred from his conduct.** In my opinion, it is a pure question of fact whether such an assent has been given or not, depending upon the particular circumstances of each case, and no other case with different facts can form any guide for the determination of that question. It has been mooted, but I do not think seriously contended, that the existence of a debt or debts, or liabilities which are outstanding prevents the assent of the executor being inferred by his conduct."

Essentially, the Court came to the conclusion that even though there remained a mortgage equal to £10,000, the estate property could still be ascertained by simply making provision for such out of the property to be passed on to the trustees or by assigning the debt to the trustees and that the fact that the debt remained unextinguished did not preclude the estate's attainment of full ascertainment.⁶⁷

65 15 T.C. 661 (C.A.)

66 7 T.C. 646.

67 See also *Carlish v. C.I.R.*, 38 T.C. 37 (C.A.), as well as *C.I.R. v. Wahl*, 17 T.C. 744 (C.A.), *Re: King's Will Trusts*, 1964 Ch. 542, *Re: Gibbs*, 1951 Ch. 933, *Re: Ponder*, 1921 2 Ch. 59, *Harvell v. Foster*, 1954 2 Q.B. 367, as well as *Martin v. Martin*, 1903 S.R. (N.S.W.) 156, *Re: The Earl of Stamford*, 1896 1 Ch. 288. In *Daw v. I.R.C.*, 14 T.C. 58, substantial mortgages with

Under most provincial Devolution of Estate Acts/Trustee Acts, depending on the property involved, vesting of property will be recognized, with respect to persons beneficially entitled thereto, at the end of an arbitrary time limit, (sometimes three years), while during that time, as per Ontario's Trustee Act, the personal representative may allow time for the payment of any debt while under Sec. 51(1) and 52(1) the personal representative has the power to distribute the residuary estate to the parties beneficially entitled thereto, upon the provision for the payment for covenants in respect of leases or liabilities in respect of rent charges. The ascertainment of a residue and the assent to the residuary gift are not equivalent and although a residuary trust may be set up with trustees separate from the executors until the latter's assent is established, even though the residue may be ascertained, the residue has not become subject to the testamentary trust.

Assent may be inferred from the executor's conduct, such as delivery of possession, while it may be deferred until settlement of disputes arising out of the nature of the situation possibly brought on by Dependant's Relief Act, Matrimonial Property Act applications.

The important concept to recognize when determining tax strategies is that the ITA does not in many instances apply to estates in the process of being administered but does when the residuary estate can be ascertained⁶⁸ hence there can be significant advantages to be obtained in retaining title of property frozen in the administrative stage and recognizing capital therefrom^{69, 70}

Nothing precludes the personal executors from giving effect to alternate directions in the will at differing times whereby the severing of potentially liability charged property from the estate occurs thus constituting operative trusts **at that point** of time, while until that point of time the trust cannot be considered in existence however the will must make provision for such.⁷¹

In *Frederick et al. v. C.I.R.*⁷² the windup of an estate was deferred due to the fact that to do so would cause the dissolution of a partnership that would eventually prove very profitable to the heirs. The administration was carried on for approximately eight years and the creditors' claims were fully satisfied within that time and the heirs allowed the title to the property to remain vested in the personal representatives so that they could continue the business. The Commissioner of Internal Revenue (USA) was unable in the Fifth Circuit Court of Appeal to successfully argue that the estate income should be recognized by the heirs⁷³ and not the estate on the grounds that the reasonable period of time for administration had passed, and the Judge found that the estate was to be recognized as a distinct tax entity. In *Chick et al. v. C.I.R.*⁷⁴ at issue was whether the estate of a testator had ceased to exist after a certain period of time thus making the residuary estate's beneficiaries subject to the recognition of its income. As provided by the First Circuit Court of Appeal:

"Indeed the executor has never filed any account, either preliminary or final, in the Probate Court, he has never transferred any of the assets of the estate from himself as executor to himself as trustee of the residuary estate, nor has he ever identified any of the assets of the estate as assets of that trusts. Neither

partial on going repayment precluded an estate from being seen to be completely administered for tax purposes precluding ascertainment of beneficiaries' rights. In *Pilkington v. I.R.C.*, 29 T.C. 160 an outstanding mortgage didn't deter residue ascertainment.

68 such as in the case of the associated corporation rules, minimum tax, Sec. 94(1) foreign resident trusts, etc.

69 The estate will generally be "testamentary" in the tax sense of the term and thus benefit from the marginal tax rates applicable to individuals. As per *Gresson, J. in Commr. of Taxn. v. Luttrell*, 1949 N.Z.L.R. 828 (C.A.), and in essence in *F.C.T. v. Whiting*, 68 C.L.R. 199, and multitudes of other cases: "The state of administration is a governing factor." See recently *Church And Commissioner Of State Revenue* [2011] WASAT 26 (11 February 2011) for an instance of questioning whether a trust had arisen out of an estate when there was some question as to the executor's conduct.

70 Subsection 104(23), in para. (a), applying implicitly to both trusts and estates, recognizes that the taxation year of "the trust" will equal the period for which the accounts of the estate/trust have been ordinarily made up and when a date of property ascertainment has been reached by the estate, it becomes a trust, another fictional tax creature. Is this change in character an adequate reason to recognize that one tax entity's tax year has come to an end by its cessation of existence while another's has started, in the instance when the residuary estate is handed over to different parties who will assume the duties of trustees? It may be since clearly accounting methods used by the latter functionary are substantially dissimilar from the former's. Until that point of time trust accounting has not applied however changes in accounting methods may have to serve as the actual basis of an application for a change in fiscal period, not merely because the arrangement has become a trust.

71 See *Brougham v. Poulett*, 1855 19 Beav. 119, 52 E.R. 294, *Lord Sudeley v. A.G.*, 1897 A.C. 11, (appropriation powers) and *Halsbury's Law of England*, 4th Ed. Vol 50 para 612.

72 145 F. 2d 796.

73 Under rules similar to Sec. 104(13).

74 166 F.2d 337.

has he ever paid any of the income from assets held by him as executor to himself as an individual or to his sister, Mrs. Foss the other petitioner, nor has he ever in any way earmarked, identified or credited any of the income received by the estate as income belonging to or distributable to himself or to his sister as beneficiaries under that trust. Since 1937, at least until after the tax year 1940, the petitioners, both of whom are on the cash basis did not report and pay federal income taxes on any of the income from the property comprising the residue of their father's estate.

Under these circumstances, The Commissioner of Internal Revenue determined deficiencies in the petitioner's income taxes for the taxable year 1940 on the ground that since the executor had collected all of the assets of the estate, had paid all its legacies and debt, and there were no contingent liabilities or civil suits pending against the estate and all acts relating to its administration had been performed, except for the transfer of the residue of the estate by the executor to himself as trustee, the income of the residue of the estate was in fact trust income taxable to the petitioners individually as beneficiaries of the residuary trust as provided in S. 162(b) of the Internal Revenue Code..."

Regulations under the U.S. Internal Revenue Code allow the Commissioners to essentially deem the estate to have ended and the residuary trust to have begun however no such power exists under the ITA for the use of the Canadian tax authorities.

In *Roy v. M.N.R.*⁷⁵ the Tax Review Board had to ascertain whether a taxpayer, who was both residuary beneficiary under an estate and its executor, had to recognize income from the estate in a particular year when non-deductible interest income was added to the beneficiary's income when the estate deducted it. Administration had begun in 1969 and the relevant year of assessment was 1974, five years after the death. Since the residue had not been distributed nor had the estate taxes been paid the Board found that the estate had not been settled⁷⁶ and thus the beneficiary could not recognize the income of the estate in his personal capacity. Five years, it would appear, is an acceptable time over which an estate can be settled. In *W.H. Grayson v. M.N.R.*⁷⁷ an entire estate was bequeathed to an accountant who was sole executor and beneficiary and although the will did not provide for the creation of a trust out of the residue of the estate the taxpayer attempted to argue, before the Tax Court, that the trust he created through the suspending of the terminal distribution did not declare income to be payable to him, the sole beneficiary. The Minister contended that even though the executor caused a trust to be created in respect of the estate the income realized thereby was still subject to an enforceable right of the taxpayer as sole beneficiary. *Kempo, T.C.J.*, provided with respect to the taxpayer's motive:

"Indeed there is a very strong inference here that the Appellant was in a legal position, as sole beneficiary, to enforce the wind-up and distribution of the estate to him prior to the end of the estate's first fiscal year end as all administrative matters had apparently been completed before that time."

This direction is entirely in line with that in *Chick et al.* in that under both the estate had reached an appropriate point of "ripeness" while under both the beneficiary and executor were the same person however this does not negate the reasoning in *Roy v. M.N.R.*⁷⁸ For a contradictory case, see *McCauley v. C.I.R.*⁷⁹ where the exact opposite conclusion was found in a situation very similar to that in *Grayson*.⁸⁰ In *C.I.R. v. Wahl*⁸¹ the U.K. House of Lords found that a *sole beneficiary* was assessable for tax on the income of the estate of which he was the *sole administrator* when such had been received by him, deposited in his personal bank account, and spent personally.⁸²

75 78 D.T.C. 1123 (TRB).

76 especially since its assets were still being administered by the taxpayer in the role of executor.

77 90 D.T.C. 1108.

78 See *Re: Heberley*, 1971 N.Z.L.R. 325, & *Re: Cook*, 1948 Ch. 212, where the beneficiary as executor ceases to hold property under executorship once duties are completed and cannot be trustee for himself. As per *Cunard's Trustees v. I.R.C.*, 1946 1 All E.R. 159, receive payments to a residuary beneficiary doesn't necessarily imply an assent.

79 193 F. Supp. 938 (1961).

80 See *J.H. Anderson v. C.I.R.* 1934 30 B.T.A. 1275, for jurisprudence similar to that in *Roy*.

81 17 T.C. 744 at 761.

82 See also *Case #57*, 1950 T.R.B.D. 209 (Australia), as well as *F.C.T. v. Whiting*, 68 C.L.R. 199, *Case # G13*, 7 T.R.B.D. 70 (1956) (Australia), and *Robertson v. F.C.T.*, 65 C.L.R. 338. For further case law, see *Patton v. U.S.*, D.C. Tex., 3 A.F.T.R. 2d 1475, *Alston v. C.I.R.*, 8 T.C. 525, *Harwood Estate*, 46 B.T.A. 750, *Stewart v. C.I.R.*, 5 Cir, 196 F.2d 397, *Estate of E.J. Hyland*, 10 C.C.H. T.C. Mem. Dec. 823 (1951), *C.I.R. v. Hedges*, 1952 18 T.C. 681, *I.R.C. v. Smith*, 1930 1 K.B. 713, *M.C.*

Testamentary Trusts.

Subsection 248(1) provides that for the purposes of the ITA "a testamentary trust" has the meaning described in Sec. 108(1)(i) which provides a definition of "testamentary trust" for purposes of subdivision k and thus it is only by virtue of Sec. 248(1) that the definition applies for purposes of the whole Act.

Aiming to maintain the testamentary trust status is critical since all other trusts are considered those *inter vivos* which suffer from the highest tax rate of 29% on their income pursuant to Sec. 122(1). Testamentary trusts enjoy graduated rates. In limited instances it may be possible to contribute property to an existing testamentary trust to benefit from lower marginal rates⁸³, or simply sell it to it to accomplish the same. Maintaining a testamentary trust status is, again, critical.⁸⁴

A General Definition

A "testamentary trust" means a trust or an estate that arose upon and in consequence of the death of an individual regardless of its residence or the deceased's residence immediately before death. In the subparagraphs of the Sec. 108(1) definition there are four provisions that preclude certain trusts or estates from being testamentary, even though the above general condition exists. There isn't an expressed time limit placed upon when the trust may arise however upon a review of the history of the provision it can be seen that, since it formerly meant "trust or estate that arose upon the death of an individual and in consequence of his death", there has to be a direct connection between the arising of the trust and the death and the time at which it arose cannot be unreasonably deferred after the time of death. From this rationale, it would appear that special powers of appointment, that can be used to create sub-trusts which must be read back into the original settlement, will be able to create a "testamentary trust" several years after the death of a settlor regardless of whether or not the will which contains the power creates itself a "testamentary trust". The sub-trust may be seen to arise in consequence of the death of the settlor (testator) and "upon" his death since the result of its exercise will be read back into the will of the testator however where the power is a general power of appointment given to the trustees of the testamentary trust property, its exercise which creates a "sub-trust" will not be read back into the original settlement and the new trust may not be "testamentary".⁸⁵

"Definition of Testamentary Trust – Sec. 108(1)"

"testamentary trust" in a taxation year means a trust or estate that arose on and as a consequence of the death of an individual (including a trust referred to in subsection 248(9.1)), other than

- (a) a trust created by a person other than the individual,**
- (b) a trust created after November 12, 1981 if, before the end of the taxation year, property has been contributed to the trust otherwise than by an individual on or after the individual's death and as a consequence thereof, and**
- (c) a trust created before November 13, 1981 if**
 - (i) after June 28, 1982 property has been contributed to the trust otherwise than by an individual on or after the individual's death and as a consequence thereof, or**

Westphal v. C.I.R., 1961 37 T.C. 340, McCaughey v. Commr. of S.D., 46 S.R. (N.S.W.) 192, Re: Mackay, 1906 1 Ch. 25, Re: Richetson, 17 S.R. (N.S.W.) 233. See also Herbert v. I.R.C., 9 T.C. 593, for J. Rowlatt's endorsement of executor's ability to withhold assent due to incidental outstanding liabilities. Such a position allowed interim payments out of income to be received as capital. See Easterbook v. Young, 13 A.L.R. 351, for change in capacity of an executor-beneficiary through assent.

⁸³ Without taste, for those who want to take it that far, is to actually transfer ownership of property to a to-be-testator, under contract, that he set up a testamentary trust of it even recognizing a Sec. 70(5) disposition: thinking a few years ahead of the game pays off in reduced taxation.

⁸⁴ See "Qualifying and Non-qualifying Testamentary Trusts", John E. Poyser, Estates, Trusts and Pensions, Vol. 24 Pg. 41 for additional comment on the importance of testamentary trust status.

⁸⁵ A special power of appointment, unlike a general one, allows the power holder to decide, within the expressed restrictions imposed by the settlor, who will receive property, while a general power is not restricted and the trustee's discretion can be exercised without restraint to the detriment of any beneficiary. The fact that the trust arising upon the exercise of the special power of appointment will not relate back to the time of the death does not detract that it arose on or after and as a consequence of death.

(ii) before the end of the taxation year, the total fair market value of the property owned by the trust that was contributed to the trust otherwise than by an individual on or after the individual's death and as a consequence thereof and the property owned by the trust that was substituted for such property exceeds the total fair market value of the property owned by the trust that was contributed by an individual on or after the individual's death and as a consequence thereof and the property owned by the trust that was substituted for such property, and for the purposes of this subparagraph the fair market value of any property shall be determined as at the time it was acquired by the trust;

Created only by the Dying Individual

Subparagraph (a) provides an important restriction whereby trusts "created by a person other than the individual", even though they may have arose upon and in consequence of that individual's death, will not be considered as "testamentary". One must have a technical understanding of the phrase "a trust created by a person other than the [testator]" to recognize the importance of this provision.⁸⁶

Whereupon the death of a taxpayer another person creates a trust for the deceased's offspring the trust will not constitute a testamentary one even when it arose upon and in consequence of the death of the taxpayer however if it was the taxpayer, upon his death and as a consequence thereof, who caused the trust to be created, the trust will be testamentary depending on where the property contributed to it came from. Thus if a testator who had a power to revoke a previously established *inter vivos* trust, or who had a general power of appointment over a trust property, exercised the power through his will so as to cause the property previously owned by the existing trust to become subject to the new trust, a testamentary trust would have been created by the taxpayer and not by the *inter vivos* trust. By virtue of the fact that the testator has **a general power** it is the individual who is contributing property to the trust through his testamentary wishes. If a taxpayer other than the deceased exercised the above power it would be he who would be recognized as the creator of the trust and the trust resulting would not be testamentary.

The result of the exercise of a **general power of appointment** is to be read **back to the person exercising the power as if he created or contributed to the trust**, not as if the trust where the legal title was previously situated created or contributed. The result of the exercise of a **special power of appointment** is recognized as being derived from the terms of the will/trust itself, not the person exercising the power, hence where a will grants a special power of appointment over property held in an *inter vivos* trust to an executor and as per the will it is restrictively "special" the exerciser may create "a testamentary trust", (if provided for), without hindrance since it is not the executor who is making the contribution but the testator as if he were to have directed the contribution. If such a power is exercised at will and the initial trust is testamentary the sub-trust will be testamentary while if the head trust is *inter vivos* the sub-trust can still be testamentary (per the balance of the full definition since the property is coming from an individual – an *inter vivos* trust). In the case of general powers it will only be when the power is exercised on death through the will that the resulting trust will be testamentary.

An *inter vivos* trust deed may contain a trust that can arise on and as a consequence of the death of the taxpayer⁸⁷ when there are various successions of interests depending on the contingent occurrence of events, however, the critical condition in order for it to be a testamentary trust is that it must have arose as a consequence of the death. In such a situation, the trust may be recognized to be *inter vivos*.⁸⁸

Even though an arrangement may derive its vigour and effect from death it need not be testamentary. If the trust is created pursuant to an *inter vivos* contract entered into by the testator that provides the trust will be created upon his death the trust will not arise as a consequence of the death but as a consequence of the terms of the contract.⁸⁹

86 See "Distributions by Canadian Testamentary Trusts" by Virginie Chan and François Morin in The Canadian tax Journal 87. as per Kent and Anor. v. Commr. of S.D., 106 C.L.R. 366, Atwill v. Commr. of S.D., 45 A.L.J.R. 703 (HCA).

88 See also Robett v. Commr of S.D., 1929 A.C. 444, Thomson v. Commr. of S.D., 1929 A.C. 450. Commr. of S.D. v. Perp. Trustee Co. Ltd., 21 C.L.R. 69, Campbell v. Commr. of S.D., 11 S.R. (N.S.W.) 426, Rosenthal v. Rosenthal, 11 C.L.R. 87, Elder's Trustee & Exor. Co. Ltd. v. Commr. of S.D. 1945 S.A.S.R. 34, Re: Bowman, 1937 S.A.S.R. 274, as well as Commr. of S.D. v. Sprague, 101 C.L.R. 184, and Re: Watkins, 1968 V.R. 486, for trusts arising on death.

89 See McFadden v. Public Trustee for Victoria, 1981 1 N.S.W.L.R. 15, for the designation of a beneficiary under a pension

In *Re: Harmsworth*,⁹⁰ a testator provided to his spouse an annuity of £ 5000 per year on condition that she create a trust out of one half of the investment property she owned at the time of death the beneficiaries under which were to be those entitled to the testator's residue. The trust was created thus the annuity paid but when the spouse died duty was not assessable upon the property held in trust; it was not held in her personal capacity.⁹¹ If these arrangements were executed in Canada, the spouse would recognize a taxable disposition of her property under Sec. 69(1), and the trust she creates would not be testamentary.^{92 93}

Advanced Anti-avoidance and Balancing Property Holdings

Subparagraphs (c)(i) and (ii) are anti-avoidance measures that cause otherwise testamentary trusts to lose their status if they have received contributions of property from "foreign" parties. As per para. (i) where the trust was created after Nov. 12, 1981, and property was contributed to that trust otherwise than by an individual on or after his death and as a consequence thereof, the trust cannot be testamentary.⁹⁴ See above notes on who contributes to trusts through the exercise of differing powers.

If property was sold for consideration payable which is equal to the fair market value of the property a "contribution" cannot be seen to have been made since a "contribution to a trust" is usually a gratuitous transfer of property. In this respect since property cannot be sold to an estate in the midst of administration unless the executor is exercising purchase options formerly held by the deceased it can only be contributed and if it wasn't contributed as a result of the death of an individual the recipient estate will automatically lose its testamentary nature. In that case, it would be preferable to wait until the estate is fully administered so that the residual trust could pay consideration to the transferor as consideration for the property allowing it to maintain its status if it is to receive outside property. Alternatively the will could be structured to allow the executor to create trusts out of specified property or contribute to created trusts property received by the estate whereby the trust recipient should retain its testamentary status. A trust and its estate are separate taxpayers as recognized under Sec. 108(1) as per the diction, though they are not at arm's length.

Since the paragraph concerns only contributions of legal title of the property to the trust but not loans of that title obviously a lending of property to the residual estate will not affect its testamentary status, and it is only as a consequence that the residual estate is considered in substance, and by the Sec. 108(1), to be a trust that the attribution rules in sections 74.1 and 74.3 will apply.⁹⁵

Would one be reading too much into the Sec. 108(1)(c) subparagraph to perceive a restriction in inter-testamentary trust beneficiary relationships created by the terms of the taxpayer's will? If the will creates two or more trusts where one holds an interest in the other is the interest-holder trust testamentary or has it received property otherwise than on as a consequence of the death of the taxpayer? Since the definition doesn't refer exclusively to property formerly held by a taxpayer it could operate to capture property created by the death however it's questionable whether the receipt of such an interest would violate the definition.⁹⁶

contract which operated to create a trust arising after the pensioner's death. The trust was found to have arose by the virtue of the contract enforceable upon death and not as a consequence of death but this may be too "narrow". See also *Beyer v. Beyer*, 1960 V.R. 126, *Cathels v. Commr. of Stamp Duty*, 1959 79 W.N. (N.S.W.) 271, *Nat. Trustees, Exors, & Agency Co. v. Trainor*, 1974 V.R. 49, while see also *Russell v. Scott*, 55 C.L.R. 440, *Williams v. F.C.T.*, 81 C.L.R. 359, *Schaefer v. Schuhmann*, 1972-3 A.L.R. 501, & *Robertson v. Ramsay*, 1891 24 S.A.L.R. 112. An *inter vivos* trust passes an immediate interest to a beneficiary at the moment it is executed which does not await the death of the settlor while a testamentary trust passes an interest only upon the death from which the agreement to create the trust becomes operative. If the agreement to create the trust is enforceable only upon the death of the taxpayer when the trust arises after the death but not necessarily as a consequence thereof.

⁹⁰ 1967 2 All.E.R. 249 (C.A.).

⁹¹ See also *Hayes v. Nat. Heart Foundation of Aust.*, 1976 1 N.S.W.L.R. 29, *In the Will of Snadden*, 1962 V.R. 571, and *Re: Gardiner*, 1971 2 N.S.W.L.R. 494, *Halsbury's Laws of Eng.* 4th Ed., Vol. 50, para. 583.

⁹² See also *Sprange v. Barnard*, 1789 2 Bro CC 585.

⁹³ See "Tax Issues in Will Planning: Parts 1 and 2" by Jane Kirby Donahue and Sheila M. Crummey in *The Canadian Tax Journal*.

⁹⁴ As per *Lord Advocate v. Bogie*, 1894 A.C. 83, *In Re: Cousen's Will Trusts*, 1937 Ch. 381, *Baskett v. Lodge*, 23 Beav. 138, property willed to a personal representative of another's will causes it to be held on the other will trust and not under the disposing will trusts. Referential trust rules have an effect here however.

⁹⁵ Until the estate is fully settled, at which time it technically becomes a trust, the major attribution adaption provision in Sec. 74.3(1) will not apply to it since that provision refers only to "trusts". The attribution provisions lie outside subdivision k where the two creatures-concepts and terms are equal.

⁹⁶ This seems to be the opinion of the Bilingual Services and Resources Industries Division on July 10th, 1990, where it

A "contribution" of property to a trust in this context must be taken to mean those actions that cause the augmentation of the particular trust's property via a gratuitous transfer and whether it can also amount to a "creation" of a trust in substance is a contentious issue. Augmentation is the addition of the property to that over which the initial fiduciary obligations are imposed so as to be subject to precisely the same interests and trust terms as those created by the original trust deed. A referring to the original will trust's terms as a supplement to, or upon which, other terms are imposed does not amount to a contribution but a referring to another trust as a means of adopting its terms in settling one's own disposition.⁹⁷

In the author's opinion a contribution can only be a transfer of gratuitous bounty as described in the UK case of *Jones v Garnett*⁹⁸:

"Not every transfer of property is a settlement for the purposes of section 660A. There has to be an "element of bounty" in the transaction. This is an old-fashioned phrase, apparently derived from the judgment of Plowman J in *Commissioners of Inland Revenue v Leiner* (1964) 41 TC 589, 596 and approved by the House of Lords in *Inland Revenue Commissioners v Plummer* [1980] AC 896,913, conjuring up the image of Lady Bountiful in *The Beaux' Stratagem*, is perhaps not the happiest way of describing a provision for a spouse or minor children. A donation to a spouse or child is traditionally expressed in a deed to be 'in consideration of natural love and affection' rather than the donor's bounty. It is nevertheless exactly the kind of thing at which the anti-avoidance provisions are aimed. In *Chinn v Hochstrasser* [1981] AC 533, 555 Lord Roskill cautioned against treating the word "bounty" as if it had been included in the statute. **It seems to me that the general effect of the cases is that, under the arrangement, the settlor must provide a benefit which would not have been provided in a transaction at arm's length.**"⁹⁹

Where the trust/estate was created prior to Nov. 13th, 1981, subparagraph (c) applies to cause the loss of testamentary status when after June 28th, 1982, property was contributed to the trust otherwise than by an individual on or after his death and as a consequence thereof, or, where the composition of property in the trust is of a certain proportion. Where the aggregate fair market value of the property **owned** by the trust that was contributed to the trust **otherwise** than by an individual upon and in consequence of his death, exceeds the aggregate fair market value of the property **owned** by the trust that was contributed by an individual upon and in consequence of his death¹⁰⁰ the trust will lose its testamentary status. It will remain contaminated only for the period in which such a proportion existed. The critical factor in this provision is the property which was previously contributed before the "new" rule came into effect, whereby if the fair market value of that property contributed other than by and upon the death of an individual exceeds that which was so contributed the trust will be disqualified hence in making in specie distributions of capital from the trust that which was **not** received upon and in consequence of the death of an individual should be drawn upon first. Both the property **owned** by the trust which was the property actually received by contributions, as well as its substitute, will be subject to the phrase hence if the property received is converted into substitute property through dispositions and

held that if a testamentary spousal trust distributes its property to another trust for offspring created as well under the testator's will upon the spouse's death the contribution will not cause the offsprings' trust to lose its testamentary character if the testator directed that such was to occur. The basis of the opinion was the intent expressed in the Technical Notes accompanying the introduction of para. (ii) & (iii):

"The present wording of (paragraph 108(1)(i)) is too restrictive since it would disqualify a trust which has received contributions by an individual that are effective after his death. It is not intended that a contribution to a trust by an individual that takes effect after the death of his surviving spouse would disqualify a trust as a testamentary trust. Subparagraphs (ii) and (iii) are amended to disqualify only those trusts receiving contributions otherwise than by an individual on or after his death and as a consequence thereof."

[Technical Notes to a Notice of Ways and Means Motion Relating to Income Tax, May 9, 1985, clause 49] A substantially identical opinion was expressed in T.I. A-8006 of April 1983 rendered by the Non-Corporate Rulings Division.

97 See the notes on "Who Creates the Trust" in the Old Preferred **Beneficiary Chapter**.

98 [2007] UKHL 35, see also *Patmore v Revenue & Customs* [2010] UKFTT 334 (TC) (14 July 2010)

99 See also *Audley v Revenue & Customs* [2011] UKFTT 219 (TC) (01 April 2011) for a UK example of how to structure a pre-Sec. 70(5) deemed disposition wealth transfer that attracted un-intended results.

100 the fair market values being measured at the time of contribution

acquisitions the rule will still apply.

The loss of its testamentary status will automatically cause it to be an *inter vivos* trust for the entire period in which the status was lost which need not be the full tax year. The definition refers to the trust "in a taxation year" and while it does not state "at anytime" the definition is a continuous one whereby part of the year the trust can be *inter vivos* and the other part testamentary. This being said, however, once the trust becomes *inter vivos* its tax year automatically defaults to the calendar year and, in the author's opinion, unless through other justification, there is no way to get a non-calendar year back once the trust becomes again testamentary.

Dependant's/Family Relief Trusts

"How trust created – 248(9.1)"

For the purposes of this Act, a trust shall be considered to be created by a taxpayer's will if the trust is created

(a) under the terms of the taxpayer's will; or

(b) by an order of a court in relation to the taxpayer's estate made under any law of a province that provides for the relief or support of dependants.

As per the Sec. 248(9.1) a trust shall be considered created by a taxpayer's will if one of the two qualifications are met. The provision does not have to say that they will be deemed to be created as a consequence of the death of the taxpayer since the Sec. 248(9.1) trusts are specifically captured as testamentary trusts in the latter's opening preamble. Such laws would, however, include Alberta's and Newfoundland's Family Relief Act. Manitoba's, New Brunswick's and Nova Scotia's Testator's Family Maintenance Act, etc.

Inter vivos Trusts.

Under subsection 248(1), an "*inter vivos*" trust has, for the purpose of the Act, the definition in Sec. 108(1) which provides that an *inter vivos* trust is a trust other than a "testamentary trust" and while the draftsmen of the definition of "testamentary trust" felt it necessary to cite both trusts and estates, that necessity was not recognized in the construction of the definition of "*inter vivos* trust".¹⁰¹

An *inter vivos* trust is any trust other than a testamentary trust and for certain purposes under the Act a trust can be only a "testamentary" or "*inter vivos*" trust. If the particular provision does not address the tax entity as an *inter vivos* trust or a testamentary trust but merely as a trust then estates are not captured since it may only be with respect to the technical definitions of the two former that estates are captured unless otherwise expressed.

A trust compelled to be created is a trust none-the-less.¹⁰²

An *inter vivos* (or even testamentary) trust is entirely able to conduct business in exactly the same manner as an incorporation without being subject to any provincial/Federal Acts concerning such. See Her

¹⁰¹ Subsection 104(1) provides: "In this Act, a reference to a trust or estate (in this subdivision referred to as a "trust") shall be read...", hence the Sec. 104(1) provision could be argued to cause the Sec. 108(1)(g) *inter vivos* trust definition reference to trust to also include a reference to an estate which is not a testamentary trust. At the same time, the consistency of the use of the terms "trust" and "estate" in Sec. 108(1)(i), which technically are not needed, could be attacked along the line of reasoning that the creators of the testamentary trust definition felt it necessary, even though it was provided for by Sec. 104(1), to have a specific reference to trusts and estates while they didn't recognize the same necessity in respect of the definition of *inter vivos* trust. Could it be argued that they didn't recognize the necessity because it didn't exist and that the Sec. 108(1)(f) provision concerns only trusts and not estates which do not meet the criteria described in Sec. 108(1)(i)?

¹⁰² *Harvey v. Sivger*, 58 T.C. 569, *Yates v. Starkey*, 32 T.C. 38. See also *Harmer and Ors. v. F.C.T.*, 90 A.T.C. 4672, where trustee didn't recognize role of trusteeship. In T.I. 51710 of Oct. 1986 rendered by the Small Business and General Section it was provided that a trust compelled to be created by a court order in favour of a spouse is a spousal trust none-the-less. In the same T.I. it was held that if the property was to revert to the contributing taxpayer after three years from the trust the trust would not constitute a Sec. 73(1) spousal trust.

Majesty The Queen v. Keith E. Ferrel¹⁰³ where the Fed. Appeal Court held:

"[2] It follows that other structures, including trusts, may also be used to save tax, as long as proper legal documentation is prepared to accomplish the purpose desired. Despite the able argument of Mr. McNary, we have not been persuaded that the agreements between the trust and the taxpayer and the trust and the company were illegal for purposes of the Income Tax Act (See Section 104 (2)) nor improper under trust law, which now appears to permit structures called "business trusts", which conduct businesses. (See Flannigan "The Nature and Duration of the Business Trust" 6 Estates and Trusts Quarterly 181)."

There has been continual controversy in the past few years concerning the treatment of bare trusts and agency arrangements and Question 32 of the 1988 Roundtable Discussions provided the Department the opportunity of expressing its opinion that an agency relationship is different from a trust relationship for purposes of the Act. There are a multitude of dissimilarities between trusts and agency-principal relationships. An agent is governed by a contract from which he draws his rights and incurs his obligations to act for his principal while the principal and agent are the only parties to that contract: a trustee acts for the beneficiaries of the trust as per the terms of the trust agreement entered into with the settlor while the settlor usually cannot be made party to the agreement once it has been accepted unless he reserves expressly direct rights against the trustee and instead only the beneficiaries would be in a position to enforce the trust. An agent binds his principal through the legitimate actions taken under the agreement while the trustee binds himself and not the beneficiaries, again unless specific authority is given, and he thus remains usually personally exposed for the actions of the trust however retains a right to be indemnified out of trust property in respect of losses rightfully and validly incurred. Agency agreements will terminate upon the death of one of the parties to the contract while trust agreements will not. The claims of the principal against his agent will abate the claims of others where the agent becomes insolvent while in the case of a trustee becoming bankrupt in his personal capacity the beneficiaries maintain the equitable proprietary interest in the trust property and it is not subject to claims against the trustee.

The courts have had little qualms in applying conventions of equitable jurisprudence to the agency relationship where the agent has benefitted from the relationship at the expense of the principal and the constructive trust mechanism has been applied as a form of remedy. A constructive trust is a remedy for an unjust enrichment with consequential deprivation without juristic reason and it has been held in Canada that it exists from the moment the need for restitution occurs. In some jurisdictions a remedial constructive trust arises when the court applies it while the substantive institution constructive trust exists during the time the unjust enrichment occurred. England, Australia, and Canada have adapted the former recognition while the U.S.A. has adopted the latter basis.

The Canadian Income Tax Act causes the liability for the actions of the agent to fall upon the principal and the beneficial owner is recognized as an end of the principal-agent conduit. Question 32 of the 1988 R.T.D. allowed the Department the opportunity to express the opinion that when a trust relationship existed, though the trust could be "bare" of all dispositive/administrative powers generally autonomously or semi-autonomously held by the trustees, the trust would still be regarded as a trust for purposes of the Act. Generally the bare trust is that under which the trustees have ceased to have, or have never had, dispositive powers or other active duties/powers but instead are compelled to deliver legal title on the request of the beneficiaries the latter being in a position of beneficial ownership of the property as compared to being merely beneficially interested in it.¹⁰⁴

103 A-746-97

104 In Internal Memo 7-0210 issued Apr. 11, 1986 to the St. Catharines DO by the Specialty Rulings Directorate, it was recognized that a corporation may hold in trust property for a shareholder when it is acquired specifically for that purpose and suggested and disclosed as such. at issue was whether the corporation, acting as bare trustee, was carrying on the manufacturing business or whether the shareholder were with the corporation acting as agent. The Department recognized that an agency arrangement exists when one is authorized to represent or act for another while a trust arrangement includes only those instances when no representations are made by the trustee, he doesn't act for the beneficiary, and he merely holds the legal title of the property. In the particular situation a manufacturing and processing activity was carried on through the trust agreement specified that the corporation was to act as bare trustee. The Department concluded that the corporation was acting as bare trustee due to: it described itself as such in its financial statements and that the use of the term "bare" was inappropriate even though as per the overall terms of the agreement a trust arrangement was to exist.

Contracts for the benefit of third parties may impose fiduciary duties on the parties whereby the party to provide the benefit must act with loyalty and in good faith and is saddled with a duty of care.¹⁰⁵ The same occurs in respect of contracts between businessmen etc. for the benefit of each other and although the contract produces contractual rights and obligations, unless expressed to the contrary, it may also be that fiduciary obligations arise. As in *International Corona Ltd. v. Lac Minerals Ltd.*¹⁰⁶ by the Ontario Court of Appeal dealing with the confidentiality of mineral information in a joint venture situation:

"We agree that the law of fiduciary relationships does not **ordinarily** apply to parties who are involved in arm's length commercial transactions. Nevertheless, it appears to be clear that the law of fiduciary relationships does apply in certain circumstances to persons dealing at arm's length in commercial transactions.

It becomes a question of fact in each case whether the relationship of the parties, the one to the other, is such as to create a fiduciary relationship. The circumstances which give rise to such a relationship have not been fully defined nor are they forever closed."

The context in which the activity is to proceed, (the normal business context), and the actions of the parties towards each other in light of the express terms of the contract may generate a fiduciary relationship and merely because the setting is initially contract¹⁰⁷ does not preclude a fiduciary environment from arising.¹⁰⁸ In instances where the fiduciary environment has been tarnished the use of the constructive trust may follow.

*Walker and Ors. v. Corboy and Ors.*¹⁰⁹ is a very illustrative case of what criteria a court will evaluate in establishing whether an agency arrangement has evolved into a trust due to the intentions of the parties and the manner of interaction. This case involved produce growers passing possession of their produce to a wholesaler who would sell it as agent in certain markets. The proceeds from the sales were intermingled with general funds of the agent, which was recognized industry practice, and when the agent was liquidated the funds from the sales were in the agent's possession and the produce growers wished to establish a more secure right thereto than merely unsecured creditor. Justice Priestly held:

"In every case, in my opinion, the circumstances of the relation between the principal and agent must first be looked at, the fact finding itself being uncolored by preconceptions as to whether they should or should not be interpreted as giving rise to a trust or to equitable obligations, and then upon consideration of circumstances found, a decision made whether (i) there was an express trust or equitable obligation

105 As per *Ryder v. Taylor*, 1935 36 S.R. (N.S.W.) 31, there must be an intention of one of the contracting parties to confer an interest in the subject matter of the contract on the third party as a result of the contract in order for a trust to arise. *Viles v. Viles*, 1939 S.A.S.R. 164, *Lloyds v. Harper*, 1880 16 Ch. 290, & *Robertson v. Waite*, 1853 8 Exch. 299, *Re: Empress Engineering Co.*, 1880 16 Ch. 125, *Re: Northcliffe*, 1925 1 Ch. 651, *Gandy v. Gandy*, 1885 30 Ch. 57, *Greenwood Shopping Plaza Ltd. v. Beattie*, 1980 2 S.C.R. 228, are all cases involving who can enforce such a contract and should be examined in detail. See *Commr. of Stamp Duty v. Pandal Nominees Pty. Ltd.*, 84 A.L.R. 590, *Bannister v. Bannister*, 1948 2 All E.R. 133, *Neale v. Willis*, 1968 19 P. & C.R. 836 (CA), *Green v. Russell*, 1959 1 Q.B. 28, *Ralna Ltd. et al. v. Can. Assurance Co.*, 1985 51 O.R. 781, *Re: Garbett*, 1963 N.Z.L.R. 384, and *MacLellan v. Wimbush*, 20 E.T.R. 300. See also "The Quitclose Trust: Who can Enforce It.", P.J. Millett Q.C., 101 L.Q. Rev. 270. In *Trident General Insurance Co. Ltd. v. McNeice Bros. Pty. Ltd.*, 1988 80 A.L.R. 574, it was held:

"The requisite intention to create a trust of a contractual promise to benefit a third party can, however, be formed and carried into effect (either by the contract itself or some other act) by a promisee who would be bemused by the information that the chose in action constituted by the benefit of a contractual promise is property and uncomprehending of the distinction between law and equity ... In the context of such a contractual promise, the requisite intention should be inferred if it clearly appears that it was the intention of the promisee that the third party should himself be entitled to insist upon performance of the promise and receipt of the benefit and if trust is, in the circumstances, the appropriate legal mechanism for giving effect to that intention."

106 1987 44 D.L.R. (4d) 592;

107 *Chase Manhattan Bank N.A. v. Israel British Bank Ltd.*, 1981 Ch. 105, *Lyus v. Prowsa Development Ltd.*, 1982 1 W.L.R. 1044, *Little v. Little*, 1988 15 N.S.W.L.R. 43, "Towards a Unified Concept of Fiduciary Relationships." 1981 97 L.Q. Rev. 51, *Shepard, "Contract and the Fiduciary Principle."* 1989 12 UNSWLJ 76, P. Finn, "Joint Venturers as Fiduciaries" 1989 2 CBLJ 34 5. *Corcoran & J.C. Tucker*.

108 This is very relevant when one reviews new Sec. 248(3) as it relates to contracts in Quebec. See also *Hospital Products Ltd. v. U.S. Surgical Corp.*, 156 C.L.R. 41, *Re: Livanos*, 1955 Q.S.R. 362, *Molchan v. Omega Oil & Gas Ltd.*, 1988 1 S.C.R. 348 (no trust), *Gordon v. Gonda*, 1955 1 W.L.R. 888, *Thompson's Trustee in Bankruptcy v. Heaton*, 1974 1 W.L.R. 605, *Re: Fada*, 1927 S.A.S.R. 590, *Walker v. Corboy*, 1990 19 N.S.W.L.R. 382, *Re: Maritime Med. Care Inc. & McLaughlin*, 1980 37 N.S.R. (2d) 521, while a partnership gives rise to a fiduciary environment; *Noranda Aust. Ltd. v. Lachlan Res.*, 1988 N.Z.L.R. 1. though the fiduciary environment of an on-going partnership isn't normally a trust: *Cameron v. Murdoch*, 1986 63 A.L.R. 575.

109 1990 19 N.S.W.L.R. 382 CA

in the circumstances, or (ii) whether the court should say that the expectations of the parties would most appropriately be served by saying that the circumstances brought a non-express trust (to use a completely neutral expression) or equitable obligation into existence, or (iii) finding no trust or equitable obligation. It is not in my opinion, a question of seeing whether a general rule has been displaced, but of seeing whether **the particular circumstances** did or did not give rise to the trust or obligation.

...

It seems to me to be prudent not to approach the question whether equitable doctrines are applicable in a commercial situation with the thought in mind that one should be disinclined to give a positive answer to the question. The question simply is, do the particular circumstances attract equitable rules. There is no reason to regret one answer rather than the other. If there are express agreements between parties to a commercial transaction, or a series of commercial transactions, requiring the application of equitable rules for their working out, then it is difficult to see that commercial life will be any the worse for those rules, which in one very real sense are as much legal rules as are common law rules, being applied. In situations where there is no express agreement, then ultimately whether a court will apply equitable rules **will depend upon the court's understanding of the expectations of the parties implicit in their dealings with one another in the commercial milieu in which the particular dispute has arisen. It is to these areas that the court's factual and evaluative attention should be directed and upon which decision should be based.**"

Justice Clarke held:

"There was **no express agreement** between the growers and Lojon (agent) that in those cases in which Lojon sold produce as an agent the latter would hold the proceeds of sale of produce on trust for the relevant grower. Accordingly it is necessary to examine the circumstances of the case, **which include the course of trading**, in order to determine whether an intention to constitute Lojon a trustee of the proceeds should be inferred. That is not to say that one disregards the fact that Lojon received the produce as agent for the grower. The general rule is that if a person delivers the goods to an agent to be sold the goods remain the property of the principal until the sale takes place and the moment the proceeds of sale are received by the agent they become the property of the principal: *Foley v. Hill* (1848) 2 HL Cas 28; 9 ER 1002. This rule is allied to a wider rule that where a principal entrusts money or property to an agent, a solicitor, for some specific purpose the agent is bound to hold the money or goods on trust to deal with them as directed."

Clarke did not concur with the use of the term "constructive trustee" to describe the agent in such a case since such would infer that the agent did not have the intention of holding the property on express (or implied) trust. Constructive trusts arise when the intention to create a trust doesn't exist. He further held:

"Although it is a general rule there will remain instances in which the courts will be required to carry out an investigation of the circumstances of the case and, in particular, **the course of trading between the parties** in order to determine whether a trust exists. In the second place the courts will, in carrying out that investigation, **be concerned to consider whether an intention to create a trust obligation should be inferred or, as it is sometimes put, imputed to the parties.** The position is different with regard to constructive trusts. They arise where the courts conclude that it would be inequitable to permit the holder of property to hold it for his own benefit: see *Chapters on Equity in New South Wales* (1921) by Jordan at p. 20; *Muschinski v. Dodds* (1985) 160 CLR 583 at 612-614 per Deane J.

...

... the general rule is that an agent will hold the proceeds of property delivered to him for sale on trust. But whether or not the general rule applies falls to be determined upon a consideration of the facts surrounding the delivery of the property. The authorities demonstrate that although a trust is readily imposed on proceeds arising from an isolated transaction the position may not be the same where property is received in the ordinary course of an **ongoing trading relationship**. The distinction is vividly demonstrated by the judgment of Jessel MR in *Kirkham v. Peel* (1880) 43 LT 171."

Justice Meagher held:

"The question whether an agent for sale holds the proceeds of sale on trust for his principal, so that the relationship between them is that of trustee and *cestui que trust*, on the one hand, or simply owes to his

principal whatever sum of money is then due on account between them, so that the relationship between them is simply that of creditor and debtor, on the other hand, is one which is not easy to answer in many factual contexts. Basically, as Scott says, the answer **must depend on the intention of the parties**: Scott on Trusts, 4th ed (1987) at 133. This must be so because, except in the case of constructive trusts where a trust is thrust on the parties irrespective of their intentions and as a matter of policy, an intention to create a trust is an essential element of a trust. **If the parties expressly spell out that their arrangements do or do not involve a trust, a trust comes into existence or does not come into existence accordingly.** However, this consideration is of little assistance where, as in the present case, the parties to the transaction are silent as to their intentions.

...

Clearly, what intention the law would regard as appropriate in the case of a simple single sale might not be the intention which should be imputed in a case involving complex and **multiple** transactions, and in the present case I am of the view that no intention to create a trust should be imputed. **It is necessary to look at the nature of the transaction, the particular provisions of the agreement of the parties, and the whole of the circumstances attending the relationships between the parties.** If one examines the whole of the relevant circumstances in the present case I am of the view that the law would not impute to the parties any intention to create a trust."

He based this opinion primarily on 5 circumstances:

- 1, that the relevant Act that concerned the creation of agency arrangements with respect to the particular activity did not require the keeping of separate trust accounts by agents in respect of proceeds realized on separate producers' produce **and** that the agency agreement allowed the agent to mix the funds with his own general reserves, something that would tend to contradict the intention of the producers that a trust be created,
- 2, that industry practice was that no trust was to be created and no separate trust accounts were to be maintained,
- 3, that the fact that the relevant agency statute law deliberately didn't require the agent to maintain separate accounts which would go against practice,
- 4, that there is a natural reluctance for the courts to impose equitable doctrine into commercial transactions¹¹⁰ in light of the practical concerns of the arrangements (which would make the accounting of the agency exceedingly complicated in light of the simplicity of the arrangement), and
- 5, that the agent's **only** duty in such a case was to merely account, which trustees also have to do, to their respective principals or beneficiaries, but the finding of a trust cannot merely be based on the fact that the agent must **only** account and is not saddled with alternate fiduciary requirements.

Re: Air Canada and M & L Ltd et al.¹¹¹ illustrates the character of an agreement that agents must enter into with their respective principals to be recognized as holding proceeds/property on trust for them. The latter company sold air line tickets for the former as agent and as per the agency agreement the proceeds were to be kept **separately** in a bank account on trust for Air Canada. Citing Canadian Pacific Air Lines Ltd. v. C.I.B.C.¹¹² the court found that the agreement with respect to the treatment of the proceeds impressed a trust upon them incidental to the general agency environment. C.P. Air concerned essentially the same circumstances and both cases held that the terms imposed on the use of the proceeds operated to impress a trust on them. In C.P. were cited Quantas Airways Ltd. v. Stevens Travel Service International Pty. Ltd. et al., Myrta Forastieri et al. v. Eastern A.L.¹¹³, Air Traffic Conference v. Downtown Travel Center¹¹⁴ and PanAm v. Lew Art Travel, to endorse the dicta that money to be received and restricted in use by the agent as per the agreement was impressed with a trust¹¹⁵ while in Air Canada Re: Morales Travel Agency¹¹⁶, Re: Shulman

¹¹⁰ citing New Zealand and Australian Land Co. v. Watson, (1881) 7 QBD 374 and Neste Oy v. Lloyds Bank Plc, 1983 2 Lloyd's Rep 658, as authority

¹¹¹ 1991 77 D.L.R. (4d) 536 (OCA)

¹¹² 1987 42 D.L.R. (4d) 375

¹¹³ 18 Avi 17,145 (1983) (CCH)

¹¹⁴ 14 Avi 17,172 (1976) (CCH)

¹¹⁵ See also Niedner Ltd. v. Lloyds Bk. of Can., 1990 74 O.R. 574.

¹¹⁶ 667 F.2d 1069

Transport Ent¹¹⁷, Re: Chaim Einhorn Vacation Planning Center¹¹⁸ & Re: Shulman Transport Ent.¹¹⁹ were cited as authority that a mere debtor-creditor relationship is involved in similar situations where there are not any restrictions on the use of the proceeds to be received by the agent and no expression of the impressing of a trust in respect of them.

Whether Non-resident Arrangements Fit as Canadian Recognized Trusts?

Whether a non-resident arrangement can be recognized as a trust for purposes of application of the provisions of the ITA to its Canadian aspects is a fundamental question that can only be answered through analysis of the characteristics of a Canadian trust and those that exist for the arrangement. Peter Sommerer and Her Majesty The Queen¹²⁰ provides exactly this type of analysis whereby the Tax Court had to consider with an Austria Private Foundation would qualify. It held, considering the 3 certainties and the overriding fiduciary duty, in detail:

2. Can the arrangement whereby Mr. Herbert Sommerer endowed the SPF with funds for the purpose set forth in the SPF Deeds be viewed as a trust for purposes of the application of the *Income Tax Act*?

[58] As already indicated, I reframed the issue in a manner that is more readily open to analysis. This should not be an issue of whether an Austrian Private Foundation under the *APFA* is a trust, let alone whether the SPF is a trust. That is the wrong question. The Appellant says it is a company: the Respondent says it is a trust. I have concluded that, depending on the terms of the Foundation Declaration and Supplemental Declaration, an Austrian Private Foundation could be considered a trust company, acting as a trustee, and with respect to the SPF, I find that that is as good a label as can be attached, when looking at it through the eyes of Canadian laws.

[59] What needs to be analyzed, however, is not what the SPF is, but what relationship exists amongst the SPF (a separate legal person), Mr. Herbert Sommerer, and Mr. Peter Sommerer and the Sommerer family. Is there a trust relationship? Can Mr. Herbert Sommerer be seen as a settlor? Can the SPF be seen as a trustee, perhaps a corporate trustee? Can Mr. Sommerer be seen as a beneficiary? Do the three certainties, certainty of intention, certainty of subject matter, and certainty of objects exist? Are there any other characteristics of the Canadian trust that are missing in the Sommerer arrangement?

[60] I agree with the Appellant's suggestion that, in characterizing a foreign arrangement, I rely on the Supreme Court of Canada's comments in *Backman v. The Queen*^[11] to look at the private law in Canada to determine the essential elements of a trust, and then compare the elements of the foreign arrangement to determine if it can be treated as its correlate under Canadian law. So, what are the essential elements of a trust under Canada law? I note, with some concern, Professor Waters' opening comments in this regard in his article "*The Concept Called 'the Trust'*":^[12]

It is agreed among text writers of the common law tradition – an opinion adopted by the Courts – that "the trust" cannot be defined. It can only be described. That means you can point to its characteristics or elements, but you cannot put into a sentence what it is.

[61] The Appellant's counsel referred me to a number of comments from authorities such as *Oosterhoff on Trusts*^[13] and *Waters Law of Trusts in Canada*.^[14] Notwithstanding Professor Waters' heads-up, I have found the following excerpts helpful:

From *Oosterhoff*:

117 17 Avi 17,363
118 59 B.R. 179 (1986)
119 744 F.2d 293
120 2011 TCC 212

An equitable obligation, binding a person (called a trustee) to deal with property (called trust property) owned by him as a separate fund, distinct from his own property, for the benefit of persons (called beneficiaries or, in all cases, *cestuis que trust*) of whom he may himself be one, and anyone of whom may enforce the obligation.

From *Waters*:

The hallmarks, the essential characteristics of the common law trust, are heavily reflective of a peculiar legal history. The foremost of these is the fiduciary relationship which exists between trustee and beneficiary. The following elements are surely essential. From the moment of the creation of the trust, there must be an ability of the beneficiary to secure an accounting or, to put it another way, a power in the beneficiary to enforce the discharge of its duties by the trustee.

[62] The Respondent, in his argument, puts the essential features more generally:

In broad terms, a trust is a means of managing wealth for the benefit of one or more persons. The essential features of a trust are specified property, a person or persons as the objects of the trust with the exclusive right to its enjoyment or dedication, and person holding title to the property and administering it on behalf of the objects. In simplified terms, a trust is an arrangement whereby a person who holds title to property is under an obligation to administer it for the benefit of another person or persons.

[63] There is no disagreement as to the need for the three certainties to create a trust, though in a somewhat circuitous, though logical, fashion, the Appellant argues that if an essential element is missing for the arrangement to be considered a trust, then there cannot have been the requisite intention to create a trust. The missing element in the SPF arrangement, according to the Appellant, is the lack of the right of the beneficiaries to enforce an obligation owed to them by the trustee. Professor Waters' attempts to address this when he states:

As necessary conditions, if any of the three certainties are not present, the courts will not recognize the existence of a trust. The presence of the three certainties are not, however, sufficient conditions to the creation of a trust; they are evidentiary in nature and represent the factual threshold at which the law will recognize as enforceable the obligations of a trustee towards the beneficiary with respect to the designated trust property.

[64] This is something of a chicken and egg statement: do the beneficiaries' rights of enforcement arise in law because there is a trust, or must the beneficiaries' rights of enforcement exist by the Trust Deed, for example, for there to be considered a trust. The Appellant suggests the latter.

[65] It is this element of accountability owed by the trustee to the beneficiaries, enforceable by the beneficiaries, that is at the crux of the dispute between the parties on this issue; in essence, the nature and extent of the required fiduciary obligation.

[66] In summary, the essential ingredients of a trust under Canadian law that I wish to address are:

a) segregated property;

b) owned by a person (trustee) having control of the property;

c) for the benefit of persons (beneficiaries);

d) to whom the trustee has a fiduciary duty enforceable by the beneficiaries.

If I find these essential features in the arrangement by which the SPF held the Vienna shares, then I will have no difficulty finding the three certainties were met to create the trust. It is absolutely clear to me that there is certainty of subject matter and objects, and if the essential features of a trust are evident, then the intention of Mr. Herbert Sommerer to create a trust can be gleaned from the Foundation Declaration, the Supplementary Deed and the application of

APFA. All to say, the analysis does not hinge on the three certainties.

[67] Turning then to the SPF and its holding of the Vienna shares, I readily find that the first two essential features are apparent in this arrangement. The property, the Vienna shares, substituted for the initial endowment to the SPF from Mr. Herbert Sommerer, was subject to the provisions of the *APFA*, which at the very outset in section 1, refer to "an endowment for achieving a permissible purpose determined by the founder". No purpose was for the SPF to use the endowment to its own account. Secondly, the property was owned by the SPF, which, as a legal person, held title to the Vienna shares, and held control over the property.

[68] Third, was the property held for the benefit of persons? In this regard, the experts testified that Austrian law distinguishes between actual and potential beneficiaries. There is also the distinction under the *APFA* between beneficiaries and ultimate beneficiaries. The Foundation Declaration and Supplementary Declaration are not expansive in their descriptions of the beneficiaries, but I take from the experts' views that the beneficiaries (Mr. Peter Sommerer, Mrs. Dawn Sommerer and children and their offspring, provided they are resident of Austria) are income beneficiaries only, and even then only potential beneficiaries, as none were resident in Austria and none were named to receive any grant. Similarly, Mr. & Mrs. Sommerer, in the event of the founders' revocation, are ultimate capital beneficiaries, though, again only potential beneficiaries until there is a revocation. This classification of actual versus potential beneficiary is of no consequence in answering the question of whether the property was held for the benefit of persons. Of course it was; that was the *raison d'être* of the SPF. The difference between actual and potential beneficiaries becomes a factor only when considering the fiduciary duty of the SPF.

[69] With respect to the income beneficiaries, the class of beneficiary was clear; it was also clear from the Foundation documents how it was to be determined who within the class might receive a grant from the SPF. The potential beneficiaries are clearly ascertainable.

[70] With respect to the ultimate beneficiaries, it is even clearer. If Mr. Herbert Sommerer decides to revoke the SPF, Mr. Peter Sommerer and Mrs. Dawn Sommerer receive the capital. They are persons who will benefit. The third essential ingredient exists.

[71] So, the penultimate question is whether the SPF had any fiduciary obligations to any of these beneficiaries, enforceable by the beneficiaries.

[72] The Appellant points to several factors in support of his position that the beneficiaries had no enforceable right to call the SPF to account. I will deal with those items, but first want to make an overriding observation regarding this essential feature. The right of the beneficiary is the flip side of the fiduciary duty of the trustee; in this case, the duty of the SPF, if any, is at issue. If there is no duty enforceable by the beneficiaries, is the SPF simply under some moral obligation and the Sommerers simply hopeful they might get something from the SPF? This would more resemble a power of appointment. My impression is that the SPF was not founded on the shifting sands of moral obligation: there were no beneficiaries other than the Sommerers; there were no ultimate beneficiaries in the case of revocation other than Mr. & Mrs. Sommerer; there are no ultimate beneficiaries in any other case other than those set out in 3.2 of the Supplementary Deed. This is not designed for the SPF to exercise any moral obligation. So, in the context of attempting to determine whether an arrangement in Austria, whose laws do not contemplate the concept of a North American trust, is akin to a trust under Canadian law, it is my overriding view that there is something well beyond moral obligation going on here. And certainly close enough to the Canadian fiduciary duty to find this final essential element for a trust exists in the SPF arrangement.

[73] I will now address those factors raised by the Appellant to suggest my impression is misplaced.

[74] First, the Appellant relies on Dr. Torggler's evidence that there is no fiduciary duty owed by the Executive Board to the beneficiaries or by the SPF itself. This, though, must be viewed in the context of Dr. Torggler's opinion that, in Austrian law, there is no literal translation of the fiduciary duty. He testified, in answer to the question whether there are any duties owed to beneficiaries as follows:[15]

Not from the outset, but at the moment a beneficiary has been appointed an endowment, usually the beneficiaries have been resolved upon and from that point in time, there was obligation on the part of the Board to fulfil this commitment.

He also stated:[16]

There is a provision that the Board of Directors' owes fulfillment of the purpose of the Foundation, and as the purpose of the Foundation, generally, is in favour of the beneficiaries, in that respect indirectly there is a duty, but there is no direct duty prescribed in the law.

[75] These opinions do not go as far as the Appellant suggests. The Foundation itself is implicitly obliged to fulfill the purpose for which it is established. Further, one of its primary organs, the Executive Board, "must perform his/her responsibilities frugally and with the prudence of a conscientious manager" (section 17(2) *APFA*). Also, the Executive Board must keep the books (section 18 *APFA*). If there is any disagreement between the auditor and the Executive Board, regarding the application of the Foundation Declaration, the Court shall decide (section 21(4) *APFA*). Every member of the Executive Board is liable for damages as a result of negligent neglect of duties (section 29(1) *APFA*). For a jurisdiction that does not recognize a fiduciary duty concept, what is to be made of the above? What I make of it is that Austria has legislated obligations, and when combined with a requirement to fulfill the purposes of the Foundation, which with respect to the SPF is to benefit the Sommerer family, I conclude Dr. Torggler's opinion of no fiduciary duty is overstated. There are sufficient parallels between the Canadian concept of fiduciary duty and the combination of the provisions of the *APFA* and the wording of the Foundation Declaration to find that some requisite duty exists.

[76] Second, the Appellant argues the rights of a beneficiary under the *APFA* are limited to section 30 rights, and in very limited circumstances, section 35(3) rights (application by a beneficiary or ultimate beneficiary for dissolution). With respect to the section 30 right of the beneficiary to information, the Appellant also argues that because Mr. Sommerer was only a potential beneficiary (as he was not an Austrian resident nor had been chosen for a grant) and potential ultimate beneficiary (as there had been no call by the founder to revoke the Foundation), he is not entitled to the section 30 rights for information. Dr. Torggler testified that there has been a court decision in Austria that section 30 is only available to actual beneficiaries. This raises the interesting situation where the SPF is established to benefit the Sommerer family, and no one else, yet they cannot be considered actual beneficiaries until certain conditions are met: in effect there are no beneficiaries. When the condition is met, certain rights kick in. Mr. Taylor acknowledged that only at that point might there be a trust. Presumably, following that reasoning, if Mr. Sommerer became an Austrian resident and the Executive Board determined to make a grant to him, at that point there would be a trust, yet after the grant is paid, Mr. Sommerer goes back to being a potential beneficiary only and there is again no trust. This cements my view, apparently shared by eminent authors on this subject, that the definition of a trust is illusory. But it also suggests to me that this essential feature of enforcing a fiduciary duty should not be viewed in isolation, nor rigidly adopted. Clearly, these rights could arise, and will arise, in the very situation that the founder contemplated of benefiting the Sommerer family. How different is this from the Canadian trust where property is held for a minor until the age of majority when he/she is entitled to a distribution of capital. What right does the minor have to enforce the trustee to pay out before attaining the age of majority?

[77] Also, it is noteworthy that the founder, Mr. Herbert Sommerer, provided that the Advisory Board was to be made up of Mr. & Mrs. Sommerer, the ultimate beneficiaries. Further, he provides the Advisory Board was to play an important role in the SPF including supervisory tasks. This confirms to me an explicit right to information given by the founder to beneficiaries, notwithstanding the provisions of the *APFA*.

[78] With respect to what the Appellant calls the limited rights found in section 35(3) of the *APFA*, of the ultimate beneficiary to apply to the court if the Executive Board does not pass a resolution to dissolve, once the founder has sought revocation, I view this as a significant right. This goes to the distribution of all of the capital of the SPF to the Sommerers. This is no limited right. Mr. Herbert

Sommerer decides to revoke and Mr. & Mrs Sommerer take all: if the Executive Board does not pass the requisite resolution to put this distribution into effect, the Sommerers can apply to court. I find this right alone is sufficient to meet the requirement for an enforceable right of beneficiaries to have the trustee, the SPF, act in their best interests.

[79] The Appellant goes on to argue that the potential beneficiaries have no right in the property of the SPF, as would all the beneficiaries of a common law discretionary trust, who could call for the property by invoking the rule in *Saunders v. Vautier*.^[17] Again, Dr. Torggler opined that even an actual beneficiary does not have a property right in the Private Foundation property. I am concerned that because common law treatment is not afforded the Austrian Private Foundation that it fails to match the essential features of the common law trust. It is important to keep in mind what process is being engaged here. The essential features of a common law trust have been identified, and now the establishment of the SPF and transfer of property into it for the benefit of the Sommerer family is being examined to determine if it can be viewed as a common law trust, notwithstanding its jurisdiction does not have such a concept. It should be no surprise that the concept of beneficial ownership of property is not apparent. I do not find that the lack of such right of beneficial ownership is fatal.

[80] Finally, the Appellant relies on the wording of the Foundation document itself to suggest the income beneficiaries have no legal claim. The Foundation Declaration states: "Beneficiaries and those who may become beneficiaries based on the purpose of the Foundation have no legal claim to grants from the Foundation". Firstly, I interpret this provision to be dealing with income beneficiaries only, not the ultimate beneficiaries. This simply makes clear the discretionary nature of income grants. They can only be to the Sommerer family, but no individual family member can come knocking on the SPF's door asking to be paid a grant. This evidence is no more than that, and is not sufficient to strip away the character of a discretionary trust.

[81] On balance, I have not been convinced that there is no fiduciary duty enforceable by the Sommerer family. Certainly, the rights may not be as extensive as one might find in many common law trusts, but for purposes of trying to determine if an arrangement involving an Austrian Private Foundation has the elements of a common law trust, it is unnecessary to find every possible right of a beneficiary against a trustee, but more appropriately the question should be, are there sufficient rights that reasonably resemble those found in the Canadian trust? I conclude there are.

[82] It should be clear that in reaching this conclusion, I am not finding the SPF is a trust: I am finding the relationship between Mr. Herbert Sommerer, the SPF and the beneficiaries constitutes a trust, with the SPF as the trustee. Further, I do not make this finding in any way as a generalization that all relationships involving an Austrian Private Foundation are trust relationships. There may well be a Foundation Declaration that is found to be more akin to a power of appointment, for example, by stripping away any rights of enforceability a beneficiary might have. **Here, on balance, there are sufficient indices of the essential features of a trust to find the arrangement can be considered a trust.** Given that conclusion, it is unnecessary for me to review the Quebec Civil Code concepts, as well explained to me by Me Tassé, to determine if the Austrian arrangement falls within any of the Quebec concepts of trust.

On appeal however the Federal Court of Appeal delved deeper into the environment with:

(C) Is there a trust?

[37] The Crown argued in the Tax Court that the Sommerer Private Foundation is a trust. Peter Sommerer argued that it is a corporation. Justice Miller concluded that it is a corporation that holds its property in trust for Peter Sommerer and the other named beneficiaries. He went on to conclude that subsection 75(2) of the *Income Tax Act* does not apply to attribute to Peter Sommerer the capital gains realized by the Sommerer Private Foundation on the sale of the Vienna shares and the Cambrian shares. He held in the alternative that Article XIII (5) of the *Canada-Austria Income Tax Convention* precludes Canada from taxing Peter Sommerer on the capital gains realized by the Sommerer Private Foundation.

[38] The Crown's appeal assumes that Justice Miller was correct when he concluded that the Sommerer Private Foundation holds its property in trust. The Crown challenges only Justice Miller's

conclusions on the application of subsection 75(2) of the *Income Tax Act* and Article XIII (5) of the *Canada-Austria Income Tax Convention*. Peter Sommerer does not agree that the Sommerer Private Foundation holds its property in trust, but as respondent in this appeal he has chosen not to argue that point. He has concentrated instead on defending Justice Miller's conclusions on the application of subsection 75(2) of the *Income Tax Act* and Article XIII (5) of the *Canada-Austria Income Tax Convention*. Because of the manner in which this appeal was argued, the proposition that the Sommerer Private Foundation holds its property in trust was not the subject of submissions, and I will express no final opinion on whether it is correct. However, I will say that in my view, it is a doubtful proposition.

[39] According to the undisputed evidence of Dr. Torggler, the law of Austria does not recognize trusts as understood in Canadian law. However, it is evident that as a practical matter (and putting aside for the moment any income tax considerations), Herbert Sommerer may well have achieved many of the objectives that could have been achieved in a common law jurisdiction by settling a trust for Peter Sommerer, his spouse and their children. He did so by creating and endowing the Sommerer Private Foundation under the Austrian *Private Foundations Act* and naming Peter Sommerer, his spouse, and their children as beneficiaries and ultimate beneficiaries. But that does not mean as a matter of law that the creation and endowment of the Sommerer Private Foundation was the settlement of a trust, or that a trust existed or came into existence when the Sommerer Private Foundation bought the Vienna shares or the Cambrian shares from Peter Sommerer.

[40] As mentioned above, an Austrian private foundation is a juridical person with the legal capacity to own property in its own right and to deal with its property on its own account. The legal right of an Austrian private foundation to deal with its own property is the same as the legal right of a Canadian corporation to deal with its own property. That is so despite the fact that the board of an Austrian private foundation must manage its affairs in furtherance of the purposes stipulated in its constating documents. The board of directors of a corporation is similarly constrained, in the sense that it must manage the affairs of the corporation in its best interests, subject to any terms and conditions in its constating documents.

[41] A corporation does not hold its property in trust for its shareholders or members, except to the extent that a trust deed or an analogous legal instrument imposes the legal and equitable obligations of a trustee on the corporation with respect to specific corporate property. Assuming it is theoretically possible for an Austrian private foundation to hold its property in trust (that is, subject to conditions that are analogous to the legal and equitable obligations of a trustee in a common law jurisdiction), that possibility cannot be realized unless those conditions are formally established. Nothing in the constating documents of the Sommerer Private Foundation or the law of Austria, as reflected in the record of this case, supports the conclusion that the right of the Sommerer Private Foundation to deal with its property is constrained by any legal or equitable obligations analogous to those of a common law trustee.

[42] Looking at the situation from another point of view, a shareholder or member of a corporation, as such, is not the beneficial owner of any property of the corporation, and has no legal or equitable claim to the corporate property (unless such a claim arises upon the declaration by the board of directors of a dividend, or when the dissolution of the corporation is imminent). Unless and until such an event occurs, a shareholder or member has only an inchoate right to receive distributions of corporate property from time to time at the discretion of the board of directors, and to share in the distribution of the corporate property upon its dissolution. The same can be said of the interest of a beneficiary or an ultimate beneficiary in the property of an Austrian private foundation. Nothing in the Austrian *Private Foundations Act* or the constating documents of the Sommerer Private Foundation gives Peter Sommerer a legal or equitable claim to the corporate property that is different from that of a shareholder or member of a corporation.

[43] For these reasons, I doubt that the Sommerer Private Foundation holds any of its property in trust for Peter Sommerer. However, in the remainder of these reasons I set aside my doubts about whether the Sommerer Private Foundation holds its property in trust, and I assume without deciding

that in October of 1996 when Herbert Sommerer created the Sommerer Private Foundation and endowed it with the equivalent of \$126,000, he settled a trust for the benefit of Peter Sommerer, his spouse and their children, with the Sommerer Private Foundation as trustee.

Trusts and Agencies.

A trust agreement or estate setting cannot be equated with an agency arrangement whereunder one party acts as agent with respect to the ownership/control of property as per the terms of the contract entered into with his principal. In such a case, the basis of the arrangement is a contract entered into by the parties whereby the agent acts as a conduit for his principal and as long as he acts within the terms of the contract, he will not be personally liable, but instead the principal will be, for his actions. A trust on the other hand, is not a contract compelling parties to act in a certain way but instead is an equitable obligation assumed by the trustee as a consequence and condition of the obtaining of the legal title to property, (transferred by the settlor), and thus he is not an agent for any party, (settlor or beneficiary), but instead as legal title holder is ultimately accountable for his own actions and is thus able to deal with the property without, (or usually without), the consent of anyone. Agents can act to bind their principals while trustees cannot act to bind either beneficiary or settlor but only themselves. A breach in the contract forming an agency can result in the agent becoming personally liable to either his principal or a third party while a breach in a trust agreement allows the trustee to become personally liable only to the beneficiaries for whom in equity, he was to act.¹²¹

Personal Trusts.

Implemented with the 1988 reform was the definition of "personal trust" upon which the bulk of any existing "favourable" provisions concerning trusts in our Act operate. The definition and amendments to the "favourable" provisions were introduced primarily as a restricting measure to disallow those favourable from applying to transactions/arrangements other than those for which they were intended. The "favourable" provisions referred to include the ability to deduct the cost of an income right in computing the taxable income received from, in connection with, the trust, the ability to receive an effectively tax free distribution of capital in satisfaction of a capital interest in the trust, or a tax free disposition of the capital interest to another party, etc.. As will be seen in subsequent chapters, the retention of the personal trust status is not so important in respect of recognizing or computing income of the trust or its beneficiaries on an on-going basis, but instead becomes critical when the trust is distributing property on a wind-up or where there is substantial trading or expected to be trading in its capital or income interests.

In any private family/estate planning environment this is the creature that "the fur of which you want to protect at any cost". Once you lose it it's gone forever and so many favourable provisions operate on its existence.

The Specific Definition

A "personal trust" as defined in Sec. 248(1) for the purpose of the Act, applicable after 1984, means a testamentary trust of **any nature**, or an *inter vivos* trust, no **beneficial interest** in which was acquired for consideration payable directly or indirectly to the trust or any person who has made a contribution to the trust by way of transfer, assignment, or other disposition of property.¹²²

¹²¹ Without referencing numerous instances it is possible for a trust to arise in an agency environment: see *Walsh Bay Developments Pty Ltd and Anor. v FCT*, 130 A.L.R. 415, FC Aust. as well as *Winterton Contructions Pty Ltd v Hambros Australia Ltd and Anor.*, 101 A.L.R. 363, FC Aust.

¹²² On the fulfillment of a condition precedent upon which the interest vests does the beneficiary acquire a new right different from that contingent previously held? In the author's opinion not necessarily and these issues illustrate perhaps one of the easier ways to preserve the personal status and have the contributing party receive consideration for the substance of the right, and not the right itself. The consideration payable to the contributor/trustee to have the right vest would not be added to the cost of the interest for the purposes of the Sec. 107(1) provision while the recipient if resident, would suffer a Sec. 105(1) inclusion but the trust would remain personal. Since the payment would not flow through to be added to the cost of the trust property via the Sec. 107(2) distribution it shouldn't exceed the a.c.b. of the trust property the interest is enforceable in respect of. There are exceptions to this however when one examines the possibility of non-resident trusts and the possibility of cost bumps.

“Definition of personal trust – Sec. 248(1)“

"personal trust" means

(a) a testamentary trust, or

(b) an *inter vivos* trust, no beneficial interest in which was acquired for consideration payable directly or indirectly to

(i) the trust, or

(ii) any person who has made a contribution to the trust by way of transfer, assignment or other disposition of property,

but, after 1999, does not include a unit trust;

“Interests acquired for consideration – Sec. 108(7)“

(7) For the purposes of paragraph 53(2)(h), subsection 107(1), paragraph (j) of the definition “excluded right or interest” in subsection 128.1(10) and the definition “personal trust” in subsection 248(1),

(a) an interest in a trust is deemed not to be acquired for consideration solely because it was acquired in satisfaction of any right as a beneficiary under the trust to enforce payment of an amount by the trust; and

(b) where all the beneficial interests in a particular *inter vivos* trust acquired by way of the transfer, assignment or other disposition of property to the particular trust were acquired by

(i) one person, or

(ii) two or more persons who would be related to each other if

(A) a trust and another person were related to each other, where the other person is a beneficiary under the trust or is related to a beneficiary under the trust, and

(B) a trust and another trust were related to each other, where a beneficiary under the trust is a beneficiary under the other trust or is related to a beneficiary under the other trust,

any beneficial interest in the particular trust acquired by such a person is deemed to have been acquired for no consideration.

“Variation of trust – Sec. 108(6)“

(6) Where at any time the terms of a trust are varied

(a) for the purposes of subsections 104(4), (5) and (5.2) and subject to paragraph (b), the trust is, at and after that time, deemed to be the same trust as, and a continuation of, the trust immediately before that time;

(b) for greater certainty, paragraph (a) does not affect the application of paragraph 104(4)(a.1); and

(c) for the purposes of paragraph 53(2)(h), subsection 107(1), paragraph (j) of the definition “excluded right or interest” in subsection 128.1(10) and the definition “personal trust” in subsection 248(1), no interest of a beneficiary under the trust before it was varied is

considered to be consideration for the interest of the beneficiary in the trust as varied.

“Definition of “disposition” – Sec. 248(1)”

“disposition” of any property, except as expressly otherwise provided, includes

(a) any transaction or event entitling a taxpayer to proceeds of disposition of the property,

(b) any transaction or event by which,

(i) where the property is a share, bond, debenture, note, certificate, mortgage, agreement of sale or similar property, or an interest in it, the property is redeemed in whole or in part or is cancelled,

(ii) where the property is a debt or any other right to receive an amount, the debt or other right is settled or cancelled,

(iii) where the property is a share, the share is converted because of an amalgamation or merger,

(iv) where the property is an option to acquire or dispose of property, the option expires, and

(v) a trust, that can reasonably be considered to act as agent for all the beneficiaries under the trust with respect to all dealings with all of the trust’s property (unless the trust is described in any of paragraphs (a) to (e.1) of the definition “trust” in subsection 108(1)), ceases to act as agent for a beneficiary under the trust with respect to any dealing with any of the trust’s property,

(c) any transfer of the property to a trust or, where the property is property of a trust, any transfer of the property to any beneficiary under the trust, except as provided by paragraph (f) or (k), and

(d) where the property is, or is part of, a taxpayer’s capital interest in a trust, except as provided by paragraph (h) or (i), a payment made after 1999 to the taxpayer from the trust that can reasonably be considered to have been made because of the taxpayer’s capital interest in the trust,

but does not include

(e) any transfer of the property as a consequence of which there is no change in the beneficial ownership of the property, except where the transfer is

(i) from a person or a partnership to a trust for the benefit of the person or the partnership,

(ii) from a trust to a beneficiary under the trust, or

(iii) from one trust maintained for the benefit of one or more beneficiaries under the trust to another trust maintained for the benefit of the same beneficiaries,

(f) any transfer of the property as a consequence of which there is no change in the beneficial ownership of the property, where

(i) the transferor and the transferee are trusts,

(ii) the transfer is not by a trust resident in Canada to a non-resident trust,

(iii) the transferee does not receive the property in satisfaction of the transferee's right as a beneficiary under the transferor trust,

(iv) the transferee held no property immediately before the transfer (other than property the cost of which is not included, for the purposes of this Act, in computing a balance of undeducted outlays, expenses or other amounts in respect of the transferee),

(v) the transferee does not file a written election with the Minister on or before the filing-due date for its taxation year in which the transfer is made (or on such later date as is acceptable to the Minister) that this paragraph not apply,

(vi) if the transferor is an amateur athlete trust, a cemetery care trust, an employee trust, an *inter vivos* trust deemed by subsection 143(1) to exist in respect of a congregation that is a constituent part of a religious organization, a related segregated fund trust (in this paragraph having the meaning assigned by section 138.1), a trust described in paragraph 149(1)(o.4) or a trust governed by an eligible funeral arrangement, an employees profit sharing plan, a registered disability savings plan, a registered education savings plan, a registered supplementary unemployment benefit plan or a TFSA, the transferee is the same type of trust, and

(vii) the transfer results, or is part of a series of transactions or events that results, in the transferor ceasing to exist and, immediately before the time of the transfer or the beginning of that series, as the case may be, the transferee never held any property or held only property having a nominal value,

(g) [Repealed, 2005, c. 30, s. 17]

(h) where the property is part of a capital interest of a taxpayer in a trust (other than a personal trust or a trust prescribed for the purpose of subsection 107(2)) that is described by reference to units issued by the trust, a payment after 1999 from the trust in respect of the capital interest, where the number of units in the trust that are owned by the taxpayer is not reduced because of the payment,

(i) where the property is a taxpayer's capital interest in a trust, a payment to the taxpayer after 1999 in respect of the capital interest to the extent that the payment

(i) is out of the income of the trust (determined without reference to subsection 104(6)) for a taxation year or out of the capital gains of the trust for the year, if the payment was made in the year or the right to the payment was acquired by the taxpayer in the year, or

(ii) is in respect of an amount designated in respect of the taxpayer by the trust under subsection 104(20),

(j) any transfer of the property for the purpose only of securing a debt or a loan, or any transfer by a creditor for the purpose only of returning property that had been used as security for a debt or a loan,

(k) any transfer of the property to a trust as a consequence of which there is no change in the beneficial ownership of the property, where the main purpose of the transfer is

(i) to effect payment under a debt or loan,

(ii) to provide assurance that an absolute or contingent obligation of the transferor will be satisfied, or

(iii) to facilitate either the provision of compensation or the enforcement of a penalty, in the event that an absolute or contingent obligation of the transferor is not satisfied,

(l) any issue of a bond, debenture, note, certificate, mortgage or hypothecary claim, and

(m) any issue by a corporation of a share of its capital stock, or any other transaction that, but for this paragraph, would be a disposition by a corporation of a share of its capital stock;

“Inadequate considerations – Sec. 69(1)”

(1) Except as expressly otherwise provided in this Act,

(a) where a taxpayer has acquired anything from a person with whom the taxpayer was not dealing at arm's length at an amount in excess of the fair market value thereof at the time the taxpayer so acquired it, the taxpayer shall be deemed to have acquired it at that fair market value;

(b) where a taxpayer has disposed of anything

(i) to a person with whom the taxpayer was not dealing at arm's length for no proceeds or for proceeds less than the fair market value thereof at the time the taxpayer so disposed of it,

(ii) to any person by way of gift *inter vivos*, or

(iii) to a trust because of a disposition of a property that does not result in a change in the beneficial ownership of the property; and the taxpayer shall be deemed to have received proceeds of disposition therefor equal to that fair market value; and

(c) where a taxpayer acquires a property by way of gift, bequest or inheritance or because of a disposition that does not result in a change in the beneficial ownership of the property, the taxpayer is deemed to acquire the property at its fair market value.

A testamentary trust can never be a "non-personal" trust, even when an interest the fair market value of which was paid for with a transfer of property, is acquired by an initially foreign taxpayer. Such a disposition will not constitute a gratuitous contribution so as to impair the status of the trust as per the Sec. 108(1) definition of testamentary trust, and since the trust remains testamentary, it also remains personal after a beneficial

interest has been "purchased" for consideration paid to the trust.¹²³

Contributions by Dispositions

Where the trust is an *inter vivos* trust it cannot be personal when any sort of "beneficial interest" is acquired for consideration payable directly or indirectly to the trust or any person who made a **direct** contribution to the trust by way of transfer, assignment or **other disposition of property**, though qualified by Sec. 108(7). The trust will lose **permanently** the personal nature. There is no definition of "beneficial interest" provided for purposes of this definition and giving it its normal meaning it would include "beneficial interests" in the form of enforceable rights to or to receive property, (income or capital, be they rights immediate or future, contingent or absolute), as well as pecuniary interests the beneficiary may have as a discretionary beneficiary having no enforceable right to or to receive property except when a discretionary power is exercised so as to grant one.¹²⁴

The deemed payment of consideration will also be considered.

The beneficial interest must have been acquired for consideration payable to either of the two parties hence there would have to be some degree of connection between the acquisition of the interest and the receiving of consideration by the trust or contributing party.¹²⁵

A Two Dimensional Scope

The definition applies in respect of *inter vivos* trusts to cause a loss of status when consideration is paid or payable directly or indirectly to the trust in which the interest was acquired or any person who has made a contribution of property to **that particular trust**.

Subsection 108(7) operates to allow the preservation of the personal trust status by deeming interests acquired in certain instances not to disqualify the trust.

This provision determines that the interest in the trust will not be considered acquired, it speaks nothing of the cost of the interest created on the contribution of property to the trust cited when such occurs.

Since the provision doesn't include persons who have **indirectly** contributed to the **particular** trust in which the interest exists some flexibility exists. A personal trust created by a settlor for two offspring beneficiaries places a general power of appointment with a friend of the family. The (general) power of appointment is exercised by that fourth party to create a distinctive new sub-trust out of some of the initial trust property, obviously operating to the detriment of the offspring beneficiaries since the new trust has as beneficiaries fifth and sixth parties. They make a gift to the original settlor or beneficiary of the initial trust, (the payment of which is possibly imposed by the second trust as a condition precedent) to reduce the adverse effects of the exercise of the power created. Although they will not be able to recognize a cost for their income or capital interests as per Sec. 106(1.1) or 107(1.1) their trust will be a personal trust since the person to whom they gifted did not in fact make a transfer, assignment or other disposition of property to the **particular** trust. That trust arose by the exercise of a **general** power of appointment which has as its creator/settlor the power holder under the initial trust and no one else. If the secondary trust's beneficiaries were to make a gift directly to the power holder

123 Can a trust have an interest carved out of it after it is created and sold by it? If so, have the other beneficiaries suffered a disposition of some of their interest rights?

124. An entitlement to be created with a power of appointment cannot be gratuitously transferred but can be conveyed for consideration, (Norman v. F.C.T., 109 C.L.R. 9, Sheppard v. F.C.T., 113 C.L.R. 385, Akron Tyre Co. Ltd. v. Kittson, 82 C.L.R. 477), and until the interest is created the trust should remain personal.

125 If the trustees thus exercise a general power of appointment so as to grant a capital interest to a particular taxpayer which operates to cause a reduction in the scope of another beneficiary's capital interest a subsequent gift to the deprived beneficiary by the appointed beneficiary will not cause a loss of personal trust status when the deprived beneficiary did not make a contribution to the trust, while as per Sec. 107(1.1) that payment **may** not constitute a cost of the capital interest acquired. If a taxpayer made a contribution to a previously existing trust which contained a general power of appointment over trust property and that taxpayer did not receive an interest therein then the personal status would not be lost. If another taxpayer made a substantial gift to the contributing taxpayer then the personal status would still not be jeopardized while if subsequent to the gift the third party power holder exercised the general power of appointment granting a capital interest to the gifting taxpayer then the Department would have a slight problem arguing that the gift made to the contributing taxpayer was as consideration for the acquisition of an interest he did not own nor had he had control over. The key aspect that would be scrutinized in such an instance would be who holds the power of appointment and the purpose of its exercise. A "gift" to a contributor could flag a series of transactions the Department could chase with section 245.

then they would possibly cause their trust to lose its personal status, if the power holder had contributed to the trust. If a beneficial interest was acquired in an *inter vivos* trust not for consideration payable directly or indirectly to the trust or a contributor to the trust but to create a trust for other beneficiaries therein interested then both trusts would retain their status and the initial trust could be varied so as to allow a discretionary power to be implemented and subsequently exercised to pay to the beneficiary, (secondary trust creator), the capital/income of the first.

Perhaps most entertaining is the fact that the consideration cannot be payable to the trust or a person who has made a "contribution to the trust by way of transfer, assignment or **other disposition...**" and be a party which **lends** property to the trust does not constitute a disqualifying recipient. The provision concerns contributions in the way of transfers, assignments or "**other dispositions**" of property, not loans which must be repaid hence a taxpayer could lead income producing property to a trust, or possibly even create one through a loan, and receive consideration paid from the income or capital beneficiary who receives a right to the income from the property, without causing the trust to lose its personal status. In *Dunkelman v. M.N.R.*¹²⁶ a loan was not considered to be a transfer for purposes of the attribution rules while in *P. Boisselle v. M.N.R.*¹²⁷ the forgiving of such a loan was. In such a manner, a substantial loan can be made to a trust, property rented can accomplish the same result, on long-term repayment, to rank second to another loan to double the income producing capacity of the trust, and the consideration paid to the settlor for his interest will not disqualify it. Has Canadian tax jurisprudence evolved to the extent that it will recognize "a transfer" of economic interest in such a case as is this why the legislators expressed more coinage than the word disposition?

Disposition of Interests acquired and their Costs

Where an interest is acquired by a settlor of the trust, at **the time the trust was created**, it will not be considered acquired for consideration payable to the trust hence the trust will be "personal" however when the interest is disposed of to another party the trust will lose its status. Consideration has been paid to a contributor. If the contributor transfers the interest to a spousal trust Sec. 73(1) will apply to offer a tax free roll-over while the contributor will receive proceeds, **deemed** so she cannot even transfer it on. This requires a bit of foresight as to where the interest and resulting economic effects are to flow to seed its' ownership in the proper place in the possible stream.

While the interaction of the Sec. 248(1) definition and Sec. 108(7) initially allows a to be trust set-up privately, once the beneficiaries start dealing in their interests, depending on their relationship to the contributor, there could be problems.

Relevant to all of the above are factors which concern the tax cost of the interest acquired and the conferring of benefits on any party by way of a trust by way of conditions precedent.

The tax cost of an interest in a personal trust is, generally, only important when it is an income interest. Under Sec. 106(1.1), an income interest will be allowed to have a deductible tax cost equal to the amount of consideration paid to a former beneficiary and not to anyone else. Payments made to a contributor of property will not be deductible unless they owned the severed out income interest before – the buyer is not buying what the contributor is selling. If a payment is made to an income beneficiary for his interest the personal status of the trust will not be tainted unless the beneficiary contributed directly to the trust.¹²⁸

Under Sec. 107(1.1), the initial cost (ACB) of a capital interests in a trust will be allowed to equal the amount of consideration paid to a former beneficiary in respect of the interest or the trust itself and while a payment to the former as consideration will not taint the trust obviously a payment to the latter, as consideration, will. (This isn't the case with testamentary trusts.) A payment to an indirect contributor may not be recognized as included in the ACB of the interest. The trust retains its personal status there is no great harm in the capital interest

¹²⁶ 59 D.T.C. 1242

¹²⁷ [1989] 1 C.T.C. 2385 (TCC)

¹²⁸ If an income interest in a temporarily non-resident trust is gifted to a non-resident on condition that the dispose of it for a certain amount subsequently to a Canadian resident Sec. 115(1)(a)(iv) will not cause taxation on the Canadian residents purchase of the interest. (There may be problems with such effective restraints on alienation but if the trust deed is structured so as to divest the interest if the instructions are not followed the restraint may be avoided.) The gift of the interest could be saddled with a condition precedent requiring payment of a sum on trust for the particular purchaser.

therein having an ACB equal to nil, except where there are to be trust-beneficiary transactions that are to be affected by the Sec. 53(2)(h) ACB adjustment provision applicable to purchased capital interests in personal trusts.

Part of the favourable provisions available in respect of personal trusts include the Sec. 107(2) disposition provision which allows another virtually tax free distribution of property in satisfaction of a capital interest. This subsection is to be aimed for when contemplating the use of a personal trust (unless the trust is to dispose of the contribution)

Subsection 105(1) Benefits and Other Considerations

A major danger in respect of any indirect transfers in settling a trust arrangement is that which the Sec. 105(1) provision poses which causes the value of all benefits to a taxpayer, (which need not be a beneficiary), from or under a trust to be included fully in his income unless they haven't already done so, or if they didn't lead to an actual or hypothetical Sec. 53(2)(h) adjustment in the ACB of the taxpayer's capital interest in the trust. Obviously payments made to an indirect contributor to the trust will be fully included in his income **if they can be traced** to being a benefit from or under a trust.¹²⁹ This can be avoided if the object the payment is made in respect of is an interest in the trust. A payment made to the holder of a general power of appointment, regardless of whether it is exercised favourably for the benefit of the payer, will fall under Sec. 105(1) and be fully included in income, even though it will not be recognizable as consideration paid for any resulting interest acquired by the payer.¹³⁰

An *inter vivos* trust will not lose its personal status if consideration is paid for a beneficial interest to a person who has made a contribution to the trust by way of a loan for value in a situation similar to that in *Dunkelman v. M.N.R.*¹³¹. The contributor could make a loan of property for a charge less than its fair market rental cost and the excess income produced would be the contribution. Until the loan is forgiven it cannot be considered a contribution by way of transfer, assignment, or other disposition of property. Since the payment can be made to the lender/creditor to compensate her for a reduced yield from his economic transfer to the trust, can it be a Sec. 105(1) benefit: is she realizing a benefit from the trust purely and is this the enlarged scope of the Sec. 105(1)-53(2)(h) mechanics? ^{132 133}

If the lender of the property, as a means of creating the trust, takes back a beneficial interest therein the closing prose of the definition's (b)(ii) will apply to retain the personal character. A contributor loans property to a trust and takes back consideration being the income interest in the trust's full income. Can that income interest have a deductible cost for purposes of Sec. 106(1) that allows it's write off? The trust remains personal since the holder of the income interest/contributor did not transfer/assign/dispose: she loaned and by virtue of the fact that she can recognize a cost equal to the consideration she did pay for her interest – she loaned property to the trust for consideration being a reduced return, to obtain more of a return with the 2nd loan's capacity. She can transfer that income interest for a larger amount and there is integration of its cost deductibility under Sec. 106(1). Again, this can knit in to an estate plan and split up deductibility of costs in various hands as the income from the property acquired by the trust is realized by the trust and paid out to various parties. First, maybe, to the contributor to a certain extent and then to the 2nd income interest beneficiary as the first interest is exhausted.¹³⁴ Variations can discretionarily occur. What is the value of a

129. Such a payment would be as consideration for exercising a power of appointment and granting a substantial capital/income interest to the payer.

130 Subsection 105(1) does not apply to non-residents by virtue of the lack of technical accuracy in Sec. 214(3)(a) hence the recipient can be non-resident without consequences.

131 59 D.T.C. 1242

132 See the recent Aust. case of *Brown and Secretary, Department of Family and Community Services* [2004] AATA 48 (22 January 2004) for a blurring of the line between loan creditor and trust beneficiary in a social security case when loans were made to an off-shore trust and repaid.

133 If such is the case can you imagine where the line is on how extensive the types of benefits CRA will recognize that a settlor can realize from his trust?

134 One would want to make sure that the primary income interest is severable to a certain extent here to ensure

loan/rental at a reduced rate and it is all assignable to the income interest's cost.

The final important aspect concerning the personal trust definition is that if so much as one beneficial interest of any degree is acquired for consideration payable to either of the two subject parties the entire trust will lose its status regardless of the actions of the other beneficiaries. When they have acquired their capital interests in such a way as to not be able to recognize an appropriately substantial ACB in relation to the value of the interest harsh tax consequences will follow, (under Sec. 107(2.1), for example), when property is distributed in satisfaction of the interest or where it is disposed of to a third party. Since income interests exist for purposes of the Act **only** in respect of personal trusts, a loss of personal status will automatically change all of the income interests into capital interests precluding the taxpayer from deducting any deductible cost it might otherwise have had under Sec. 106(1).¹³⁵ Substantial care must be taken in working within the definition of personal status since once a particular trust loses it, it is lost forever with significant tax consequences.

Who "Creates" or "Contributes" to That Trust or "Creates a New Distinct One with that Other's Terms"?

Ascertaining who creates a new trust through adopting another's terms or merely contributes to one that already exists is of considerable importance in the ITA since so many rules target contributions to trusts and creations thereof. Does the contribution of property to a previously existing trust recreate the trust already existing, or does it merely increase/augment the existing trust's property without effect on the fiduciary obligations for both common-law and consequential tax purposes? Or, is there merely an adoption of an existing trust's terms to create a new one?

In the author's opinion, CRA and Finance are bound by this jurisprudence since there are selective uses of the words "create" or "contribute" in various provisions in the Act. And what is interesting is that it seems that through the inconsistent use of the terms they may have un-intended consequences.

The issue is extremely important since all over our ITA there are references to

- beneficiaries having interests in trusts,
- contributions to trusts by targeted parties,
- creations of trusts, and
- their relation with "the trust" being the intermediary

so the issue of **"which trust" is being spoken of, statutorily, cannot be underscored enough**. They exist since our fiscal authorities seek to capture those instances where taxpayers use trusts to transfer economic benefits to others however if the taxpayer is able to demonstrate that "another trust" was actually at issue the formulated provisions may not apply. Such is the case with, amongst others, the testamentary trust definition, the personal trust definition, the preferred beneficiary election and the non-resident trust rules.

In *Baldwin v. C.I.R.*¹³⁶ the Supreme Court of New Zealand had to decide whether a trust had been "created" in an income tax situation and it essentially had occurred when property was transferred for 1 shilling to an already existing trust which as per its terms could accept any such contributions. MaCarthur J. held:

"The dictionary meaning of the word "create" is "to make, form, constitute, or bring into legal existence": see Shorter Oxford Dictionary. In my opinion the phrase "a trust has been created" in s.84A simply means "a trust has been brought into legal existence". No particular method of creation of a trust is indicated by the section. I think therefore that if it is shown that trust obligations have been imposed or constituted in respect of certain property by one or more of the specified persons then a trust has been created by that person or those persons within the meaning of the section."

maximum flexibility.

¹³⁵ On the other hand, if the existing capital interests under the trust have substantial a.c.b.'s (brought about by becoming resident etc.) and the income interests have substantial undeducted deductible costs, and the trust is to be wound up, it could prove beneficial, depending on the f.m.v. and tax cost of the trust's property, to taint it so that the income interests become capital interests and thus create capital losses when canceled. Integrated use of Sec. 106(3) and selective Sec. 107(2) distributions may have to occur prior to the taint but at least the deductible income interest cost, that quite likely caused income recognition in the hands of its previous beneficiary, can gain some sort of tax benefit rather than be completely lost.

¹³⁶. 1965 N.Z.L.R. 1

The same approach was used in *Tucker v. C.I.R.*¹³⁷ where a taxpayer augmented a previously existing trust with property and in that case the same court concluded that the taxpayer had made use of the previously existing trust's terms to effect his own dispositions and that he had created a trust by having the intention of making property subject to the previously existing terms in favor of beneficiaries which were known to him.

In *Truesdale v. F.C.T.*¹³⁸ the Australian High Court had to ascertain whether a taxpayer created a trust upon gifting property to a previously existing arrangement in an income tax issue and *Menzies J.* held:

"There is an obvious difference between creating a trust in respect of property, on the one hand, and, on the other, transferring property to a trustee to hold upon the terms of an established trust. To read the section as if it applied to such a transfer would be, in the absence of a context, to expand it. Such a reading would be tantamount to saying that the transfer to the trustee of property to be held as part of the assets of an already constituted trust would be to create a second trust, **whereas, from the point of view of both the trustee and of the beneficiary, there would be but one trust, and the property transferred would be nothing more than an addition to the property subject to the trust.**"

Tucker & Baldwin were considered inapplicable. In the author's opinion *Truesdale* may not be entirely well concluded. Without property there is no trust and as Counsel for the F.C.T. contended, the original settlor of the trust could not create "a" trust in respect of the property that was subsequently contributed, though he may allow the trustee to accept other property. Contrary to the highlighted phrase the fact that the trustee and beneficiaries perceive only one set of fiduciary obligations does not negate the possible existence of two trusts with identical terms over different property for the same beneficiaries in the same share created by two different people.¹³⁹ Critical to the establishment of a trust by a subsequent transfer to a previously existing trust would appear to be that the transferor has the intention of creating a trust out of the property for the benefit of the specific beneficiaries (with their specific interests) and if the transferor doesn't concern himself with who his property is to benefit then he can't create a trust when he gifts it to the trustees even though he knows they are receiving it in that capacity. If he gifts the property with the full recognition of the terms and how the beneficiaries will receive it then it should be said that he's concerned himself with who and how the gift is to benefit and has thus adopted and created a trust.¹⁴⁰

¹³⁷ 1965 N.Z.L.R. 1027 (SC)

¹³⁸ 120 C.L.R. 353

¹³⁹ See also *Mills v. I.R.C.*, 1974 1 All E.R. 977, & *Crossland v. Hawkins*, 1961 2 All E.R. 812.

¹⁴⁰ In *J.W. Broomhead (Vic.) Pty. Ltd. (in liq.) v. J.W. Broomhead Pty. Ltd. & Ors.*, 1985 V.R. 891, the Supreme Court of Victoria had to ascertain, amongst other issues, whether a business transferred to a trust became part of the original trust fund or created a new trust when the original trust's terms defined the trust property to include 'any moneys which may accrue or be added' to the settled sum. Citing *Prichard v. Prichard*, 1870 L.R. 11 Eq. 232, *Perrin v. Morgan*, 1943 A.C. 399, *Re: Lenry*, 1975 V.R. 601, & *Kensington Cellars Pty. Ltd. v. Bactanee Pty. Ltd.*, 1984 2 A.C.L.C. 245, the court found that the description attached to the trust fund by its settlor was wide enough to allow the trust's obligations to be imposed on the augment and that the business was to be treated as included in the sole trust fund.

Width of description of the trust property is, in the author's opinion, of importance in determining whether an identical trust is created or if a settled amount is increased when a subsequent gift is made. If one can take the view that a trust can only be created by a dispositive act it could perhaps be argued that a gift of 'subsequently realized' property will allow it to be considered as part of the trust on account of the fact that it is the subject of the gift, while if the trust deed is so restrictive as to expressly apply only to the initial property dealt with its terms property subsequently 'added' thereto cannot be considered as part of the initial gift and thus **must** constitute a new disposition **consequently** creating a new trust with identical terms. See also *Marsal Pty. Ltd. & Ors. v. Comp. of Stamps*, 82 A.T.C. 4536. In *B.L. & M. Grollo Homes Pty. Ltd. v. Comp. of Stamps*, 1985 V.R. 445, the Full Court had to ascertain whether a deed that transferred property to a previously existing trust the terms of which arguably were phrased as to apply to after acquired land received gratuitously operated as itself a settlement or merely a gift for stamp duty purposes. The case was not argued excessively on the scope of the initial trust's terms but the court pointed out that even if they were restrictive "a" trust could have been created via the assent of the recipient trustee to hold on the terms of the original trust. The fact that the deed of transfer didn't create any new interests different from the original trust didn't prevent the holding that there was the creation of a settlement following the imposition of the terms of the initial trust upon the property while it was also held that it was **both** the initial trust and that of the transfer which operated to create the trust in respect of the property: **the former could not create one alone by virtue of the fact that it didn't vest in the trustee any title to the control of the property subsequently contributed.** (This broke with the dicta in *C.S.B. v. Hopkins* wherein it was held that for stamp duty purposes it was the deed that declared or described the trust that was dutiable as that creating it.) Could it be argued that this case allows Sec. 108(1) to be undermined in respect of *inter vivos* trusts whenever a contribution is made so as to "create a trust"? Were the legislators concerned with this jurisprudence at the time of the enactment? It appears not from their choice of expression.

See also the recent NZ case of *Begg & Ors v. CIR*, NZCA 127/2008 [30 April 2009], where *Baldwin* was cited as well as *Adams and Richardson's Law of Estate and Gift Duties* (5ed 1978) with:

In the Sec. 108(1) context in respect of *inter vivos* trusts and the definition of personal trust the difference between a creation of a trust identical to one existing and a mere contribution to one existing has considerable repercussions. The former will also allow the settlor status for the preferred beneficiary election to be preserved since the initial trust is not being affected: a completely new one is being constituted, and although the income from the augmentation property can't benefit from the P.B.E., (unless the settlor is the same or other qualified person), the income of the initial trust will continue to gain P.B.E. treatment. If the contribution does not create a trust in respect of the property but merely augments the initial's portfolio then there must be concern for the proportions. While if it can be argued that a contributor chose to adopt an existing trust's terms to create his own the application of the personal trust definition may not be drawn into for consideration.

Ignorance of the beneficiaries, how they are to share, or the trust's terms itself **may** be the deciding factor in the author's opinion while the width of the description of property to be held under the initial may also be of paramount importance.¹⁴¹

[43] In our view, the position is accurately stated by Sir Ivor at [2/34] [*Adams and Richardson's Law of Estate and Gift Duties* (5ed 1978) – Ed.] of his text:

A trust is "created" for the purpose of para (b) when specific property is impressed with the terms of a trust. The words "a trust has been created" in s 84A of the Land Income Tax Act 1954 (now repealed) were considered by Macarthur J in *Baldwin v CIR* [1965] NZLR 1 where he said (p 6):

"In my opinion the phrase 'a trust has been created' in section 84A simply means 'a trust has been brought into legal existence'. No particular method of creation of a trust is indicated by the section. I think therefore that if it is shown that trust obligations have been imposed or constituted in respect of certain property by one or more of the specified persons then a trust has been created by that person or those persons within the meaning of the section".

A trust is created, then, when trustees accept the transfer of property to them to be held in trust. Where the terms of the trust are set out in a trustee deed executed by the trustees and the settlor a trust is "created" only in respect of that property which is actually impressed with a trust at the time the deed is executed. Later transfers of property to the trustees to be held on the terms of the deed create further trusts in respect of that property. Each separate transfer is the creation of a separate trust, and is consequently a separate disposition of property under para (b): *Re Adlard* [1953] 2 All ER 1437; *Re Bowden* [1936] Ch 71.

[44] In our view, there is no doubt that specific property, namely the donor's home, did become "impressed with the terms of a trust" under the Public Trust template from the date of execution of the deed. It does not matter that the settlor and the trustee were one and the same person, for the reasons given, in particular by Edwards J, in *Perry*. The point is that, after execution of the deed, the settlor no longer had the full beneficial interest in his or her home; he or she held it as trustee in terms of the declaration of trust.

[45] Sir Ivor then went on to refer to *Perry*, with no suggestion that that case was wrongly decided. (We may add that, in the last edition of *The Law of Estate and Gift Duties in New Zealand* written by the original author, E C Adams, there is also no suggestion that *Perry* was wrongly decided: see (3ed 1956) at [102]. Mr Adams, himself formerly an Assistant Commissioner of Stamp Duties, was in his day New Zealand's leading scholar in this field and, we may add, in others.)

[46] Sir Ivor then continued at [2/35]:

Although it is clear that the creation of a trust is an effective means of disposing of property within the meaning of the definition, the application of the definition as a whole raises more problems. The principal difficulty is that the various steps involved in the creation and performance of a trust seem to include a number of possible dispositions within the definition. The transfer of property to trustees on trust, the creation of various equitable interests in the trust property, and the transfer of property to beneficiaries under the terms of the trust, all appear to come within the terms of the Act.

There might be some difficulty in deciding which of these dispositions is the most relevant for gift duty purposes. It might even be concluded that the creation and performance of a trust involve not one but several dispositions.

By virtue of para (b), however, the creation of a trust is itself to be regarded as a disposition. Consequently it is suggested that any transfers, payments, or conveyances made in the performance of the trust are not separate dispositions, for they are incidental to the creation of the trust or flow from it.

[47] At [2/39], Sir Ivor discusses the case where trusts create future or contingent interests. Even in those circumstances, he concludes, a gift is made at the time the trust is created "even where the various interest and beneficiaries are unascertained or contingent" and "even when the final destination of those interests cannot be determined until a later date".

The case actually involved whether a disposition for purposes of gift tax occurred on the binding of a trust deed even when the property would not be transferred to it until substantially subsequently: In this case the appeal court found that even when the contributions were made substantially deferred, they "created" a trust many years previously when the documentation was executed.

141 See also *Re: Chester*, 19 S.A.S.R. 247, *Re: Sharpe*, 1945 18 A.L.J. 156, *Smith v. Cock*, 12 C.L.R. 30 & *Atwill v. Commr. of S.D.*, 1970 92 W.N. (N.S.W.) 869. If the jurisprudence reveals that a "contribution" to a trust "creates" another,

In the recent Tax Court case of *Peter Sommerer And Her Majesty The Queen*¹⁴² the court had to consider the instance where a taxpayer had sold property to an non-resident trust and had been assessed under s. 75(2) as a contributor in respect of its subsequent capital gains. The court held:

[87] The opening words are significant - "by a trust created...property is held on condition". In this case, one could insert the date and have the opening words: "where, by a trust created on October 3, 1996, property is held on condition". The provision does not say "where property is held in trust or in a trust on condition". It specifically refers to a trust created and a time at which the trust is created. I suggest it invites an interpretation to look at the conditions on the creation of the trust, the creation in this case by Mr. Herbert Sommerer, the settlor. The nature of the trust, and whether it is of a type contemplated by subsection 75(2) of the Act, is to be discerned at the time of creation. **On the creation of the trust by a settlor, there can only be one person from whom property is received – the settlor. There is no other person. This does not however preclude the possibility of another person settling property in trust with the same trustee and on the same terms, but in such a case, I would suggest there is another trust created.** In effect, by the opening words of subsection 75(2) of the Act only a settlor, or a contributor akin to a settlor is contemplated as being the defined person.

...

[94] Does this mean that Mr. Peter Sommerer could never be "the person" for purposes of this section? No. **If he settled the shares in the same trust, by contributing them to the trust (that they be held on the same conditions), he could be seen as creating a new trust and could, therefore, be a settlor and subject to the application of subsection 75(2) of the Act.** He would, however, had to have been a contributor. But he did not do that. **He did not transfer shares into the SPF as a settlor or contributor creating a trust.** He sold the shares unconditionally to the SPF, who, as trustee of the property, held the property on conditions created by Mr. Herbert Sommerer, substituting those shares for the shillings endowed by Mr. Herbert Sommerer. In these circumstances, Mr. Peter Sommerer could not be "the person" as defined.

...

[104] This view has garnered some favour amongst the academics. *Maurice Cullity in Taxation and Estate Planning* indicates the usual object of subsection 75(2) attribution is the settlor, though could apply to a subsequent transferor in the sense of a contributor. In that regard, I concur with Justice Bowie's comments in *Greenberg Estate v. The Queen*^[20] that "contributed" signifies a voluntary payment made to increase the capital of the estate: a sale to the trust at fair market value does no such thing. **As I indicated earlier, if Mr. Peter Sommerer was to contribute to the trust, he might be viewed as a settlor creating a new trust. A fair market sale of property to a trust is not a contribution and the vendor is not a contributor, nor therefore a settlor.** The property sold to the trust cannot, as argued by the Respondent, be viewed as "original property"; it can only be substituted property, as consideration was given for it by the trust.

It's important to note that there is an inherent reinforcement of the "4 Quadrant multifaceted" trust described in a previous subchapter since the definition in s. 104(1) "drills down to a property by property basis" and *this judicial recognition of the creation of new seemingly individual trusts upon future individual augment accommodates that*. And, it should be noted that until the Minister deems the two trusts to be the same, as allowed pursuant to s. 104(2)¹⁴³, they are not: that subsection is termed only in respect of *principally* the **same**

regardless of whether it can be argued to be the same original trust, the use of the two terms is wholly inadequate. See also *Inland Revenue v Rysaffe Trustee Company (CI) Ltd* [2003] EWCA Civ 356, [2003] NPC 39, [2003] STC 536, (2002-03) 5 ITELR 706, [2003] WTLR 481, [2003] EWCA Civ 356, [2003] BTC 8021, [2003] STI 452 where the issue of how many trusts were created where the term "disposition" was argued to be relevant in their context.

142 2011 TCC 212

143 "Taxed as individual – Sec. 104(2)"

(2) A trust shall, for the purposes of this Act, and without affecting the liability of the trustee or legal representative for that person's own income tax, be deemed to be in respect of the trust property an individual, but where there is more than one trust

contributor/settlor.

Again, this has repercussions all over the ITA on such things as:

- The PBE
- The 21 Deemed Disposition rule
- The accessing of beneficial distribution mechanics in s. 107

to name a few.

A trustee is not under any obligation to accept property as that of the trust he is administering unless it is specified in the constituting deed. In the author's opinion he may accept to act as trustee for an identical trust in respect of that subsequent disposition but he should not be, in the author's opinion, **compelled** to augment the wealth of the trust which he is administering through donative receipts - though of course he may through its own terms. If, through such an act, he impairs the personal status//P.B.E. mechanics application a charge of impartiality/imprudent actions causing damages could be constituted. It would prove more effective, rather than relying on such a threat, to expressly prevent an augmentation that would jeopardize an unforeseeable instance.

Revocable, Protective and Bare Trusts

Technical News 7, of 1996, allowed CRA to provide their opinion on the issue of the above purpose driven trusts. To the author's opinion, they have not changed.

"Income Tax Technical News No. 7

February 21, 1996

The following is the text of a presentation given on November 29, 1995 by Michael Hiltz of the Income Tax Rulings and Interpretations Directorate of Revenue Canada at the annual conference of the Canadian Tax Foundation held in Toronto.

Revocable Living Trusts

Some people use a **revocable living trust** to avoid the potential impact of provincial probate taxes. By the Declaration of Trust the settlor is a trustee and, during his or her lifetime, is the sole income and capital beneficiary. The settlor retains the ability to revoke, alter or amend the terms of the trust at any time. Additionally, the settlor has the unfettered ability to deal with the property as he or she sees fit during his or her lifetime. The Declaration of Trust further provides for the vesting of the income and capital interests in the trust in other beneficiaries at the time of the settlor's death.

Revenue Canada has previously opined that because the settlor retained beneficial ownership of the property during his or her lifetime, a transfer of property to a revocable living trust resident in Canada would not be a disposition of property, pursuant to paragraph (e) of the definition of "disposition" in section 54 and that we would ignore the trust for income tax purposes during the lifetime of the settlor. Consequently, the settlor would be considered to be the owner of the property for all purposes of the Act.

Recently, we have received a number of technical interpretation requests concerning the income tax consequences of a transfer of property to a revocable living trust. In connection with these requests we reconsidered our previous opinion, our response to question 33 of the Revenue Canada Round Table at the 1988 Canadian Tax Conference, and the relevant jurisprudence and literature.

and

- (a) substantially all of the property of the various trusts has been received from one person, and
- (b) the various trusts are conditioned so that the income thereof accrues or will ultimately accrue to the same beneficiary, or group or class of beneficiaries,

such of the trustees as the Minister may designate shall, for the purposes of this Act, be deemed to be in respect of all the trusts an individual whose property is the property of all the trusts and whose income is the income of all the trusts.

It is now our opinion that a revocable living trust should be recognized for income tax purposes at the time that legal title to property is transferred to it and that the transfer of the property is at its **full fair market value** (and not at the value of the remainder interest only). Consequently, our response to question 33 of the 1988 Revenue Canada Round Table is withdrawn and the income tax consequences of transactions completed by taxpayers who relied on our previous opinion on transfers of property to a revocable living trust will be determined on a case by case basis. Subsection 75(2) will be applicable during the lifetime of the settlor while he or she is resident in Canada.

Protective Trusts

Revenue Canada has received a number of enquiries concerning whether the transfer of property to a **protective trust** results in a disposition of the property for income tax purposes. A protective trust would be established by a settlor to protect property in the event of some contingency such as deteriorating health.

It is our view that a trust will be considered a protective trust when its indenture contains all of the following terms:

- The settlor is the sole beneficiary of the trust.
- The settlor is entitled to so much of the annual income and any realized capital gains of the trust as he or she may request or, in the absence of such a request, such amounts as the trustees, in their absolute discretion, deem advisable. (For this purpose, the income of the trust is its net income calculated without reference to the provisions of the Act. Realized capital gains are capital gains as calculated in accordance with the provisions of the Act.)
- The property of the trust reverts to the settlor if the trust is terminated prior to the settlor's death.
- The trust will terminate upon the death of the settlor unless it is terminated at an earlier date. (When the settlor dies, any property held by the trust will devolve in accordance with the terms of the settlor's will or, if the settlor dies intestate, the property of the trust will devolve in accordance with the laws of intestacy that are relevant to the estate.)

Transfers of property to a protective trust will not result in a disposition, pursuant to paragraph (e) of the definition of "disposition" in section 54 of the Act. However, a protective trust is recognized for income tax purposes and is the owner of the property for all purposes of the Act. The settlor will have an income and capital interest in the protective trust and subsection 75(2) will be applicable during the lifetime of the settlor while he or she is resident in Canada.

Bare Trusts

Revenue Canada stated in a paper entitled "Bare Trusts" at the 1989 Corporate Management Tax Conference that, pending a review of our position, where property is held by a bare trust, we will ignore the trust for income tax purposes and will consider the transferor/settlor to be the owner of the property for all purposes of the Act.

It was further stated that we generally view a trust under common law to be a bare trust when:

- the trustee has no significant powers or responsibilities, and can take no action without instructions from the settlor;
- the trustee's only function is to hold legal title to the property; and
- the settlor is the sole beneficiary and can cause the property to revert to him or her at any time.

Our review of this matter has been completed and the above position remains unchanged."¹⁴⁴

¹⁴⁴ See *Bruton Holdings Pty Limited (In Liq) v Commissioner of Taxation* [2011] FCAFC 79 (17 June 2011), an Aust. case dealing with the duties of a bare trustee. See also *Paul Perovich v. Her Majesty The Queen*, 97-3644-IT-G, where the Tax Ct. refused to recognize a bare trust, while in *Salvatore Peragine And Her Majesty The Queen*, 2012TCC348, the Tax Court further held:

[18] In *De Mond*, above, Justice Lamarre stated as follows:

31 This approach has also been followed by the courts, as it has been held that losses incurred in a real estate transaction conducted in the name of a corporation as a bare trustee should be deducted by the person who has an absolute right to the profit. In *Brookview Investments Ltd. et al v. Minister of National Revenue* (1963), 63 D.T.C. 1205 (Can. Ex. Ct.), an arrangement had been devised under which a trust was constituted in order to purchase land as a bare trustee. Cattanach J. concluded that the sole function of the trust was to convey the property as directed by the group of investors. He therefore concluded that the investors could deduct the losses incurred due to the real estate transaction, which had turned bad. Cattanach J. affirmed that had a profit been realized, such profit would not have been taxed in the hands of the trust but rather in the hands of the person who had an absolute right to the profit. Mr. W.D. Goodman, in "The Character of the Bare Trust in Canadian Tax Legislation", in D.W. Waters, ed., *Equity, Fiduciaries and Trusts* (Toronto: Carswell, 1993), at p. 219, made the following comment on *Brookview Investments*, at p. 233:

... Unfortunately, the reasons for judgment do not clearly indicate the legal basis for this decision, but presumably it was based on the view that a bare trust may be totally ignored for tax purposes, so that the property held by the bare trustee and any income or loss flowing from such property had to be regarded as belonging to the beneficiaries of the bare trust.

...

34 In "The Character of the Bare Trust in Canadian Tax Legislation", *supra*, Mr. Goodman referred at page 222 to an article by Professor Hayton in which a bare trust was characterized as not being a true trust. Professor Hayton wrote:

If, despite the form of the trust instrument, the trust is a sham, apparently having legal effects, but not really intended to have any legal effect, the settlor having real dispositive control over capital and income, then the trust is not a true trust but a bare trust where the whole equitable ownership remains in the settlor.

However, Mr. Goodman took care to suggest that Professor Hayton's statement should not be interpreted as implying that provisions in the *Act* regarding trusts are inapplicable to bare trusts.

35 In the Corporate Management Tax Conference 1989: "Creative Tax Planning for Real Estate Transactions --- Beyond Tax Reform and into the 1990s", Revenue Canada's view of the bare trust concept is stated as follows at p. 8:1:

From Revenue Canada's perspective, difficult income tax issues arise from the use of bare trusts for commercial purposes. The reason these issues are difficult is that in order to arrive at apparently equitable tax results, the existence of a trust, which is effective for commercial purposes, has to be ignored for income tax purposes.

Although a bare trust is not defined in the *Income Tax Act*, Revenue Canada generally views this to be a trust under common law where the trustee has no significant powers or responsibilities, and can take no action regarding the property held by the trust without instructions from the settlor. Normally the trustee's only function is to hold legal title to the property. Furthermore, the settlor is also the sole beneficiary and can cause the property to revert to him at any time. Thus a bare trust does not include a blind trust or other trusts in which the trustee has established powers and responsibilities.

36 Aside from the definitions of bare trusts referred to by counsel for the appellant, *supra*, it has also been stated that a bare trustee is a person who holds property in trust at the absolute disposal and for the absolute benefit of the beneficiaries (see *Halsbury's Laws of England*, 4th ed., volume 48, paragraph 641, and *Adams v. R.* (1998), 98 D.T.C. 6232 (Fed. C.A.)).

37 Bare trustees have also been compared to agents. The existence of a bare trust will be disregarded for income tax purposes where the bare trustee holds property as a mere agent or for the beneficial owner. In *Trident Holdings Ltd. v. Danand Investments Ltd.* (1988), 64 O.R. (2d) 65 (Ont. C.A.), Mr. Justice Morden, speaking for the Ontario Court of Appeal, made the distinction between an ordinary trust and a bare trust. He reproduced the following passages from Scott, *The Law of Trusts*, 4th ed. (1987):

An agent acts for, and on behalf of, his principal and subject to his control; a trustee as such is not subject to the control of his beneficiary, although he is under a duty to deal with the trust property for the latter's benefit in accordance with the terms of the trust, and can be compelled by the beneficiary to perform this duty. The agent owes a duty of obedience to his principal; a trustee is under a duty to conform to the terms of the trust [Vol. 1, p. 88].

A good Tax Court case that explains the interaction of bare trust, resulting trust and agency concepts is *Sjc Property Management Inc., Dsd Properties Inc., Learning Boost Inc. v. Her Majesty The Queen*¹⁴⁵ whereby the Court held:

[1] These appeals are brought by Shirley Fourney (the “Appellant”), SJC Property Management Inc. (“SJC”), DSD Properties Inc. (“DSD”), and Learning Boost Inc. (“Learning Boost”) from reassessments for each of their respective tax returns for the years 2003, 2004 and 2005. The Appellant alleges that the three companies she incorporated, SJC, DSD and Learning Boost, were merely acting as her agents and bare nominees, and that she never gave up beneficial ownership of her business assets and activities. A summary of the reassessments at issue in these appeals is to be found in Schedule 1 to these reasons for judgment.

...

Analysis: Beneficial Ownership

[22] Subsection 248(1) of the *Income Tax Act* (the “Act”) specifically excludes certain transfers where no change in beneficial ownership occurs. In the present case, the relevant provision is as follows:

248(1) Definitions — In this Act,

...

“disposition” of any property, except as expressly otherwise provided, includes

(a) . . .

but does not include

...

A person may be both agent of and trustee for another. If he undertakes to act on behalf of the other and subject to his control he is an agent; but if he is vested with the title to property that he holds for his principal, he is also a trustee. In such a case, however, it is the agency relation that predominates, and the principles of agency, rather than the principles of trust, are applicable [Vol. 1, p. 95].

38 Mr. Justice Morden also quoted with approval from an article by M.C. Cullity, “Liability of Beneficiaries — A Rejoinder”, (1985-86), 7 *Estates & Trusts Quarterly* 35, at p. 36:

It is quite clear that in many situations trustees will also be agents. This occurs, for example, in the familiar case of investments held by an investment dealer as nominee or in the case of land held by a nominee corporation. In such cases, the trust relationship that arises by virtue of the separation of legal and equitable ownership is often described as a bare trust and for tax and some other purposes it is quite understandably ignored.

The distinguishing characteristic of the bare trust is that the trustee has no independent powers, discretions or responsibilities. His only responsibility is to carry out the instructions of his principals --- the beneficiaries. If he does not have to accept instructions, if he has any significant independent powers or responsibilities, he is not a bare trustee.

[19] Subsection 104(1) of the *Act* provides as follows:

104. (1) In this *Act*, a reference to a trust or estate (in this subdivision referred to as a “trust”) shall, unless the context otherwise requires, be read to include a reference to the trustee, executor, administrator, liquidator of a succession, heir or other legal representative having ownership or control of the trust property, but, except for the purposes of this subsection, subsection (1.1), subparagraph (b)(v) of the definition “disposition” in subsection 248(1) and paragraph (k) of that definition, *a trust is deemed not to include an arrangement under which the trust can reasonably be considered to act as agent for all the beneficiaries under the trust with respect to all dealings with all of the trust’s property unless the trust is described in any of paragraphs (a) to (e.1) of the definition “trust” in subsection 108(1).*

(emphasis added)

[20] It seems to me that the Appellant was simply acting as the agent for Leo Peragine in holding the Victoria Property. The Appellant did not have any beneficial interest in the property nor did the Appellant have any independent power, discretion, or responsibility with respect to the Victoria Property. Therefore the trust would not be a trust as determined in accordance with the provisions of subsection 104(1) of the *Act* and would be what has been described as a bare trust. As a result any gain arising from the sale of the Victoria Property would not be included in the Appellant’s income.

(e) any transfer of the property as a consequence of which there is no change in the beneficial ownership of the property, except where the transfer is

- (i) from a person or a partnership to a trust for the benefit of the person or the partnership,
- (ii) from a trust to a beneficiary under the trust, or
- (iii) from one trust maintained for the benefit of one or more beneficiaries under the trust to another trust maintained for the benefit of the same beneficiaries,

[Emphasis added.]

[23] Subsection 104(1) of the Act provides that references to trusts in paragraph (e) of the definition of "disposition" in subsection 248(1) do not include transfers to bare trusts, which will not be considered dispositions under subsection 248(1) when the trust acts entirely as the agent of the beneficiary, holding title with no change in beneficial ownership:

104(1) Reference to trust or estate – In this Act, a reference to a trust or estate (in this subdivision referred to as a "trust") shall, unless the context otherwise requires, be read to include a reference to the trustee, executor, administrator, liquidator of a succession, heir or other legal representative having ownership or control of the trust property, but, except for the purposes of this subsection, subsection (1.1), subparagraph (b)(v) of the definition "disposition" in subsection 248(1) and paragraph (k) of that definition, a trust is deemed not to include an arrangement under which the trust can reasonably be considered to act as agent for all the beneficiaries under the trust with respect to all dealings with all of the trust's property unless the trust is described in any of paragraphs (a) to (e.1) of the definition "trust" in subsection 108(1).

[24] In this case, the Appellant argues that there was no disposition under subsection 248(1) of the Act because only the legal ownership of the business assets and interests was transferred, with no actual taxable disposition occurring because the incorporated entities were merely holding title to the properties as the Appellant's bare nominees or agents, without acquiring beneficial ownership thereof. The Appellant argues that the lack of consideration for any of the properties, combined with the lack of intent to create a trust or give a gift, shows that true ownership was never transferred. She further submits that any additional purchases or sales of property were made through the corporations in their roles as agents.

[25] In considering this argument, I will explore the meaning of beneficial ownership, the law regarding transfers of property for no consideration, and the factors required in order to establish an agent-principal relationship. First, with regard to beneficial ownership, the concept emerges from the need in equity to distinguish between a person who holds title to a property (the "legal owner") and the person who has the true right to the benefits of ownership. As recognized by the Supreme Court of Canada in *Covert et al. v. Minister of Finance of Nova Scotia*,^[1] citing Hart J. in *MacKeen Estate v. Minister of Finance of Nova Scotia* (1977), 36 A.P.R. 572:

It seems to me that the plain ordinary meaning of the expression "beneficial owner" is the real or true owner of the property. The property may be registered in another name or held in trust for the real owner, but the "beneficial owner" is the one who can ultimately exercise the rights of ownership in the property.

[26] More recently, the Supreme Court of Canada, in *Pecore v. Pecore*, addressed the meaning of beneficial ownership,^[2] acknowledging the distinction between legal and beneficial ownership as emerging from equity considerations:

Equity . . . recognizes a distinction between legal and beneficial ownership. The beneficial owner of property has been described as "[t]he real owner of property even though it is in someone else's name": *Csak v. Aumon* (1990), 69 D.L.R. (4th) 567 (Ont. H.C.J.), at p. 570.^[3]

[27] When the person who has legal ownership by holding title is different from the person having beneficial ownership of the same property and the legal owner has no discretion to do anything with the property, the property is understood to be held in a bare trust, whether by an agent or a trustee.

In *De Mond v. The Queen*,^[4] the Tax Court of Canada explored the meaning of bare trust:

. . . Professor Waters defines a bare trust as follows:

The usually accepted meaning of the term "bare," "naked" or simple trust is a trust where the trustee or trustees hold property without any further duty to perform except to convey it to the beneficiary or beneficiaries upon demand.

. . .

Every fiduciary, which includes an agent holding the title to property for a principal, is a bare trustee of the property he holds for another.^[5]

. . . it has also been stated that a bare trustee is a person who holds property in trust at the absolute disposal and for the absolute benefit of the beneficiaries (see *Halsbury's Laws of England*, 4th ed., volume 48, paragraph 641, and *The Queen v. Robinson et al.*, 98 DTC 6232 (F.C.A.)).^[6]

[28] Judge Lamarre then reviewed the relationship between the concepts of bare trustee and agent:

Bare trustees have also been compared to agents. The existence of a bare trust will be disregarded for income tax purposes where the bare trustee holds property as a mere agent or for the beneficial owner. In *Trident Holdings Ltd. v. Danand Investments Ltd.*, 64 O.R. (2d) 65 (Ont. C.A.), Mr. Justice Morden, speaking for the Ontario Court of Appeal, made the distinction between an ordinary trust and a bare trust. He reproduced the following passages from Scott, *The Law of Trusts*, 4th ed. (1987):

. . .

A person may be both agent of and trustee for another. If he undertakes to act on behalf of the other and subject to his control he is an agent; but if he is vested with the title to property that he holds for his principal, he is also a trustee. In such a case, however, it is the agency relation that predominates, and the principles of agency, rather than the principles of trust, are applicable [Vol. 1, p. 95].

[38] Mr. Justice Morden also quoted with approval from an article by M.C. Cullity, "Liability of Beneficiaries - A Rejoinder", (1985-86), 7 *Estates & Trusts Quarterly* 35, at p. 36:

It is quite clear that in many situations trustees will also be agents. This occurs, for example, in the familiar case of investments held by an investment dealer as nominee or in the case of land held by a nominee corporation. In such cases, the trust relationship that arises by virtue of the separation of legal and equitable ownership is often described as a bare trust and for tax and some other purposes it is quite understandably ignored.

The distinguishing characteristic of the bare trust is that the trustee has no independent powers, discretions or responsibilities. His only responsibility is to carry out the instructions of his principals --- the beneficiaries. If he does not have to accept instructions, if he has any significant independent powers or responsibilities, he is not a bare trustee.^[7]

[29] For the Appellant's theory of the case to stand up, the transfers (and any subsequent purchases) of property must have resulted in legal ownership in bare trust by the corporations. Any further activity undertaken by the corporations with the properties held in bare trust would need to be conducted as agents of their principal, the Appellant.

[30] A transfer of property for no consideration generally results in a rebuttable presumption of a resulting trust. The transferee is obligated to prove the transferor's intent to make a gift in order to rebut the presumption that the property is merely being held in trust for the transferor. As stated by the Supreme Court of Canada in *Pecore*:

A resulting trust arises when title to property is in one party's name, but that party, because he or she is a fiduciary or gave no value for the property, is under an obligation to return it to the original title owner: see D.W.M. Waters, M.R. Gillen and L.D. Smith, eds., *Waters' Law of Trusts in Canada* (3rd ed. 2005), at p. 362. . .

24. The presumption of resulting trust is a rebuttable presumption of law and general rule that applies to gratuitous transfers. When a transfer is challenged, the presumption allocates the legal burden of proof. Thus, where a transfer is made for no consideration, the onus is placed on the transferee to demonstrate that a gift was intended: see *Waters' Law of Trusts*, at p. 375, and E. E. Gillese and M. Milczynski, *The Law of Trusts* (2nd ed. 2005), at p. 110. This is so because equity presumes bargains, not gifts.[8]

[31] While in *Pecore*, the Supreme Court went on to evaluate the appropriate burden of proof that the transferee must meet in order to show the transferor's intent to gift, such considerations are not relevant in this case. The Appellant denies having had the requisite intent to transfer the property gratuitously, and as she was the majority shareholder of the transferee, it would lie with her to rebut the presumption that, having received the properties by way of gratuitous transfers, the corporation held those properties in resulting trust.

[32] Further, a gift will not be valid unless the donor's intention to gift was absolutely unambiguous:

Inter vivos gifts are gifts from one living person to another living person, literally between the living. *Inter vivos* gifts can be oral or by deed.

(a) – Oral

The intention to gift must be unequivocal. If a donor's words or actions are equivocal or consistent with a possible intention to give or not to give, the courts will not infer a gift. The difference between a complete and an incomplete gift often turns on the use of specific words (*Jones v. Lock* (1865), LR 1 Ch App 25).

Delivery is not merely evidence of a gift being made. Courts demand full transfer of possession to complete an oral gift. The donor must put the good out of his control. . . .

(b) –By Deed

To make a gift by deed, the donor must deliver to the donee a sealed instrument in writing that states the intention to give and the subject of the gift. The seal is needed to corroborate the intent in the written document. The sealed instrument must be delivered out of the possession of the donor. It is now less clear how formal the instrument needs to be. While a sealed instrument many no longer be required, there must still be sufficient formality to corroborate an informed and considered intention to gift.[9]

[33] As the Land Titles Registry's transfer documents are deeds, it might be argued that no consideration was required when such deeds were used to transfer real property to DSD. Such an argument was considered and rejected by the Supreme Court of Canada in *Niles v. Lake*, [1947] S.C.R. 291, [1947] S.C.J. No. 13 (QL):

. . . the mere fact of the document in question being under seal does not prevent the appellants from showing that there was no consideration. That, they have done, and the resulting trust follows.[10]

[34] In the present case, the evidence suggests that there was no meeting of the minds with regard to forming a valid contract between the Appellant and the corporations. As submitted by the Appellant:

A contract can only arise if there is the *animus contrahendi* between the parties. With the expressed or implicit intention that a contract should emerge as a result of the language or conduct of the alleged parties, no contractual obligations can be said to exist and be capable of enforcement.[11]

[35] The resulting trust doctrine should apply to all the properties transferred in this case. All transfers of business assets and interests to the corporation were done gratuitously. There is no evidence to indicate an intention to gift. Further, as outlined below, the conduct of the Appellant and the corporations over the three-year period does not indicate an intention to transfer property to the corporation. Instead, an implied agent-principal relationship is indicated, with the Appellant always maintaining beneficial ownership of the properties and businesses.

[36] The Appellant contends that although there was no written agreement, the agency relationship between her, the alleged principal, and the three corporations, her alleged agents, is implied by their behaviour during the taxation years at issue. The Federal Court of Appeal explored the meaning of the term "agency", and how an agency relationship arises, in *Kinguk Travel Inc. v. Canada*:^[12]

The term agency has been defined as:

"... a fiduciary relationship which exists between two persons, one of whom expressly or impliedly consents that the other should act on his behalf so as to affect his relations with third parties, and the other of whom similarly consents so to act or so acts." (*Bowstead & Reynolds on Agency* (17th edition, Sweet & Maxwell 2001)).

In *Royal Securities Corp. Ltd. v. Montreal Trust Co. et. al* 59 D.L.R. (2d) 666, Gale C.J.H.C. identified the essential ingredients of an agency relationship as follows:

1. The consent of both the principal and the agent;
2. Authority given to the agent by the principal, allowing the former to affect the latter's legal position;
3. The principal's control of the agent's actions.

In reality, points 2 and 3 are often overlapping, as the principal's control over the actions of his agent is manifested in the authority given to the agent.^[13]

[37] *Bowstead and Reynolds on Agency* explains that an agency relationship can emerge in the following ways:

(1) The relationship of principal and agent may be constituted –

- (a) by agreement, whether contractual or not, between principal and agent, which may be express, or implied from the conduct or situation of the parties;
- (b) retrospectively, by subsequent ratification by the principal of acts done on his behalf.^[14]

[Emphasis added.]

[38] The Respondent submits that the Appellant is trying to retroactively recharacterize her business transactions and calls her credibility into question, insisting that she is a capable and educated woman who chose whatever form was most convenient at various times. The Respondent argues that the Court should not now allow her to pick beneficial ownership with an agency relationship as the current most convenient choice because it avoids the adverse tax consequences she is facing. Counsel includes in his case law authorities that refer to the frequently cited passage in the Federal Court of Appeal's decision, in *The Queen v. Friedberg*, 92 OTC 6031 at page 6032, [1991] F.C.J. No. 1255 (QL), regarding the importance of form in tax matters:

In tax law, form matters. A mere subjective intention, here as elsewhere in the tax field, is not by itself sufficient to alter the characterization of a transaction for tax purposes. If a taxpayer arranges his affairs in certain formal ways, enormous tax advantages can be obtained, even though the main reason for these arrangements may be to save tax (see *The Queen v. Irving Oil* 91 DTC 5106, *per* Mahoney, J.A.). If a taxpayer fails to take the correct formal steps, however, tax may have to be paid. If this were not so, Revenue Canada and the courts would be engaged in endless exercises to determine the true intentions behind certain transactions. Taxpayers and the Crown would seek to restructure dealings after the fact so as to take advantage of the tax law or to make taxpayers pay tax that they might otherwise not have to pay. While evidence of intention may be used by the Courts on occasion to clarify dealings, it is rarely

determinative. In sum, evidence of subjective intention cannot be used to 'correct' documents which clearly point in a particular direction.

[39] The Respondent argues further that the Appellant is calling upon the Court to lift the corporate veil. As one of the Respondent's own submitted authorities notes, however, the courts have accepted agency as a suitable reason to characterize the relationship between a corporation and another entity by its substantive nature:

The third basis on which courts have purported to disregard separate corporate personality is by finding that the corporation is merely acting as the agent of someone else, usually the controlling shareholder that is, itself, a corporation. Conceptually, the corporate form is not disregarded by a holding that it is an agent. Rather, the business of the corporation or whatever activity gives rise to the claim by a third party is determined to be carried on not by the corporation directly but only as an agent of the controlling shareholder.[15]

There is no general bar to seeking to determine whether the corporations were indeed agents of the Appellant. As will be seen below, however, the test for finding an agency relationship in the absence of a written agreement is restrictive; it requires evidence of the necessary conduct.

[40] In *Denison Mines Ltd. v. Minister of National Revenue*, [16] Cattanach J. analyzed an argument that a subsidiary corporation was merely the agent of its parent company, which held all of the subsidiary's shares:

Briefly the appellant's position is that the business of Con-Ell was in reality the business of the appellant and in contradistinction thereof the position of the Minister rests on the *Salomon* case (*Salomon v. A. Salomon & Co. Ltd.* [1897] A.C. 22) that there are two separate legal entities and the losses of one are not the losses of the other.

It is well settled that the mere fact that a person holds all the shares in a company does not make the business carried out by that company the shareholder's business, nor does it make that company the shareholder's agent for carrying on the business. However it is conceivable that there may be an arrangement between the shareholder and the company which will constitute the company the shareholder's agent for the purpose of carrying on the business and so make the business that of the shareholder.

It is immaterial that the shareholder is itself a limited company.[17]

[41] More recently, a corporation's ability to act as its shareholder's agent was acknowledged without question by Paris J. of the Tax Court of Canada in *Avotus Corp. v. The Queen*. Paris J. cited *Denison Mines* in support of the following assertion:

It is established in the case law that there is no bar to a corporation acting as agent for its shareholder. In *Denison Mines (supra)* Cattanach J. noted at page 5388:

. . . it is conceivable that there may be an arrangement between the shareholder and the company which will constitute the company, the shareholder's agent, for the purpose of carrying on the business and so make the business that of the shareholder.

It is immaterial that the shareholder is itself a limited company.[18]

[42] It is established, then, that corporations can act as agents, and this concept is not repugnant to the rule that corporations have separate legal personality a matter addressed in the oft-cited *Salomon* case.

[43] In the present case, in the absence of a written agreement expressing the clear intent to establish an agency relationship, what is the evidence required in order to support the Appellant's claim? In *Avotus*, there was a written agreement between the principal and the agent, although it had been drafted and signed in 1996 and the agent-principal relationship had actually begun in 1994.[19] Regardless of the timing of the agreement, Paris J. concluded that its existence was the deciding consideration:

In *Denison Mines (supra)* there was no express contract of agency between the taxpayer and its subsidiary corporation, and the court declined to find that there was an implied contract of agency between them. By contrast, in this case the Appellant

and Americas entered into a written agency agreement.

...

... It is only in the absence of a written agreement that the conduct of the parties must be examined for the purpose of determining whether an agency agreement may be implied.[20]

[44] Here, given the absence of a written agreement, the Court needs to closely examine the conduct of the parties to determine whether there was an implied intention to create an agency relationship, as described by G.H.L. Fridman in *Canadian Agency Law*:

... To arrive at the conclusion that there was an agency involves an intricate analysis of the facts to elucidate the correct nature of the relationship between the parties ...

... the agency relationship may be impliedly created by the conduct of the parties, without anything having been expressly agreed as to terms of employment, remuneration, etc. The assent of the agent may be implied from the fact that he has acted intentionally on another's behalf. In general, however, it will be the assent of the principal which is more likely to be implied, for except in certain cases, "it is only by the will of the employer that any agency may be created."

...

Mere silence will be insufficient. There must be some course of conduct to indicate the acceptance of the agency relationship. The effect of such an implication is to put the parties in the same position as if the agency had been expressly created.[21]

[45] Here, a key consideration in reviewing the conduct of the alleged principal (the Appellant) and her agents will be determining the level of control the Appellant exerted over the corporations:

... It is important that the alleged agent be under the control of the alleged principal.

In the language of the court in 2000 in *Advanced Glazing Systems Inc. v. Frydenland*.

"The greater the power of control over the agent/trustee, the greater the likelihood that the principles of agency ... are applicable." [22]

[46] The Appellant in this case had full control over every action of the corporations. Indeed, the corporations could not act without her; even if the minority shareholders became active, the Appellant would remain the controlling party. The mere fact that she had such control, however, is not sufficient for a finding of an agent-principal relationship, otherwise many privately controlled corporations could be characterized as the agents of their majority shareholders. What, then, is the actual test to apply in determining whether an agency relationship existed?

[47] In *Otineka Development Corporation Limited et al. v. The Queen*,[23] the Tax Court of Canada emphasized the need for a high threshold of evidence for a finding that a corporation was actually acting as an agent:

... Where a corporation holds itself out to third parties as owning its property and business, keeps separate financial records, files its own corporate income tax returns and acts like any other corporation that is independent of its shareholders, it would require extremely cogent evidence to establish that all along it was really just an agent or trustee for its shareholders on the basis of an unwritten oral understanding or assumption on the part of some of the shareholders or directors.[24]

[48] Here, DSD and SJC also each held itself out to third parties as owning its property and business, but only in limited instances. DSD held title to certain real property, but, as previously discussed, the properties were held in resulting (bare) trust as they were acquired through gratuitous transfers. Beginning in 2005, DSD carried all mortgages on the properties. In 2003 and 2004, however, after DSD's incorporation, the mortgages had remained in the Appellant's name. There is no evidence that the Appellant transferred the mortgages to DSD's name in 2005 to minimize risk, rather, she continued to be the guarantor for all the mortgages, and all payments on the mortgages came out of her personal accounts. In certain limited circumstances, SJC did contract with third parties, concluding rental agreements with tenants, for example; it also handled some correspondence with tenants. SJC was found, however, in the CRA audit, to be doing essentially nothing as a corporation.

[49] Neither SJC nor DSD kept separate financial records, although it appears that the Appellant did her best, using her financial spreadsheets, to track general income and expenses. All of SJC and DSD's transactions went through the Appellant's personal accounts. While SJC's name was used on letters and contracts with tenants, rent cheques were made out to Ms. Fourney, and she was shown as the landlord on documents filed with the Office of the Rentalsman.

[50] Both DSD and SJC filed corporate tax returns, however, the Appellant reported and claimed income and expenses that were the same as or similar to those claimed by the corporations. The reporting and claiming by the Appellant personally implies an intention to act as a principal, with the corporations being mere agents and bare trustees. The Appellant's credibility is strong in this case; the accountant did not demonstrate adequate and reasonable care or professional skill when he prepared corporate returns without being able to trace any of the assets in the corporations. The double-claiming by the Appellant was not intentional and the reporting of income and claiming of expenses on the corporate returns should not be taken as evidence against an agency relationship when the Appellant's claiming of the same expenses personally provides evidence of exactly the contrary.^[25]

[51] The Appellant testified that she adopted the strategy of transferring the properties to DSD in order to achieve her goal of hiding her assets from her brother. She testified that she set up the corporate structure to make it more difficult for her brother to discover what properties she owned. According to the Appellant, her brother, accustomed to managing and operating a farm, placed an inordinately high value on land. The Appellant alleges that her brother was bitter that the Appellant had stood with her mother in the latter's attempt to have her son honour his commitment to paying the debt he owed her. That debt originated from the sale to him of the family dairy farm after the Appellant's father had died. According to the Appellant, her brother stopped paying her mother because he decided unilaterally that he had paid her enough. The Appellant's concern about protecting against a possible litigation risk turned out, with hindsight, to be ill-founded. Her mother's claim was upheld by the courts, thanks in large part to the considerable assistance of the Appellant.

[52] The evidence reveals that the Appellant did not have a panoply of structures to choose among to achieve her alleged objectives. She could transfer the properties outright to DSD in exchange for less liquid shares. The beneficial and legal ownership of the properties would then reside with DSD. That is the Respondent's theory of what the Appellant in fact did. The evidence presented by the Appellant does not allow me to share this view.

[53] The other course of action was for the Appellant to transfer only registered title to DSD. DSD would hold the properties as bare trustee and would be constituted as the Appellant's agent in dealing with those properties. The Appellant could also choose not to disclose the agency agreement to third parties. This is often done for real estate transactions. Disclosure of the verbal agreement would in fact defeat the purpose of that agreement.

[54] The Appellant, in my opinion, has established that such an arrangement is what she intended, implemented, and caused the corporations to carry out on her behalf. Undoubtedly, it would have been much simpler had the Appellant caused a bare trust and agency agreement to be drawn up. She did not, and she has paid a very heavy price, including having her life turned upside down by an audit, an assessment and these appeals, all at considerable cost to her.

[55] The empowering of DSD to act on the Appellant's behalf is confirmed by numerous factors. While the bare trust and agency relationship was not totally disclosed to the lessees and suppliers of DSD, the wary certainly had reasons to believe that this relationship existed. For example, the evidence reveals that the rental cheques were made payable to the Appellant. The invoices for repairs and renovations were addressed to the Appellant. It was the Appellant who advertised the rental properties, collected the rent cheques, cleaned the properties and was listed as the landlord with the Office of the Rentalsman. The Respondent actually acknowledges that SJC did nothing.

[56] As noted earlier, the Appellant's troubles originate from the fact that both she and the corporations reported the same revenue and expenses. This led to a duplication of the claims for losses. Mr. Chambers, the person who prepared the corporations' tax returns, made a number of

startling revelations during his testimony, which explains in part how this occurred. The evidence shows that there was an absence of effective communication between the Appellant and Mr. Chambers. For example, he admitted that the Appellant was presented with copies of the corporations' 2003 and 2004 tax returns much later, after they had been electronically filed. Those returns are not comprehensible to anyone other than a person who has memorized the line codes opposite which the tax information appears. The codes correspond to an electronic coding of the information, and this coding is known only to the most skilled tax compliance professional. A taxpayer, or a tax lawyer for that matter, cannot determine what the codes mean unless they have access to a detailed coding manual which explains their meaning. The CRA officer appearing for the Respondent admitted that CRA personnel receive specialized training to enable them to understand electronically-filed tax returns. On reviewing the returns at issue, the Appellant had no way of knowing that Mr. Chambers claimed the same losses as she had claimed on her personal tax return. [57] The most startling revelation made by Mr. Chambers is his admission that he completed and filed the tax returns without understanding how DSD acquired the properties. If the Appellant had intended to transfer the properties on a tax-deferred basis, she would have had to file an election under section 85 of the Act assuming all the preconditions had been met. Generally speaking, because the Appellant had accrued gains, she would have filed, if properly advised, a section 85 rollover election. The present value of the tax payable will always exceed the present value of the future depreciation expense. This is due to the fact that the depreciation rate is low, meaning that the future tax savings have a low present value. The Appellant did not file an election because, as the evidence shows, she intended to retain beneficial ownership. In her mind, no taxable disposition occurred. On a related-party transfer of property, a professional completing tax returns will ask to see the transfer agreement in order to discern whether the transfer qualifies for a tax-free rollover or not. I note that the Appellant's two sons were given shares in the bare trust corporation. If a true disposition had occurred and there had existed an element of gift in the form of a shifting of some of the value of the transferred properties to the shares of the Appellant's sons part of the transfer could be taxable. On the other hand, if, as Mr. Chambers admitted, he learned later that a section 85 rollover election had not been filed, he needed to know the fair market value of each property in order to determine the undepreciated capital cost (UCC) balance for DSD. Under the technical rules of the Act, only one-half of the accrued gain is added to the UCC balance to match the taxation on one-half in the hands of the transferor. In this case, the UCC balance is equal to the sum of the cost of the property to the transferor and one-half of the gain.

[58] A few basic questions on Mr. Chambers' part could have clarified the situation. He could have asked, for example: Where is the purchase and sale agreement? What was the consideration that was paid? Do you realize that the sale could be construed as taxable unless you document your retention of beneficial ownership? Are you aware that you will realize a taxable capital gain, which will exceed the net present value of the future tax savings from the depreciation expenses if the transaction is found to be taxable? He could have said: I need to know the foregoing to establish the UCC balance, if any, of the properties. The confusion was compounded by the fact that the electronic returns were filed twice, long before the Appellant received copies. Had Mr. Chambers done as indicated above, these matters could have been cleared up without an audit and resulting reassessments.

[59] The Appellant testified that she felt comfortable using off-the-shelf tax software to complete her personal tax returns as she had done in the past. She was, in her words, terrified by the complexity of the tax software used to prepare electronically-filed tax returns. This is understandable as it takes a great deal of sophistication to convert financial information into the tax information required in the returns. She turned to Mr. Chambers for this service. Mistakes were made but the evidence shows that it was not the Appellant who wrongly claimed the expenses, as alleged by the Respondent. It was DSD and the other corporations that did so in the returns prepared and filed by Mr. Chambers. The basis for the Respondent's claim of tax, interest and penalties against the Appellant is that the Appellant failed to report the gains from the transfers and claimed losses to which she was not

entitled. With regard to DSD and SJC, the evidence clearly shows that she was entitled to do so.

[60] Learning Boost held itself out to third parties as a separate legal entity in more ways than DSD and SJC. Learning Boost did have its own bank account and did prepare financial statements every year. The Appellant however, took care of every aspect of Learning Boost's activities except the work performed by the hired tutors. She collected payments from students, took care of all advertising, and designed the Learning Boost logo. The Appellant personally took on the risk when she contracted in her own name to renovate her home for Learning Boost's office. Unlike the procedure followed for SJC, however, payments for tutorial services were made to Learning Boost and not the Appellant. Contracts with tutors were made between the tutors and Learning Boost, as were confidentiality agreements. Learning Boost had a business number and a business licence, and issued T4s under its own name. The tutorial company maintained its own phone number and Web site. Still, the Appellant continued to claim Learning Boost's income and expenses in her personal returns.

[61] The mere maintenance of a separate bank account and careful attention to budgeting for a business endeavour do not necessarily mean that such an endeavour (here, Learning Boost) is not an agent, but the number of instances of the corporation holding itself out to third parties as a separate legal entity does weaken the appearance of an implied agency relationship (in this case, with the Appellant). I believe that other tests regarding agent-principal relationships and beneficial ownership can guide me in my decision on the status of Learning Boost.

[62] J. Anthony VanDuzer in *The Law of Partnerships and Corporations*, tells us that the test for whether an agency relationship exists is as follows:

. . . The factors referred to in *Smith, Stone and Knight Ltd. v. Birmingham Corp.* are almost universally cited as those relevant to a determination whether agency exists:

- Were the profits treated as profits of the shareholder?
- Was the person conducting the business appointed by the shareholder?
- Was the shareholder the head and brain of the trading venture?
- Did the shareholder govern the adventure and decide what should be done and what capital should be committed to the venture?
- Did the shareholder make the profits by its skill and direction?
- Was the shareholder in effectual and constant control?[26]

[63] All three corporations herein can answer each of the above questions in the affirmative. The Appellant had total control of these corporations and there is no evidence of any restraints by the minority shareholders or anyone else on her discretion to guide the business, commit (her own) capital to that business, choose what to do with profits, and so on. Still, VanDuzer goes on to stress that the mere presence of the above factors is not sufficient:

Extensive and even complete control by a single person, however, is contemplated in the *CBCA*, so the existence of control satisfying the test in *Smith* cannot in any way be conclusive. . . .

. . .

There is nothing in any corporate statute which suggests that any particular degree of control is inappropriate or prohibited. In *Alberta Gas Ethylene Co. v. M.N.R.*, Madame Justice Reed observed that *Smith* does not stand for the proposition that one must ignore the separate existence of a subsidiary corporation when the six criteria are met. One must ask for what purpose the corporation was incorporated and used, and consider the overall context in which the obligation to the third party arose.[27]

[64] Rip A.C.J. (as he was then) undertook in *Prévost Car Inc. v. The Queen*[28] a detailed analysis of the meaning of "beneficial owner" in Canadian common law, as that term was undefined in the agreement in question in that case. He concluded that an agency relationship in which the principal retains beneficial ownership can only exist in narrow circumstances that meet very specific criteria:

. . .

When the Supreme Court in *Jodrey* stated that the "beneficial owner" is one who can

"ultimately" exercise the rights of ownership in the property, I am confident that the Court did not mean, in using the word "ultimately", to strip away the corporate veil so that the shareholders of a corporation are the beneficial owners of its assets, including income earned by the corporation. The word "ultimately" refers to the recipient of the dividend who is the true owner of the dividend, a person who could do with the dividend what he or she desires. It is the true owner of property who is the beneficial owner of the property. Where an agency or mandate exists or the property is in the name of a nominee, one looks to find on whose behalf the agent or mandatary is acting or for whom the nominee has lent his or her name. When corporate entities are concerned, one does not pierce the corporate veil unless the corporation is a conduit for another person and has absolutely no discretion as to the use or application of funds put through it as conduit, or has agreed to act on someone else's behalf pursuant to that person's instructions without any right to do other than what that person instructs it, for example, a stockbroker who is the registered owner of the shares it holds for clients. . . . [29]

[65] This is such a case: all three corporations could be characterized as mere conduits for the Appellant. They had no ability to act on their own; there is no evidence of minute books or annual meetings; the corporations had neither the discretion nor any right to use any income earned through them; they could indeed be described as mere conduits or agents of the Appellant.

[66] In *Larose v. Minister of National Revenue*, [30] this Court describes as follows the beneficial ownership test: "A property is deemed to be beneficially owned when one person possesses the three attributes of the ownership of property (*usus, fructus, abusus*). . . ." [31] In *Smedley v. The Queen*, [32] the Tax Court of Canada reiterated that ". . . the test for beneficial ownership is the date at which the party has acquired the indicia of ownership, those being risk, use and possession." [33] With respect to DSD and SJC, the Appellant clearly meets this test, as she takes on all the risk personally, using all the business assets herself and having possession of them. Only the case of Learning Boost raises some doubt in that the Appellant took risks in terms of her investment in home renovations for teaching space, but at the same time reduced her risk by using the corporate name to contract with third parties, including the tutors, in some contexts.

[67] In the specific case of Learning Boost, although it is not perfect, the evidence establishes on a balance of probabilities that Learning Boost was also acting as a bare nominee and agent of the Appellant. Indications of such a relationship include the following:

- (a) The Appellant created the television and print advertisements for Learning Boost.
- (b) The Appellant designed and created the Learning Boost logo.
- (c) The Appellant collected the fees from Learning Boost students.
- (d) The Appellant converted her single-car garage into a "Learning Boost Office".
- (e) The Appellant personally contracted with tradespeople to effect renovations to the Learning Boost teaching space.
- (f) The Appellant travelled to the students' homes to sign contracts and assist with tutoring.
- (g) The Appellant hired tutors to work with Learning Boost students.
- (h) The Appellant used personal funds during the tax years in question to cover operating expenses for the Learning Boost business.

VI. PENALTIES

Appellant's Position

[68] In the Appellant's view, gross negligence penalties should not be imposed in this case for the following reasons:

- Given the manner in which the Respondent worded her pleading, which cannot be changed without affecting the fairness of the trial, gross negligence penalties can only be imposed if the Appellant's agency claim fails. Any references to double-claiming by the Appellant of some of the expenses, if such references are not found in the Respondent's pleading, cannot be considered now, as the Respondent has no right to

appeal her own assessment. This issue is different than the double-claiming issue raised by the Respondent to support the assessments. The issue raised in the pleading concerns the double-claiming by the corporations and the Appellant of the same expenses. At trial, the Respondent brought up the fact that the Appellant claimed some of the same expenses twice in her tax returns. This is a matter not covered by the assessments issued against the Appellant and was raised for the first time at trial. As a result, this matter did not form part of the basis of the assessment of gross negligence penalties against the Appellant.

- The burden of proof lies with the Respondent, who failed to establish the evidentiary grounds for gross negligence, having never provided the penalty calculation despite the Appellant's request and the CRA's undertaking during examination for discovery to provide the relevant documents.
- The Respondent has not proven that the Appellant had the necessary intent justifying the assessment of such penalties.
- Despite the reference to such a test in the Respondent's reply to the notice of appeal, the gross negligence penalty provisions in subsection 163(2) of the *Act* and section 285 of the *Excise Tax Act* (the "ETA") do not impose an "ought to have known" test. Rather, the phrase used is "knowingly, or under circumstances amounting to gross negligence".
- The Respondent has in no way proven that the Appellant knowingly, or under circumstances amounting to gross negligence, made false statements or omissions in her returns. The Appellant has no formal education in taxation or accounting, but she kept detailed books and records and shared that information with her accountant on the assumption that she was obtaining qualified professional assistance that would ensure that she was meeting her tax obligations.
- Although the Appellant had experienced two previous audits, they related to different issues and were prior to the incorporations.
- The Appellant never had the opportunity to review her 2004 and 2005 corporate returns before they were e-filed. While she did see the 2003 return, the Appellant did not have the requisite skill to understand the corporate returns, a claim supported by the CRA appeals officer's concession that the corporate returns require special training in order for a person to be able to read and understand them.
- Even without the double-claiming, the Appellant's returns for the years in question would still show her to be in a loss position.

Respondent's Position

[69] Gross negligence penalties should be imposed, the Respondent having proven the existence of multiple grounds for doing so, namely:

- (a) "Ms. Fourney has recklessly disregarded her legal obligations with respect to personal and corporate taxation. The evidence supports a finding that Ms. Fourney chose to do whatever seemed to work for her, regardless of whether or not it conformed to the requirements of the *Income Tax Act* or the *Excise Tax Act*." [34]
- (b) "Ms. Fourney's cross-examination disclosed errors in her personal tax returns and in the corporate tax returns of the incorporated Appellants, almost too numerous to mention. . . . The problem of errors in the various personal and corporate tax returns was pointed out to Ms. Fourney at the audit and appeals stages; there is no ambush." [35]
- (c) The Appellant was previously audited for issues relating to the capitalization of expense items and the non-reporting capital gains. [36]
- (d) The Appellant should have properly shared information with her accountant. [37]
- (e) Mr. Chambers, the accountant, testified that once he noted the double-claiming, he informed the Appellant in 2005 that she needed to amend her personal return. [38]
- (f) As a person who had been in business since 1994, the Appellant should have taken steps

to inform herself to a greater degree about tax accounting matters.[39]

(g) The large number of errors in the Appellant's returns shows that her bookkeeping system was clearly inadequate.[40]

The amounts involved are substantial. With respect to DSD, the unreported income is substantial in relation to the reported net income for 2003, 2004, and 2005. With respect to Learning Boost, it is evident that the losses claimed are substantial in relation to the income reported for 2003 and 2004. With respect to Ms. Fourney, it is evident that the business losses claimed with regard to the business activities of DSD, SJC and Learning Boost are substantial. As regards SJC's GST matters, the amounts involved are substantial in relation to the total amounts reported and claimed.

Penalties Analysis

[70] It is abundantly clear from the reply to the notice of appeal, that it was the Minister's position that penalties should apply to the Appellant if and only if this Court were to find that both beneficial and legal ownership of the properties was transferred to the corporations and that the corporations were not appointed agents of the Appellant for the purposes of dealing with the transferred properties and operating the businesses on her behalf. In this regard, the reply frames the issues as follows:

The issues are:

- a) whether Shirley Fourney was the beneficial owner and operator of the assets and activities of DSD, SJC and Learning Boost in 2003, 2004 and 2005;
- b) if Shirley Fourney was not the beneficial owner and operator of the assets and activities of DSD, SJC and Learning Boost in 2003, 2004 and 2005, whether the Minister properly assessed the appellant to:
 - i) increase rental income by \$3,824.57 in 2003 and reduce rental income by \$11,151.67 in 2004;
 - ii) add business income of \$146,335 in 2003, \$136,071.80 in 2004 and \$49,215.28 in 2005;
 - iii) include shareholder benefits of \$10,800 in each of the 2003, 2004 and 2005 taxation years;
 - iv) include taxable capital gains of \$8,710.76 in 2003 and \$26,412.33 in 2004 in respect of the disposition of properties; and
 - v) include penalties pursuant to subsection 163(2) of the *Act* in respect of the appellant's 2003, 2004 and 2005 taxation years.

The Respondent's counsel attempted to put forward a different position at trial, which met with strenuous objections from the Appellant's counsel. The Respondent invited me to consider the fact that the Appellant admittedly double-claimed some expenses in 2003 and 2004 tax returns. This Court has stated in the past that taxpayers generally have the right to rely on the issues being as framed by the Respondent in her reply. While leave may be granted to amend the reply, the discretion to do so is generally not exercised once the trial has begun. In any event, I note that the Respondent did not move to have her reply amended but raised the issue in argument. The purpose of the above-stated position of the Court with regard to the issues is to avoid trial by ambush and preserve the parties' right to properly prepare for trial. More generally, the Respondent's claim for penalties should be dismissed either way because the Respondent failed, for detailed reasons stated below, to establish on a balance of probabilities that the conditions giving rise to the assessment of penalties have been met.

[71] Subsection 163(2) of the *Act* describes the standard for imposing gross negligence penalties:

False statements or omissions

163(2) Every person who, knowingly, or under circumstances amounting to gross negligence, has made or has participated in, assented to or acquiesced in the making of, a false statement or omission in a return, form, certificate, statement or answer (in this section referred to as a "return") filed or made in respect of a taxation year for the purposes of this Act, is liable to a penalty of the greater of \$100 and 50% of the total of. . . .

The subsection uses the word "knowingly" but not the phrase "ought to have known", which the Respondent uses in both her reply to the notice of appeal and her Additional Written Submissions.

[72] Section 285 of the ETA uses the same standard as the Act, again without the phrase “ought to have known”:

285. Every person who knowingly, or under circumstances amounting to gross negligence, makes or participates in, assents to or acquiesces in the making of a false statement or omission in a return, application, form, certificate, statement, invoice or answer (each of which is in this section referred to as a “return”) made in respect of a reporting period or transaction is liable to a penalty of the greater of \$250 and 25% of the total of. . . .

[73] The standard referred to by the Respondent in her written submissions is wrong. Instead, the Appellant’s actions need to be reviewed on the basis of whether her false statements were made “knowingly, or under circumstances amounting to gross negligence.” The case law provides a road map for applying this standard to the facts herein. First, the Federal Court of Appeal’s decision in *Lacroix v. Canada*,^[41] supports the Appellant’s position in the present case that the burden is on the Minister to prove that penalties should be imposed:

Although the Minister has the benefit of the assumptions of fact underlying the reassessment, he does not enjoy any similar advantage with regard to proving the facts justifying a reassessment beyond the statutory period, or those facts justifying the assessment of a penalty for the taxpayer’s misconduct in filing his tax return. The Minister is undeniably required to adduce facts justifying these exceptional measures. In *Richard Boileau v. M.N.R.*, 89 D.T.C. 247, Judge Lamarre Proulx stated as follows, at page 250:

Indeed, the Appellant was unable to contradict the basic elements of the net worth assessments. However, in my view, this is not sufficient for discharging the burden of proof which lies on the Minister. To decide otherwise would be to remove any purpose to subsection 163(3) by reverting the Minister’s burden of proof back onto the Appellant.

In a similar vein, in *Farm Business Consultants Inc. v. Her Majesty the Queen*, [1994] 2 C.T.C. 2450, 95 D.T.C. 200, Judge Bowman wrote the following at paragraph 27:

27. A court must be extremely cautious in sanctioning the imposition of penalties under subsection 163(2). Conduct that warrants reopening a statute-barred year does not automatically justify a penalty and the routine imposition of penalties by the Minister is to be discouraged. . . .

Moreover, where a penalty is imposed under subsection 163(2) although a civil standard of proof is required, if a taxpayer’s conduct is consistent with two viable and reasonable hypotheses, one justifying the penalty and one not, the benefit of the doubt must be given to the taxpayer and the penalty must be deleted^[42]

[74] The Federal Court of Appeal, in *Lacroix*, went on to make a statement regarding the Minister’s burden that has since caused some confusion:

What, then, of the burden of proof on the Minister? How does he discharge this burden? There may be circumstances where the Minister would be able to show direct evidence of the taxpayer’s state of mind at the time the tax return was filed. However, in the vast majority of cases, the Minister will be limited to undermining the taxpayer’s credibility by either adducing evidence or cross-examining the taxpayer. Insofar as the Tax Court of Canada is satisfied that the taxpayer earned unreported income and did not provide a credible explanation for the discrepancy between his or her reported income and his or her net worth, the Minister has discharged the burden of proof on him within the meaning of subparagraph 152(4)(a)(i) and subsection 162(3).^[43]

[75] When reviewing the above passage in *Dao v. The Queen*,^[44] Campbell J. of the Tax Court of Canada found it confusing, that it made it unclear whether the Federal Court of Appeal was imposing a new standard for gross negligence penalties:

. . . With respect, the reasons of Pelletier J. in *Lacroix v. The Queen*, [2008] F.C.J. 1092, leave me bewildered and somewhat perplexed when I compare his analysis to the preceding cases in both the Tax Court and the Federal Court of Appeal. At paragraphs 30 to 32 of *Lacroix*, the two provisions are essentially lumped together and the same onus is imposed upon the Minister with respect to both provisions. The effect of this would be to remove the requirement for the element of *mens rea* and, consequently, establish circumstances that would allow penalties in many unsuccessful appeals. Where a taxpayer is accused of reckless and reprehensible conduct bordering on criminal behaviour for which he may be slammed with the punishment of gross negligence penalties, the Minister under subsection 163(2) has a duty to justify its decision which will not be satisfied merely, as *Lacroix* suggests, by showing that the taxpayer has unreported income but could not provide a credible explanation.^[45]

[76] I do not believe that the decision of Pelletier J.A. in *Lacroix* constitutes a departure from the principles enunciated in previous case law, as suggested by my colleague in *Dao*. Pelletier J.A.'s comments must be considered in light of the nature of the appeal he was dealing with. Mr. Lacroix was reassessed on the basis of the findings of a net worth assessment. The trial judge found that the appellant in that case had no explanation for the large discrepancy between his reported income and his significantly greater net worth. I understand Pelletier J.A.'s comment to mean that a trial judge can draw a reasonable inference from the evidence presented by the Respondent. If no reasonable explanations are given to explain the discrepancy, a trial judge can draw the inference that the taxpayer was grossly negligent in failing to report his or her income. I caution, however, that the inference must be reasonable and further, that the evidence must not allow for a different explanation. If it does, then the Minister must establish on a balance of probabilities that this explanation is untrue.

[77] Because subsection 163(2) is penal in nature, it calls for a higher degree of culpability and must be applied only where the evidence clearly justifies so doing. If the evidence creates any doubt that it should be applied in the circumstances of the appeal, then the only fair conclusion is that the taxpayer must receive the benefit of that doubt in those circumstances. In *Farm Business Consultants Inc. v. The Queen*, 95 DTC 200, a decision which was upheld by the Federal Court of Appeal (96 DTC 6085), at pages 205 to 206, Judge Bowman (as he was then), stated:

A court must be extremely cautious in sanctioning the imposition of penalties under subsection 163(2). Conduct that warrants reopening a statute-barred year does not automatically justify a penalty and the routine imposition of penalties by the Minister is to be discouraged Moreover, where a penalty is imposed under subsection 163(2) although a civil standard of proof is required, if a taxpayer's conduct is consistent with two viable and reasonable hypotheses, one justifying the penalty and one not, the benefit of the doubt must be given to the taxpayer and the penalty must be deleted . .

[78] An extensive body of case law refers to the need for evidence of intent or recklessness on the part of an appellant in order for gross negligence penalties to be imposed. Here, no such evidence has been provided. The Appellant sought professional accounting assistance to complete her tax returns. Mr. Chambers provided no plausible explanation showing how he could have acted with reasonable care as an accountant without having had with the Appellant a conversation about the tax consequences of transferring properties to the corporations, about the need to trace the corporate assets, and about the Appellant's intentions regarding the reporting of income and claiming of expenses personally or through the corporations. Mr. Chambers' testimony that he noticed the double-claiming in 2005 and that he told the Appellant to amend her returns at that time lacks credibility considering the general lack of care that he displayed. In any event, it was by then much too late for the returns that had already been filed. Finally, his advice was inconsistent with the factual reality that the Appellant transferred only the legal title to the properties to the corporations that acted

as her exclusive agents in connection with those properties and the business.

[79] The evidence shows that the Appellant strived to become self-reliant in building her rental property business from scratch and launching Learning Boost following her retirement as a teacher. As a single mother she wanted a better life for her two sons and herself. Rental businesses are not high-profit activities. To be successful, one cannot afford to outsource all services to outside professionals. It is obvious that the Appellant went one step too far in trying to become self-reliant with respect to her tax compliance obligations. She believed that she had mastered the use of the personal tax preparation software, when in fact she had not. Undoubtedly, she has learned from this unpleasant and costly experience. The double-claiming of expenses on her personal returns was attributable to the fact that she did not understand that she had to enter the information under either the rental property section or business section of the software, but not both, as this would lead to a duplication of her declared losses. She incorporated Learning Boost on her own to save costs. She completed the real estate transfer documentation on her own, not fully appreciating that she could have succeeded in implementing her plan by using a written bare trust and agency agreement. She had the judgment not to tackle the preparation of the electronic tax returns of DSD, SJC and Learning Boost herself because she realized that she would be out of her depth. She hired Mr. Chambers for this purpose. Rather than sitting down and gauging the Appellant's true intent, Mr. Chambers filed the returns without taking stock of the situation. It is clear that the Appellant recognizes that she needs help in meeting her tax compliance obligations. Nonetheless, the Appellant should be applauded for having succeeded in building two businesses and should not be punished for honest mistakes that clearly, in light of the evidence, do not constitute grossly negligent behaviour. In any event, the evidence shows that the Appellant retained beneficial ownership of the properties and businesses, meaning that the Respondent has failed to prove that the Appellant wrongly claimed the expenses at issue in these appeals.

[80] It is clear that the Appellant lacks basic knowledge of accounting and tax matters. Her numerous errors in her tax returns point to her lack of skill in these areas. In a self-assessing tax system, however, gross negligence penalties are not imposed for mere mistakes by a taxpayer who lacked the intention to misstate or omit. Further, the case law establishes that if there is any doubt about intent, the benefit of that doubt should go to the taxpayer since the penalty provision in question is penal in nature. The same reasoning applies to the penalties assessed against the corporate appellants under the Act.

[81] The Minister also reassessed SJC with respect to input tax credits (ITCs) claimed on taxable supplies. The evidence shows that the properties and businesses belonged to the Appellant. For these reasons, SJC was not entitled to claim ITCs and the reassessments should stand.

VI. CONCLUSIONS

[82] The Appellant's beneficial ownership claim succeeds for the reasons set out above. The resulting trust doctrine applies to all the properties transferred in this case; the corporations merely had legal ownership of property transferred gratuitously in circumstances where there was no evidence of an intention to gift. An assessment of the conduct of the Appellant and the corporations over the three-year period indicates an implied agency relationship. The Appellant always was the owner of the assets and businesses registered in the name of the corporations.

Spousal Trusts.

Subsections 70(6) and 73(1) provide favourable provisions whereby property, of varying nature, that is transferred by a taxpayer to his spouse, (formerly upon his death and latterly *inter vivos*) or a trust under which she has a certain interest and is designed in a certain way, will be considered disposed of for its tax cost and not its fair market value, hence allowing the transferor to recognize a tax-free disposition. The tax-free roll-over is elective. A "spousal trust" is a trust under which no one but the spouse is entitled **to receive** the income therefrom before her death and no person other than the spouse may receive or obtain the use of any of the income or **capital** of the trust before her death. While Sec. 70(6)(b) and 73(1) provide for transfers of property to a trust for the benefit of the transferor's spouse, there are no such provisions available to reduce tax

exposure when the taxpayer transfers property to a trust **for her** whereunder income therefrom is to be paid to the transferor.

Subparagraph 54(c)(v) allows an exemption from the recognition of a disposition when property is transferred and there is a change in legal ownership without a change in beneficial ownership, (but only for the purposes of subdivision C), hence when a transferor contributes property to a trust whereunder the income is payable to him but the capital is payable to her upon his death a taxable disposition will be recognized by the fact that the beneficial ownership of **the capital element** of the property has been changed.

Subsection 73(1)-(1.1) provides that an *inter vivos* transfer of property directly to a spouse by a taxpayer can be effectively tax free hence rather than transfer the property to a trust whereunder he is an income beneficiary, and recognize a disposition, it would be obviously more beneficial to transfer the property to the spouse, and after "a few years", have it transferred back to a trust under which "her spouse", the original owner, was entitled to receive all of the income of the trust before his death, whereupon the capital would revert to her. In that case, she would not recognize potentially substantial tax consequences on the transfer to the trust, by virtue of the applicability of section 73 and the initial owner would continue to be able to recognize the income.

"joint spousal or common-law partner trust"

"joint spousal or common-law partner trust" means a trust to which paragraph 104(4)(a) would apply if that paragraph were read without reference to subparagraph 104(4)(a)(iii) and clause 104(4)(a)(iv)(A);

"Inter vivos transfers by individuals – Sec. 73(1)"

Sec. 73. (1) For the purposes of this Part, where at any time any particular capital property of an individual (other than a trust) has been transferred in circumstances to which subsection (1.01) applies and both the individual and the transferee are resident in Canada at that time, unless the individual elects in the individual's return of income under this Part for the taxation year in which the property was transferred that the provisions of this subsection not apply, the particular property is deemed

- (a) to have been disposed of at that time by the individual for proceeds equal to,**
 - (i) where the particular property is depreciable property of a prescribed class, that proportion of the undepreciated capital cost to the individual immediately before that time of all property of that class that the fair market value immediately before that time of the particular property is of the fair market value immediately before that time of all of that property of that class, and**
 - (ii) in any other case, the adjusted cost base to the individual of the particular property immediately before that time; and**
- (b) to have been acquired at that time by the transferee for an amount equal to those proceeds.**

"Qualifying transfers – Sec. 73(1.1)"

(1.01) Subject to subsection (1.02), property is transferred by an individual in circumstances to which this subsection applies where it is transferred to

- (a) the individual's spouse or common-law partner;**
- (b) a former spouse or common-law partner of the individual in settlement of rights arising out of their marriage or common-law partnership; or**
- (c) a trust created by the individual under which**
 - (i) the individual's spouse or common-law partner is entitled to receive all of the income of the trust that arises before the spouse's or common-law partner's death and no person except the spouse or common-law partner may, before the spouse's or common-law partner's death, receive or otherwise obtain the use of any of the income or capital of the trust,**
 - (ii) the individual is entitled to receive all of the income of the trust that arises before the individual's death and no person except the individual may, before the individual's death, receive or otherwise obtain the use of any of the income or capital of the trust, or**

(iii) either

- (A) the individual or the individual's spouse is, in combination with the other, entitled to receive all of the income of the trust that arises before the later of the death of the individual and the death of the spouse and no other person may, before the later of those deaths, receive or otherwise obtain the use of any of the income or capital of the trust, or**
- (B) the individual or the individual's common-law partner is, in combination with the other, entitled to receive all of the income of the trust that arises before the later of the death of the individual and the death of the common-law partner and no other person may, before the later of those deaths, receive or otherwise obtain the use of any of the income or capital of the trust.**

"Exception for transfers – Sec. 73(1.02)"

(1.02) Subsection (1.01) applies to a transfer of property by an individual to a trust the terms of which satisfy the conditions in subparagraph (1.01)(c)(ii) or (iii) only where

- (a) the trust was created after 1999;**
- (b) either**
 - (i) the individual had attained 65 years of age at the time the trust was created, or**
 - (ii) the transfer does not result in a change in beneficial ownership of the property and there is immediately after the transfer no absolute or contingent right of a person (other than the individual) or partnership as a beneficiary (determined with reference to subsection 104(1.1)) under the trust; and**
- (c) in the case of a trust the terms of which satisfy the conditions in subparagraph (1.01)(c)(ii), the trust does not make an election under subparagraph 104(4)(a)(ii.1).**

"Interpretation – Sec. 73(1.1)"

(1.1) For greater certainty, a property is, for the purposes of subsections (1) and (1.01), deemed to be property of the individual referred to in subsection (1) that has been transferred to a particular transferee where,

- (a) under the laws of a province or because of a decree, order or judgment of a competent tribunal made in accordance with those laws, the property**
 - (i) is acquired or is deemed to have been acquired by the particular transferee,**
 - (ii) is deemed or declared to be property of, or is awarded to, the particular transferee, or**
 - (iii) has vested in the particular transferee; and**
- (b) the property was or would, but for those laws, have been a capital property of the individual referred to in subsection (1).**

"Capital cost and amount deemed allowed to spouse, etc., or trust – Sec. 73(2)"

(2) Where a transferee is deemed by subsection 73(1) to have acquired any particular depreciable property of a prescribed class of a taxpayer for an amount determined under paragraph 73(1)(e) and the capital cost to the taxpayer of the particular property exceeds the amount determined under that paragraph, for the purposes of sections 13 and 20 and any regulations made under paragraph 20(1)(a)

- (a) the capital cost to the transferee of the particular property shall be deemed to be the amount that was the capital cost to the taxpayer thereof; and**
- (b) the excess shall be deemed to have been allowed to the transferee in respect of the particular property under regulations made under paragraph 20(1)(a) in computing income for taxation years before the acquisition thereof.**

IT-406R2

DATE: May 11, 1990

SUBJECT: INCOME TAX ACT

Tax Payable by an Inter Vivos Trust

REFERENCE: Subsection 122(2) (also sections 117, 117.1 and 127.53, subsections 96(1), 104(2), 104(18), 122(1), 122(1.1), 149(5) and 248(1), and paragraphs 125(7)(d) and (e))

Application

This bulletin cancels and replaces Interpretation Bulletin IT-406R dated June 21, 1982. Current revisions are indicated by vertical lines.

Summary

This bulletin sets out the rates of tax payable by inter vivos trusts. It also discusses the circumstances in which inter vivos trusts established before June 18, 1971 may receive more favoured treatment by being taxed at graduated individual rates.

Discussion and Interpretation

1. An inter vivos trust is subject to a flat rate of federal tax on its amount taxable for the year equivalent to the highest rate for individuals, except where all of the conditions set out in subsection 122(2) are met by the trust (see 2 below). For 1988 and subsequent taxation years, subsection 122(1) imposes a federal tax rate of 29 percent on inter vivos trusts. For the 1985 to 1987 taxation years, the rate was 34 percent. By virtue of subsection 122(1.1), an inter vivos trust may not claim the personal tax credits provided in section 118.

2. Where an inter vivos trust (other than a mutual fund trust) meets all of the conditions set out in subsection 122(2), it is taxed at the graduated federal tax rates for individuals which are set out in section 117. For 1988 those rates are: 17 percent on the amount taxable up to \$27,500, 26 percent on the next \$27,500, and 29 percent on the amount taxable in excess of \$55,000. For 1989 and subsequent taxation years, section 117.1 establishes an indexing formula for adjusting these dollar values to reflect increases in the Consumer Price Index in excess of 3 percent. The conditions of subsection 122(2) are met if the trust:

- (a) was established before June 18, 1971 (see 3 and 4 below),
- (b) was resident in Canada on June 18, 1971 and without interruption thereafter until the end of the taxation year (see 5 below),
- (c) did not carry on any active business in the year (see 6 and 7 below),
- (d) has not received any property by way of gift since June 18, 1971 (see 8 below), and
- (e) has not, after June 18, 1971, incurred
 - (i) any debt or
 - (ii) any other obligation to pay an amount,

to, or guaranteed by, any person with whom any beneficiary of the trust was not dealing at arm's length.

3. Paragraph 122(2)(a) requires the trust to have been established before June 18, 1971. Variations in the terms of the trust must be examined to determine if a particular change is of such a nature as to constitute the establishment of a new, successor trust. Where a trust was established before June 18, 1971, a subsequent change in one or more of the trustees would not cause the trust to be viewed as a new trust as of the date of the change. Conversely, under the provisions of subsection 149(5), an inter vivos trust that is deemed to have been created in respect of a club, society or association cannot have come into existence prior to the end of 1971 even though the club, society or association was in existence prior to June 18, 1971.

4. Where a trust was in existence prior to June 18, 1971 and, on or after that date, a second inter vivos trust was created, with the circumstances of the two trusts being such that the conditions specified in subsection 104(2) are met, the two trusts may be designated by the Minister as being one trust and that trust will not meet the requirements of subsection 122(2). The creation of a second trust, in these circumstances, may be tantamount to a contribution of additional property to the first trust, which is a disqualifying event as specified in paragraph 122(2)(d).

5. Paragraph 122(2)(b) requires the trust to have been resident in Canada on June 18, 1971 and to have remained a resident of Canada at all times thereafter. For this purpose, the normal rules for determining

the residence of a trust are applicable. See the current version of IT-447 entitled Residence of a Trust or Estate.

6. As indicated in paragraph 122(2)(c), a trust fails to meet the requirements of subsection 122(2) if it carried on any active business in the year. In subsection 248(1), "active business" is defined to mean any business carried on other than a "specified investment business" or a "personal services business". Since each of the excluded types of business can only be carried on by a corporation (see paragraphs 125(7)(d) and (e)), any business carried on by a trust in the year is an active business. The word "year" in this context has reference to the taxation year of the trust, i.e., the calendar year, and not the fiscal period of any business. Unlike the other requirements of subsection 122(2) where, if any one of them is not met for a particular year the trust becomes subject to taxation under subsection 122(1) not only in that year but also in all subsequent years, a failure to meet the requirement in paragraph 122(2)(c) in one year does not necessarily affect the trust in subsequent years.

7. Where the trust is a partner (whether a general or limited partner) in a partnership which carries on a business, the trust and each of the other partners is viewed as carrying on that business. The assumption in subsection 96(1), namely, that the partnership, as distinct from the partners, is to be viewed as if it were a separate person that carries on the business, is only for the purpose set out in subsection 96(1) and has no relevance for purposes of subsection 122(2).

8. In paragraph 122(2)(d) there is the requirement that the trust must not have received any property by way of gift after June 18, 1971. For this purpose, the word "gift" is not considered to include a property received as a bequest under the will of a deceased taxpayer or under the terms of a testamentary trust, even where the deceased taxpayer was the settlor of (or other contributor to) the inter vivos trust receiving the property.

9. In paragraph 122(2)(e) it is provided that a trust becomes subject to subsection 122(1) if, after June 18, 1971, it incurred any debt or any other obligation to pay an amount to any person with whom any beneficiary of the trust was not dealing at arm's length. This rule applies also where the debt or other obligation of the trust is guaranteed by such a person. The trust would not be considered to have incurred an "obligation to pay an amount" in the sense contemplated by subparagraph 122(2)(e)(ii) where, in return for immediate payment of fair market value consideration, a trust acquires property or assets from a person with whom any beneficiary of the trust was not dealing at arm's length. (For further discussion of the meaning of "arm's length", see the current version of IT-419.)

10. If a settlor (or other contributor to a trust) and a beneficiary are connected by blood relationship, marriage or adoption, then they are deemed not to deal with each other at arm's length. Even if the settlor (or other contributor) is not so related to any beneficiary, the circumstances may indicate that the settlor (or other contributor) and at least one beneficiary do not in fact deal with each other at arm's length. In either of these situations, if an amount is owing by the trust to the settlor (or other contributor to the trust), or if the trust assumes responsibility for any debt or other obligation guaranteed by such a person, the requirement in paragraph 122(2)(e) would not be met.

11. The debts or other obligations of a trust referred to in 9 and 10 above do not include ordinary operating debts or bank loans (other than those guaranteed by or owing to a person not dealing at arm's length with a beneficiary).

12. Paragraph 122(2)(e) is not contravened by a debt or other obligation of the trust to pay to a beneficiary an amount required by the terms of the trust, provided it is paid out to the beneficiary during the reasonable time needed to discharge the debt or obligation. A reasonable time will usually not be considered to extend beyond the end of the taxation year following the year in which the debt or obligation became payable by the trust. However, where subsection 104(18) applies with respect to the income of a trust in which a minor beneficiary has a vested interest, a reasonable time will usually not be considered to extend beyond the end of the taxation year following the year in which the child reaches the age of majority.

13. For the purposes of the "Alternative Minimum Tax", paragraph 127.53(1)(b) allows an exemption of \$40,000 to an inter vivos trust which meets the criteria of subsection 122(2). A single such exemption must be allocated among multiple trusts that arose as a consequence of contributions by the same individual.

“Tax payable by inter vivos trust - Sec. 122(1)”

(1) Notwithstanding section 117, the tax payable under this Part for a taxation year by an *inter vivos* trust is the total of

(a) 29% of its amount taxable for the taxation year, and

(b) if the trust is a SIFT trust for the taxation year, the positive or negative amount determined by the formula

A × B where

A is the positive or negative decimal fraction determined by the formula

C + D - E where

C is the net corporate income tax rate in respect of the SIFT trust for the taxation year,

D is the provincial SIFT tax rate of the SIFT trust for the taxation year, and

E is the decimal fraction equivalent of the percentage rate of tax provided in paragraph (a) for the taxation year, and

B is the SIFT trust's taxable SIFT trust distributions for the taxation year.

“Deductions not permitted - Sec. 122(1.1)”

(1.1) No deduction may be made under section 118 in computing the tax payable by a trust for a taxation year.¹⁴⁶

“Where s. (1) does not apply – Sec. 122(2)”

(2) Subsection 122(1) is not applicable for a taxation year of an *inter vivos* trust other than a mutual fund trust if the trust

(a) was established before June 18, 1971;

(b) was resident in Canada on June 18, 1971 and without interruption thereafter until the end of the year;

(c) did not carry on any active business in the year;

(d) has not received any property by way of gift since June 18, 1971;

146 1988 FINANCE TECHNICAL NOTES: While a trust is treated as an individual for tax purposes, subsection 104(3) denies any deduction to a trust in respect of personal exemptions. That subsection is repealed (and replaced by new subsection 122(1.1)) as a consequence of the repeal of section 109, which is itself repealed as a consequence of the conversion of such exemptions to credits.

(e) has not, after June 18, 1971, incurred

(i) any debt, or

(ii) any other obligation to pay an amount, to or guaranteed by, any person with whom any beneficiary of the trust was not dealing at arm's length; and

(f) has not received any property after December 17, 1999, where

(i) the property was received as a result of a transfer from another trust,

(ii) subsection (1) applied to a taxation year of the other trust that began before the property was so received, and

(iii) no change in the beneficial ownership of the property resulted from the transfer.

Picking the Trustees, Changes in Corporate Control and the Case for the "Drunken Trustee".

Care should be taken in the initial and evolving status of the trustees of a family trust for at least two tax reasons:

- changes in control of any corporate ownership that is embodied in the trust and,
- changes in residence of the trust.

CRA has provided the following opinion with respect to changes in corporate control where one of the trustees is changed¹⁴⁷:

"Change in Trustees and Control"

In May of this year, the CRA issued a technical interpretation that could have widespread consequences for corporations that have trusts as shareholders. The technical interpretation deals with the question of whether there is an acquisition of control of a corporation on the replacement of one or more of three trustees of an *inter vivos* trust holding a majority of the voting shares of the corporation. The CRA essentially indicated that a change in any of the trustees of the trust would generally result in a new group of persons controlling the corporation so that the acquisition of control rules in the Act would apply, unless a saving provision in paragraph 256(7)(a) applied. The consequences of an acquisition of control could be quite onerous for the corporation. For example, the availability of its tax losses and other accounts could be restricted, and it would have a deemed taxation year-end that could have several adverse tax consequences. It does not seem appropriate that these results should arise when there has been no change in the beneficial ownership of the corporation.

Question 1

What is the legal basis for the CRA's interpretation?

Response 1

The Supreme Court of Canada held, in *M.N.R. v. Consolidated Holding Company Limited* that where the majority of the voting shares of a corporation are held by a trust, it is the trustees of the trust who have the legal ownership of the shares, who have the right to vote those shares (subject to any restrictions on such right in the trust indenture) and who, therefore, control the corporation.

¹⁴⁷ Prepared for discussion at the annual Canadian Tax Foundation conference held in Vancouver on September 27, 2005. Members of the panel were Mr. Marc Vanasse, CA, Director, and Mrs. Theresa Murphy, CGA, Manager, Income Tax Rulings Directorate, Mrs. Arlene White, Director, Vancouver Tax Services Office, Mrs. Sandra Jack, CA, Felesky Flynn LLP of Calgary and Mr. Mark Robinson, CA, Deloitte & Touche LLP of Toronto.

Question 2

The technical interpretation indicates that where only one of three trustees is replaced, there would be an acquisition of control by a group of persons. Why is that the case?

Response 2

The technical interpretation acknowledged that where a trust has multiple trustees, the determination as to which trustee or group of trustees controls the corporation can only be made after a review of all the pertinent facts, including the terms of the trust indenture. However, it went on to indicate that in the absence of evidence to the contrary, we would consider there to be a presumption that all of the trustees would constitute a group that controls the corporation. We took this view because we believed that the fiduciary obligation that each of the trustees would have to act in the best interests of the beneficiaries of the trust would make it unlikely that two trustees could properly act together to control a corporation, to the exclusion of a third trustee.

Question 3

Some commentators have suggested that the position in the technical interpretation contradicts the CRA's position in paragraph 10 of IT-302R3. Do you agree?

Response 3

Paragraph 10 of IT-302R3 indicates only that control of a corporation will be regarded as remaining unchanged where the executor, administrator or trustee of an estate is replaced as a result of that person's death or inability to fulfill his or her functions. Therefore, that position does not apply to the replacement of trustees of an *inter vivos* trust.

Question 4

Why will the CRA not extend the interpretation bulletin position to *inter vivos* trusts, given that it appears to be an administrative concession?

Response 4

The interpretation bulletin position was first adopted when a previous version of paragraph 256(7)(a) provided a legal basis for the position. A 1994 amendment to paragraph 256(7)(a) has removed the legal basis for the position. Therefore it cannot be extended, and consideration will have to be given to withdrawing the current bulletin position when the bulletin is next revised.

Question 5

Does the possibility of an acquisition of control of a corporation when there has been no change in its beneficial ownership present a policy issue?

Response 5

We have raised the matter with the Department of Finance and understand that Finance recognizes that there is an issue."

One would think that this is something to disagree with given our ITA designates the entirety of a trust to nestle with the trustees for purposes of assessment, not individual trustees but with the entirety of the trustees: the trust itself though is recognized as one tax creature, not a mass of several and even though per Sec. 104(1) ownership or control attracts assessment, it is still as one entity. If one trustee is changed the trust, in exact same form, as such continues in the same way as before. While in common law partnerships do have look-through essence and corporations, not, a trust can only be equivalent to the latter when it comes to ownership and control issues. In particular to Q2 above, when the specific trustee holding and voting for the shares in the trust is changed, the equation is not changed since she is still voting them pursuant to the office of a trustee: the ownership and control follows the office, not the specific person and since they are saddled with the trust obligation that continues unchanged, changing the person in no way should reflect down to a change in control of the corporation: the shares are owned by the trust and as an indivisible tax creature that is where the equation ends. Also, is a purported trustee acting as a trustee when she adversely votes them out of line with

her co-trustees opinions? This should be even so if one adversely votes them not in congruence with their majority since trustees do owe themselves joint and several liability for their individual actions and a rogue trustee's adverse voting exercise can be petitioned and rescinded since she was not actually "wearing the hat" of proper trusteeship when the vote was made – is she acting as a trustee of the trust when her contrary minority vote is placed(?). Does not the corporate share registry cite the trust/trustee?

However, *Minister of National Revenue v. Consolidated Holding Co.*¹⁴⁸, a Supreme Court decision, is an excellent case whereby the issue was well addressed with reference to numerous UK precedents. In this instance a testator had bequeathed shares into a trust, one trustee of which was a third party and two other trustees were his sons. The trust deed stated that two of the trustees could compel the third to accept their opinion on how the shares were to be voted. When the Minister assessed the son's corporation and the testator's as related due to being controlled by the same group the trust argued that the trustee was not so subject to the group control scenario. The Court held:

"Do Harold Duncan Gavin and Robert Duncan Gavin, who control "Consolidated", also control Martin & Robertson Limited by virtue of their ability to combine and give a direction to the third trustee, Montreal Trust? The Exchequer Court held, in accordance with the Company's Articles, that Montreal Trust Company had an equal voice with the two co-executors and could prevent the two co-executors from exercising that control which is accorded by the said will.

In determining whether a group of persons controls a company, it is not sufficient in the case of trustees who are registered as shareholders to stop the inquiry at the register of shareholders and the Articles of Association. **It is necessary to look to the trust instrument to ascertain whether one or more of the trustees have been put in a position where they can at law direct their co-trustees as to the manner in which the voting rights attaching to the shares are to be exercised.**

From the point of view of the company, apart from protective provisions, trustee shareholders must vote as a unit. If they are not unanimous, the shares cannot be voted. In this event, the control would be in "Consolidated", the two shareholders of which are the two Gavin trustees. Merely to look at the share register is not enough when the question is one of control.

The problem here is not solved by a decision that a company is not bound to see to the execution of trusts to which its shares are subject or that it may take the vote of the first named trustee on its share register. These are merely protective provisions in favour of the company and do not touch the question of control. Here, if one looks at the facts as a whole, one finds that the two Gavins, by combining, can control the vote of the estate shares.

...

I do not think that the decision in *I.R.C. v. J. Bibby & Sons Ltd* [1945], 1 All. E.R., 667., establishes anything more than this proposition—that a person who is the registered owner of 50 per cent of the shares with voting rights controls the company and that it is immaterial whether or not his exercise of that voting power can be controlled either by co-trustees or through appropriate proceedings by order of the Court. It does not establish the proposition that in a case such as this, where two trustees have the power to subject a third trustee in the exercise of the voting rights of the shares, one must disregard that power.

The respondent Consolidated Holding Company Limited submits that there is no right to go behind the share register of Consolidated Holding Company Limited and investigate the character in which any shareholder holds the shares registered in his name and that when three persons hold shares jointly, in this case, Harold Duncan Gavin, Robert Duncan Gavin and the Montreal Trust Company, then the provision in the will, of which they are executors, that two may impose their decision on the third, is irrelevant. The respondent further submits that under the ordinary rules of corporation law there must be unanimity in the voting of the said shares before they may be validly voted. The respondent cites *Lumbers v. Fretz* (1928), 62 O.L.R. 635., where a judgment of Wright J. was affirmed on appeal to the Court of Appeal[6]. Wright J. said at p. 649-650:

148 [1974] S.C.R. 419

Counsel for the defendants has cited to me some American decisions to the effect that in such cases a trustee or executor is entitled to vote the shares when the other trustees are not present. I do not think these decisions are in harmony with the English decisions. In *Masten and Fraser's Company Law of Canada*, 2nd ed., p. 528, it is stated that "joint holders must concur in voting, unless the by-laws provide otherwise," and that statement or opinion appears to be the logical deduction from the decisions in *In re T.H. Saunders & Co. Ltd.* [1908], 1 Ch. 415, and *Barton v. London and North Western Railway Co.* (1889), 24 Q.B.D. 77; *Burns v. Siemens Bros. Dynamo Works Ltd. (No. 2)* (1918), 88 L.J.Ch. 21.

In *Corpus Juris*, vol. 14, p. 903, para. 1397, it is stated: "Where there are two or more personal representatives, no one or more can vote against the protest of the other or others."

It is manifest that the action of L.O. Lumbers and Maria Lumbers in protesting against the introduction of the by-laws in question, and requesting an adjournment of the meeting, was an emphatic protest on their part against the other executors assuming to represent or vote the shares of the estate.

I accept as the law the statement already cited from *Masten and Fraser's* book, and hold that the votes for the estate of James Lumbers in respect of the 40 shares held jointly as trustees by Maria Lumbers and W.G. Lumbers were improperly cast.

Inland Revenue Commissioners v. J. Bibby and Sons Ltd. [1945], 1 All. E.R. p. 667., a decision of the House of Lords, dealt with a section of the *Finance (No. 2) Act* of 1939 which provided in s. 13(3) that a company was entitled to have its standard profits increased by the percentage of the increase in its capital and in subsection (9) permitted that increase to come to 10% provided that the directors had a "controlling interest" in the company. There were eight directors who were the beneficial owners and registered holders of 209,000-odd ordinary shares out of the 500,000 issued. Three of those directors were also registered holders of another 57,500 shares which they held as trustees of their sister's marriage settlement. The Commissioners contended that those latter shares, of which the said three directors were not the beneficial owners although they were the registered owners, could not be counted in determining whether the directors had a controlling interest. The House of Lords unanimously found in favour of the company. Lord Russell of Killowen said at p. 669:

My Lords, I agree with the view of the Court of Appeal. When the section speaks of directors having a controlling interest in a company, what it is immediately concerned with in using the words "controlling interest" is not the extent to which the individuals are beneficially interested in the profits of the company as a going concern or in the surplus assets in a winding up, but the extent to which they have vested in them the power of controlling by votes the decisions which will bind the company in the shape of resolutions passed by the shareholders in general meeting. In other words, the test which is to exclude a company's business from subsect. (9) (a) and include it in (9) (b), is the voting power of its directors, not their beneficial interest in the company.

For the purpose of such a test the fact that a vote-carrying share is vested in a director as trustee seems immaterial. The power is there, and though it be exercised in breach of trust, or even in breach of an injunction, the vote would be validly cast vis-a-vis the company, and the resolution until rescinded would be binding on it.

Lord MacMillan said at p. 670-671:

In my opinion the Court of Appeal rightly rejected the contention of the Inland Revenue Commissioners. The question whether the directors of the respondent company have the control of it by their voting power as shareholders must in my view be determined by the memorandum and articles of the company and by the register of shareholders. By the constitution of the company, as I have already mentioned, the voting power is vested in the ordinary shareholders and the register shows that the directors hold a majority of these shares. As was said by Jessel, M.R., in *Pullbrook v. Richmond Consolidated Mining Company*, (1878), 9 Ch.D. 610, at p. 615:

The company cannot look behind the register as to the beneficial interest but must take the register as conclusive and cannot inquire... into the trusts affecting the shares.

And again on the latter page:

Suppose that all the shares held by the directors in the present case were held by them as trustees, could it be said that they did not control the company? If so, then in whose hands was the control of the company?

Lord Porter said at p. 672:

Nevertheless for good or ill the trustee like the beneficial owner controls, though if his powers be wrongly exercised they may in some way or other be capable of being challenged.

...

The apparent clash between that decision and the decision in *Bibby* was explained by Lord Evershed, M.R., in *I.R.C. v. Silverts Ltd.* [1951] Ch. D. 521., when he pointed out that the control may be exercised either directly or indirectly through the agency of another company. The *Silverts* case is interesting in the present situation as there of four directors one, S.J. Silvert, was the registered holder of all the "B" shares. No other director was the registered holder of either "A" or "B" shares. The "A" and "B" shares conferred equal voting rights on their holders and there was no provision for a casting vote. The "A" shares were all the subject matter of a settlement in favour of an infant. By the settlement, the National Provincial Bank Limited was appointed a custodian trustee but two of the other directors were appointed managing trustees. The question was whether those two directors together with the other director S.J. Silverts controlled the company. The Court of Appeal held that they did not do so and that the National Provincial Bank Limited being the registered shareholder of all the "A" shares excluded the two directors from being considered as controlling the company despite the fact that they were managing trustees of the settlement. At p. 526, Lord Evershed, M.R., said:

The distinction (between a custodian and bare trustee) is, for practical purposes, perhaps a fine one; but it is a real one. Indeed, it has not been seriously contended before us on the part of the Crown that the bank in the present case can be properly regarded as a bare trustee in the sense intended by the House of Lords in the *Bibby* case.

The situation in the *Silverts* case would seem to be very close to the present one. By the statute under which the trustees were appointed, the *Public Trustee Act*, 1906, in s. 4, subs. (2)(b), all powers and discretions remain vested in the managing trustees, but by para. (d) the custodian trustee was not bound to give effect, for example, by voting in all cases to the wishes and effects of the managing trustees.

In my view, however, the matter is dealt with authoritatively in *Barclays Bank Ltd. v. Inland Revenue Commissioners* [1961] A.C. 509. In that case, the deceased person held at his death 1,100 shares in a company. By a settlement made nineteen years before, he had settled another 3,650 shares of the company on a trust for his wife and children taking no beneficial interest himself. In the settlement deed, he named four trustees and he was the first of those named. Under Table A of the *Companies (Consolidation) Act*, 1908, which had been incorporated in the company's articles of association, being the first-named of the four trustees, the deceased exercised the power of voting the shares. The two blocks together were a majority of the issued share capital of the company. It was held that the deceased had "control of the company" within the meaning of the relevant sections of the *Finance Act* 1940. Five members of the House of Lords sat on the appeal, Viscount Simonds, Lord Cohen and Lord Keith of Avonholm holding that a person who had the power by exercise of voting rights in accordance with the constitution of a company to carry a resolution in general meeting had control for the purpose of the subsection and that it was irrelevant that the shareholder who had the apparent control might himself be amenable to some external control. Lord Reid dissented and Lord Denning concurred only because the settlor was the person who held the joint holding having created it in his own disposition. The view of the majority would seem to apply exactly in the present case. There, the settlor being the first-named trustee voted by virtue of the provisions of the articles of the company despite the fact that he might have been amenable to control by the other three trustees.

Here, by virtue of corporations law, the three executors and trustees must agree on the voting of the shares despite the fact that by virtue of the clause in the will two of the three might control the decision of the third."

Thus, when planning the use of *inter vivos* or testamentary trusts that are to hold decisive corporate shares care should be taken to prevent the above dicta from applying to your environment.

The residency issues are dicussed subsequently.

Trusts when Equity looks to Intent and Not Documentation.

Express trusts are those created through express declaration by the owner of the property whereby either he continues to hold legal title but for the benefit of the stated beneficiaries or whereupon the legal title is transferred to another person whereby they are compelled in equity to hold the property as per the terms of the trust. In order for an express trust to be accepted as being capable of being constituted it must have, in the absence of certain violations of specific technicalities such as remoteness, the rule against perpetuities etc., three basic, very broad characteristics;

- the settlor must have shown the intent to have a trust created,
- the subject matter of the trust, being its present property and its future property must be ascertainable, and
- the beneficiaries under the trust, and their interests or rights to the property must be ascertainable.¹⁴⁹

While these aspects need not be overly complicated in application they must be ascertainable by the courts if need be, upon a review of the substance of the relationships between the parties involved. If they cannot be clearly ascertained then the express trust cannot be recognized as being in existence and potentially significant tax consequences may result. In such a case a resulting trust may arise, if legal title has been conveyed to another party, whereunder the settlor will be recognized as the beneficiary having not passed the beneficial interest.¹⁵⁰

Documentation without Substance.

Perhaps one of the most analyzed Canadian tax cases concerning the existence of a trust is *Kingsdale Securities Company Limited v. M.N.R.*¹⁵¹ where five family trusts were to carry on a limited partnership thus facilitating flexibility in income splitting however there was some question as to when exactly the trusts were thoroughly constituted. As a simple income splitting/estate planning arrangement the five taxpayers were encouraged to settle separate trusts, none of them actually knowing until a later date what they were doing, while the bank accounts and initial contributions to the trusts were opened and made by a party who was effectively directing the arrangement and encouraging the three taxpayers. At a later date the constituting documentation was presented to them for their signature, and it was only then that they were provided the required comprehensive explanation of the mechanics of the arrangements. Until that time they did not even know exactly who their respective trust's beneficiaries would be. At issue was whether the trusts had in substance been created prior to the time above mentioned since if they were not, the partnership which they were part of would also not come into existence until a later time.

Urie, J. of the Federal Court of Appeal after a listing of the three certainties, provided that:

"Accepting as I do the findings of fact of the learned trial judge, none of the settlers, with the possible exception of Jack Shnier, had evinced any intention to create a trust for ascertainable beneficiaries at least until the trust deeds were received in Oklahoma in March or April 1964. Moreover no monies were advanced by any settlor except Jack Shnier **nor authorized to be advanced by him on their behalf** even after the execution of the trust deeds. Neither had they appointed trustees nor did some know even the names of some of the trustees they purported to appoint."

Quoting from *Snell's Principles of Equity*¹⁵² he also provided:

"Absence of certainties. The effect of the absence of any of the certainties may be summarized as follows. The paramount certainty is that of subject-matter, in the first sense; if there is no certainty as to the property to be held upon trust, the entire transaction is nugatory. Next, if that certainty is present but

149. See *Knight v. Knight*, 1840 3 Beav 148, 49 E.R. 58, for the landmark case. See *Royal Trust Co. v. Tucker*, [1982] 1 S.C.R. 250, where the issue of the extent of how to identify beneficiaries was at issue in a testamentary situation.

150 Will such a trust be personal or non-personal if the settlor acquires the interest subsequent to the contribution which creates the trust?

151. [1975] C.T.C. 10 FCA

152 27th ed. at pg. 115. See also the Aust. cases of *FC of T v. Gulland*, *Watson v. FC of T*, *Pincus v. FC of T*, 85 ACT 4765 where they were referred to in QT87/4231 and *Commissioner of Taxation* [1990] AATA 450 (1 May 1990) that the creation of a trust was objectively considered to be only for the diversion of income, thus subject to GAAR-like disregard.

there is no certainty of words, the person entitled to the trust property holds free from any trust. Finally, if both these certainties are present but there is uncertainty of objects, there is a resulting trust for the settlor for "once establish that a trust (of definite property) was intended, and the legatee cannot take beneficially" 92 (Briggs v. Penny, (1851) 3. Mac. & G. 546 at 557, per Lord Truro L.C.) the same applies where there is uncertainty of the subject matter as regards the beneficial interest, unless one of the beneficiaries can establish a claim to the whole."¹⁵³

Counsel for the taxpayers also contended that if the deeds were properly executed then the existence of the trust should be given **retroactive effect** while Urie, J. felt otherwise:

"It seems to me that in advancing the argument that the deeds of trust, after the execution thereof, should be given retrospective or retroactive effect, the appellant is saying that the oral agreements allegedly made on December to become settlers or the opening of the bank accounts, constituted **agreements** to create trusts in the future. In Underhill's Law of Trusts and Trustees, 12th Ed, the author of this authoritative work discusses the validity of that kind of agreement at page 47, where he says:

"The rule that a valid agreement to create a trust in future, is sufficient to create a trust in praesenti, so as to bind the property in the hands of the parties, or those having notice of the agreement, depends on the maxim that **"Equity regards that as done which ought to be done."** It follows, therefore that where a trust is alleged to have been created by **an agreement** to do something, its validity depends on the question whether the agreement is one of which courts of equity would decree specific performance(s). If it is merely a voluntary promise (or even a covenant under seal, not supported by valuable consideration), no trust will be created; for equity gives no assistance to volunteers, and consequently there is nothing which can, under the foregoing maxim, be regarded by the court as done."

The findings of the learned trial judge make it clear that none of the settlers were even volunteers at that date. That being the case there were **no enforceable agreements**. Logically then, it seems to follow that there could be no retrospective or retroactive effect given to the trust deeds after their execution."

"With respect to question 2, the appellant argued that if the trust deeds had no retrospective effect, executory trusts were created through the fiduciary control of the trust's bank accounts by the trustees, and these were the same trusts whose terms were reduced to writing and confirmed by the trust deeds. The fallacy of this argument is that on the evidence, as found by the trial judge, **none of the settlers had evinced any interest in creating trusts at the time the trust accounts were opened in the names of the trustees by one of the Shnier brothers**. While executory trusts can be created using fewer **formalities** than are required in bringing executed trusts into existence, **they cannot be created unless the intention of the settlers can be ascertained**. Since the earliest at which their intention could have been ascertained was, as found by the learned trial judge, not until March or April 1964, no executory trusts could have come into existence prior to that time."

Ryan, J. also commented on the existence of a trust and how it comes into existence vis-a-vis the intention of the settlor:

"The role of the settlor is, of course, vital in the creation of a settled trust. It is the settlor who transfers to the trustee the property which constitutes the trust fund or res; it is the settlor who defines the objects of the trust; it is the settlor who vests the powers in the trustee: **only the settlor can do these things**. Once the trust is established, the participation of the settlor may come to an end, as was contemplated in this case, **but only he can bring the trust into existence.**"

While later, as to the timing of the creation, he provided:

"The submission would be that by the time the relevant partnership documents were executed, the trusts had been constituted, (albeit retroactively), the trustees appointed and in a position under the trust indentures to make the partnership contract. My response is that the family trusts were created, if they were created at all, by execution of the trust indentures. Each of these trusts came into being (if at all) as a result of the execution of the indenture containing a declaration by the settlor of an intention to create a trust and a designation of object, and by a vesting in the trustees of the trust res. The trust came into

¹⁵³ See also Re: Leek, 1968 1 All E.R. 793, I.R.C. v. Broadway Cottages Trusts, 35 T.C. 577, and Innes v. Harrison, 35 T.C. 594.

being, if it did come into being, **when the constructive acts were done.**"

From such analysis the Court found that the trusts had clearly not come into being until after the partnership documents had been properly filed with the provincial authorities, however they had been constituted upon a review of the trust deeds, and agreement to through signing, by the "settlers" in the spring of 1964, well later than the "creation" of "the partnership".¹⁵⁴

In *Atinco Paper Products Ltd. v. The Queen*¹⁵⁵ a similar estate planning/income splitting arrangement was attempted whereunder a business was to be carried on by a partnership, three partners of which were corporations controlled by individual taxpayers, and two of which were trusts the beneficiaries of which were certain wives and children of the other individual taxpayers, however the weaknesses in the structuring was in the nature of "the trusts" which were created when an aunt had made essentially two absolute gifts of \$250.00 to the male taxpayers expressing the hope that the money would be invested for the benefit of the wives and children. The gifts were sent with a letter which didn't contain imperative directive language. The recipients of the gifts used the gifts as a basis for the creation of the trusts, thereupon drafting two trust agreements which the giftor eventually signed, as settlor.

Urie, J., commenting on whether the gifts made by the aunt created trusts which were later formalized by documentation, referred to the necessity of the three basic certainties; words employed, as taken as a whole, must be imperative, the subject matter must be certain, and the objects must be certain, and then went on to comment on Keetan and Sheridan's *Laws of Trusts* observation, 10th Ed, pg.90:

"Since equity looks at intent rather than at the form, no special form of words is necessary for the creation of a valid trust, and if an **intention** to create a trust may unmistakably be construed from the expressions which the settlor has used, the court will give effect to that intention. The really difficult question in these case is, what did the settlor really intend? For example, if he used words, precatory, recommendatory, or expressing a belief, did he intend to create a binding trust or not?"¹⁵⁶

If, from a review of the whole of the language used by a taxpayer and his actions at the time of the supposed creation and subsequently, it cannot be found that he wished either a trust to be expressly created or a fiduciary relationship with respect to the subject matter to come into existence, the courts will not give recognition to the supposed intention that never manifested. Commenting on Ryan, J's. comment on settlor involvement in *Kingsdale Securities*, Urie, J. then went on to provide:

"Finally, it should be observed that it is clear from the jurisprudence on the subject that if the words purporting to create the trust cannot be construed as imperative then the person holding the trust property holds it free from any trust. Thus, if it is found, as the Trial Judge found, that the words contained in Miss Stein's letters are not imperative, then, **notwithstanding what later may have been done**, she would have been unsuccessful in establishing on the basis of those letters, that a trust had been settled on her nephews."

Referring to several authorities cited in Underhill's *Law of Trusts*¹⁵⁷, he then went on to comment:

"The documents in either type of case, of necessity, must speak for themselves but where there is doubt

¹⁵⁴ It was then that the three certainties existed; see *Re: Rose*, 1952 1 Ch. 499, *I.R.C. v. Allan*, 9 T.C. 234 (H.L.), as to the timing of creation while see also *F.C.T. v. Phillips*, 20 A.L.R. 607, *Gullard v. F.C.T.*, 55 A.L.R. 65, and *Watson v. F.C.T.*, 56 A.L.R. 505. For an excellent recent case of a trust existing and the evaluation of countering arguments in the case of the dual objective of tax planning and matrimonial planning poorly "poured in concrete" see the Aust. case of *Robson v Robson* [2011] QSC 234 (12 August 2011).

¹⁵⁵ 78 D.T.C. 6387 FCA

¹⁵⁶ It was put more eloquently in *Heartley v. Nicholson*, (1875) L.R. 19 Eq. 233:

"It is not necessary that the declaration of a trust should be in terms explicit. But what I take the law to require is, that the donor should have evinced by acts which **admit of no other interpretation**, that he himself had ceased to be, and that some other person had become, the beneficial owner of the subject of the gift or transfer, and that such legal right to it, if any, as he retained was held by him in trust for the donee."

See also *Byrnes v Kendle* [2011] HCA 26 (3 August 2011) for an Aust. High Court examination of whether a trust existed when there was inconsistent activity with what the purported trustee did with the property and various assertions he made as well as the Aust. case of *Crouch v Smith & Anor* [2004] FMCA 676 (12 November 2004) and *Hyhonie Holdings Pty Ltd & Anor v Leroy & Anor* [2004] NSWCA 72 (18 March 2004). See *Ali v Ali* [2011] NSWSC 261 (7 April 2011) for examination of intention to create a trust.

¹⁵⁷ 11th ed., at pg. 33

in *inter vivos* trust cases, as here, as to the settlor's intention, it seems to me that assistance in the interpretation of the purported trust documents may be derived from the testimony of the settlor. Not only may the Trial Judge obtain some actual assistance in the ascertainment of what was intended by the ambiguous language used, but, perhaps more importantly, he is afforded an opportunity to assess from the witnesses demeanor, manner, hesitation and other nuances his impression of the likelihood that what is alleged to be the intention was or was not the intention **at the time the document, or in this case the letters, (which supposedly created the trust), were written.**"

In the previous court the Trial Judge did just this and gained the most damning of evidence that caused, quite effectively the case to "go down for the count for lack of simple coaching" by revealing that she left the trust to be created by the instigating taxpayers, rather than execute the needed procedures herself or make the appropriate expressions to have them executed. An example being:

"Q: Am I fair to say that that letter describes what you wanted to do?

A: Right. (Miss Stein)

Q: Then am I correct that you left it up to Philip and Irving...

A: Right.

Q: To prepare the Trust agreements and things of that nature.

A: Right.

Q: **Am I correct, that you never instructed Mr. Harris a solicitor to prepare a trust agreement?**

A: No, I didn't.

Q: **That these agreements were brought by Philip that he brought both of them?**

A: Right."

Concluding commentary provided by Urie J. was quite appropriate in that it summarized the application of the imperative standard to the content of the letters in which the gift was made:

"Whether such evidence did so influence him or not, it does, in my view, support the conclusion that the gifts were made to the nephews absolutely unencumbered by any limitations on them other than an expressed hope that the ultimate benefit, therefrom would accrue to the nephew's respective wives and children. That hope does not convert absolute gifts into trusts. Nor did depositing the money in separate bank accounts, even if that was done shortly after their receipt change their nature since it is the **intention of the donor or settlor that is determinative in ascertaining the nature of the gift, not what the recipients do with them.** The settlor did not define the objects of the trusts in any but the most general way and the same may be said of the powers she purportedly conferred on the trustee of each. All of the instructions as to the preparation of the trust documents **and the contents thereof** came from the Granovsky brothers, not the settlor."

"...The short answer to that contention is that the evidence shows that no settlement was made **or contemplated** by Miss Stein in the terms of the executed trust documents. They were drawn by the Appellant's Solicitor on the instructions of the Granovskys. The only gifts she ever made were the personal ones to Philip and Irving with super imposed thereon the expressed wish as to what they should do with the money..."¹⁵⁸

In *Herdegen v. F.C.T.*¹⁵⁹ a married couple argued that shares held by them individually were held in trust for corporate tax recoupment purposes but no documents were drawn up and the spouse didn't understand the alleged conversation which supposedly caused her to create the trust out of her shares. Upon questioning by the Commissioner's counsel it became obvious that she didn't know what she was doing:

"Can you remember what you said?"

"I just left it to him (the husband)."

"Can you remember how many shares were to be held for these people?"

"No."

"Any particular reason for that, that you can't recall it?"

¹⁵⁸ See also *Parker v. Westby & others*, 1941 Q.S.R. 47, for a letter not creating an express trust though purported otherwise due to the vagueness in who were to be the beneficiaries which created a resulting trust in favor of the giftor.

¹⁵⁹ 84 A.L.R. 271 (FCA)

"Well, there was probably some form of conversation at the time but I just really don't recall it, you know; what was said I probably, something was probably said at the time and I just left it to John."

"Why did you leave it to him?"

"I always leave all of my business to him."

Sound familiar; no trust was created. Settlor intention (and not mere motive) is critical to the creation of the trust.¹⁶⁰

In *Ablan Leon (1964) Ltd. v. M.N.R.*¹⁶¹ a "settlor" issued 43 cheques to his brother-in-law to create 43 separate trusts to be used in an income splitting/corporation association avoidance scheme and did so, in his own words, to fulfil "the purpose of the trust **and the purpose of my brothers-in-law**". No trust documents were created until subsequently and the cheques were not impressed with directions for any particular trust. (They were all for nominal amounts.) The trusts really weren't meant to be in this case since the purported settlor was acting as a nominee in the tax scheme, did not familiarize himself with the trusts terms and was only "to drive in the pegs upon which the tax minimization scheme was to hang"¹⁶². As per Megarry V.C. in *Tito v. Waddell*¹⁶³ acknowledging the frequent and sometimes incorrect use of the term trust to describe an arrangement:

"In every case one has to look to see whether in the circumstances of the case, and on the trust construction of what was said and written, a sufficient intention to create a true trust has been manifested."¹⁶⁴

One of the only ways a trust may be created without settlor intention is where the court steps in to impose a constructive trust in an unjust and inequitable situation¹⁶⁵.

One should note the similarities and dissimilarities between *Kingsdale Securities* and *Atinco Paper* being the former concerned the timing of the creation of the trusts, whereby the trust could not come into existence until the three certainties were ascertainable while the latter did not concern the timing of the trust creation, but instead questioned whether the trusts had in fact been constituted when one of the certainties (intention to create) was missing. Both "trusts" were extensively documented and attested to by the respective parties however the latter, though formally substantiated, lacked one of the main characteristics being the conveyance of valuable consideration **with** intention to create a trust. Documentary evidence is only prima facie proof of its content as per *Barnes and Chrustie* (post). Though a lack of it may prove more critical in trying to prove a trust merely having it is not conclusive and the actions of the parties must be an issue.

The *Official Assignee v. Wilson*¹⁶⁶ is very illustrative of what a court will look to in determining whether a purported trust is a sham or an alter ego of the settlor when the constituting documentation was in order but the conduct of the parties afterwards was such that the settlor practically continued to carry on the trustee functions as his own but did have all transactions posted in the trust's name. While weak on references to streams of other jurisprudence this case does get into the nitty-gritty of where a court will split hairs as to the extent of how far into a trust environment a settlor can project his involvement without it being considered a sham. In this case, a sham was not proven and all conduct was acceptable.

Paul Antle v. The Queen, 2009 TCC 465, is very illustrative of documentary evidence being used to impeach the idea that a trust was even created. In this Tax Court case the taxpayer ostensibly attempted to hive off assets to a Sec. 73(1) spousal trust, in which ostensibly he actually "had no trust", by executing

¹⁶⁰ See *Corozo Pty. Ltd. v. Total Aust. Ltd.*, 1988 Qd. R. 366, Re: *Armstrong*, 1960 V.R. 202, *Commr. of Stamp Duty v. Jolliffe*, 28 C.L.R. 178, *McPherson v. L'Hirondelle*, 1927 S.C.R. 429, *Kauter v. Hilton*, 90 C.L.R. 86, Re: *Wall*, 25 A.L.R. 615, & *Austin v. Keele*, 72 A.L.R. 579, *Paul v. Constance*, 1971 1 W.L.R. 527, *Williams v. Lloyd*, 50 C.L.R. 341, Re: *Lamshed*, 1970 S.A.S.R. 224, *Comp. of Stamps v. Howard-Smith*, 54 C.L.R. 614, *Winter v. Grady*, 21 S.R. (N.S.W.) 686, *Teasdale v. Webb*, 57 W.N. (N.S.W.) 151. In *Baldassarra v. M.N.R.*, 91 D.T.C. 289, mere intention for offspring to benefit wasn't sufficient to create a trust when it wasn't acted upon/evidenced in incorporating documentation/subscription declarations.

¹⁶¹ 76 D.T.C. 6280 FCA

¹⁶² One has to ask if it is possible to have a nominee create a trust for a principal and have the principal recognized to be the settlor.

¹⁶³ 1977 3 All E.R. 129

¹⁶⁴ See also *Case R3*, 84 A.T.C. 120.

¹⁶⁵ Re: *Hope*, 1985 59 A.L.R. 609, *Allen v. Snyder*, 1977 2 N.S.W.L.R. 685.

¹⁶⁶ [2006] 2 N.Z.L.R. 841 HCNZ

the sale of the assets that were to be held by the trust when the trust actually hadn't been created in respect of them. Judge Campbell J. Miller held appropriately:

"[58] With certainty of intention and certainty of subject matter in question and, more significantly, no actual transfer of shares, there is no properly constituted trust: the Trust never came into existence. This conclusion emphasizes how important it is, in implementing strategies with no purpose other than avoidance of tax, that meticulous and scrupulous regard be had to timing and execution. **Backdating of documents, fuzzy intentions, lack of transfer documents, lack of discretion, lack of commercial purpose, delivery of signed documents distributing capital from the trust prior to its purported settlement, all frankly miss the mark – by a long shot.** They leave an impression of elaborate window dressing. In short, if you are going to play the avoidance game, it is not enough to have brilliant strategy, you must have brilliant execution. I find no Trust was duly constituted. The Trust's appeal is therefore quashed. With respect to Mr. Antle's appeal, with no valid trust he either sold the shares to his wife and triggered a gain in his hands or he rolled the shares to his wife and had the gain attributed back to him. Either way, he has been correctly assessed on the resulting capital gain, and his appeal is dismissed."

On appeal the Court further held that:

"[3] The assessments in question arise from a sale of shares by the appellant to a Canadian arm's length purchaser. In order to shelter the resulting capital gain from tax, the appellant embarked on a plan known in tax circles as a capital step-up strategy. In summary, the plan was for the appellant to settle a Barbados trust in favour of his wife, to convey the subject shares to the Trust which would then sell the shares to his wife, who in turn would sell them to the arm's length purchaser. This series of transactions was to take place in sequence in the course of the same day so that the proceeds of disposition would find their way back into the appellant's newly incorporated business the next day by way of a loan from his wife. Documents purporting to give effect to this plan were executed on December 14, 1999 and the Trust was said to have come to an end in early 2000 upon payment of the trustee's account.

...

[5] The first assessment issued by the Minister disregards the interim sale of the shares to the Trust on the basis, *inter alia*, that the Trust was not validly constituted, and levies the applicable tax in the appellant's hands on the assumption that the shares were sold directly to the arm's length purchaser. The second assessment was issued on the alternative assumption that the Trust did acquire the shares before they were sold to the arm's length purchaser, and is liable to the applicable tax.

...

[7] In support of his appeal, the appellant submits that the Tax Court judge applied the wrong legal test to determine if the Trust had been validly constituted and that he incorrectly determined that there had been an abuse of the Act and the Treaty. The Trust likewise maintains that it was validly constituted and that the assessment issued against it ought to have been vacated solely because it had been dissolved at the time when the assessment was issued, and the Act does not empower the Minister to assess a Trust which no longer exists.

...

[9] The appellant does not dispute that he never intended to grant the trustee control of, or discretion over, the shares. Nor does the appellant challenge the factual finding of the Tax Court judge that, when all surrounding circumstances are considered, there was a failure of certainty of intention in this case. The sole attack against the Tax Court judge's conclusion is that it is based on circumstances that are external to the trust deed which is otherwise clear and unambiguous. The contention is that this amounts to an error of law.

...

[11] It would be a surprising result if courts were bound by the formal expression of the parties and could not look to the surrounding circumstances, including the conduct of the parties, in assessing whether the intent to settle a trust is present. Indeed, in *Fraser v. Minister of National Revenue*, 91 DTC 5123 at page 5128, Reed J. stated that both the written documents and the actions

of the parties were to be considered in the determination of the intention of the parties:

... in any event, intention is determined by all of the evidence, including the conduct of the parties and the terms of the written documentation which flowed between them, and not merely on the basis of one person's subjective view.

On appeal, (95 DTC 5685), this Court reiterated that a finding of whether or not a trust has been created was to be made on the facts of the case, as evidenced by both the documents and the actions of the parties.

[12] A test that requires one to look at all of the circumstances, and not just the words of the trust deed, is an approach that appears to have been adopted by Canadian courts generally. In *Mohr v. C.J.A.* (1991), 40 E.T.R. 12, for instance the British Columbia Court of Appeal held that (p. 13):

While the words "trust", "trustees", and "trust deed" appear from time to time in the agreement, and there is an incomprehensible reference to "a liquidation trust provision in keeping with the current *Trust Act of B.C.*," those words and expressions are not determinative of the issue. The task of the Court is to construe the agreement against the background facts to determine "objectively the 'aim' of the transaction".

[My emphasis]

...

[16] The authors of *Waters' Law of Trusts in Canada*, 3rd Edition, Thomson Carswell at page 145 address the concept of a sham as it applies to the very situation with which the Tax Court judge was confronted:

What is the position if the terms of the trust instrument appear usual in character, but the actual intention is to disregard those terms and for the settler, either as trustee himself or as instructor of the trustee, to retain control of the assets and do with the trust property as he pleases? This hidden intention being revealed, is the trust void as a "sham", or is the trust valid but the trustee is acting in breach of trust?

The term "sham" in English and offshore parlance, adopted in Canada, is not a precise term. It is more a turn of speech; its meaning has been given as "something that is not what it seems; a counterfeit" (Black's Law Dictionary, 7th ed. (St-Paul. Minn.: West Group 2000)). It originated in England with regard to transactions, to which of course there are always at least two parties, and it means the parties' true intent is that others shall be misled by the terms appearing in the transactional instrument. The real terms are something other, and the instrument is therefore declared void. Used in the trust law setting, now a practice in Canada as elsewhere, it describes a trust that the courts will declare void because the provisions in the trust instrument do not represent the settlor's true intent as to the terms upon which the trustee is to hold the trust asset(s). Though the trust instrument sets out the persons or purposes that are to benefit, the settlor's true intent is to retain control of the assets purportedly held in trust because the true intent is to appear to have disposed of the assets and so to evade tax, to defeat personal creditors, or prejudice the claim of an estranged spouse or the children of the relationship. A trust created by the settlor who declares himself the trustee of the property, rather than make a transfer of assets to another as trustee, lends itself to this misrepresenting behaviour. But another as trustee who agrees to assist the falsity, or who is indifferent to whether, in fact, he merely implements the settlor's decisions, will equally enable the assertion to be made that the fraud [*sic*] [I believe the intended word was "trust"] is but a deception, and consequently void.

...

[18] However, he ruled that there was no intentional deception and therefore no sham (Reasons, para. 71):

The stumbling block for the [r]espondent is that, while all the circumstances point to an arrangement that was inaccurately reflected in the Trust Deed, there was no intentional deception but, if there was deception it was by the very existence of this clever

avoidance strategy. Although [the appellant] and [the trustee] and indeed, Mr. Brown, Mr. Devries and Mr. Batallia could all, with some legitimacy, say we believe the trustee always had the discretion to say no, I find they all knew with absolute certainty that the trustee would not say no. The plan was such it made no sense for the trustee to say no.

[My emphasis]

...

[20] In so holding, the Tax Court judge misconstrued the notion of intentional deception in the context of a sham. The required intent or state of mind is not equivalent to *mens rea* and need not go so far as to give rise to what is known at common law as the tort of deceit (compare *MacKinnon v. Regent Trust Company Limited*, (2005), J.L.Rev. 198 (CA) at para. 20). It suffices that parties to a transaction present it as being different from what they know it to be. That is precisely what the Tax Court judge found.

[21] When regard is had to the reasons as a whole, it is apparent that the only reason why the Tax Court judge reached the conclusion that he did is his finding that the appellant and the trustee - as well as all participants in the plan - could say "with some legitimacy" that they believed that the trustee had discretion over the shares (Reasons, para. 71). While the claim to "some legitimacy" may show that there was no criminal intent to deceive (as would be required in a prosecution pursuant to subsection 239(1) of the Act) and perhaps no tortious deceit, it does not detract from the Tax Court judge's finding that both the appellant and the trustee gave a false impression of the rights and obligations created between them. Nothing more was required in order to hold that the Trust was a sham.

[22] I respectfully conclude that the Tax Court judge was bound to hold that the Trust was a sham based on the findings that he made."¹⁶⁷

An "executory trust" is a trust which is established in principle being that the intent to create a trust has been recognized and the trust property has been transferred to the trustees but the beneficiaries and the scope of their interests have not yet been specified¹⁶⁸, while an "executed trust" is a trust which is a trust that has been reduced to writing and agreed to be the settlor and acknowledged by the trustee; in essence, a trust the terms of which can be referred to through a review of the documentation. The mere fact that the courts will recognize executory trusts and give them consideration and protection equal to that afforded "validly" constituted executed trusts offers a very offensive method of providing flexibility in tax planning in that if an executory trust can be proven to have come into, or been in, existence at a given point of time without supporting, (or in some cases disproving), documentation, then the relevant taxpayers may be quite capable of gaining from available provisions applicable to the trust¹⁶⁹. In complex trust situations obviously in order to maintain the rights of the beneficiaries the trust will need to be substantiated in writing however in cases where simple relationships exist, the trust need not be put to writing if other valid forms of evidence of its existence and of its nature can be recognized. There is no provision in the Act which requires a trust to be evidenced in writing, (although in the case of certain non-resident trusts recognized under section 94 there is an indirect requirement). When a beneficiary's interest fails due to lack of certainty or other reasons, which includes an executory trust situation, the property is held on resulting trust for the settlor¹⁷⁰ or in a testamentary situation for the residuary beneficiaries¹⁷¹. Subsection 75(2) would apply to the executory trust generally due to the fact the property may revert to him and also the contributor may have control over to whom it will pass subsequently. If alternative directions are given on the initial transfer so as to cause the property to be conveyed to a certain party (creditor,

¹⁶⁷ See also the Aust. case of *Keach & Keach and Ors* [2011] FamCA 192 (9 March 2011) for an interesting examination of elements of sham trusts in a divorce proceeding.

¹⁶⁸ *Re: Bostock's Settlement*, 1921 2 Ch. 469, & *Re: Flavel's Will Trusts*, 1969 1 W.L.R. 444.

¹⁶⁹ There must be an intention to create a trust when the property is conveyed.

¹⁷⁰ *Boyce v. Boyce*, 1849 16 Sim 476

¹⁷¹ though the terms of the disposing deed will obviously be important in ascertaining the secondary destination of the interest

charitable institution), so that reversion isn't possible. Sec. 75(2)(a)(ii) is still satisfied notwithstanding no resulting trust arises. Executory trusts do however have a use in, amongst others, reducing the impact of the Sec. 256(1.2)(f) trust-beneficiary corporation association rules, facilitating residency cost bumps in certain situations, etc. though if Sec. 75(2) applies to the arrangement Sec. 107(4.1) may create hardship when any and all trust property is subsequently distributed¹⁷².

Proving in the Absence of Documentation.

The burden of establishing that there was an intention to create a trust is on the person who alleges that a trust was created.^{173 174}

The classic case of the executed trust being treated in the tax environment as valid without being substantiated with documentation is that of *E. Bouchard v. The Queen*¹⁷⁵ where a taxpayer purchased a house solely for his son, whereby he held the legal title thereto until the son paid him consideration. The Minister, not one to miss a free lunch, or listen to facts, assessed the taxpayer as making a disposition of the property to the son under Sec. 69(1), when title was finally conveyed, for fair market value proceeds, instead of treating the disposition as that of a tax-free distribution, to be handled by Sec. 107(2). The facts of the case are fairly simple; the taxpayer purchased a house for his son due to his lack of funds and financial credibility on the agreement that the son and his wife repay him. The plaintiff took on a mortgage secured by the property with the vender while the sale itself was closed with the vender understanding and accepting the fact that the house was being purchased for the son, and that the legal title would be transferred thereto upon the plaintiff realizing the payments from him. The father plaintiff computed monthly payments to be made by the son, a significant portion of which could be described as interest, and in the meantime the son and wife occupied the house as if it were their own. The plaintiff recognized the excess of the payment received from the son over that paid by him to the vender in respect of the mortgage as rent and declared it in his income whereupon he deducted capital cost allowance on the house. The beneficiary son and wife made substantial additions and alterations to the property as they occupied it and it was only when they planned on taking a trip that they accordingly recognized that a written declaration should be made whereupon an "Agreement of Sale and Purchase" was entered into to attest to some degree of interest they had in the property¹⁷⁶. The Minister recognizing their version of the facts where a property had been bought by a father and "sold" to a son for consideration less than its FMV pounced under the pretence of Sec. 69(1)(b), assessing the father. The whole arrangement was a direct result of the personal attribute of the father being his utter rejection of ever guaranteeing or endorsing loans of someone else, including his son, hence he could not co-sign for his son's mortgage, however he also didn't want to loan directly to the son the amount needed as consideration to buy the home directly. One of the main issues also concerned whether the plaintiff was eligible to prove a "parole" trust while the Judge commented on three cases involving the applicability of the Statute of Frauds to parole evidence use to

172 That subsection applies only to property and not businesses and only when the contributor is resident in Canada.

173 *Herdegen v. F.C.T.* (1988) 84 A.L.R. 271 In that case the two taxpayers agreed, I guess, to sit at a kitchen table and said to the beneficiaries that they held shares in their corporation for the benefit of the purported beneficiaries' benefit, but did absolutely nothing to evidence it or act on it. When the shares were sold the taxpayer's attempted to contend that they held them as bare trustees. The taxpayer's straight-faced claim failed EVERYWHERE when the court considered *FCT v. Clarke* (1927) 40 C.L.R. 246, *McPhail v. Doulton* [1971] A.C. 424 *Rollestone v. National Bank of Commerce* (1923) 252 SW 394, *Busch v. Truitt* (1945) 160 P 2d 925, *Pullan v. Koe* [1919] 1 Ch 9, *Sackville-West v. Holmesdale* (1870) LR 4 HL and *Pass v. Mills* (1886) 7 LR(NSW) (Eq) 34. See also a humorous Aust. case of *Fletcher v George & Ors* [2011] FMCA 553 where just about everything was tried to prove a poorly documented trust.

174 It is not important that the term "trust" actually be used in the documentation creating it – it can be established from external sources and circumstances: *Valeress Pty Ltd v Valenest Pty Limited (in liquidation)* [2011] NSWSC 465 (20 May 2011). See also the examination of whether a trust has been established in a less than formal situation between siblings' expressions in the Aust. case of *Sheikholeslami v Tolcher* [2011] FCA 1050 (9 September 2011). See also the recent case of *Sutherland v Woods* [2011] NSWSC 13 (3 February 2011) for conflicting testimony on the creation of trusts for Aust. tax purposes that ran astray for other purposes. While also see the Aust. case of *Georgas and Department of Family and Community Services* [2002] AATA 371 (20 May 2002) concerning proving an oral express trust.

175 83 D.T.C. 5193 FCTD

176 The agreement was drawn up by lawyers of the father.

substantiate oral trusts, one of the main ones being *Hull v. Allan*¹⁷⁷ wherein Boyd, C. commented:

"...the parole evidence was insufficient to establish a case in the acquisition of land held by the defendant so as to give relief to the plaintiff notwithstanding the Statute of Frauds. Doubtless the law as set forth in *James v. Smith*, [1891] 1 Ch. 388, (384 is the correct page) is modified and perhaps changed entirely by *Rochefoucauld v. Boustead*, [1897] 1. Ch. 196; but it is essential that the evidence of such alleged trust be clear and complete to the satisfaction of the Court."

In *Rochefoucauld v. Boustead* it was held appropriately by Lindley, L.J. that:

"But it is not necessary that the trust should have been declared by such a writing in the first instance: it is sufficient if the trust can be proved by some writing signed by the defendant, and the date of the writing is immaterial."

"...It is further established by a series of cases, the propriety of which cannot now be questioned, that the Statute of Frauds does not prevent the proof of a fraud: and that it is a fraud on the part of a person to whom land is conveyed as a trustee, and who knows it was so conveyed, to deny the trust and claim the land himself. Consequently, notwithstanding the statute, it is competent for a person claiming land conveyed to another to prove by parole evidence that it was so conveyed upon trust for the claimant, and that the grantee, knowing the facts, is denying the trust and relying upon the form of conveyance and the Statute, in order to keep the land himself."

Cattanach J. then went on to comment:

"When a trust may be established by parole despite the Statute of Frauds as I accept as a premise in this appeal sound policy demands that its existence must be brought within reasonable certainty and not left within the realm of conjecture."

The evidence that needs to be provided in court must be clear and complete as to the existence of the trust which would include the existence of the specific characteristics of the trust and thus the parole evidence provided must attest with clarity to the existence of the three certainties required of any trust.¹⁷⁸

Cattanach J. found that as per the claim of a trust the Court should ask itself and obtain clear answers to the following questions:

- "1: is the claim supported by probability?
- 2: is it supported by writing in any form?
- 3: is it supported by any indisputable facts?
- 4: is it supported by disinterested testimony?
- 5: is the parole evidence quite satisfactory and convincing?"

As per the first question the Court examined most of the substantial aspects of the situation being that the plaintiff was an unusual individual and had legitimate cause to structure the deal in the manner he did. The Minister contended that since the plaintiff had recognized the payments from the son **as rent** in his income, and since he held legal title and also claimed C.C.A. and maintenance expenses, as if he were realizing income from rental property, at the least the relationship consisted solely of a proprietor - tenant nature however the Judge quite accordingly disposed of the argument as the fault of the C.A.s who prepared the tax returns and didn't comprehend what they were dealing with:

"The plaintiff's income tax returns were prepared by chartered accountants retained by him. The monthly income received was income to which the adjective "rental" was applied as was logical to do rather than embark upon an explanation, as the chartered accountant sought to do later after the fact of assessment without a full appreciation of the legal implications involved in reaching the result they did."

A particularly interesting aspect about the arrangement was that the plaintiff claimed C.C.A. and recognized income from the property in computing his **own personal income**, and while he was the legal owner of the property, the Judge provided that, "that does not detract from the possibility that as legal owner he held the property in trust for the equitable owner". The interesting part that obviously isn't described anywhere in the case text is that to recognize income as such and to claim C.C.A. in respect of the property held in trust he

¹⁷⁷ [1902] 1 O.W.N. 782.

¹⁷⁸ See *Re: Johnson*, 1962 30 D.L.R. (2d) 474, *Owchar v. Owchar*, 1949 2 W.W.R. 97, *Farrar v. Commr. of S.D.*, 1975 5 A.T.R. 364, *Re: Riffel Estate*, 28 E.T.R. 1, *Re: Snowden*, 1979 Ch. 528, *Bloch v. Bloch*, 55 A.L.J.R. 701, and *Last v. Rosenfeld*, 1972 2 N.S.W.L.R. 923.

plaintiff must have also been recognized implicitly as the income beneficiary of the trust with respect to \$76.00 net inflow of funds. In substance what the plaintiff had done, could have been done instead through an executed trust, that being that he had purchased the property and assumed the mortgage to the vender as trustee, paid mortgage payments as trustee, received payments from his son, as trustee, but received a certain excess net amount from the trust as income from a property which was an interest in a trust, but only after he, as a trustee, had deducted C.C.A. and maintenance expenses. Although he obviously did not file the appropriate documentation in respect of the separate tax entities but instead fused them together the deductions were still allowed. If the trust had been documented he would have deducted C.C.A. at the level of the beneficiary or could have deducted both it and maintenance expense at the trust level.¹⁷⁹¹⁸⁰

Cattanach, J. also commented on the fact that the son and wife had made substantial expenditures altering the property:

"That is not consistent with the relationship of tenant and landlord between the plaintiff's son and the plaintiff. Rather it is more consistent with the relationship of beneficiary of a trust and the trustee...It is a principle of equity that a beneficiary who is induced to change his position in reliance on a trust as reason for incurring an expense may well be entitled to a lien for compensation on the property or a right to the conveyance of the legal title. This is particularly so if the person in the position of beneficiary did so in the belief that he owned the property, that he was encouraged in that belief by the person in the position as nominal owner, or such owner stood by and let such beneficiary make the expenditure without disabusing his mind."¹⁸¹

With these facts in mind the Judge found it quite probable that a trust existed while with respect to evidence in writing he turned to the Agreement to Purchase and Sell entered into by the parties quoting:

"I say this because of the statement in Lewin on Trusts (16th Ed. at page 25) that "The trust, however late the proof, operates retrospectively from the time of its creation" and the remarks of Lindley, L.J. in *Rochefoucauld v. Boustead* (supra) already quoted but here repeated that "it is sufficient if the trust can be proved by some writing signed by the defendant and the date of the writing is **immaterial**." The Chairman placed reliance on the circumstance that "trust" was not mentioned by the plaintiff until the assessment was contested. I attach no particular significance to the plaintiff's failure to do so. There is ample authority for the proposition that equity looks at the intent rather than at the form. It is quite clear

¹⁷⁹ See also *Jeffries v. Stevens*, 56 T.C. 134, for similar instance where incorporators of a corporation lacking financial integrity purchased in their names property and arranging for financing then "rented" it to the corporation where the rent was to essentially pay for the property whereafter legal title would be transferred. Beneficial ownership didn't pass to the corporation and rent was deductible by the corporation where there wasn't any declaration of trust only that corporation to ultimately benefit. See also *Sec., Dept. of Social Security v. James*, 95 A.L.R. 615 (F.C. of Aust.), where a parent purchased a house for her mentally infirm daughter and provided various expressions that the house was purchased for her in correspondence while she also provided that should the daughter not need it it would be disposed of but the proceeds would be used exclusively to benefit her. The fact that nominal "rent" was charged to the daughter who had a stream of relief did not undermine the fact that a trust had been established. *Paul v. Constance*, 1977 1 W.L.R. 527, provides a very good example of where repeated expressions amounting to the gift and recognition of a past gift of a beneficial interest were held to have created a trust. The phrase "This money is as much yours as mine" repeated was imperative and though there was no express disclosure of the sums being held on trust such did not detract from the passage of beneficial interest after the numerous expressions.

¹⁸⁰ See also *Thexton v. Thexton* [2001] 1 N.Z.L.R. 237 HCNZ, where it was held:

"In order to create a trust there must have been either a transfer of the shares or a declaration of trust by David Junior so as to bring about complete constitution. Whilst it is not difficult to find an intention on the part of David Junior, the existence of a declaration of trust presents problems. There is no written document existing so other evidence of the existence of such a declaration is required. If the trust is not completely constituted then absent consideration on the part of the beneficiary, the trust is not binding on the settlor: equity will not assist a volunteer. A declaration of trust does not require a technical form of expression, it is a question of construction whether the words used, taking into account the surrounding circumstances, amount to a declaration of trust: *Paul v. Constance* [1977] 1 All ER 195. Where no words exhibiting the necessary intent are used it may in exceptional cases be possible to infer a declaration of trust from acts showing that a person has constituted themselves as trustee, ie from conduct evincing an intent to deal with his property so that somebody feels to his own exclusion acquires the beneficial interest in his property."

¹⁸¹ For proprietary estoppel see *Chalmers v. Pardoe*, 1963 3 All E.R. 552 (PC), *Dillwyn v. Llewellyn*, 1862 4 De G & E & J 517/45 E.R. 1285, *Dagley v. Dagley*, 1906 38 N.S.R. 313 (CA), *Campbell v. Campbell*, 1932 3 D.L.R. 501, *Pascoe v. Turner*, 1979 1 W.L.R. 431 (CA). See the five essential conditions for proprietary estoppel in *Crabb v. Arun District Council*, 1979 Ch. 179. See also *Loone v. Tasmanian Trustees Ltd.*, 1987 Tas. R. 146, for situation similar to *Bouchard*.

that a trust can be created without the use of the word "trust". Intention is a question of fact to be proven as any other fact is to be proven. If from the facts the interest that the plaintiff **intended** to be given to his son is clear then that is the interest he gave."¹⁸²

Understandably a simple agreement for purchase and sale may not in itself prove the existence of a trust since, if vaguely worded, all it would provide for was a binding commitment to dispose of and acquire property by respective parties. The technical attributes of the Agreement in Bouchard were not commented upon by the court (however the final conveyance deed was), and from this it should be recognized that the court could not find, from a review of the speech therein, a reference, implicit or otherwise, to an executory trust, and thus the Agreement was interpreted as being a component of the larger transaction. If the Agreement would have been phrased so as to draw attention to the circumstances in which the property was purchased initially, as well as the reason for which the agreement was being made, giving recognition to the acquirors as beneficiaries or those beneficially interested from the start of the series of transactions, the Court could have placed far more reliance on the Agreement.

Perhaps the linch-pin of the evidence came in the form of the impartial, "disinterested" testimony, provided by the original vender of the property to the plaintiff, when she provided testimony substantiating the claim that the property was expressly, (orally), purchased **for the son**. The Judge was also of the opinion that the son and wife acquirors were also "disinterested" parties since the only parties to the question were the Minister of National Revenue and the plaintiff father, while the son or wife had themselves "nothing to gain from the proceedings". Cattanaach, J. found Mrs. Unger's evidence to confirm the plaintiff's contention and since he found her to have all of the attributes of a good disinterested party; impartiality, independence and credibility, he found her testimony (and more importantly credibility) unimpeachable. An important note must be made here being the vender of the property to the "trustee" was a very good disinterested party but such parties could come in many forms such as inquisitive potential third party purchasers of the property, friends of the family who were independent, etc. Essentially a disinterested party could be literally invented "at the drop of a hat" so as to meet the needs.

In Bouchard the evidence provided by the plaintiff was considered satisfactory and convincing enough to substantiate the existence of an undocumented executed trust, the singular property of which was the legal title to a dwelling, however, it was the sheer bulk of the evidence, and its mutually confirming aspects that allowed the Federal Court Trial Division to consider it adequate.¹⁸³

Belton v. I.R.C.¹⁸⁴ illustrates the quality of evidence that must be provided to prove an oral trust and have it recognized retroactively to the date of declaration by the settlor. In this case the settlor declared himself trustee to hold property on trust for his offspring whereafter live stock was purchased in the offspring's name, proceeds from its realization were received in his name on an on-going basis while a separate bank account was opened, (under the offspring's name), to handle the proceeds. The trust was initially oral but was documented nine years subsequently. During the activities the livestock was grazed separate from his own while funds were expended on the son. The trustee was recognized to feel compelled to keep the activities separate from his own which indicates his frame of mind. He did borrow money from the offspring's trust accounts to cover a temporary overdraft but this was disclosed on his personal balance sheet as a loan that would have to be

¹⁸² It seems interesting that the matter of expressing an equitable interest in the property was carried out through an agreement to purchase and sell when **the solicitors** of the plaintiff should have recognized the essence of the arrangement, (or were they properly informed as to the initial purpose of the plaintiff actually purchasing the property)?

¹⁸³ See Jane Gardner v M.N.R., 88 D.T.C. 1649 TCC, for a very similar situation resulting from the real purchaser not being financially sound. A dwelling was purchased **as trustee expressly** for the taxpayer by her spouse due to the fact that the spouse could not provide collateral/stability and didn't have the funds herself at the time and both trustee **and** taxpayer were to be registered as joint tenants of the property to secure the 100% mortgaged purchase. The trustee had relatively substantial financial integrity. Mortgages were extinguished by the taxpayer when she received the funds from other sales and when the spouse-trustee executed a quit-claim of his legal ownership of the joint tenancy allowing all the legal ownership to reside in the taxpayer-spouse-beneficiary so as to facilitate a sale the Minister contended that such was a transfer within the Sec. 160(1) context and thus the spouse became liable for the husband's tax debt. The court found that the quit claim did not operate to transfer a beneficial interest, that such an interest existed exclusively in the spouse-beneficiary before the execution, and that the husband acted as a trustee only. See also Anderson v. Hervieux, 46 R.F.L. (2d) 230 (SCA).

¹⁸⁴ 1959 N.Z.L.R. 1372 (SC)

repaid.¹⁸⁵ The tax assessors contended that the income from the activities was his during the period in which no documentation existed but the Supreme Court recognized that the intention was clear and the property ascertained while the beneficiaries were specified with clarity. In respect of oral declarations by taxpayers to hold on trust the Court held out certain needs of evidence citing *Lewin on Trusts*¹⁸⁶:

"If the settlor proposes to convert himself into a trustee, then the trust is perfectly created, and will be enforced as soon as the settlor has executed an express declaration of trust intended to be final and binding upon him... In all cases where a declaration of trust is relied on, the Court must be satisfied that a present irrevocable declaration has been made."

while citing *Bentley v. Mackay*¹⁸⁷, *Gee v. Liddell*¹⁸⁸ and *Halsbury*:

"In case of doubt, the contemporaneous and subsequent acts of the settlor may be looked at."¹⁸⁹

A discussion of the quality required of a disposition to be recognized in the taxation context as an adequate declaration of trust would not be complete if *Thomas Purcell v. D.F.C.T.*¹⁹⁰ were not referred to. In this case the taxpayer declared that he held on trust his sheep station property in Queensland for the benefit of his wife and daughter and himself with respect to both capital and income and then went on to carve out exceedingly wide and fundamental powers (that could easily undermine the disposition) to manage the business. Powers reserved to himself to be exercised by and large without regard to any fiduciary obligation included: to carry on or wind-down the business, mortgage and give security "as if I were the absolute owner thereof and that these presents had not been executed", sell or dispose of the business or solicit partners, use the trust premises without interference from those beneficially interested in them, appoint new trustees though disallow them from compelling transfer of title to them and preventing them from ascertaining income entitlements of the beneficiaries, while if he were to die without such trustees being nominated the property would revert to his testamentary estate. The abilities of both the beneficiaries and potential trustees to interfere with his administrative or dispositive powers were substantially eliminated and when he was assessed in respect of the business's income in a subsequent year the trust deed, though unregistered, was forwarded as evidence that the trust existed. Three of the four High Court judges did not find that the retention of substantial managerial or dispositive powers offended any rule of equity while the fourth, dissenting, found that the substance of the powers operated to negate the gift purported to be executed. The trust declaration was recognized as¹⁹¹ valid.¹⁹²

Belton should definitely be compared with *Baldassarra v. M.N.R.*¹⁹³ to illustrate perhaps how superficially the Tax Courts will address a nebulous trust situation where there is a lack of hard proper documentary evidence establishing a clear chronology. In that case the taxpayer/incorporator could not prove that he

¹⁸⁵ See *Glynn v. Commr. of S.D.*, 1977 2 N.S.W.L.R. 673, and *Andrews Estate v. M.N.R.*, 66 D.T.C. 798, for conduct subsequent to declaration evidencing existence notwithstanding personal appropriations.

¹⁸⁶ 15th Ed. p. 51

¹⁸⁷ 51 E.R. 440

¹⁸⁸ 55 E.R. 1038

¹⁸⁹ See also *Williams v. Lloyd*, 50 C.L.R. 341, and *Critchton v. Critchton*, 43 C.L.R. 536, for subsequent conduct and declarations as evidence and *Perp. Exors. & Trustees Assn. v. Wright*, 23 C.L.R. 185, for authenticity of writings and circumstances subsequently evolved. See also *Woollends v. Woollends*, 1983 41 B.C.L.R. 391, *Paul v. Constance*, 1977 1 W.L.R. 527 (CA), *Re: Kayford Ltd.*, 1975 1 All E.R. 604, *F.C.T. v. Purcell*, 29 C.L.R. 464, *Cain v. McEacham*, 16 V.L.R. 62 though with limits: *Stewart Dawson and Co. Pty. Ltd. v. F.C.T.*, 48 C.L.R. 683, *F.C.T. v. Wade*, 84 C.L.R. 105, *C.I.R. v. Brooks*, 1915 A.C. 478. In *MacFarlane v. F.C.T.*, 67 A.L.R. 624, the fact that a taxpayer recognized and paid tax on income from property as if it was his own did not preclude a trust from being recognized in respect of it. Conduct of the parties subsequent to the alleged creation can be used to rebut the existence of the trust: *Shephard v. Cartwright*, 1955 A.C. 431, *Calverley v. Green*, 155 C.L.R. 242, and *Williams v. Lloyd*, 50 C.L.R. 341, or confirm its existence; *Boccalatte v. Bushelle*, 1980 Qd.R. 180, and *Donaldson v. Freeson*, 51 C.L.R. 598. See *Halsbury's Laws Of Eng.*, 4th Ed., Vol. 48, para. 605. See *Don King Productions Inc. v. Warren and ors.*, [1998] 2 All E.R. 608 ChD, where it was held that a taxpayer can create a trust out of non-assignable interests in a partnership.

¹⁹⁰ 29 C.L.R. 464 at 468-472

¹⁹¹ See also *Tunley v. F.C.T.*, 39 C.L.R. 528, for valid declaration notwithstanding that the settlor/trustee maintained exceedingly wide dispositive/distributive powers while *C. of T. (W.S.) v. Hedges*, 1935 3 A.T.D. 255, is another such case.

¹⁹² See also *Kitto J. in Glynn v. F.C.T.*, 111 C.L.R. 169 at 174, for:

"It is true that proof of a formal statement by the owner of property to the effect that he holds it upon trust, for special circumstances may explain the statement as having been due to some other intention than that of creating a trust."

See also *Commr. of S.D. v. Joliffe*, 28 C.L.R. 178.

¹⁹³ 91 D.T.C. 289 (TCC),

received shares subscribed for as trustee and the weight of incidental evidence suggested that he didn't. The Tax Court judge provided:

"I can find no basis in the evidence for a conclusion that a trust was created. No doubt the appellant intended that the children derive benefit from the operation of the company and that they ultimately become owners of the common shares. However, the existence of that rather imprecise intention is not sufficient to create a binding trust upon the Appellant from the moment the shares were issued to him. There is no evidence of a prior declaration of trust, of issuance to the Appellant as trustee or of the use of trust funds as consideration for the issuance of shares.

The written contemporaneous evidence is entirely consistent with the evidence of an intention on the part of the Appellant to effect a settlement by way of transfer of the common shares to Angela Baldassarra in trust for the children. It may be that Mr. Larson devised a plan whereby the Appellant's wishes in relation to the children might have been carried out in such a way as to avoid the clutches of subsection 75(1). Assuming that such a plan was devised there is simply no evidence that it was carried out. The desire to avoid an adverse tax consequence is not sufficient by itself to conjure up a trust at the precise point in time required to achieve the desired tax result nor is it evidence of a declaration of trust."

In *Caplan v. M.N.R.*¹⁹⁴ a corporation wished land adjacent to land it owned to be purchased for it rather than purchase it itself owing to the fact that if it did problems could arise under the local Planning Act. One of the three shareholders agreed to purchase it under her name, which it was, with the corporation paying the token down payment, registration fee, land transfer tax and legal fees and subsequently administering it paying the taxes and mortgage payments to the vendor. Unfortunately the shareholder reported the income from the land, (rent charged to the corporation), on her personal returns for two years while the subsequent transfer to the corporation was recorded as a "sale" though no consideration was paid. The transfer price was equal to the original purchase price. (The shareholder hadn't paid anything for the property essentially.) The Tax Court judge cited the commentary of D. Waters in *The Law of Trusts in Canada* on implied trusts:

"The term "implied trust" is commonly used for two situations. First where the intention to create a trust is not clearly expressed but has to be discovered from the indirect and ambiguous language. This is all that distinguishes such an implied trust from the express trust. Secondly, where one [person has gratuitously transferred his property to another, or paid for property and had the property put into another's name. The intention of the transferor or purchaser is implied to be that the transferee is to hold the property on trust for the transferor or purchaser."

Key evidence to rebut the existence of the trust was the lack of clarity with which the particular relationship was described in the corporation's financial statements and although the Bouchard dict was recognized as valid of little relevance was the fact that the corporation was the party which had executed every transaction with respect to the property's title/mortgage etc.. in conclusion for the Minister the Tax Court found that the intention of the corporation was to have beneficial and legal ownership reside with the shareholder so as to allow her to deal with the property to the greatest extent, (quite likely to preclude Planning Act problems from arising), and that the trust didn't exist. (When the property was sold within a short period of time after its receipt by the corporation for an amount approx. 3 times its transfer price the Minister assessed the transfer under Sec. 69(1) causing sever tax consequences for the shareholder.) Does beneficial ownership have to reside with a beneficiary under an implied (resulting) trust and was the fact that it resided with the trustee not due to a legitimate reason, (pursuant to an attempt to avoid the Planning Act problems). Could the avoidance motive not be the base for all of the actions taken by the parties and could the corporation not prove in the courts of equity subsequently if need be that the resulting trust existed when it was the party which orchestrated the purchase, provided the purchase funds, administered the property as if it was its own?¹⁹⁵ In the author's opinion the case should have been appealed.¹⁹⁶

¹⁹⁴ 86 D.T.C. 1489

¹⁹⁵ All of the book entries evidencing a sale could still be legitimately argued to have as their reason the avoidance motive. Facts attesting to intention at the time of the initial purchase could have out-weighted the evidence admitted to rebut the resulting trust.

¹⁹⁶ See *Tucker Estate v. Gillis*, 22 E.T.R. 73, *Boulos v. Boulos*, 24 E.T.R. 56, *Coverdale v. Griffith*, 1977 3 B.C.L.R. 291 (S.C.), *Ruff v. Strobel*, 1978 3 W.W.R. 588, *Russell v. Fenwick*, 1927 S.A.S.R. 42, and especially *Re: O'Brien v. Walker*, 1981 5 A.C.L.R. 564, *Roynat Inc. v. Utd. Rescue Services Ltd.*, 1982 44 C.B.R. (NS) 1 (MCA).

In *J.B. Lansdell v. M.N.R.*¹⁹⁷ the Federal Trial Court had to decide whether a trust existed with respect to a speculation in some shares when one party, having personal accounts at a brokerage firm, acted on behalf of several other unrelated parties whereby he took their monies and gave it to the brokerage firm to invest in particular shares. The taxpayer opened a separate trust account at the firm but the brokerage firm accounted for the relevant transactions very poorly and the taxpayer's personal account was used to perform the purchases and sales. The Minister assessed the taxpayer in respect of the profit earned and included it in his income however the Trial Court found that the evidence provided by the stock broker and the taxpayer's wife was sufficient evidence so as to substantiate the existence of the trust.¹⁹⁸

Obviously a taxpayer will not be doomed if his documentary evidence attesting to the existence of a trust isn't in order, if he has some other credible proof. Such may take the form of insurance contracts, municipal tax bills, land registry entries, etc. listing the ownership of the particular property as in trust. Documentation relating to transactions that refer to the existence of the trust, (and that were executed on the premise of its existence), even though they have no bearing on the trust, or that refer to the trust documents themselves may prove valuable in substantiating the trust's existence if they display the appropriate credibility.¹⁹⁹ In the absence of such the acts must speak for themselves and documentary evidence implicitly not evincing a trust may be determinative and prove insurmountable in proving the trust's existence. This was the case in *Baldassarra and Caplan* as well as latterly *Barnes v. M.N.R.*²⁰⁰ where two spouses each owned 50% of a common corporation and the husband unilaterally had \$45,000 of the corporate funds advanced to a friend's corporation to buy shares the motive of which was to help the friend's corporation. the shares were listed in the husband's name on the corporation's register as on his personal account without any trust and were sold by him whereafter the proceeds were deposited in the spousal corporation's account and part of the realization credited the "loan receivable" account that had been set up to eliminate it while the balance was used to create a "loan payable to shareholders account" and was distributed equally between his spouse and himself. Although the spouse had initially discussed the plan with him she did not get involved with the dealings and it was thoroughly a one-men show. The Tax Court held that the spouse shareholder had actually received a loan from his corporation on his personal account and had invested in the shares not as a trustee for himself and his spouse but exclusively for himself and the fact that he didn't take steps to have the share register corrected to reflect a trust when he had all the opportunity in the world or to more elaborately account for the corporation's loan with a journal entry indicating the trust relationship indicated that the situation had been properly described and that his exclusive oral testimony was of little weight. Proper descriptions in books of record are and will continue to be a major stumbling block until taxpayers recognize that in such an "official" medium it's critical to "say what you mean".

In *Morris v. M.N.R.*²⁰¹ the credibility of the witnesses attesting to the existence of a trust as well as that of the fiduciary documentation itself was definitely lacking in integrity and the Exchequer Court found that no trust existed. The main essence of the case was that property had been conveyed to the taxpayer for the expressed consideration of natural love and affection...and \$2. The taxpayer's father, as well as mother and the taxpayer had initially acquired the property as joint tenants and not as tenants in common while his surviving father was the party that transferred the legal title solely to him. Prior to this conveyance the taxpayer's wife, (a practicing lawyer), had assumed a mortgage lien on the property albeit under a trust agreement whereby the particular taxpayer was to manage, (at times in accompany with his wife), the property which produced rental revenue, using the proceeds to pay down the mortgage, while what remained was to be shared by him and his two sisters equally. The particular taxpayer thus collected the rents...and didn't pay over the relevant share to his two sisters, and the trust agreement was initiated by his wife, herself being an intricate factor and was carried out, through her law office, but was never registered. The taxpayer during the years in questions received

¹⁹⁷ 72 D.T.C. 6057

¹⁹⁸ In *Hunter v. Moss*, [1994] 3 All E.R. 215 CA, it was held that when a oral trust statement was with respect to 5% of the sole class of shares of a corporation, the fact that that property could be ascertained allowed the trust to come into being notwithstanding that the settlor also owned additional shares of the sole class.

¹⁹⁹ See *Ash Street Prop. Pty. Ltd. & Ors. v. Pollow & Ors.*, 87 A.T.C. 4606 (SCNSW), as well as "The Trust of Real Estate vs. The Registry Act.", R.R. Anger, E. & T.Q., 1988-89 pg. 340.

²⁰⁰ 86 D.T.C. 1546 TCC

²⁰¹ 63 D.T.C. 1044 (Exch)

mortgages on the property, the proceeds of which were never divided with his sisters, and in applying for the mortgages he listed his ownership as fee simple and thus had the right to convey the property. The sisters of the taxpayer, who were also supposedly beneficiaries under the supposed trust had never received anything from the property, nor had they, it seemed, being advised that they were in fact beneficiaries of the supposed trust since they were in a safe position to have their respective rights measured and protected, (being related either as spouse or parent to lawyers), had they been. The evidence (Registrar's Abstract of Title) showed that the appellant was the sole owner of the property and there was no documentary evidence which referred to the unregistered trust agreement after it was constituted. The evidence showed that the appellant had been assessed as sole owner for purposes of municipal property taxes in the relevant years, while he had arranged for several mortgages on the property, as sole owner, the relevant share of the proceeds of which, net or otherwise were not paid to his sisters, as required by the trust agreement. The most damning of evidence was that he had not paid anything to the sisters in respect of the proposed rights, rights the beneficiaries acquaintances would have definitely upheld had they been recognized. As closing comment Cameron, J. held in respect of the rental income of the trust:

"But I am quite unable to accept the evidence of the appellant when it is in conflict with either documentary evidence or with other oral evidence. His explanation of the manner in which he has dealt with these receipts is quite incredible. That he did receive them in his personal capacity is not open to question. He has been collecting them since 1948 and has not paid one cent to his sisters nor accounted to them in any way. At the conclusion of his evidence, he did say that he held them in trust under the trust agreement and that he still had them "on hand" although declined to state where or on what form they now are. He said, also, that his sisters were entitled to a share therein, but he had not paid it over as he did not want them to dissipate the money - namely, money which he now says belonged to them, each being presumably a woman of mature years. Finally, he said that his wife at some unspecified time had demanded that he return the money to her, but he had refused to do so. His wife, however, made no mention of such demand. Now he says he is willing to turn over the shares to the sisters if they demand it. Frankly, I do not believe his last-minute conversion to the theory that he held the money in trust and made for the first time fifteen years after he first began to receive the payments and under pressure of a demand for income tax there on."

Obviously the five aspects needed to prove even undocumented trusts as described by Judge Cattnach in *Bouchard v. The Queen*²⁰² could not be satisfied in the *Morris* case. The "trust" was supported by a trust deed of questionable integrity, while the trust arrangement could not be supported by indisputable facts. The claim for the existence of the trust could not be recognized as supported by probability, nor could it be supported by disinterested testimony. If the sisters under the trust deed had brought an action against the trustees in *Morris*, (essentially against the action of the appellant), although the appellant would obviously sustain an immense liability at least the trust would have been legitimately recognizable.²⁰³

Implied Trusts.

A trust need not be evidenced in writing if the intentions of the parties involved are known by each other and thus the actions of the parties as a consequence of relying on those tacitly recognized intentions may suffice to provide adequate proof of the existence of the fiduciary environment. In *Rolf Drescher v. The Queen*²⁰⁴ the Federal Court Trial Division had to decide whether an implied trust existed with respect to the ownership of a 1 million dollar lottery winning, (and thus the interest revenue thereupon), when the entire process of claiming the prize was carried out by one individual, "the head of the family". The taxpayer, and his wife and daughter,

202 83 D.T.C. 5193

203 See *Starr v. Starr*, 1935 S.A.S.R. 263, Re: *McGuire*, 41 W.A.L.R. 120, Re: *Appleby's Estate*, 25 Tas. L.R. 126, but Re: *Lamshed*, 1970 S.A.S.R. 224, *Perp. Exors. & Trustees Assn. of Aust. Ltd. v. Wright*, 23 C.L.R. 185, Re: *Hampton*, 1922 S.A.S.R. 286. Not every arrangement will give rise to a trust if the term "trust" is used to describe it: *Te Teira Te Paea v. Te Roera Tareha*, 1902 A.C. 56, *Tito v. Waddell*, 1977 3 All E.R. 129, Re: *H. B. Haina & Assc. Inc.*, 1978 86 D.L.R. 262, F.C.T. v. *Higgins*, 44 C.L.R. 297, *Kinlock v. Sec. of State for India*, 1819 L.R. 1 A. & E. 109. The legal/equitable right situation must be examined. This was especially so in *Case D45*, 82 A.T.C. 213, where a trust was purportedly created though all the parties continued to regard their ownership abilities as before: found to be a sham.

204. 85 D.T.C. 5064

had habitually purchased lottery tickets the incidental winnings therefrom being "replayed" after being unanimously agreed upon by the three. The particular winning ticket was purchased by one of the group although his/her identity could not be determined and when "the jackpot" was realized the father and wife picked up the cheque together the cheque being made out to the father since it was solely he who had placed his name on the back of the ticket. Through the publicity and process at the lottery offices the two of them expressed what "**they**" would do with the money and at home afterwards, in private the daughter joined in to plan the investment thereof in a term deposit. The Minister attempted to assess the father on the total amount of the interest income from the term deposit since the investment was made solely in his name as per the bank's books, (which were in the process of being changed so as to make notice to the fact that the wife and the daughter were also joint owners of the term deposit). In the second year after the winning impending tax law complications were recognized and a trust declaration was drawn up the most crucial provision of which was:

"And whereas the said Rolf Drescher...did receive a cheque in the sum of...\$1,000,000 which, for convenience, was taken in the name of said Rolf Drescher only, **but on behalf, [of], his wife...and their daughter.**"

Judge Muldoon paid particular attention to this provision providing:

"The operative provisions are to the same effect and disclose that the plaintiff was "not the beneficial owner of the entire sum...but holds one third of the same...in trust and as nominee of and for his wife...and holds one-third of same...in trust and as nominee of and for his daughter..." Further provisions recite the plaintiff's willingness to account to his wife and their daughter and upon demand of either, to convey to her her undivided one-third interest in the principal and the interest. Appended as a form of consent signed by Edith and Evelyn Drescher releasing the plaintiff from any liability which he may incur for having their share of the sum, but holding him "responsible for his proportionate share of any loss or liability incurred." So, if the learned member of the Tax Review Board described a weakness in one preamble, it must nevertheless be noted that the entire instrument appears to be quite robust enough to stand firmly for its stated purpose. However, having been drawn up and executed so long after the date, (June 1, 1978), which the plaintiff wrote therein for his own satisfaction, (and perhaps as an aide - memoire), the best use of it in this case would be to demonstrate the continuity of the Dreschers' intentions; **but the important question revolves around their intentions from the beginning.**"

And it is with respect to this last question that the taxpayer in any given situation must be so acutely aware of his actions and of those around him. Documentation expressing a trust, though latently created, will add nothing to the plausibility of a fiduciary environment if at least the existence of the confidence cannot be derived from the implications it has on the behavior of the parties involved especially before the documents are drawn up. Judge Muldoon provided with respect to the actions:

"On this evidence there is virtually no doubt that in obtaining the cheque and in taking out the two term deposits in his name alone, the plaintiff was acting as the agent, the amanuensis, the nominee and trustee of the group consisting of himself, Edith Drescher and Evelyn Drescher. Any other conclusion goes against the evidence, the weight of the evidence, logic, reason, and human nature. On this evidence, had the plaintiff balked at according his wife and their daughter their equal, equitable and non legal shares, there is no doubt that they would have a formidable right of action which would be pursued successfully to judgment in law and in equity in their favor. **Evidence of the three Drescher's prior conduct would be virtually conclusive against anyone of them who might have acquired merely the apparent legal title and control of the prize money, as the plaintiff did, and who would have refused to disgorge in favor of the whole family.**"

"...The evidence here lacks one main ingredient which alone could make it consistent with such conclusions (of the Minister): the plaintiff's stealth in all this, of which there was not only no evidence but plainly opposite and contrary evidence. In all of the circumstances of a close, sharing family so amply demonstrated in the evidence, the plaintiff could be considered to be acting solely on his own behalf only if he had taken out the term deposits secretly. He certainly did not behave in this manner. In fact, the plaintiff and his wife went together to the lottery office, and then all three Dreschers went together to the airport to retrieve the cheque.

There was no stealth at all, and that constitutes a salient gap in the evidence."²⁰⁵

Resulting Trusts.

In *Martin Chrustie v. M.N.R.*²⁰⁶ the Tax Court had to decide whether a **resulting trust** arose when an interest in a M.U.R.B. was purchased by a taxpayer with funds personally provided by him but when the legal title of the interest was transferred to a corporation set up by the taxpayer. Essentially the taxpayer was to become a joint venturer in the construction of a M.U.R.B., with three other individuals, through the purchase of a 25% interest, while he was to own one half thereof. The four incorporated a company to provide competitively price supplies for the construction of the building, as a cost control conduit, but although the corporation was not to become a joint venturer the joint venture agreement was drawn up with the interest being acquired under Russ-Mar Investment Ltd. even though the offer to acquire the joint interest was made only to the incorporators of Russ-Mar and, in the taxpayer's case, the payment for the interest, \$20,000, was made by the taxpayer in his personal capacity not by the corporation with the taxpayer acting as executive officer. When rental losses were recognized the Minister disallowed the deduction thereof by the taxpayer on the grounds that his corporation owned the interest, not the taxpayer, while the taxpayer contended that he had beneficial ownership of the 12½% interest and that legal title thereof was held by Russ-Mar only as trustee and agent for him. The taxpayer's counsel provided documentary evidence in the form of the minutes of Russ-Mar where the three incorporators expressly provided that "the investor's position would be for private and individual investment to receive any tax benefit and enjoyment that would apply" while also provided was the taxpayer's personal cheque as payment of the down payment. Russ-Mar had been incorporated three weeks prior to the formal date of the joint venture agreement and upon briefly analyzing section 14 of the C.B.C.A. the judge found that there was an absence of the intention that the corporation be bound upon its creation for prior acts of its incorporator. Although taxpayer's counsel cited *Bouchard v. The Queen* as a precedent for the validity of attempting to invoke the provisions of the Statute of Frauds, (and satisfy the five question test), so as to prove the trust the judge was of the opinion that such rules did not apply to trusts created by the operation or construction of law but instead could apply only to express or declaratory trusts.

Finding a resulting trust to be in existence with respect to the purchase Judge Kempo provided, quoting from *Equity Jurisprudence in Wilson v. Owens*, (1878), 26 Gr. 27:

"The resulting trust is said to have its origin in 'the natural presumption, **in the absence of all rebutting circumstances**, that he who supplies the money means the purchase to be for his own benefit rather than for that of another; and that the conveyance in the name of the latter is a matter of convenience and arrangement between the parties **for other collateral purposes**.'"

Going on, he found that the trust could be proven through parol evidence if need be and then noting documentation supporting the personal payment for the interest, the consistency of the appellant's performance under enquiry and the integrity thereof and viewing the case evidence and factual circumstances the judge found that the appellant had successfully established the existence of the trust. Having been found to be beneficial owner of the 12½% interest the rental losses were recognizable by the taxpayer. It is not only by virtue of Sec. 75(2) that the beneficial owner of property held in trust is allowed to deduct capital losses sustained by the trust. If beneficial **ownership** of the property was found not to reside with the particular taxpayer, although he could have been found to be beneficially interested/entitled thereto, the losses would have been stuck in the trust unless Sec. 75(2) could have applied on some other grounds. Had rental income been recognized the taxpayer could have been successful at establishing that the interest was owned by the corporation and not by him however the arguments would have been quite different. The interesting aspect about this case is that the beneficial ownership of the interest, in technical sense of the term, was never examined but instead, apparently, was found to exist simply because a resulting trust had occurred and the corporation was **controlled** by the appellant. A slightly different result could have been of consequence had the corporation not been controlled by the taxpayer since although, in such a case, a resulting trust would have

²⁰⁵ See also *Trevey v. Grubb*, 44 A.L.R. 20, and *F.C.T. v. Clarke*, 40 C.L.R. 246, for similar implied trust situations as well as *Andrews Estate v. M.N.R.*, 66 D.T.C. 798 (TAB) where subsequent conduct and previously established convention helped prove a family trust in respect of a lottery winning.

²⁰⁶. [1984] C.T.C. 2533

occurred, beneficial ownership of the interest would not have resided with the appellant. The M.U.R.B. losses would then be deductible by the trust **and** by the taxpayer since technically the property could revert to him and thus Sec. 75(2) could apply. Beneficial ownership of and being beneficially entitled to property are not equivalent.

In *A. Nelson v. The Queen*²⁰⁷ the taxpayer and his three sons in equal partnership agreed to incorporate the activity into a corporation in which each would have equal shareholdings however due to errors in the process the partnership business was transferred to the corporation and the taxpayer received 96% of the common shares personally. His sons and himself had subscribed on incorporation for 1 share each and although the father was to receive an additional 96 shares of the class the sons were also to receive additional shares of a different class without voting powers to equalize their participation in the corporate earnings. The class B shares were never issued. Dividends were paid by the corporation some time subsequently but the father directed that all four of the former partners were to be paid an equal amount. The Minister contended that such constituted a direction to have income diverted under a provision similar to Sec. 56(2) and though the Trial Division held that no constructive or resulting trust arose due to the fact that the shares upon which the dividends were paid were meant to be owned by the father the Appeal Division held that a resulting trust did exist with respect to the shares issued legitimately in the father's name because they were issued to him as consideration for the sons' interests in the partnership and the agreement called for equal sharing.

In *Brookview Investments Ltd. et. al. v. M.N.R.*²⁰⁸ property was to be purchased for a corporation that had not yet been incorporated and the taxpayers entered into purchase agreements "as trustee for companies to be incorporated". The final purchase agreement, entered into by a lawyer acting for the corporation not yet incorporated, as per Cattanach J., recited: "that Maxwell S. Lewis, as **trustee** for a company to be incorporated, had entered into an agreement to purchase a 60 percent interest in the land in the Township of Toronto, that Armley had been incorporated and that the members of the group had agreed the land was to be purchased in the name of **Armley as trustee for them in their individual capacities**. The operative portion of the agreement then provided that the members agreed to contribute such sums as were required to complete the purchase in the proportions stipulated in the agreement and that **Armley held the land as trustee only for members of the group and undertook to convey the land to the members of the group in accordance with their respective proportionate interest therein as and when called upon to do so by them.**" The land value apparently decreased and the corporation was only partly incorporated, since it didn't issue shares, while the group sought to cut its losses and allowed the letters patent to be canceled by the provincial government while at the same time defaulting on the mortgage payments that were to be made to the vendor on a mortgage secured on the property. Foreclosure quickly followed and the group then attempted to deduct, as a business loss, the lost funds that they had actually pumped into the arrangement. The Minister of National Revenue contended that the corporation had sustained the loss and not the group however the Court found that a bare **trust** relationship existed and that the loss was to be deductible by the group. Justice Cattanach Held:

"Assuming a profit had been realized, such profit would not represent taxable income of Armley, for as Thorson P. said in *Kenneth B.S. Robertson v. M.N.R.*, 1944 Ex. C.R. 170, 184 and approved by Taschereau J, as he was then, in delivering the unanimous decision in *Sura v. M.N.R.*, 1962 S.C.R. 65 at 68:

"...it lacks the essential quality of income, namely, that the recipient shall have an absolute right to it and be under no restriction, contractual or otherwise, as to its disposition, use or enjoyment.""

In the recent UK case of *Singh v Revenue & Customs*²⁰⁹ the First-Tier Tribunal had to consider a situation where a taxpayer had dealt in real estate and had uncharacterized despoits into his bank account and when assessed for hidden income by HMRC the taxpayer contended that they resulted from resulting (or constructive) trust relationships he had with his siblings with respect to the transactions. The Tribunal held:

36. S1 of the Taxation of Chargeable Gains Act 1992 charges capital gains tax on the disposal of

207 1974 C.T.C. 360 FCA

208 [1964] Ex. C.R. 123

209 [2011] UKFTT 584 (TC) (08 September 2011)

assets. The only person who can make a disposal of assets is the owner. Under English law, the owner of an asset and the person who will make a gain from its disposal is the beneficial owner.

37. Mr. Kelly argued that the legal title to the four properties is not conclusive in determining the beneficial ownership of the properties. He asserts that the properties were held by Mr. Singh as nominee, or trustee for himself and his brothers.

38. Section 60 TCGA 1992 provides

'60 Nominees and bare trustees

(1) in relation to [property] held by a person as nominee for another person, or as a trustee for another person absolutely entitled as against the trustee....this Act shall apply as if the property was vested in, and the acts of the nominee, or trustee in relation to the [property] were the acts of the person for whom he is the nominee, or trustee..

(2) It is hereby declared that references in this Act to any [property] held by person as trustee for another person absolutely entitled as against the trustee, are references to a case where that other person has the exclusive right to direct how that [property] shall be dealt with'.

Therefore disposals by nominees and their trustees are attributed to the person for whom they are nominee, or trustee and who is absolutely entitled to the asset. Chargeable gains accrue to the person who is absolutely entitled to the asset, that is, the beneficial owner.

39. HMRC say that section 60 TCGA1992 has no application in this case because they do not accept the assertion by Mr. Singh that the gain made on the disposal of the four properties should be divided between Mr. Singh and either one or both of his brothers.

40. HMRC acknowledge that English law distinguishes between the legal and beneficial ownership of property and that section 60 TCGA 1992 assesses the beneficiary to capital gains tax rather than the legal owner. However HMRC assert that the concept of beneficial ownership is only of relevance where evidence shows that the ownership of the asset has become fragmented in some way and it is shown that expressly or otherwise the beneficial ownership of the property is held by someone other than the actual legal title owner. HMRC contend that the documentation relating to the purchase mortgage and sale of the four properties shows that it was Mr. Singh in whose name the properties were registered and that it was he who mortgaged the properties and received the proceeds of sale.

41. HMRC argue that there is no evidence that a trust existed nor that any oral agreement in that regard between Mr. Singh and his brothers was subsequently recorded or otherwise evidenced in writing. They contend that there is no documentary evidence, legal or otherwise, to show that the brothers of Mr. Singh held any proprietary or beneficial interest in the properties whatsoever.

42. Mr. Kelly acknowledges that there is no formal documentary evidence of a trust but argues that a constructive trust or a resulting trust existed in relation to the four properties and referred the Tribunal to s 53(2) of the Law Property Act 1925.

...

44. S.53 (2) makes it clear that s.53 does not affect the creation or operation of resulting implied or constructive trusts. HMRC, in their statement of case and submissions to the Tribunal, do not address the issue as to whether or not, on the acquisition of the properties by Mr. Singh, a resulting or constructive trust arose in favour of one or both of his two brothers, other than to say that they have not seen any evidence that a trust existed. HMRC says that, 'whilst an agreement could initially be made orally, it must be followed up in writing prior to the disposal of the asset'. No case law authority for this particular proposition was offered by HMRC and it is not one with which the Tribunal would necessarily agree. The Tribunal's view is that, under a resulting trust, the interest held under trust must have been created at the date of acquisition of the property and, in the case of a constructive trust, prior to the property's disposal.

45. Mr. Kelly on behalf of Mr. Singh sought specifically to rely upon the provisions of section 53(2) arguing that a resulting or constructive trust had arisen on the acquisition of the four properties. He referred extensively to the case of *Stack v Dowden* [2007] 9 ITELR 81. In that case, the property in question had been purchased for £190,000 of which Miss Dowden had paid £125,000, the remaining

£65,000 having been met by a mortgage advance. The property was held jointly. The court had to decide firstly whether there was a joint tenancy in equity or a tenancy in common and secondly the proportions of the respective beneficial shares of the parties.

46. This appeal largely turns on different issues. The essential ingredient of both resulting and constructive trusts is 'common intention', that is an intention common to both, the legal estate holder and the claimant to a beneficial interest, that the claimant acquired an interest in the property. The distinction between resulting and constructive trusts is that in resulting trusts this common intention is presumed from the situations which give rise to the trust (see *Gissing v Gissing* [1971] AC 886). Whenever the legal title to land is purchased in the name of one (or more) person, but is actually paid for (in whole or in part) by another (or others), the titleholder will hold on trust for himself and the other contributor in proportions reflecting their contributions. As a general principle the consideration paid or contributed (or at least the common intention which lies behind the payment or contribution) must exist at the time of acquisition of the legal estate. Payment of a deposit by someone other than the legal estate holder would raise the presumption of resulting trust.

47. Resulting trusts are therefore founded on contributions of money towards the acquisition of the legal title to the property. Any other form of contribution would fall under constructive trusts or 'implied common intention', so that for example, mortgage payments made after the acquisition of the property would not be regarded as payments towards the purchase price. Thus, if the intention does not arise until after the acquisition of the legal title, the Courts would normally consider there to be a constructive trust rather than a resulting trust.

48. In this case, Mr. Kelly argues that a presumed intention existed and in consequence a resulting trust arose upon payment of the £52,080 by 'DS' but that a constructive trust also arose which overrode the resulting trust. He argues that a constructive trust arose firstly because of the £52,080 contribution by DS, secondly because of the contributions to the mortgage installments which he contends were partially or even entirely defrayed from cash payments to Mr. Singh's private bank account by 'DS' and 'GS', and thirdly because of the whole course of dealing between the brothers regarding the acquisition and disposal of the properties, evidenced their common intention to own them jointly.

51. HMRC have not sought to argue that there may have been a presumption of advancement in respect of either the £1000 or the £52,080 'deposit monies'. Where equity imposes a moral duty upon one party to provide for another, for example a father to support his child, the doctrine of advancement raises a presumption of gift so that the equitable interests follow the legal title. In such circumstances, no resulting trust will arise in favour of the person who has provided the money. Clearly in this case there is no presumption of advancement with regard to the deposit monies paid by 'DS'.

52. Much of the correspondence with the solicitors acting in the acquisition of the properties and the associated legal documentation, for example the contract and deed of transfer, was not copied to the Tribunal. The copy documentation was limited to the 'client care letter', a letter confirming receipt of contract documentation with a 'pre-exchange of contracts report', a letter enclosing an authority instructing the solicitors to proceed to an unconditional exchange of contracts (despite the fact that a mortgage had not at that stage been arranged), a letter confirming unconditional exchange of contracts and finally a letter following completion of the purchase of the property which enclosed the NHBC insurance certificate in respect of one of the properties.

53. The Tribunal noted that it was 'DS', who initially contacted and instructed the solicitors but on behalf of Mr. Singh and 'GS'. Mr. Singh says that this was because the purchase of the properties was the idea of 'DS' and that because 'DS' had already remortgaged his property for a substantial sum, he would not have been able to participate in the acquisition of the properties and act as a co-mortgagor. The Tribunal also noted that, although the final letter from the solicitors which enclosed the NHBC certificate for one of the properties was addressed to 'Messrs G & T Singh', the property, along with one of the other properties, had by then already been acquired in Mr. Singh's sole name.

54. Following completion, it was Mr. Singh who arranged for the properties to be let and the rental

monies to be paid to him pending a resale of the properties. Rental monies were paid into his private account.

55. A constructive trust will arise where an agreement or common intention can be inferred from all the circumstances. Direct contributions to the purchase price whether initially or for example by payment of mortgage instalments generally justify the inference necessary for the creation of a constructive trust, (see *Passee v Passee* [1988] *Fam Law* 132). However the fundamental question which must always be resolved is whether independently of any inference to be drawn from the conduct of the parties during the course of dealing with the property, there must at some time prior to disposal of the property have been an agreement or understanding between them that the equity in the property is to be shared beneficially. The finding of an agreement or arrangement in this regard can be based on evidence of discussions between the individuals concerned, however imprecise the terms may have been. Once a finding to this effect is made it is only necessary for the contributor to show that he has acted to his detriment, or significantly altered his position on the basis of that understanding or agreement in order to give rise to a constructive trust.

56. Without doubt, a resulting trust arose in respect of the £52,080 contribution by 'DS'. The issue is whether Mr. Singh also held the property on constructive trust for himself and either one or both of his brothers pursuant to their alleged common intention to share the beneficial ownership of the properties. A distinction must be drawn between resulting and constructive trusts when calculating the parties' beneficial shares. A resulting trust only recognises the actual payments made. For a constructive trust there must be a finding of either an implied common intention resulting from a substantial contribution or an express common intention between the parties, of shared beneficial ownership in the property, plus an act of detrimental reliance on that intention by the party or parties not on the title. Only where such a common intention cannot be found can a resulting trust be inferred from financial contributions towards the acquisition of the property. If a common intention and thus a constructive trust is found, a court can ascertain the individual beneficial shares at its discretion.

57. The difficulty in this case is that, whilst it is fairly clear that at the outset the three brothers shared a common intention to purchase the four properties, it is not clear whether that intention continued up to completion of the purchase. 'GS' only provided £1000 towards acquisition costs, but 'DS' says it was he who paid the £1,000. Although it was 'GS' and Mr. Singh who exchanged contracts to purchase the properties, it was Mr. Singh who completed the purchase utilising mortgage funds arranged in his sole name. 'GS' says that he had a bad credit record and that this was the reason he could not act as co-mortgagor whereas Mr. Singh was self-employed and could easily secure mortgage facilities by means of a 'self-certificated' annual income confirmation. 'DS' was not involved in the purchase of the properties at all other than to initially contact the solicitors and provide the 'deposit monies' of £52,080 although of course on acquisition of the properties these monies effectively represented the entire equity in the properties. Perhaps Mr. Singh and his brothers were not advised as well as they could have been as there was no reason why the deed of transfer (form TR1) could not have contained a simple declaration that the beneficial interest in the property was held by Mr. Singh on behalf of himself and either one or both of his brothers in whatever proportions they chose.

58. Although it seems clear that 'DS' was repaid his contribution of £52,080 in one form or another, it is not clear that he was also paid a one third share of the profits. Mr. Singh says that the profit element was paid to 'DS' in small denominations of £200 or £300 by ATM cash withdrawals from his account. 'GS' says he was paid his share of the profits in similar manner. All three brothers say they ended up with a one-third share of the profits but none of them was able to say how much that was after allowing for payment of mortgage interest and acquisition and disposal costs. Significantly, in evidence, Mr. Singh said that he could not specifically remember how the profit was divided. He said it was a 'family transaction' and that he paid money from the proceeds of sale to his brothers as and when they needed it. The application of the proceeds or profits is however a separate matter and irrelevant to how those proceeds or profits were actually owned.

59. Mr. Singh's account of the acquisition of the properties varied throughout the course of the enquiry. Initially, he suggested that the monies paid into his account were a loan but that was at a stage in the enquiry when HMRC were unaware of the capital gain made on the properties. Following the Discovery Assessment, he said that the properties were purchased firstly by himself, then with one brother and their respective wives and then with two brothers and their three wives. Finally, in evidence, he said the properties were purchased by him for himself and his two brothers.

60. Whatever Mr. Singh said to HMRC during the course of the enquiry with regard to ownership of the properties it is clear to the Tribunal that DS would not have remortgaged his property for a substantial sum simply to effect a gift of £52,080 to his brother. It is equally unlikely, given the evidence overall that these monies were intended to be a loan. No loan agreement had been drawn up but that was because there was mutual trust between the brothers. Plainly, DS was interested in the purchase and disposal of the properties in order to make a profit. DS played a significant role in the acquisition of the properties. On the other hand, GS was only peripherally involved and following exchange of contracts took no further part in the transaction.

61. The Tribunal concluded that a resulting trust must have arisen in respect of the £52,080 contribution made by 'DS', but that the resulting trust gave way to a constructive trust derived from the implied common intention of Mr. Singh and DS, as inferred from the whole course of dealing between them and their respective contributions towards the purchase price. However imperfectly recalled and imprecise Mr. Singh may have been in recounting to HMRC exactly on whose behalf the properties had been purchased, it would be unreasonable to conclude that DS was not expecting to receive a substantial part of the profits. Mr. Singh and DS therefore held the beneficial interest in the properties equally. It is unclear whether GS paid £1000 towards the purchase of the properties. It seems clear that there was an intention at one stage that he should share in the acquisition of the properties. However he subsequently withdrew from any involvement and crucially, unlike DS there was no detrimental reliance by him on an agreement that he should participate in the beneficial ownership of the properties. GS therefore had no beneficial interest in the properties.

Having an arrangement recognized as a trust unilaterally by CRA can have very unfortunate tax consequences if the parties have not properly planned for it. In *Fraser et. al. v. M.N.R.*²¹⁰ 95 taxpayers in an investment "syndicate" took their case to the Tax Court when the Minister assessed their investment vehicle as a unit trust and contended that losses it incurred in the mortgage business were not deductible by the taxpayers. For nine years the syndicate had realized business income, since the acting party attending to the activities performed such as an occupation, which the beneficiaries had recognized. The syndicate was set up through the issue of "units" for a par value while the members could have their units redeemed at any time however they could not receive any interest in any mortgage investments held but only cash as proceeds. Control of the investments was maintained by a management company and this control was recognized by the court as "full" control ie; that arising out of full legal and beneficial ownership, while the investors never directly participated in the running of the business but instead investment decisions were executed by the management company only and were not subject to the opinion of the investors. The instigator of this arrangement contended that:

"As participation in the General Mortgage Syndicate represents ownership of an undivided share in the underlying mortgages, every taxpaying participant must report as income his or her share of the mortgage earnings accumulated during each year."

while he also contended that the ownership of the mortgages represented tenancies in common and that "true" trusts did not arise. The Minister contended that an *inter vivos* trust had arose, that the investors were beneficiaries under the trust administered by the management company and that a partnership had not been created since the investors were in no legal position to control the investments or the party controlling the investments.

Garon. T.C.J., found that the fiduciary element needed for the creation of the trust was present:

"A second requirement for the existence of the trust is the existence of a fiduciary relationship. In the present case, the subscriptions from the individual members of the G.M.S. were turned over to Marlowe-Yeoman on the understanding that they are to be used for the purpose of being invested in mortgages." In respect of the taxpayer's submissions of tenancy in common ownership he held:

"I do not agree with that characterization for a number of reasons. First the unitholders **have no control over the property**; it is out of their hands. If **they were co-owners of the property they could assume the management of the property**. This was not possible here having regard to the terms of the offering memorandum dated March 16, 1973 and the restatement of principles relative to the participation in the G.M.S. formulated in the memorandum of January 10, 1979. Secondly, if the investors were tenants in common in respect of the mortgages, they could not withdraw from the syndicate and be entitled upon 30 days notice to an amount representing the value of the share without the consent of the other co-owners. Here there is a right of redemption on notice entitling them to the value of their share minus certain deductions. There was a provision in the contractual arrangements that if funds were lacking, payments will be made to withdrawing members in the order in which requests for redemption were received. There is the further point that this right of repayment was canceled directly by Marlowe-Yeoman in October 1981 without securing the consent of the members of the syndicate. If they were co-owners, how could this be done?"

Garon, T.C.J. concluded that the arrangement constituted a trust and that beneficial ownership did not reside with the investors and that the losses incurred were not deductible by them but only by the trust.²¹¹ On appeal to the Federal Court-Trial Division²¹² the application of Sec. 75(2) was latently forwarded by the taxpayer to allow deduction of the loss but Reed J. held correctly that it applied only to property income and not that from the business of the trust.²¹³ In such a situation, where it is suspected that CRA will recognize as a trust an arrangement that could be proven in court to be such, it would be advantageous, if the investors are to recognize the income from the investment fund yearly, regardless of if it is to be paid to them or not, to arrange the terms of the fund so as to allow subsection 75(2) to apply to it in years when losses are being sustained. If the property or its substitute contributed by the taxpayers can revert to them in specie, be passed to others determined by them, or be precluded from being disposed of without their consent or in accordance with their direction both the trust and the investors will be able to recognize the same loss even though beneficial ownership may not reside with the investors.

²¹¹ See also Case NOS 3-6/1980, (1981) 12 A.T.R 55.

²¹² 91 D.T.C. 5123

²¹³ Unfortunately he considered an absolute reversionary interest necessary for Sec. 75(2) to operate and considered the trust to carry on a business both of which can be argued to be incorrect, latterly as per *Charles Trust v. F.C.T.* etc. in the subsequent chapter "Does it Carry on a Business?" and were mere investment activities. If the fund would have had any of the above three characteristics the decision could perhaps be favorably appealed.

Multiple Trusts.

Subsections 70(6) and 73(1) provide provisions that allow tax-free roll-overs of property to spousal trusts while with the 1988 reform, amendments have been made to section 107 that allow for tax-free distribution of property in satisfaction of capital interests under a personal trust only.

As per Sec. 104(4), testamentary or *inter vivos* spousal trusts, (as well as all other trusts), be they created as such, or in the latter case, take on the spousal nature at anytime, will be required to recognize a deemed disposition of their property at certain times. Just satisfying the spousal characteristics as described in Sec. 70(6)(b) or 73(1) being; that the settlor's spouse must be entitled to **receive** all of the income of the entire trust that arises before her death and that no person other than the spouse may before her death receive or obtain the use of any of the income or capital of the entire trust, is a trying feat, (especially upon examining the technical requirements in the former attribute: the ability **to receive** the income). While there is a method by which a tainted spousal trust having limited "contamination" may be adjusted to qualify for Sec. 70(6) treatment, as provided in Sec. 70(7)-(8), a singular trust created wherein spouse and offspring share entitlement at the same time will never be able to obtain the favourable treatment due to the fact that the trust was created with the disqualifying characteristics. Given that in a testamentary environment, the taxpayer may understandably want to bequeath benefits not only to his spouse but to a lot of other individuals, quite possibly to be held in trust, it would be a waste of the available provisions to give them all entitlements in one residuary estate trust and instead it would be far more advantageous to have a will create multiple separate trusts, one of which has as its exclusive beneficiary the spouse, thereby allowing property transferred to it to obtain Sec. 70(6) treatment. That spousal trust can even have interests in the others so as to allow it to participate more fully for the spouse's benefit. This also relates to the transfer of rights the substance of which have been allowed reserves in computing income as per Sec. 72(2).

It is not solely with respect to obtaining the benefit of the Sec. 70(6) or 73(1) spousal trust provisions that multiple trusts, be they testamentary or *inter vivos*, may be contemplated. Subsection 107(4.1) applies to the distribution of **any** property in satisfaction of a capital interest in a personal trust which was subject, **in respect of any property, at any time**, to Sec. 75(2) attribution by virtue of the fact that the contributor of property retained some degree of control or influence over property held by it, as described in Sec. 75(2), the result being that the distribution will not be as tax-free as that otherwise available in Sec. 107(2) and thus by segregating that contributor influence or control to another separate trust, property in the former trust will not be affected when distributed. Subsection 104(14) allows a preferred beneficiary election to be elected whereby income accumulating in the trust will be recognized by, and taxed, possibly at the lower rates of, a beneficiary however the specific characteristics of the particular trust. Without going into detail about the conditions here, (since they are meticulously covered in a later chapter), it could prove very beneficial if instead of one contaminated trust, whereby the P.B.E. would simply be inapplicable to all beneficiaries, two trusts are instead created whereby at least one trust's preferred beneficiaries will benefit from the election being available.

Since the ITA imposes tax at progressive rates upon marginal levels of income recognized, the more taxpayers to recognize a stream of income the less they will have to recognize individually and consequently the lower the effective tax rate on the economic benefits, in the absolute amount, being realized. Multiple trusts having multiple beneficiaries for which the income is be accumulated can serve an obvious purpose in this case, especially given that an *inter vivos* trust is automatically subject to the highest tax rate of 29%. Thus this instance of multiple trusts should only be considered in respect of testamentary trusts since they incur tax on graduated rates: if a testator can splinter the income flow of multiple properties across numerous accumulating testamentary trusts, all enuring to the benefit of the same set of beneficiaries he is that much farther ahead.

Perhaps one of the best uses of the reasons for creating multiple trusts is that of the insurance against enormous tax consequences to the trust and its beneficiaries, recognizable immediately or over the long term, upon the trust losing its personal status through an ignorant, forced, or voluntary transaction whereby consideration is received either by the trust or a person who made a contribution of legal title of property to the trust as proceeds for the acquisition of an interest in the trust by another party. Also, all trusts have dispositions deemed to occur every 21 years: splintering up ownership across multiple trusts allows for lower rates on any

tax consequences of these instances. Under Sec. 107(2) a distribution of property in satisfaction of capital interests in a personal trust will rarely result in the immediate recognition of a capital loss by the beneficiary where he has purchased his interest in that a legitimately excessive ACB of the interest satisfied will only be tacked on to the tax cost of the property received, (tax cost of the property to the trust previously), as per para.(b). If the single capital beneficiary under a personal trust can recognize as a tax cost of his capital interest a legitimate excessive ACB, inflated as a result of becoming resident and being affected by Sec. 128.1(1) (where the trust isn't resident), or as a result of disposing of and reacquiring the interest, favourably as per Sec. 107(1)(a), (both instances not causing tax consequences to any party), then that high ACB will not have any benefit until the property received from the personal trust in satisfaction of the interest is disposed of whereby it will reduce a capital gain or increase/create a capital loss. If, often the ACB of the capital interest has been systematically inflated, and the trust loses its personal status, (by a token transaction), the single capital beneficiary may be immediately allowed to recognize a capital loss due to the high ACB, of his capital interest as per the distribution provision in Sec. 107(2.1)(c), when property is distributed to him. If the fair market value of the property has declined substantially since the trust acquired it, to being materially less than its ACB to the trust, then a distribution by a **personal** trust, in respect of a capital interest, will defer the recognition of that implicit loss as per Sec. 107(2)(a), while if a **non-personal** trust were to make such a distribution, as per Sec. 107(2.1)(a), the beneficiary would recognize the loss immediately, while so too will the trust.

The use of multiple trusts obviously provides a means with which to alleviate the problem of the loss of a personal status affecting other property held by the trust that would have otherwise obtained favourable treatment upon distribution, if by a personal trust. A loss of a personal status will not only immediately eliminate the existence of any income interests in the trust, (as per the technical definition thereof in Sec. 108(1)), and turn them into capital interests but it will also expose all of the trust's property with respect to the trust, and all of the capital interests with respect to the beneficiaries to deemed dispositions for fair market value proceeds when property is distributed in satisfaction of them. A loss of a personal status will, over the long term, possibly be very expensive to both the trust and its beneficiaries and thus by reducing the property that a particular trust owns, as well as the number of beneficiaries under the trust, through the use of multiple separate trusts, the tax consequences may be significantly reduced, while the other property and beneficiaries are sheltered when one single trust loses its personal status.

It has been held by some fairly high courts that the contribution of property to an *inter vivos* or testamentary trust by a giftor who knows how the trust operates and how the beneficiaries are to benefit creates a trust separate from that the terms of which are being adopted and this would seem logical when the initial settlor cannot create a trust out of the subsequent property he doesn't know will be contributed. The distinction between an augmenting contribution and the settlement of an identical trust may reside in whether the giftor concerns himself with how the beneficiaries are to benefit. Ignorance of such could validate a contribution only.

Subsection 104(2) provides one of the Department's first statutory attempts at blocking such beneficial use of multiple trusts and, in the author's opinion, the provision was solely formulated to hinder the use of multiple trusts as a means of reducing effective taxation of income being recognized. The provision provides that "where there is more than one trust and substantially all of the property of the various trusts has been received from one person, and the various trusts are conditioned so that **the income** thereof accrues or will ultimately accrue to the same beneficiary, or group or class of beneficiaries, such of the trustees as the Minister may designate shall, for the purposes of this Act, be deemed to be in respect of all the trusts an individual whose property is the property of all the trusts." As per the first condition all that is required is that **substantially all** of the property of the trusts, be it legally owned or simply borrowed, be received, (transferred or loaned), from one individual while none of the trusts need be created by that person hence gifts made to trusts may be enough to cause application.

Although the provision doesn't comment on substitute property but only property in its initial form being received from one person, the provision does not specify a time at which the Minister, may designate all as one hence where the trusts initially stated with loaned property the income of which was capitalized, even after the loaned property has been returned the Minister may not be able to make a designation retroactively

applicable to that initial period which will be retroactive through to the present where the property held has not technically been received from one person.

It would seem that the designation must be made in the year in which all of the target property owned by the trust was property received from the one taxpayer and thus if the property of one trust is sold and other property is acquired the taxpayer can set up another trust without fear of the application of Sec. 104(2). All of the property of the initial trust has, at the time of creation of the second, not been received from the taxpayer albeit it is his contribution's substitute. The provision does not refer to substitute property.

Again, this provision need not be of concern only in respect of graduated tax rates applicable to testamentary trusts but also instances of non-rate related issues in the *inter vivos* trust setting.

"Taxed as individual – Sec. 104(2)"

(2) A trust shall, for the purposes of this Act, and without affecting the liability of the trustee or legal representative for that person's own income tax, be deemed to be in respect of the trust property an individual, but where there is more than one trust and

(a) substantially all of the property of the various trusts has been received from one person, and

(b) the various trusts are conditioned so that the income thereof accrues or will ultimately accrue to the same beneficiary, or group or class of beneficiaries,

such of the trustees as the Minister may designate shall, for the purposes of this Act, be deemed to be in respect of all the trusts an individual whose property is the property of all the trusts and whose income is the income of all the trusts.

Thankfully the provision applies only to property received from one person **directly** and not property received **indirectly** from one person through another person or trust. Nor does it apply when the property received has been converted into substitute property at a later time.

The second circumstance which must exist in order for the provision to apply is that the trusts must be conditioned so that **the income** accrues, immediately or ultimately, to the same beneficiary or group or class of beneficiaries and it would appear that the present standing of a trust is irrelevant in light of a past designation made by the Minister when at that time the condition existed. This is an interesting provision since where in the chain of beneficiaries does the Minister measure to make her determination. It's pretty safe to say that since the focus of the provision is the accrual of income rather than income payable it was sought to target those instances where the income was not payable to a beneficiary and those instances where the creation of multiple trusts was in attempt to access lower marginal rates on the total income, but, what beneficiary is to be measured. The focus is on the particular trust and its beneficiary so as long as that trust has a different beneficiary then it would seem not be caught. The provision applies if the trusts are conditioned so that the income accrues or will ultimately accrue to the same beneficiary of all of the trusts **directly**, or group or class of beneficiaries **directly** hence if there exists a sole income beneficiary under trust B, (but not under trust C), who has a right to income from trust B while trust B is sole income beneficiary under trust C the provision will not apply to trust B & C since with respect to those two trusts directly, the sole income beneficiary isn't "the same beneficiary" under both. Trust B has been planted, as a beneficiary, between Trust B and Trust C has been planted, as a beneficiary, between Trust C and the income beneficiary.^{214, 215}

Where the income of the trusts is to accrue to the same beneficiary, or group etc. the provision will apply hence by settling up numerous personal trusts which have as sole capital beneficiaries different parties, and

214. The individual entitlements of each member of the common class under multiple trusts do not have to be equal from trust to trust in order that the provision apply.

215 Until a power of appointment is exercised a common or common classes of beneficiaries is not created. Thus the whole provision can be drastically avoided by simply not vesting the interests until there is need.

by structuring the trusts so that they accumulate their income the provision will only apply at the time where a singular taxpayer acquires all of the singular capital interests and not before hence when Sec. 107(1) offers such a favourable personal trust capital interest disposition provision, (by artificially inflating the ACB thereof), it could prove tax effective to execute this sort of arrangement, (even when Sec. 69(1) is applied to the acquisition of the capital interests).

If the personal trusts are structured so as to hold exclusively non-income producing capital property, which can only be distributed in satisfaction of capital interests, then no income can be realized or accrue, even though the value of the capital property may appreciate, and thus the provision won't be applicable on the grounds that **income**, including recognized capital gains, does not accrue to the benefit of any beneficiary, but an increase in value of the property does.

In the case of spousal trusts it could be argued that where more than one has been created and principally contributed to by a taxpayer they will be considerable as one since the income will accrue to the same beneficiary, the spouse, however it would seem that this argument doesn't take into consideration the intent of the legislators when the provision was enacted. The provision expressly refers to "various trusts are conditional so that the income thereof" accrues to the same beneficiary or group and it doesn't refer to "various trusts are conditioned so that income thereof" accrues to the same beneficiary or group and difference in the two references is subtle but there.

"The income" refers to **all** of the income to ever be realized by the trust while simply "income" without any "the" reference may mean any particular income realized. With this in mind numerous spousal trusts may be set up, with the income accruing in the interim solely to the spouse, however, if after the spouse's death the trusts continue **to exist and earn income for the benefit of distinct beneficiaries** they cannot be caught under Sec. 104(2).

The subparagraph 104(2)(b) condition is satisfied when the income "accrues or will ultimately accrue to the same beneficiary" however it does not state whether it has to be paid to the beneficiary directly or applied for his benefit rather than through his actual receipt. "Accrue" is a particularly vague term in respect of trust entitlements however it could be argued that the basis of application is the beneficiary's ability to receive the income in person. The provision does recognize that the income need not be payable to the beneficiary as it is realized. This provision directly attacks those situations where the income is not payable but held in the trust thus accessing the (testamentary) trust's (graduated) tax rates.

Subsection 104(2) can create absolutely disastrous results when applied to two family trusts, one of which is personal, the other not. In such an instance the consolidated trust will not be personal and thus the property becomes "locked in" pursuant to the effect of Sec. 107(2.1).

In *Mitchell v. M.N.R.*²¹⁶ a taxpayer created four virtually identical trusts one for each of his offspring, whereby the settlor transferred income producing shares to them. The Minister attempted to contend that the four trusts were to be treated as one, as per the Sec. 63(2) (identical to Sec. 104(2)) provision in the pre 1972 Act. The Tax Appeal Board did not agree whereby it was provided:

"I am of the opinion that the facts of this case do not bring it within the ambit of section 63(2) for, even though it could be held that substantially all of the property of the four trusts has been received from the same person, i.e., the appellant, these trusts are not conditioned so that the income thereby accrues, or will ultimately accrue, to the same beneficiary **or group or class of beneficiaries, each trust providing for a different beneficiary.**"

Thus by altering the taxpayers of a group of beneficiaries who are to receive or obtain the use of the income under several trusts so that no two beneficiary groups are identical the application can be avoided.²¹⁷

It is not at the taxpayer's discretion as to whether the provision will apply if the conditions are existing but

²¹⁶ 56 D.T.C. 521 ITAB.

²¹⁷ See Case E21, 73 A.T.C. 164, for a situation involving ten identical trusts clearly based on an income splitting motivation.

only at the Minister's hence a favourable application would be expectedly rare. Given that the provision operates to cause all of the trusts to be recognized as one, if it applied, all of the appropriate trustees of the legally distinct trusts would have to file a singular T3 consolidating the income to be reported and since all of the trusts then, for the purposes of the Act, fuse into a singular trust, all of the distinct trustees, although understandably having little ownership or control over legal trust property other than their respective own, will be identifiable under Sec. 104(1), for purposes of the imposition of liabilities, with the whole of the designated composite trust. This would have serious tax consequences in respect of the Sec. 104(2) PBE, the associated corporation rules, as well as imposing an obligation for income tax on a trustee who has neither control nor ownership of the actual trust(s) property. This can be avoided easily with a holding trust created by the beneficiary out of one of the interests in one of the two initial trusts.²¹⁸

If the Minister deems the trusts to be one then it applies for purposes of the entire Act however what happens when one of the two trusts becomes in common law entirely non-resident? If two unequal size trusts are deemed to be one, and the trustees of the smaller trust, being a technical minority of the aggregate, became non-resident then since the two trusts are deemed one individual and the majority of the control and ownership of that deemed aggregate trusts property still resides in Canada the residence of the deemed aggregate will not have changed. Could the non-resident trust then be varied so that the Sec. 104(2) criterion is not satisfied thus causing the Sec. 104(2) provision to cease to apply? The answer of course depends on whether the designation of the Minister under Sec. 104(2) is of permanent nature or whether it can fail after the trusts have varied and it could be argued that the former would seem to be, unfortunately, as per the statute, more valid. If the designation isn't permanent then favourable attraction of the application of the provision could be created, so that trusts are considered one, after which they could be varied so as to achieve the result wished by the trustees-beneficiaries.

Multiple trusts may be created under the same deed, be they *inter vivos* or testamentary, however if so done, clear unequivocal speech should be used.

Finally, a personal note: if this provision's purpose is to prevent income splintering and accessing of lower marginal rates through creation of multiple testamentary trusts, and it has its origin long before the relatively elaborate associated corporation rules were evolved, it begs the question "Why bother having it?" when its application can be so easily avoided: why not make it a bit more refined to apply to those nebulous instances that it doesn't apply to now (it is a discretionary provision), or, not bother. Sometimes you have to feel sorry for the Minister with her discretions....

Some Cases on Multiple Trusts.

In *MacNeill Estate v. M.N.R.*²¹⁹ the testator provided in his will for the establishment of a trust of 50% of his residuary estate exclusively for his spouse while the remaining 50% was to be held in trust for his offspring however, the testator provided in his will that certain charges relating to a house occupied by his mother were to be levied on "the estate" but he didn't indicate which part of it. The basic question at issue was whether the taxpayer had severed the spousal trust from his general estate, thus sheltering it from the dwelling charge to be levied against "the estate" while the Chairman recognized that on the way the instrument was structured, the intent of the testator had been to sever at least 50% of the estate, unencumbered, for the benefit of his spouse. The will made references to two distinct residue distributions: one creating the spouse's trust, the other for the offspring. Flanigan Q.C. held:

"... placing myself as nearly as possible in the shoes of the testator and, more particularly, in the mind of the testator, I find it difficult to believe that he would have involved himself in such difficulties or gone to such lengths or given such detailed instructions to draft two separate paragraphs under the so-called "distribution of residue" portion of the will, if he did not in fact intend to sever and place aside for his widow at least 50% of his estate."

²¹⁸ See Case K69 (1960) 10 TBRD 364 (Aust.), and *Thomas v. Marshall*, 34 T.C. 178. In order for this to be successful the intermediary trust shouldn't be so bare as to allow the common law to disregard it and have the ultimate beneficiary recognized as such under the top tier trust.

²¹⁹ 73 D.T.C. 189 TRB.

and on those grounds, (the "other" trust was hence charged with the dwelling liabilities), the spousal trust severed and unencumbered was allowed to obtain relief under Sec. 7(1)(b) of the Estate Tax Act, (substantially similar to Sec. 70(6)(b) of the ITA).

In *Kamichik Estate v. M.N.R.*²²⁰ a similar situation arose wherein the will of a taxpayer instructed executors and trustees to hold the residue of the estate in trust and to pay one half of the net revenue to the spouse for life and to accumulate the other half for the offspring whereupon turning 25, it would be distributed to them while upon the death of the spouse the capital would be distributable to the children. The executors attempted to obtain the benefit of Sec. 7(1)(b) of the Estate Tax Act, which is identical to Sec. 70(6)(b) of the ITA, while the Minister contended that while there was only one trust, only 50% and not 100% of its income was payable to the spouse hence Sec. 7(1)(b) could not apply. Flanigan Q.C. of the Tax Review Board quickly held that the granting of administrative powers over the spouse's and the offspring's entitlements to the same executors was irrelevant. In arriving at his conclusion that the testator had created two trusts the Chairman placed considerable significance upon the diction used, particularly the plurality of the designation of "trusts" in the clause granting everyday powers to the executors and that upon the death of the spouse the children were, as per the will, entitled to receive the capital set aside for her, (or what was left at that time).

Clearly, one would not want to leave the interpretation of a will or other testamentary document open to question in respect of the Sec. 104(2) on account of poor draftsmanship and thus it should be obvious that clear unambiguous speech should be used, under a will to create multiple trusts, through the use of clear designations and descriptions.²²¹

In re: *Beaumont*²²² an *inter vivos* marriage settlement was created by a taxpayer and subsequently her father's will directed that his trustees hold "upon the same trusts and with and subject to the same powers ... as are in their respective marriage settlements contained with respect to the funds thereby settled." There were two separate settlers, separate funds and separate sets of trustees while some question arose as to whether there were two separate trusts or merely an accretion to that *inter vivos*. *Hindle v. Taylor*²²³, *Cooper v. MacDonald*²²⁴ and *Trew Perpetual Trustee Co*²²⁵ were cited to support the contention that there were two separate trusts not an accretion though In re: *Perkin's*²²⁶ was put forward to argue that when a testator directs that funds be held "upon the same trusts" and not "upon the like trusts" a blended fund is intended. L.J. Farwell held that since new trustees were directed to execute the trust an accretion was not intended and two trusts arose.²²⁷ Separate trustees of numerous settlements created under a will or by reference to those *inter vivos* was also a conclusive factor in In re: *Wood*²²⁸ where Cozens- Hardy M.R. held:

"What do we find here? We find in this will that there certainly are several distinct settlements with different beneficiaries, with different trusts, and different persons entitled on failure of issue of all of them taking the respective settled funds, and it appears to me they must be regarded as independent trusts. I suggested during the argument what I thought then, and think now, is not a fair test. Could not separate

220 73 D.T.C. 177 TRB.

221 See Case R67, (1966) 16 TBRD 308, Case G20, (1956) 7 TBRD 114, and Re: Munro, 1910 V.L.R. 395. In *McArthur Estate v. M.N.R.*, 74 D.T.C. 1070 (TAB), one trust was found to exist even though as per its terms there was deemed to be two for income computation / entitlement purposes: diction was very indicative and the severance of the fund for income computation did not serve to be so in respect of the interests as well. See also Re: Agar, 1981 N.Z.L.R. 684, Re: Paul's Settlement Trusts, 1920 1 Ch. 99. *Jarmon or Wills*, 8th Ed. 1951, p. 692, for presumption against multiple charges in referential trusts stated in wills.

222 1913 1 Ch. 325

223 5 D.M. & G. 577

224 L.R. 16 Eq. 258

225 1895 A.C. 264

226 1893 1 Ch. 283

227 See also In re: North, 1897 76 L.T. 186. In Re: Hickman's Will Trusts, 1950 2 All E.R. 285, a taxpayer covenanted that upon his death his executors would augment an existing marriage trust of his offspring by £10,000 however when his will directed that £20,000 be given the trustees of the *inter vivos* trust "to be held by them on the trusts of the settlement" "in addition to the sum of £10,000 covenanted by me to be settled upon her by the ... settlement" some question arose as to the destination of the £20,000: whether it was an accretion or a new fund similar to that existing and void due to the death of a beneficiary under it. On the language use, though it was held that as per Re: Campbell, 1922 1 Ch. 551, the donative description "addition" is not conclusively determinative to its manner of receipt, the larger sum was to be treated as an accretion and to pass with the £10,000.

228 1913 2 Ch. 574

trustees have been appointed in respect of each of these funds? I think they clearly could, and counsel for the appellant quite admitted that could be so, at least before there was any grandchild who attained twenty-one or attained a vested interest. If separate trustees might have been appointed of these funds there would be no coalescence; one could not be deemed to be an accretion to the other. If separate trustees had been appointed I know of no process of law by which the one set of trustees could be required to hand over the funds to another set, although the beneficiaries might be the same. It seems to me to be exactly like the case where you have a will and a settlement, or, if you like, two settlements with similar trusts. Can it make any difference that in one particular event at a future date the beneficiaries happen to be the same? In my opinion it cannot. They are still separate trusts although under those trusts in one event, which may or may not happen, the beneficiaries may be the same. I am unable to find on this will any such scheme or any such rule of law or any such presumption as will justify me in saying that the fund, one half of William's one third which went over on this death without issue, is to be treated as a mere accretion to the elder son's share in the sense that all the original powers and provisions, including the hotchpot clause set out in the will with reference to his share, would apply not merely to the original fund, but to the accretion."

In *Re: Paul's Settlement Trusts*²²⁹ a testator directed that £20,000 "be held upon the trusts" settled by a deed executed the same day as the will so that such trusts should "take effect in relation to the said sum of £20,00 in the same manner in all respects as if such sum had formed part of the property originally settled by such indenture". It was held in the Chancery:

"In my judgment the true effect of clause 10 of his will is to make the £20,000 legacy in all respects an accretion to the trust funds originally settled by the settlement of August 11, 1910. The testator does not say that the legacy is to be held on **similar or upon the same trusts** as are declared by that settlement, but bequeaths it to the trustees of the settlement upon **the** trusts and with and subject to **the** powers and provisions therein declared concerning the trust funds thereby settled; and then, to place his meaning beyond doubt, he adds that the trusts and powers of the settlement are to take effect in relation to the legacy in all respects **as if it had formed part of the property originally settled**. In my opinion the testator could hardly have used clearer words in which to express his intention to make the bequest operate so that the legacy should form part of the trust fund settled by the settlement and should not form an independent trust fund settled by his will."

In *Fraser or Robinson v. Murdoch*²³⁰ executors were given the power to appropriate portions of residue and hold on several trusts in satisfaction of legacies created by the will and once this was validly done one of the funds suffered a loss which the beneficiary contended could be equalized with assets from the other fund. Lord Watson held with respect to the result of the exercise of the power:

"The real question in this case, according to my apprehension of it, comes to be - What was the effect of the severance of the two legacies upon the right of indemnity competent to these trustees so long as they held, and were justified in holding, the trust estate as an undivided whole? I cannot agree with the opinion expressed by the late Lord Ormisdale, one of the two judges composing the majority of the Second Division, to the effect that the appropriation of the stocks held by the trustees consisted of mere book entries made for the convenience in dealing with the interest of the life-rentors, Mrs. Sinclair and Mrs. Robinson. The appropriation of these stocks, if authorized, as I hold it to have been, by the terms of the trust deed, was an act of administration which the trustees of themselves had no power to undo. The immediate effect of that act was to alter the pecuniary interest of the two sets of beneficiaries concerned, and the relations subsisting between them and the trustees. The beneficial interests of Mrs. Sinclair and her issue on the one hand, and of Mrs. Robinson and her children on the other, were henceforth limited to the stocks severally assigned to them, and the trustees ceased to be under any liability to account to either life-rentrix and her children for the stocks appropriated to the others. Two trusts were created instead of one, with separate funds, and different beneficiaries having no community of interest. Such being the legal result of the appropriation, it is, in my opinion, immaterial whether the

229 1920 1 Ch. 99
230 1881 6 A.C. 855

authority to constitute these two trusts was derived from one and the same deed, or whether each was constituted by virtue of a separate deed under the hand of the testatrix."

Pexton v. Bell & Anor, Crowe v. Appleby²³¹ is illustrative of the underlying principles of appropriation powers. In the former case on the life tenant's death the trust fund in which he was interested was to suffer a deemed disposition in a manner similar to Sec. 104(4) of the ITA. Due to the diction used in the legislation some question arose as to how extensive and in respect of which assets the life interest was based. The will setting out the trust provided that the fund was to be held in trust for such of the testator's male offspring as attained the age of 25 and female offspring as attained the age of 21 or married. Each offspring's share was to be separately invested. The will further proceeded, "Nevertheless as to the share of every daughter of mine in my trust property I direct that the same shall not be paid to her but shall be retained by my trustees upon the trusts herein after declared concerning the same that is to say - As to the share of every such daughter separately upon trusts to invest the same pursuant to the clause concerning investments hereinafter contained and upon further trust to pay the income of such share and the investments thereof for the time being (which are hereinafter referred to as 'the portion of my said daughter') to my same daughter without power of anticipation during her life" with certain subsequent gift overs to grandchildren. Unfortunately the trustee did not make an appropriation of the shares of the daughters out of the fund to meet each interest as it sprang up on the attaining of the age and when one died the tax assessors contended that the whole fund was to suffer a disposition for FMV proceeds while the taxpayers contended that the whole fund wasn't assessable, only the proportion of the particular life tenant's interest in it (in accompany with others) pending the appropriation. Sir John Pennycuik held:

"Mr. Taylor, for the taxpayer in the case, relied on the further point raised in his cross-notice. He expressed this further point (unless I misunderstood him) in these terms:

"(1) Pending appropriation Mrs. Robert's share consisted of one fourth off each specific asset, that is to say, the mortgage and the money on deposit; and (2) the testator himself expressly created separate settlements."

So far as the first of these contentions goes, I do not think it really solves the problem. I will assume that, pending appropriation, each of the beneficiaries should be treated as entitled to a fourth of each specific asset, in contradistinction to a fourth of the fund as a whole. But, even if one goes down to the blocks of shares or single shares, the fact remains that pending appropriation, the shares are still held for the four tenants in common in undivided shares and no item of property, not one single share, could be said to belong exclusively to one of the settled shares."

...

"I should mention one further difficulty in the way of Mr. Potter's contentions, namely, that it would make the charge of duty depend upon the purely administrative acts of the trustees by way of appropriation or omission to appropriate. Liability for tax frequently follows from the exercise of a discretion of trustees affecting beneficial interests, but the Court is normally reluctant to make liability to tax depend on purely administrative acts of the trustees."

...

"Mr. Millett contended that under a disposition in the present form the settlor creates not a single settlement but several distinct settlements, namely the, first, a settlement of a trust fund upon his children as tenants in common absolutely and, secondly, a separate settlement upon each child of the share of that child upon trusts for the child and his children. I do not think this is a correct analysis of the position. It is, of course, competent for the owner of an undivided share in property to make a settlement of that share; and I do not doubt that, if he does so, that would be a different settlement distinct from the head settlement which creates the undivided share. **But where the trusts of each share are declared by the settlor himself, then I think there is a single settlement upon the totality of those trusts and a single trust fund subsisting until it is broken up by the payment out or appropriation. In deed, the settlor could not achieve his purpose otherwise, since, once he had divested himself of the ownership of the fund by settlement upon his children as tenants in common without more ado,**

231 51 T.C. 457 (CA)

it would no longer be open to him to declare trusts of those shares by s different disposition."

Case U111²³² illustrates a taxation tribunal's approach to the appropriation which give rise to separate trusts out of current income. In that case the trust deed specified that the trustees were to have the absolute discretion of deciding what amount of income would be distributable in the future to the beneficiary and the Appeals Tribunal held that once such a power was exercised a new trust, distinct from the head trust, was created. Case U4²³³ illustrates a sub-trust creation where amounts are credited and create a sub-trust, the head trust apportions interest in respect of the credit balance in the account and takes a deduction while the sub-trust recognizes "interest" income. There were held to be two distinct trusts.²³⁴ A concrete adjustment in the scope of a power of advancement requiring its exercise has been held not have created a new trust.²³⁵

In the case of any testamentary disposition where multiple trusts are to be created accurate diction should be used to convey the settlor's desire that multiple distinct units with independent interests be created.²³⁶ In the case of *inter vivos* dispositions equally clear terms should indicate whether the existing trust disposition should apply to that being made or that the disposition not augment that existing but that the terms of that existing be adopted to govern the disposition as if creating a new trust.

²³² 87 A.T.C. 667

²³³ 88 A.T.C. 123

²³⁴ See also Case V53, 88 A.T.C. 403, Case U157, 87 A.T.C. 912, and Vestey's Exors. v. I.R.C., 31 T.C. 1.

²³⁵ Case U202, 87 A.T.C. 1129. See also "Unravelling the Confusion", Tax'n in Aust., Aug. 1990. P.D. Giugni. See additional comments in the Chapter Preferred Beneficiary Election, "Who creates the trust".

²³⁶ See Special Powers of appointment in a following chapter for special considerations.

The Taxation Year of A Trust.

The taxation year of an *inter vivos* trust varies considerably from that of a testamentary trust owing to the substance of Sec. 104(23)(a) which provides that the taxation year of a testamentary trust will be the period for which the accounts of the trust (or estate) have been ordinarily made up and accepted for purposes of assessment, while in the absence of an established period, the period adopted by the trust for that purpose which cannot exceed 12 months.

In the absence of a similar provision in respect of *inter vivos* trusts, the taxation year thereof will be that provided in Sec. 249(1)(b) being the calendar year since an *inter vivos* trust is considered an individual.

“Testamentary Trusts – Sec. 104(23)”

(23) In the case of a testamentary trust, notwithstanding any other provision of this Act the following rules apply:

(a) the taxation year of the trust is the period for which the accounts of the trust have been ordinarily made up and accepted for purposes of assessment under this Act and, in the absence of an established practice, the period adopted by the trust for that purpose (but no such period may exceed 12 months and a change in a usual and accepted period any not be made for the purpose of this Act without the concurrence of the Minister);

(b) when a taxation year is referred to by reference to a calendar year, the reference is the taxation year or years coinciding with, or ending in, that year;

An executed trust is fully constituted only after the three certainties exist and thus until all of them are clear the trust does not come into existence and thus its taxation year does not begin until that time however in the instance where the testamentary trust consists of an unadministered estate, regardless of whether or not the taxpayer died intestate, the "testamentary trust" will be treated as constituted immediately after his death, even though the residuary estate, being the technical trust, has not been constituted.²³⁷

As per *Anning v. Anning*²³⁸ in order for an *inter vivos* trust to be constituted via a transfer to another party the gift creating it must be perfected and this, in equity, can occur only if the transferor has done all of those acts which he is obliged to do personally, or, that he must have done all of the acts possible or that must have ensured that the acts were done so as to make the conveyance.²³⁹ There must be an effective passage of legal title of the property while the manner in which such can occur isn't important.

In *Milroy v. Lord*²⁴⁰ the taxpayer wished to convey shares to a trustee on trust for certain beneficiaries and although the share certificates were delivered the formal conveyance method, an entry in the registry of the company, had not been completed when dividends were received. The Lord Justices held that the trust failed, (and implicitly that the transferor also did not intend to act as executory trustee), due to the imperfect gift. The courts will not step in to complete an imperfect gift where the settlor has expressed merely an intention to create a trust but has not acted on that intention to create via the concluding act of legal conveyance.²⁴¹ This

237. In the case of executory trusts, the transfer of property/provision for transfer of valuable consideration is the act that initiates the arrangement and it should, in the author's opinion, be considered as the time at which the trust is created and thus the beginning of its tax year. The fact that beneficiaries and their interests are decided upon subsequently should not cause the subsequent trust to be recognized as different, **for taxation purposes**, from the executory one.

238 4 C.L.R. 1049.

239 See *In re: Rose*, 1952 1 Ch. 499.

240 45 E.R. 1185.

241 See the Aust. case of *JACA Nominees Pty Ltd v Waldarra Pty Ltd & Anor* [2010] VSC 546 (2 December 2010) where, concerning a sale gone wrong that:

129 In *Shepard v Doolan* (2005) NSWSC 42. White J provided a useful summary of the applicable principles.

34. Where a constructive trust is imposed, based upon the parties' common intention as to the ownership of property upon which the claimant has acted to his or her detriment, the inquiry is as to the actual intention of the parties. The law does not impute a presumed intention to the parties based upon

was the case in *I.R.C. v. Allan*²⁴² where a taxpayer wished to create a trust out of shares held personally, expressed such to the beneficiaries and disclosed of such to the corporation's directors, but did not execute any trust declaration so as to give the intention legal effect. Dividends were received and until the deed was

what the Court considers fair and reasonable persons in the position of the parties would have intended had they turned their minds to the issue. (*Pettitt v Pettitt* [1969] UKHL 5; [1970] AC 777 at 804, 810, 810, 816-817; *Gissing v Gissing* [1970] UKHL 3; [1971] AC 886 at 900, 902, 905-909; *Allen v Snyder* [1977] 2 NSWLR 685 at 690, 698, 701).

35. It is unnecessary to enter the debate as to whether a trust based on the parties' common intention is properly characterised as a constructive trust, or whether it should be characterised as an express trust which is enforceable notwithstanding the want of writing as it would be an equitable fraud for the legal owner to rely on the absence of writing to deny the beneficiary's interest. (*Allen v Snyder* at 692-3; 699). In later cases, eg *Grant v Edwards* [1989] CH 638; *Maharaj v Chand* [1986] AC 898 at 907; *Green v Green* (1989) 17 NSWLR 343; *Brandling v Weir* [2003] NSWSC 723; *Parianos v Melliush* [2003] FCA 190; (2003) 30 Fam LR 524, this class of trust has been classified as a constructive trust, even though it is based on the parties' actual intentions, rather than imposed despite their intentions.

36. The intention to be established need not be that the parties have a specific share of the property. It is sufficient that they intend that the claimant should have a beneficial interest or "some form of proprietary interest". (*Green v Green* at 355, 356; *Grant v Edwards* at 654; *Parianos v Melliush* at [31], [39]).

37. The intention may be established in various ways. There may be an agreement between the parties as to how the property should be held. There may be express statements as to their intention. There intention may be inferred from their conduct. The question of what acts demonstrate an agreement or common intention referable to the beneficial enjoyment of the property is one of evidence, not law. *Allen v Snyder* at 691; *Green v Green* at 355). A common intention that a party have a beneficial interest in a property owned by another will not be inferred merely from their joint occupation of property, nor the carrying out of household duties, nor the bringing up of children on the property, nor the doing of repairs, renovations, maintenance, decoration or improvement, nor the provision of furniture. (*Pettitt v Pettitt* [1969] UKHL 5; [1970] AC 777 at 805-6, 811, 181, 826; *Gissing v Gissing* [1970] UKHL 3; [1971] AC 886 at 900, 910; *Burns v Burns* [1984] Ch 317 at 326, 328, 342).

38. The intention may be inferred from financial contributions, direct or indirect, to the acquisition of property, including the paying off of mortgages, or the payment of expenses which free up funds for that purpose. (*Burns v Burns* at 328-329; *Gissing v Gissing* at 900, 902-3, 906-907; *Grant v Edwards* at 647, 648-9, 653-4, 655; *Green v Green* at 355). This is a wider enquiry than whether a contribution was made to the purchase money such as to give rise to a presumption of a resulting trust. Whilst both enquiries address the inferences to be drawn as to the parties' actual intentions, a contribution to the purchase price creates a presumption of beneficial ownership in the proportion which the amount contributed bears to the price. For a "common intention" constructive trust, a contribution, direct or indirect, to the costs of acquisition of the property is a matter from which an intention that the claimant have a beneficial interest in the property might be inferred. There is a difference between a fact from which an inference can be drawn, and a fact from which a rebuttable presumption arises. The significance of the difference will depend upon the strength of the presumption. In the case of the "common intention" constructive trust, there is no presumption that the beneficial interest is in proportion with the contribution on the purchase price.

39. Other evidence from which conclusions may be drawn about the intentions of the parties include declarations of the parties before or at the time of the transaction or so close in time after the transaction as to constitute a part of it. Subsequent declarations of intention are only admissible against interest. (*Calverley v Green* [1984] HCA 81; (1984) 155 CLR 242 at 262 and 269; *Charles Marshall Pty Ltd v Grimsley* [1956] HCA 28; (1956) 95 CLR 353 at 365; *Bryson v Bryant* (1992) 29 NSWLR 188 at 215).

40. The plaintiff must also show that she acted to her detriment in a way referable to the agreement or intention that she have an interest in the property. *Austin v Keele* (1987) 10 NSWLR 283 at 291; *Grant v Edwards* at 648; *Carruthers v Manning* [2001] NSWSC 1130 at [124]. Conduct which is insufficient to establish a common intention as to the ownership of the property may be insufficient to constitute relevant actions to the plaintiff's detriment to establish a trust if the common intention is established otherwise. Conduct may be both the evidence from which an intention that the plaintiff have a beneficial interest can be inferred and the act of detrimental reliance.

In the case the judge went on to find that with the most minimal documentation there was an agreed express trust dictated in its terms.

242 9 T.C. 234 (HL).

actually endorsed they continued to be his income.²⁴³ See also *Baldassarra v. M.N.R.*²⁴⁴ where incorporation subscribed for shares for 40 offsprings in what was contended to be a trustee capacity however the Tax Court found that since there was no evidence of a declaration of trust, receipt as trustee, or the use of trust funds to acquire the shares, a mere intention that the offsprings benefit was insufficient. *Milroy v. Lord* was expressly cited.

As per *Williams v. C.I.R.*²⁴⁵ property not presently owned cannot be conveyed by gift, assigned, or imposed with a trust though it may be subject to an agreement to impress it with a trust once it comes into the hands of the assigner.²⁴⁶ This is the second rule arising out of *Milroy v. Lord*: the transferor must have done everything which according to the nature of the property is necessary to convey it. Future property cannot be conveyed by nature.²⁴⁷ Equitable interests may be transferred if intention is sufficiently clear though, **unless** statutorily required, no legal conveyance method need be adhered to.²⁴⁸ There are two exceptions to perfect an otherwise imperfect gift;

- 1) the purported donee is made executor of the gift,²⁴⁹ and
- 2) equitable estoppel, where possession is granted to the donee without legal conveyance and with the implied or explicit assent of the donor the donee invests on the faith of the gift.²⁵⁰

If a will provides that from the initial estate certain property is to be conveyed to certain trustees on trust then the testamentary trust will arise only when the property can be conveyed clear of testamentary encumbrances which may have been assigned to it as per the will and when the executors have assented to the conveyance.

Upon the execution of a will and the continual administration of an estate there could be a multitude of concurrent T3s to file, corresponding to the estate itself and any severed testamentary trust that has arisen out of it. Although the Sec. 108(1)(i) definition of testamentary trust includes both estates and trusts it would be foolish to equate a true trust arising out of the estate that is not in the form of the residue to being equivalent to the estate itself for purposes of determining a tax year which depends upon the time of creation since clearly one is created later than the other. An estate comes into being at the moment after the time of death and the final residuary estate, being technically a trust, may take years to ascertain.²⁵¹

It may prove quite beneficial to surviving beneficiaries to have several pure trusts arise out of an estate, each with a different time of creation and resultingly different tax year, (as per Sec. 104(23)(a)), many of which may be inter-connected through discretionary income beneficiary-trust relationships so as to allow the deferral of the recognition of the income actually being realized.²⁵² They will also come in extremely handy in a spousal situation as the deemed disposition provisions in Sec. 104(4) will not have much effect on a trust that owns no, or small amounts of, property, and thus a trust-beneficiary distribution just prior to the applicable date will allow for the avoidance of the effect of that onerous subsection. Since the trusts will be usually "testamentary"

²⁴³ See *F.C.T. v. Clarke*, 40 C.L.R. 246 (HCA), for mere promises and incomplete legal steps, as well as *Arthur v. Public Trustee*, 1988 90 F.L.R. 203.

²⁴⁴ 91 DTC 289 (TCC)

²⁴⁵ 1965 N.Z.L.R. 395 (CA).

²⁴⁶ See *Norman v. F.C.T.*, 109 C.L.R. 9 and *Blair v. C.I.R.*, 1936 300 U.S. Rep. 5.

²⁴⁷ In *Case No. B-26-31*, 75 A.T.C. 303, a taxpayer shareholder held shares in a closed corporation the articles of which precluded the shares from being held by anyone but specified shareholders, (registered pharmaceutical chemists). The taxpayer entered into an agreement to sell them to his family holding corporation and executed a trust deed to this effect, holding them in trust for the corporation, but the dividends paid to him as trustee were assessable in his hands since he continued to hold the shares as shareholder albeit trustee. See also *Hollycock v. Comm. of Taxn.*, 71 A.T.C. 4202, for application of anti-avoidance provisions to similar arrangement entered into to split income. For other problems in complete conveyances see *Taylor v. Dep. F.C.T.*, 1969 1 A.T.R. 97, and for retroactivity of expressions; *J.W. Broomhead v. J.W. Broomhead*, 1985 V.R. 891 at 921 and 923.

²⁴⁸ See *Comp. of Stamps v. Howard-Smith*, 54 C.L.R. 614, and *Grey v. I.R.C.*, 1960 A.C. 1.

²⁴⁹ *Strong v. Bird*, 1874 L.R. 18 Eq. 315.

²⁵⁰ See *Bouchard v. The Queen*, 83 D.T.C. 5193.

²⁵¹ All testamentary trusts are not created immediately under the will of a testator; one only has to examine the case of general powers of appointment given to executors and their ability to create trusts, if the power is properly delegated, for an example.

²⁵² Their creation may be based on the occurrence of a contingent event so that relation back to the time of death may not necessarily result.

they will not cause Part XII.2 tax to apply.

Residuary trusts arise when the residue is ascertainable. Specific bequest trusts relate back to the moment immediately after death and trusts based on contingent events or that can be created with the exercise of properly delegated discretionary powers arise when the event occurs or the power is exercised.²⁵³

The fact that an executrix has disclaimed her office or testamentary trustee has no her office has no bearing on the tax year of the arrangement: it exists regardless of whether a party exists to attend to its functions.

Where a person dies without a will, (or other similar testamentary document), concerning certain property formerly held he is considered to have died either wholly or partially intestate however he is still considered to have an estate identifiable with the person who has control, (possession or de jure), over the intestate property, and the estate is considered to have arose immediately following his death, even though it still has to be processed through the courts, but its tax year commences at that date. If the Courts provide, under the appropriate provincial statutes, that a trust is to be set up for dependants out of property in the estate that trust begins as at the date of the court order and not retroactively, (unless the order or specific statute specifies otherwise), hence even when there isn't a will there can be some manipulation (albeit limited control), of the taxation years of the entities resulting in the intestate situation.

Subsection 104(23)(a) provides that the tax year of a testamentary trust will be the period for which the accounts of the trust have been ordinarily made up and accepted for purposes of assessment while in the absence of such a practice, the period adopted by the trust for that purpose while a change in a usual and accepted period may not be made for the purpose of the Act without the concurrence of the Minister. There may be significant advantages in playing around with the fiscal period of an estate or trust, (such as deferral of income recognition), but upon a review of I.T. 179, the Department's overall opinion can be ascertained to be that there would have to be a good reason, other than personal convenience or deferral of tax, in order for the Minister to concur with a change. With respect to corporations and businesses the Department considers as valid reasons for a change in fiscal periods the alignment of fiscal periods with parent or associated corporations or the alignment with seasonal low levels of inventory or slack operational periods, however it does not provide examples of acceptable reasons for the change in the fiscal periods of testamentary trusts which is clearly allowed as per the wording in Sec. 104(23)(a).

A valid reason could include the terminal ascertainment of the unencumbered property of an administered estate which then becomes fully subject to the beneficiaries' entitlements, in that the form of the entity has been altered significantly, as well as its accounting.

Another valid reason for a change, similar to that in the case of corporations, is the alignment of fiscal periods of trusts created under a will or intestate court order so as to facilitate more comprehensive and a manageable accounting by mutual trustees while variations of the trust's terms should also serve as valid reasons.

Where the trust's sole activity is the carrying on of a business then it could also alter its fiscal period on the same basis normally afforded proprietorships; alignment with low inventory levels or seasonal slack periods. I.T. 179, para. 4(e), provides that a request for a change in fiscal periods need not be forwarded when an estate or trust is wound up, however, it could be valid reason, to alter a fiscal period, when a trust is varied through statute law/court order approaches so as to allow it to carry on initially prohibited activities such as a business, or incorporation of activities, et cetera.

The basic necessity for a change to be allowed is that it can be demonstrated to be prompted solely by sound business reasons, (other than the obvious two previously disclosed), and since a testamentary trust is usually a non-business focused entity the Department would most likely accept non-business reasons which harbour the same degree of legitimacy.

Since under subdivision k, an estate is equated with a trust, and since Sec. 104(23)(a) refers only to trusts it would appear that the draftsmen provided for the continuation of the estate's tax year even when a trust had

²⁵³ See Re: Batty, 1952 1 All E.R. 425 (Ch). In Estate of Tolley, 1972 5 S.A.S.R. 466, Brougham v. Poulett, 52 E.R. 294, Burke v. Dawes, 59 C.L.R. 1, and Halsbury's 4th Ed., Vol. 50, para. 612.

been ascertained, otherwise the subsection would have been placed outside of subdivision k. In the author's opinion, a testamentary trust arising out of residue will not be allowed to **automatically** apply for a tax year different from the estate simply because it's a trust and not an unadministered estate. Subsection 104(23) must be read within the context of subdivision k which equates estates and trusts and thus there is little argument to recognize functions and duties of executors and trustees as distinctive for purposes of subdivision k. Outside of the subdivision, the Department and the taxpayer can treat estates and trusts as distinctive, but within the subdivision they cannot. The continuity of the tax entity within subdivision k is inferred.

Income Tax Interpretation Bulletin

Change of fiscal period

IT-179R

DATE: May 28, 1993

SUBJECT: INCOME TAX ACT

Change of fiscal period

REFERENCE: Subsection 248(1) (also subsections 25(1) and 99(2); paragraphs 87(2)(a), 104(23)(a), 128(1)(d) and 128(2)(d))

Application

This bulletin cancels and replaces Interpretation Bulletin IT-179 dated September 23, 1974 and the Special Release dated June 13, 1986. Current revisions are indicated by vertical lines.

Summary

This bulletin discusses the criteria which apply and the procedure to be followed when a taxpayer requests a change in the fiscal period of a business. The bulletin also notes several events which can cause a change in the fiscal period by operation of law.

Discussion and Interpretation

1. "Fiscal period" means the period for which the accounts of the business of a taxpayer have been ordinarily made up and accepted for assessment purposes under the Income Tax Act. A fiscal period of a corporation must not exceed 53 weeks, whereas a fiscal period for other taxpayers must not exceed 12 months.

2. According to the definition of "fiscal period" in subsection 248(1), a taxpayer may not change the usual and accepted fiscal period without approval (see 3 and 4 below). This requirement is to prevent taxpayers from rearranging their fiscal periods primarily to minimize taxes. Requests for changes in fiscal periods will be approved if they can be demonstrated to be prompted solely by sound business reasons other than obtaining tax benefits. On the other hand, there are various events which can cause a fiscal period to terminate prematurely by operation of law, and such changes in fiscal period do not require approval (see 5 below).

REQUESTED CHANGE IN FISCAL PERIOD

3. Each request for a change of fiscal period is reviewed on its own merits. "Sound business reasons" normally include the following:

- a) A corporation changes its fiscal period to end on the same date as that of its parent or associated company.
- b) A business changes its fiscal period to end when its inventory is at a seasonally low level or within a seasonally slack period.
- c) A taxpayer has transferred property used in carrying on a business to a corporation under section 85 or to a partnership under subsection 97(2) and changes the fiscal period of the business to end on the day immediately before the day of transfer. This is acceptable where the only purpose for such change is to enable capital cost allowance to be deducted in the last fiscal period ending before the transfer and the transferor and transferee are not both entitled to claim capital cost allowance on a particular property for a common time period. (Refer to the current version of IT-172, Capital Cost Allowance - Taxation Year of Individuals.)

Neither the personal convenience of the taxpayer nor, for the purposes of this paragraph, the saving or deferment of income taxes is accepted as a sound business reason. Normally a retroactive change will not be approved.

Procedure for Requesting Change

4. A taxpayer other than a registered charity or registered Canadian amateur athletic association should submit a written request for approval of a change in fiscal period to the Director of the local district taxation office. A request by a registered charity or registered Canadian amateur athletic association should be referred to:

Director,
Charities Division,
Revenue Canada, Taxation,
Ottawa, Ontario,
K1A 0L8.

The request should be accompanied by a written statement (signed by the taxpayer or the taxpayer's representative) explaining the reasons for the change.

CHANGE IN FISCAL PERIOD - OPERATION OF LAW

5. Requests for a change in fiscal period are not required where the fiscal period is revised by operation of law. Also, the filing of certain valid elections under the Act will extend the fiscal period beyond the date that would be applicable if there were no such election. The following events can result in a change to the current fiscal period:

- (a) A sole proprietor dies or disposes of a business, or an election is made under subsection 25(1) to retain the normal year-end for a business disposed of by an individual proprietor.
- (b) A partnership ceases to exist (see 6 and 7 below) or a partner elects to retain the normal year-end of the partnership pursuant to subsection 99(2). (See the current version of IT-358, Partnerships - Deferment of Fiscal Year-End.)
- (c) A corporation becomes bankrupt (see 10 below).
- (d) An estate or trust is wound up.
- (e) Taxable Canadian corporations are amalgamated as described in subsection 87(1) and accordingly paragraph 87(2)(a) applies.
- (f) A Canadian corporation is wound up as described in subsection 88(2) and accordingly subparagraph 88(2)(a)(iv) applies.
- (g) Control of a corporation is acquired and paragraph 249(4)(d) applies.

OTHER COMMENTS

Death of a Partner

6. A partner's fiscal period with respect to a partnership ends when the partner dies, whether or not the partnership ceases to exist. Approval to change the fiscal period of the partnership is not required if the partnership ceases to exist. However, approval would be required if the partnership did not cease to exist and it decided to end its fiscal period on the date of the partner's death.

Termination of Partnership

7. Pursuant to subsection 99(1), the fiscal period of a partnership is deemed to end immediately before the time the partnership ceases to exist, even where subsection 98(1) deems the partnership not to have ceased to exist because of an incomplete distribution of partnership property.

Receivership

8. The fiscal period does not end automatically when the business carried on by an individual or a corporation is placed in the hands of a receiver, liquidator or trustee (other than a trustee for a corporation in bankruptcy - see 10 below).

Bankruptcy of an Individual

9. If the business is disposed of or ceases in the course of bankruptcy, the fiscal period would end at that time. However, if the business operated by an individual is carried on during bankruptcy, the bankruptcy would not of itself cause a change in the fiscal period.

Bankruptcy of a Corporation

10. Where a corporation becomes a bankrupt during a fiscal period, paragraph 128(1)(d) provides that the current taxation year is deemed to end on the day immediately before the day it becomes a bankrupt, and a new taxation year is deemed to commence on the day it becomes a bankrupt. Since the taxation year is the fiscal period, the effect of this is to cause the current fiscal period to be deemed to have ended.

Lapse of a Corporation's Charter

11. Where a corporation's charter lapses but is later reinstated, and in the meantime operations are continued as usual in the corporation's name, the corporation should continue to use the fiscal period which it established before the lapsing of its charter.

Fiscal Period Longer Than 365 Days

12. No change is considered to occur where a corporation follows the practice of ending its fiscal period on a chosen day of the week that is nearest to a certain day of the year, provided that the resulting period does not exceed 53 weeks.

Accounting Period versus Fiscal Period

13. A change in the year-end for accounting purposes will not automatically result in a change to the fiscal period for tax purposes. Although normally the year for accounting purposes coincides with the fiscal period for income tax purposes, there is no requirement for this to be so. If the taxpayer wishes to change the accounting year and have the fiscal period coincide with that year, a request should be made to change the fiscal period.

If you have any comments regarding the matters discussed in this bulletin, please send them to:

Director, Technical Publications Division
Legislative and Intergovernmental Affairs Branch
Revenue Canada, Taxation
875 Heron Road
Ottawa, Ontario
K1A 0L8

Constructive Trusts.

A constructive trust in Canada has primarily taken the form of an equitable remedy imposed by the Court for "unjust enrichment" wherein the "enriched" party will stand as trustee to the "deprived" party in respect of subject property allowing the rules of trusts to be applied to the arrangement, however, it must be recognized that though the constructive trust to be applied to the arrangement is an entity of the Courts it comes into existence not as a result of their action but as a result of the unjust enrichment.²⁵⁴

In *Pettikus v. Becker*²⁵⁵, Dickson J. provided a fairly accurate description of a constructive trust in a matrimonial dispute context:

"In *Murdoch v. Murdoch*²⁵⁶ Laskin, J. as he was then introduced in a matrimonial property dispute, the concept of constructive trust to prevent unjust enrichment. It is imposed without reference to intention to create a trust, and its purpose is to remedy a result otherwise unjust. It is a broad and flexible equitable tool which permits courts to gauge all the circumstances of the case, including the respective contributions of the parties, and to determine beneficial entitlement. It is described this way in *Rathwell*²⁵⁷ at page 455:

"The constructive trust, as so envisaged, comprehends the imposition of trust machinery by the court in order to achieve a result consonant with good conscience. As a matter of principle, the court will not allow any man unjustly to appropriate to himself the value earned by the labors of another. That principle is not defeated by the existence of a matrimonial relationship between the parties; but for the principle to succeed, **the facts must display an enrichment, a corresponding deprivation, and the absence of any juristic reason, - such as a contract or disposition of law - for the enrichment.**"

Although the resulting trust approach will often afford a wife the relief she seeks, the resulting trust is not available, as Professor Waters points out: "where the imputation of intention is impossible or unreasonable." One cannot imply an intention that the wife should have an interest if her conduct before and after the acquisition of the property is "wholly ambiguous", or its association with the alleged agreement "altogether tenuous". Where evidence is inconsistent with resulting trust, the court has the choice of denying a remedy or accepting the constructive trust."²⁵⁸

Such an arbitrarily assigned relationship by the courts could come in the form of a remedy for agent-principal disputes where the former has benefitted unjustly from the latter²⁵⁹ while the important aspect to recognize is that the "trust" need not even have been contemplated or recognized to exist by the parties prior to the court action, in order to be validly recognized as such once the court has assigned the relationship, although usually there is the existence of a fiduciary relationship.²⁶⁰

In *N.J. Fletcher v. M.N.R.*,²⁶¹ the Tax Court of Canada had to decide whether a constructive trust was eligible for treatment under subsection 104(1), 108(i)(j) and 115(b)(vi), when a fiduciary relationship existed with respect to proceeds held by a party as consideration on a sale or orchestrated by the party through the direction of the legal though absent owner. The funds were lost through bad mortgages entered into by the holder at his own discretion not through the direction of the non-resident "beneficiary" and the mortgages personally benefitted the intermediary through his interests in the mortgage. (The holder acted on his power of attorney granted by the legal owner.) After the \$95,000 loss had occurred, the two parties entered into a

254 Whether or not it is a true substantive institution or merely a remedy in Canadian law, especially for income tax purposes, has not been settled: *Nelson v. M.N.R.* forthcoming. The English consider it a substantive institution while the Americans consider it a remedy only. See *Rawluk v. Rawluk*, 1990 1 S.C.R. 70. For advanced commentary, see D. Waters "The Constructive Trust" & "The Development of the Remedial Constructive Trust" forthcoming.

255 1980 2 S.C.R. 834.

256 1972 1 S.C.R. 423.

257 1978 2 S.C.R. 436.

258 See "Constructive and Resulting Trusts as Defensive Strategies" by John E.S. Poyser and Jacob D. Giesbrecht, *Estates, Trusts and Pensions*, Vol. 25 Pg. 302 for some discussion.

259 See *Keech v. Sandford*, 1726 Sel Cas Ch 61.

260 A constructive trust was not available in *Rosenfeldt et al. v. Olson et al.*, 22 E.T.R. 83, while see also *Re: Dreger*, 1976 12 O.R. (2d) 371, and *Schobelt v. Barber*, 60 D.L.R. (2d) 519. For more constructive trust cases involving various situations of unjust enrichment, see *Chase Manhattan Bank NA v. Israel-British Bank Ltd.*, 1981 Ch. 105, *DHN Food Dist. Ltd. v. Tower Hamlets Ldn. Bour.*, 1976 1 W.L.R. 852, *Bannister v. Bannister*, 1948 2 All E.R. 133, *English v. Dedham Vale Prop. Ltd.*, 1978 1 All E.R. 382, *Carly v. Farrelly*, 1975 1 N.Z.L.R. 356, *Hussey v. Palmer*, 1972 1 W.L.R. 1286 (CA).

261 [1987] 2 C.T.C. 2341.

"trust agreement" acknowledging their trustee-beneficiary relationship whereafter the "beneficiary" sold his interest therein for \$1. As per Sec. 107(1.1), the interest had cost him \$95,000, thus the loss was recognizable but the Minister claimed otherwise contending what the relationship consisted of a principal-agent and thus when the interest was disposed of the loss was from a disposition of a mortgage, not a trust interest. The non-resident taxpayer contended that the loss was from a disposition of a capital interest in a trust resident in Canada while the beneficiary had also been successful before the Supreme Court of British Columbia in contending that a breach in trust had occurred with respect to the intermediary's actions. With respect to the timing of the conception of the constructive trust Sarchuk, T.C.J. held, contrary to the opinion of counsel for the Minister:

"I do not accept the view that a constructive trust does not exist until the Court so declares in the course of, for example, an action by the beneficiary against the trustee."

and quoting from "The Development of the Remedial Constructive Trust,"²⁶² he provided the dicta:

"The trust may arise at the outset when the property is acquired, or later on, as the circumstances may require.

...

The evidence before this court leaves no doubt that there was a fiduciary relationship between the appellant and Hyman, which relationship gave rise to the placing of trust and confidence by Fletcher in the fiduciary. This relationship existed at the time that the "misappropriation" occurred while Hyman was acting within the general scope of his fiduciary duty."²⁶³

With respect to the appellant's contention that the constructive trust was eligible for treatment under Sec. 115(1)(b)(vi), as opposed to the Minister's contention that only express trusts were to be treated, the Judge held:

"The careful manner in which the word "trust" has been used in Division B and D of the Income Tax Act and the fact that the legislators chose not to define the term "trust" for purpose of Division D, or to exclude a constructive trust or a resulting trust, can only be taken to mean that for the purposes of subparagraph 115(1)(b)(vi) the term "trust" encompasses all forms of trusts."²⁶⁴

Subparagraph 108(i)(j) defines "trust" for purposes of some of the subdivision K rules and not for purposes of the Act in general, however even with respect to the technical provision the Tax Court Judge's concluding comment concerning character expression would be valid.

Fletcher was successful at suing the trustee Hyman for breach of trust in the B.C. Supreme Court, however, if he sold his capital interest for \$1 thus crystallizing the loss, how would the proceeds the Supreme Court Judge awarded him be treated under the I.T.A.? The trustee would be personally liable for the payments thereof to the former beneficiary, (unless the judge ordered that the payments be made to the trust itself then distributed out to the beneficiary: a ludicrous arrangement in this particular instance but possibly not so in others), and if he made payments to the beneficiary directly then Sec. 53(2)(h) would not apply, (to cause a capital interest ACB adjustment), even if the beneficiary maintained his capital interest since the trust is not making the payments of capital; the trustee is and is only in his personal capacity. If the capital interest had already been disposed of prior to the making of the payments then Sec. 53(2)(h) would definitely not be applicable. Since such payments would not be otherwise includable in computing the recipient's income, being awards on account of capital subsection 105(1) would most likely apply to them, to cause them to be fully includable in computing their recipient's income, since they are clearly a benefit from a trust though not from being a beneficiary under it per se.^{265 266} If the Court provides that the trustees are to pay the damages

262 J.L. Dewar, (1982), 60 Can. Bar Review 265.

263 With respect to the timing of the creation of the constructive trust, see *Howard v. Miller*, 1915 A.C. 318, *Central Trustee & Safe Deposit Co. v. Saider*, 1916 1 A.C. 266, *Hussey v. Palmer*, 1972 1 W.L.R. 1286 (CA), *Gissing v. Gissing*, 1971 A.C. 886, though see *Angeletakis v. Thymaras*, 32 E.T.R. 300 (remedial trust not arising until order of court).

264 Could this approach be fostered, with its obvious conclusion, with respect to the fact that the Sec. 115(1)(b)(vi) provision does not refer to capital interests in estates which are not completely administered?

265 In the Fletcher case, the plaintiff was a non-resident: Sec. 105(1) does not apply in respect of non-resident: Sec. 105(1) does not apply in respect of non-resident since there is no adapting provision in respect of it under Part XIII or Division D, thus the plaintiff could recognize the loss under Sec. 115(1)(b)(vi) and realize the value equivalent to it tax free.

266 See the Aust. case of *Shail Superannuation Fund and Commissioner of Taxation* [2011] AATA 940 (23 December

through the trust vis-a-vis segregate the funds and make them subject to the trust's terms then upon a distribution Sec. 105(1) will not usually apply and the proceeds will be received under the effect of section 107.

Splitting Income/Ownership.

In *Fletcher v. M.N.R.*, a constructive trust was imposed by the B.C. Supreme Court and the Tax Court had to deal with the legal/equitable relationship when the Minister questioned its tax consequences, but will a Tax Court recognize a constructive trust unilaterally to alleviate an otherwise unjust/inequitable imposition of taxation when no court has done so with respect to the situation previously?²⁶⁷ In *Nelson et al. v. M.N.R.*²⁶⁸ the Tax Court had to decide whether a constructive trust as a remedy was within the context of the trust provisions of the I.T.A. when the trust had not been recognized previously, and whether it had the jurisdiction, (under the Tax Court of Canada Act), to recognize one so as to adjust the tax positions of the taxpayers in such a manner as to reach an equitable taxing situation.²⁶⁹ The court concluded ominously, though assuming without deciding that it could apply the doctrine:

"As contrasted to the various Family Law Acts, there is no basis upon which one can assume that the legislator who enacted the Income Tax Act were aware of the existence and effect of the constructive trust remedy, nor is there anything in this Act which either directly or by inference suggests that access to equitable remedy was intended or accepted as a doctrine.

...

Although there is no specific prohibition it seems to me necessary at some point of time to consider whether by implication remedial use of the constructive trust is precluded by the very nature of the Income Tax Act."

As submitted by the Minister, citing *Herdacz v. M.N.R.*²⁷⁰ and *Clemas v. M.N.R.*²⁷¹ the Court does not have power to apply equitable principles as a relief of a taxpayer's mistake or omission while it also is not allowed, as per *Matheson v. R.*²⁷² to rearrange the relationships of the taxpayers to assist in deriving a more beneficial tax position.²⁷³

Does the I.T.A., by its very nature, preclude the use of the constructive trust doctrine against inequitable tax situations unless previously the doctrine has been invoked to rearrange ownership interests independent of the concerns of the I.T.A.? In short, does a taxpayer have to secure a provincial/federal court's judgment invoking the constructive trust in order for the proceedings with respect to the I.T.A. to be based on its existence: the Tax Court may be able to recognize it but not impose it in addressing the fact situation?²⁷⁴ In

2011) as well as *Burgess v Commissioner of Taxation* (1988) 80 ALR 639 for deductibility of these losses. CRA has generally provided that when funds are misappropriated they are included in the income of those who took them and are deductible when they are paid back.

267. Sarchuk T.C.J. did without hesitation in *Fletcher* providing:
"I do not accept the view that a constructive trust does not exist until the Court so declares in the course of, for example, an action by the beneficiary against the trustee. There is nothing in *Pettkus v. Becker* (supra) which supports such a conclusion"

and citing Martland J. in *Pettkus*:

""The areas in which a constructive trust has been found to exist have usually been in cases where a fiduciary relationship exists, eg., a trustee or fiduciary taking advantage of his position to make a profit for himself.""

268 91 D.T.C. 37.

269 In this case there would not have been a cause for applying to the courts to impose the trust since there would not have been a deprivation.

270 56 D.T.C. 34.

271 84 D.C.T. 1289.

272 74 D.T.C. 6176.

273 As per Case V150, 88 A.T.C. 948, relying on *Masterman* of the lower court, the factual situation only is to be examined. How valid this is in light of the decision in the appeal depends on whether the constructive trust is recognized as substantive or remedial: in Australia Case V150 would not be authority, while in Canada, perhaps where the constructive trust will be held to be merely remedial, it illustrates the point that tax positions can't be rearranged by subsequent remedies.

274 In *Erickson v. M.N.R.*, 1988 2 C.T.C. 2380, the Tax Court recognized that the trust, as a remedy and not a substantive institution, following the Supreme Court in *Sorochan v. Sorochan*, came into being only upon the intervention of the courts: since no court had created the trust it wasn't recognizable (though on different grounds the case was decided in favor of the taxpayer).

Thomas N. Collins v. The Queen²⁷⁵ the Appeal Court noted that they did not express an opinion on whether the Tax Court could recognize a constructive trust [within its mandate] and then went on to provide that the facts didn't indicate such regardless.

The Australian courts have had to address this particular issue in the *Masterman-MacFarlane v. F.C.T.*²⁷⁶ cases. In this case, both man and de facto spouse contributed capital and effort to the operation of a business though the property was registered solely in his name. The activity was subsequently incorporated and investment income received exclusively by the man was contended to be held 50% on constructive trust for the spouse.²⁷⁷ The tax assessors contended that the doctrine of constructive trust could only be invoked by a court of equity on application by the de facto spouse against the husband if he was acting unconscionably or inequitably and until such a situation occurred the tax court was to regard the legal relationships existing.

Enderby J. cited *Allan v. Snyder*²⁷⁸ and held:

"A constructive trust differs from an express trust in that it is raised by operation of law without reference to the intention of the parties concerned... Constructive trusts arise where no trust was directly or indirectly been declared, but where, accordingly to the principles of equity, it would be a fraud for the person on whom the court imposes the trust to assert a beneficial ownership."²⁷⁹

Pointing out that the de facto spouse could not show evidence of a deprivation or suffering from unconscionable behavior the Judge implied that a constructive trust could not be invoked though, not argued in the instance, an implied trust might exist.²⁸⁰ Providing that the power of equity does not displace the law but follows it and modifies it the constructive trust had to be seen in its context and concluding Judge Enderby held:

"In this case, there was no legally enforceable agreement between the appellants. There was a relationship that may or may not have permitted relief being given if one or the other had used or abused his or her legal rights unconscionably but that is all. The Commissioner was a stranger to their relationship and their supposed true intentions and had no notice of them. He only knew of their stated intention.

It would be an extraordinary thing, if, after all these years of representing one state of affairs, the appellants could come to this Court and successfully argue against the legal forms that they had freely agreed should govern their business activities. **There is no dispute between them.** Their dispute is with the Commission and the doctrine of constructive trust has no application. It only operates if it would be a fraud for one of them. Mr. MacFarlane in this case, on whom the court might impose a trust, to claim a beneficial ownership.

I find that no constructive trust can be raised such as would permit the appellants to use it in their dispute with the Commissioner and reduce tax, which is otherwise due. It is an attempt to split an income by using a principle that has a proper role in other distinctly limited situations that are different from the one being considered."²⁸¹

MacFarlane appealed against the decision and the opinion of Beaumont J., (concurring with entirely by Burchett J. forming the majority), definitely provides good argument for "constructive" income splitting. He provided:

"In my opinion, the learned Judge erred in holding that, for the purposes of the Act, the legal title to income is determinative. The Act, in my view, takes the taxpayer's income as it finds it - that is to say, **subject to the general law in all aspects.** This will pick up the position at law and in equity, modified by any relevant legislation, including the provisions of the Act itself. In *Stewart Dawson & Co. (Victoria) Pty. Ltd. v. F.C. of T.*, (1933) 48 C.L.R. 683, Dixon J., speaking of the presumption of advancement,

275 A-664-95

276 86 A.T.C. 4009 while in 86 A.T.C. 4469 the taxpayer appealed to the Full Federal Court.

277 Once again there wasn't a deprivation upon which a legitimate constructive trust claim could be based.

278 1977 2 N.S.W.L.R. 685 at 697.

279 as from Jacob's Law of Trust in Australia, 4th Ed., pg. 232.

280 See the UK case of *Halpin v Revenue & Customs* [2011] UKFTT 512 (TC) (26 July 2011) concerning the proportionality of interest income recognition on joint accounts.

281 See Case V150, 88 A.T.C. 948, where the Administrative Appeals Tribunal refused to accept the concept of constructive trust to split income in a spousal situation citing *Masterman/MacFarlane v. F.C.T.*

said (at p. 691):

"I see no reason why this rule should not apply in revenue matters. If liability for tax depends upon the existence or non-existence of a trust, the occasion seems to demand the application of the rules by which the determination of such questions is governed by the Courts of Equity."

Dixon J. was there dealing with a question arising under land tax legislation, but his observations are equally applicable to the operation of the Act.

I should add that nothing here turns on the circumstance that, in the events happened, it was not necessary for Miss Masterman to seek relief from a court of equity with a view to enforcing her rights as beneficiary under a trust. The learned Judge, viewing the case as one of constructive trust only, was much influenced by the fact that equitable relief had not actually been granted or even sought by Miss Masterman. His Honour thought that, unless and until such relief were granted, the respondent, as a "stranger" to the trust could ignore any equitable interest claimed by Miss Masterman.

With all respect to the learned Judge, I cannot agree. Since equity will regard as done that which ought to be done, the existence of equitable interests does not depend upon the making of a crucial order granting equitable relief, even in the case of a constructive trust (see *Muschinski v. Dodds* (supra) per Deane J. at p. 451). The position is a fortiori in the cases of express and resulting trusts, where the kind of relief granted by the court of equity is more uniform than in the case of a constructive trust."^{282 283 284}

The constructive trust arises at the time there is a duty to provide restitution²⁸⁵ and this necessitates an unjust enrichment accompanying a deprivation and if there isn't such then the trust may not be validly applied.²⁸⁶ To this end would it be possible to argue for purposes of bringing up the form of remedy in an income tax litigation, that to do otherwise would cause the income to be taxed at higher rates in a spouse's hands thus a deprivation of the excess marginal tax? An unjust enrichment implies a deprivation but who is being enriched in the instance where the remedy isn't invoked? In fact, may a spousal party enduring a higher effective tax on all her income to which her spouse has an interest not be the party also sustaining a deprivation? Is not the taxman realizing an unjust enrichment by taxing the income in one set of hands at consequently higher rates and does it matter within the constructive trust environment?²⁸⁷

As a concluding note it would appear that as long as the lower courts in Canada recognize a constructive trust as a remedial device that arises only upon its imposition by the court the remedy will be of little assistance

282 This doesn't seem to be the opinion of Gerein J. in *Bedard v. Schell*, 1987 59 Sask. R. 71, where a spouse contended that a constructive trust could save her interest in property legally owned by her spouse that had been assigned in bankruptcy proceedings. The Queen's Bench court held that the Supreme Court in *Sorochan v. Sorochan* and *Pettkus v. Becker* had imposed the trust as a remedy, had not recognized it as a substantive institution, and concluded with respect to the rights: "In the case of a constructive trust such identification and segregation cannot take place until the Court imposes the trust taking into account the claims of the creditors."

Can this be correct given the unjust enrichment of the bankrupt spouse?

283 In the lower court, the Commissioner had contended that the taxpayers were estopped by representation from purporting a constructive trust since such would be to his detriment and the court held after citing numerous authorities that the delay in accurate assessment would constitute a detriment for these purposes. The Full Court disposed of this opinion in pointing out that the tax returns did not disclose any expression of beneficial interests of the de facto spouse and in fact were entirely silent on the matter eroding the base for estoppel. Detriment could also not be proven when the Commission had the ability to reassess without time restrictions any previous tax year if fraud or evasion could be proven inherent in the declaration (as is the case in Canada), and this is further eroded the basis for estoppel. The Appeal Court did however order that all previous years relevant returns be amended to reflect the arrangement.

284 See the recent NZ case of *BB v Commissioner of Inland Revenue* [2011] NZTRA 1 (25 January 2011) where the tax authorities tried, unsuccessfully, to argue that a trust partnership which had misappropriated their partners'-beneficiaries' trust funds caused them to stand as constructive trustees for the trust thus it was the trust that should recognize the consequences of the transactions. Even in the face off the misappropriation, the Tax Review Authority held that the party to recognize the transactions was the partners.

285 *Pettkus v. Becker*, *Chase Manhattan Bank*, *McDonald v. MacDonald*, 1988 R.F.L. (3d) 321, *Rawluk v. Rawluk*, *Hussey v. Palmer*, 1972 1 W.L.R. 1286.

286 See Case W21, 89 A.T.C. 242, for precisely this result.

287 For an excellent relevant article that could shed insight into this unsettled issue, see "The Remedial Constructive Trust: A Principled Basis for Priorities over Creditors." David M. Paciocco, C.B.R. Vol. 68, pg. 315.

in Canadian income tax splitting unless the participants can secure it via court order prior to the tax litigation. If it's **authoritatively** held that the Canadian constructive trust can be substantive for certain purposes following English/Australian and not American law, then it could prove of use following the Masterman precedent.

*Rawluk v. Rawluk*²⁸⁸ would seem to provide this authority in that in this case a slim majority of the Supreme Court moved away from the historic American version of the constructive trust and provided when the point was directly in issue:

"It is important in this respect to keep in mind that a property interest arising under a constructive trust can be recognized as having come into existence not when the trust is judicially declared but from the time when the unjust enrichment first arose. As Professors Oosterhoff and Gillese state, "the date at which the constructive trust arises.. is now generally accepted to be the date upon which a duty to make restitution occurs" (Oosterhoff and Gillese, A.H. Oosterhoff: Text, Commentary and Cases on Trusts (3rd ed. 1987), at p.579). Professor Scott has stated in *Law of Trusts*, op. cit., at pp. 323-24, that:

.... **"The beneficial interest in the property is from the beginning in the person who has been wronged. The constructive trust arises from the situation in which he is entitled to the remedy of restitution, and it arises as soon as that situation is created... It would seem that there is no foundation whatever for the notion that a constructive trust does not arise until it is decreed by a court. It arises when the duty to make restitution arises, not when that duty is subsequently enforced."**

I agree completely with the position taken on this issue by the authors of these helpful texts.

As well in *Hussey v. Palmer*, supra, at p.1290 (quoted by Dickson J. in *Rathwell v. Rathwell*, supra, at p.455), Lord Denning M.R. noted that a constructive trust "may arise at the outset when the property is acquired, or later on, as the circumstances may require". As a result, even if it is declared by the court after the parties have already separated, a constructive trust can be deemed to have arisen when the duty to make restitution arose. It should therefore be considered as part of the property owned by the beneficiary at valuation date."

The slim minority held that the constructive trust had been consistently regarded as the American remedy in Canada and that the English version of the substantive institution in the unjust enrichment environment had not been followed. Instead the courts were to assess the relevant remedies available and consider which is appropriate to apply and on these grounds the remedial constructive trust arises only when the court chooses its genre of equitable restitution in light of the inadequacy of those otherwise available. Until that time, as held by citing numerous Supreme court passages, the trust isn't imposed. It's to be noted that these points concern the constructive trust in the context of an unjust enrichment.²⁸⁹ It could prove more easy to argue that an implied trust existed where the actions of both parties can indicate a mutual intention that the trust was created.²⁹⁰

In order to establish a constructive trust in a matrimonial situation²⁹¹, the spouse has to establish that her contributions were made to acquire an interest in specific property acquired and that by not acquiring such an instance of unjust enrichment would arise.²⁹² As per *Atlas Cabinets v. National Trust Co.*²⁹³ an unjust enrichment in a matrimonial environment may be quite different from that in a commercial environment. The connection must be direct and substantial and, as the case in *Pettkus v. Becker*, it may be indirect in that it

²⁸⁸ 1990 1 S.C.R. 70

²⁸⁹ Professor Donovan Waters has written yet again another article on the cutting edge of the evolving discussion "The Constructive Trust in Evolution: Substantive and Remedial", *Estates and Trusts Journal*, 1991 pg. 334, and for advanced commentary it should be the primary source to consult.

²⁹⁰ See the Aust. case of *JACA Nominees Pty Ltd v Waldarra Pty Ltd & Anor* [2010] VSC 546 (2 December 2010) on the application of a constructive trust when an oral trust was all that was witnessed and understood.

²⁹¹ See *BJ v MJ* (Financial Remedy: Overseas Trusts) [2011] EWHC 2708 (Fam) (27 October 2011) for a UK judicial discussion of types of matrimonial trusts.

²⁹² See *Heon v. Heon*, 34 E.T.R. 252, *Coates v. Hunt*, 34 E.T.R. 291.

²⁹³ 1990 68 D.L.R. (4d) 161 BCCA

enables one to acquire the property through a lessening of financial burdens, while in order for the unjust enrichment to occur, there must be a connection between the acquisition of the particular property and the deprivation.²⁹⁴ In *Nelson v. M.N.R.*, the spouse could not show that she had contributed to the acquisition of the property in any form and could thus not show a consequential deprivation. Her purported indirect contributions to the business, (ancillary banking activities at most consonant with the voluntary activities of a rural wife), did not substantiate a propriety "connection" with the land while her activities following the land acquisition did not change substantially. She also thought that the whole exercise of acquiring the land was to build up the personal wealth of her de facto spouse so that the offspring would ultimately benefit. Due to primarily the inadequacy of the evidence but also the nature of that which existed a constructive trust could not be equitably invoked. This wasn't the case in *Sorochan v. Sorochan*²⁹⁵ where it was also held that the contribution doesn't have to have a direct link with the acquisition of the property but relates to the property's preservation, maintenance and improvement if it's already owned²⁹⁶, and *Rawluk v. Rawluk*²⁹⁷ where contributions of the deprived spouses were more proprietarily focused and extensive.²⁹⁸

294 See *Guzzo v. Catlin Estate*, 33 E.T.R. 163. As per *Sorochan v. Sorochan*, post, a second consideration is whether the deprived expected to receive an interest in the actual property and whether the enriched knew or should they have known of that expectation. See *Gill v. Grant*, 30 E.T.R. 255.

295 1986 2 S.C.R. 38.

296 See also *Novick Estate v. Lachuk Estate*, 33 E.T.R. 103.

297 1990 1 S.C.R. 70.

298 See also *Naylor v. Naylor*, 37 E.T.R. 274, for lesser cases concerning respective contributions and *Passee v. Passee*, 1988 1 F.L.R. 263 (a resulting trust case) as well as *DaCosta v. DaCosta*, 1991 74 D.L.R. (4d) 439, for the inadequacy of consideration in maintenance or acquisition. See also "A Question of Intention", J. Montgomery, *The Conveyancer*, 1987 pg. 16, "Remedial Constructive Trusts of Homes; An Overseas Overview", D. Hayton, *The Conveyancer*, 1988, pg. 259, "The Melting Down of the Remedial Trust", R.P. Austin, 1988 11 UNSWLJ #1, 66, and "Casual Connection in Constructive Trusts", K.B. Farquher, 1985-86 E.& T.Q., pg. 161.

The Trust as a Taxable Individual and its Residence.

Subsection 2(1) imposes income tax upon taxable income for each year of every person resident in Canada at any time in the year while taxable income of the person, as per Sec. 2(2), is that income, as computed in Section 3, that is net of the adjustments applicable in Division C²⁹⁹. If the person is not resident in Canada but was employed in Canada, carried on a business in Canada, or disposed of taxable Canadian property he will sustain tax liabilities under Division D, section 115-116.

"Person" defined in Sec. 248(1) for purpose of the Act includes heirs, executors, administrators, and other legal representatives of a person as well as any body corporate or politic, and although a trust is only an agreement and not a separate legal entity it is only Sec. 104(2) which gives it the quality of "a person" for purposes of the Act.³⁰⁰

Under subsection 104(1), as commented upon previously, a reference to a trust or estate in most instances shall be read as a reference to the trustee or executor having ownership or control of the trust property, while under Sec. 104(2), a trust shall, without affecting a liability of the trustee/executor/legal representative etc. for his own income tax, for purposes of the Act, be deemed to be an individual "in respect of the trust property" and thus although a corporation may be sole trustee, the trust will still retain its individual nature.³⁰¹

A trust/estate, (and thus the trustee or executor thereof), must file a return within 90 days from the end of its tax year while obviously the trust/estates return (on a T3) will not pertain to the same income etc. as that personally of the trustee/executor who must likewise file separately under Sec. 150(1)(d), as per Sec. 104(2).

A trust or estate is to be identified, for purposes of the imposition and collection of tax, with the "trustee or the executor, administrator, heir or other legal representative having ownership or control of the trust property" and in this regard, the tax is to follow the party supposedly closely involved with the trust property.³⁰² In simple trust arrangements, the trust property may be both legally, though nominally, owned, and controlled by virtue of this fact, by the same party, or limited number of parties however the final aspect that allows such a trust to be caught for taxation under Sec. 104(1)-2, is that such property is owned or controlled by a person as trustee, executor, administrator, heir, et cetera, and not in any other capacity.³⁰³ Subsection 104(1) thus captures only trusts consisting of property that were owned or controlled by a person acting in a fiduciary capacity. If the legal ownership of the right to receive the income/gain from the borrowed property is vested with a trustee even though the income producing activity/-property lent to a trust may not be owned or controlled by the trustees if they have the right to the income in the fiduciary capacity the trust will understandably exist. If a transfer to a taxpayer is made so as to create a trust, and the recipient disregards the trust agreement and the Statute of Frauds must be used in proving the trust, until the trust is proven in what capacity does the recipient act with respect to the property received? Does he hold title unencumbered in his personal capacity subject to subsequent equitable judgment or does he continue to hold the title as trustee of a trust that he doesn't recognize? Since upon favorable judgment the court will recognize the recipient to have always been a trustee he'll not shake off the Sec. 104(1) targeting merely because he refuses to act as a trustee and disregard the fiduciary relationship.

The subsection 104(1) targeting provision begins to appear even more all-encompassing when one examines the nature of the arrangement and the effect of Sec. 104(2), being, that although Sec. 104(2) provides that a trust is to be a singular individual it may have numerous trustees that have varying degrees of ownership or control over the property. Property, the legal title of which has been transferred to a trust, may be jointly legally owned by all or only some of the trustees as per the trust terms while those same trustees may not have control over it whereby instead the day-to-day control is vested with other trustees, or beneficiaries, and the other trustees hold only bare de jure ownership. Where the legal title isn't transferred but the

299. Subdivision 9, section 81 describes amounts that will not be includable in that income, while Division H, Section 149 contains a list of entities that are exempted from paying tax under Part I.

300 See *Drummond v. Collins*, 1915 A.C. 1011, and *Wood v. Owen*, 23 T.C. 541, for trustees' liability.

301 For a discussion of the extent and importance of the individual status see Case M92, 80 A.T.C. 659.

302 As per *Henderson Estate*, *Bank of N.Y. v. M.N.R.*, 1973 C.T.C. 636 (FCTD), and *Bank of N.Y. v. M.N.R.*, 1975 C.T.C. 497 (FCA), an executor *do son tort* is identifiable as the estate/trust under Sec. 104(1).

303 Constructive trustees may not be captured if it is conclusively held that until the Court imposes the trusteeship they don't act as such though once the Court does assign the remedy the party must attend to the tax consequences.

trustees control the property lent to them then in respect of above there arises the question as to who the relevant trustees are. The essential aspect to recognize about the Sec. 104(1) targeting provision is that where a trust's liability is imposed, by adjusting the nature of the trustees' ownership and control the property the liability cannot be avoided in that the targeting is such that it charges the liability against both sets of parties having ownership or control of the property. (Jointly). This is so even in respect of bare trusts where the trustees have no control over the property but do won it through the holding of legal title.

Subdivision K doesn't offer a single provision that provides a method by which the residence of a trust can be determined, however, since Sec. 104(1) imposes the tax liability on the trustee in respect of it, the residence of the trustees can be regarded as the sole significant factor to examine in determining residence of the trust. Where a trust has a single owning and controlling trustee in respect of its property, the residence of the trust will be attributed to that trustee, regardless of whether that trustee is resident in two or more jurisdictions and thus it is entirely possible for a trust (or estate) to have two or more places of residence for tax purposes. Such a case may arise where the sole trustee is a corporation, that is not subject to the Sec. 250(4) residency provision, that has de facto mind and management of the highest level being exercised from two or more countries.³⁰⁴ Where such a common law dual residency is found the trust will be subject to the taxing statutes of both jurisdictions however remedy will most likely always come in the form of an existing tax treaty-convention between the two jurisdictions and the associated powers usually therein provided allowing for elimination of double taxation³⁰⁵ on the trust however there may still be problems encountered on taxation of the beneficiaries.

Where the trust has two or more equally controlling or owning trustees then the determination of residence becomes more difficult owing to the fact that the Act recognizes a singular trust but doesn't preclude the possible recognition of two or more trustees. Generally, unless provided to the contrary in the trust deed, all trustees of a trust must be of unanimous opinion in order to carry out any action, be it investing of funds or distribution of income, etc., since they will all be jointly and not severally liable and held accountable should such action turn unfavorable. Given this fact the residences of all of the trustees are relevant and since the Act recognizes a single trust that cannot be split up, allocating ownership or control of property to particular trustees, it would be foolish to argue that a trustee resident in Canada that has control or ownership of trust property can be held liable under Sec. 104(1) for even part of the trust income, (regardless of its source), when the trust has "99" other trustees resident in another country. Unless that singular trustee is the supreme controlling or owning trustee, holding or exercising more than 50% of either, the trust can never be regarded as residing in Canada. Since the Act doesn't preclude the recognition of two or more trustees, the residence of all of those trustees must be examined to ascertain where the majority of the ownership or control of the trust resides or is exercised/exercisable. The trust, as a singular (deemed) entity, will have a residence where the majority of the control or ownership resides. Understandably this present problems where three equally controlling and owning trustees reside in three countries since as per the Sec. 104(1) provision a residence will not be ascertainable.

Generally, the legal title of the trust property is vested jointly in all of the trustees of a simple trust, (although there may be instances where as per the trust deed of more complex trusts property is vested in certain groups), and from this ownership the trustees also have instilled in them de jure control while de facto control (possession) may reside in some other person. Where a singular trustee has a general power of appointment over trust property his power should not be considered as a determining factor since the power is exercisable only in respect of certain trust property and does not, per se, affect the trust as an ongoing (deemed) entity in its day to day existence. The same reasoning applies in respect of powers of advancement or encroachment. Hence, effectively, a trust could otherwise be considered non-resident due to the majority of its day-to-day ownership residing outside of Canada, while a Canadian taxpayer, (who need not actually be a trustee), could have considerably influence over the ultimate destination of the trust property. Where a Canadian trustee/settlor reserves the power to appoint trustees, regardless of where they are to be resident,

304 Where the parties exercising such control reside is not so much a factor as where that control is actually exercisable.

305 See Art. XXI of Canada-U.K. Tax Convention (1978).

he cannot be found to have a controlling position on that fact alone since until he exercises that power he is not in such a position, hence residence cannot be attributed on that factor alone. Where he does have the power to bind the trustees, regardless of their opinion, (which can only follow when the trust deed spells the power out), then he may be considered to be a controlling trustee in that his actions will influence all of the rest, and they do not have the ability to veto his decisions, however, once again, the scope of the power, vis-a-vis the aspects of the trust it may affect, would have to be examined as well as the manner in which it is exercisable. In I.T. 447 the Department, in para. 2, provides the opinion that a trustee who has management and control of the trust will be the person who has most or all of the,

- (1) control over the changes in the trust investment portfolio,
- (2) responsibility for the management of trust property or businesses,
- (3) responsibility for banking, financing arrangements,
- (4) ultimate responsibility for preparation of trust accounts and reporting to beneficiaries,
- (5) power to contract with or deal with trust advisors (auditors, lawyers, etc.).

In *N.B. Dill and J.A. Pearson, both of the Parish of Pembroke in the Islands of Bermuda, Trustees of the Thibodeau Family Trust v. The Queen*³⁰⁶ the ascertaining of the residence of a trust was at issue. The trust was created in Canada by a Canadian taxpayer where two resident trustees were initially agreed upon, wherein one had the power to appoint others. The other retired and resigned from his post while the remaining trustee appointed two new ones, both resident in Bermuda. Upon being appointed the assets of the trust and their administration were transferred to Bermuda where the two trustees took possession and stored them, however, it would appear that all of the trustees had equal ownership of the assets. From then on, the Canadian resident trustee made investment suggestions to the Bermuda trustees, who would then either reject them or act upon them while the Canadian trustee had no power to legally enter into the investments or bind the trusts, and a substantially number of his suggestions were absolutely rejected. Control of the entirety of the trust funds, (and the administration of the trust), obviously lay with the Bermuda trustees. The investments made by the trust were scattered around in several countries while the beneficiaries were either resident in the U.S. or Canada at all material times.³⁰⁷ For a period of time, the trust recognized investment income from investments made in Canada, upon which the 15% withholding rate had been applied, (as if it was non-resident), while the trust did not at any time carry on business in Canada. In 1972, the trust disposed of some shares in a corporation and the Minister attempted to tax the trust on the capital gain as being resident. The trustees objected.

The Minister's argument dwelt upon the substance of the infamous *De Beer's Consolidated Mines Ltd. v. Howe* case³⁰⁸ where corporate residence was found to be where the company carried on its real business i.e.: where the central management and control actually resides. Counsel for M.N.R. also argued that the trust could be found to have dual residence as per the arguments presented in *Unit Construction Co. Ltd. v. Bullock*³⁰⁹ being that the central management and control of a company may be divided and it may "keep house and do business" in more than one place. The Minister's submissions were that the Court could find at least part of the paramount or supreme authority of the trust resident in Canada based on the fact that the Canadian resident had the power to appoint trustees, took an active interest in the affairs of the trust and was the initiator of the investment program, had circumscribed the authority of the Bermuda trustees and acted unilaterally on at least two occasions, while the Minister also contended that the initial retirement of the second Canadian trustee was ineffective and consequently there were two Canadian resident trustees, that the only way to transfer administration to Bermuda was via an Ontario Variation of Trusts Act court order which should have terminated the trust and constitute a new one, (a ridiculous suggestion), and that the real settlor was the Canadian trustee, (creating the trust when he sold shares to it), rather than the real settlor thus that trust that was actually transferred was not substantiated by the documentation and thus that trust did not contain an express power to transfer the assets and administration as the actual trust did.

306 78 D.T.C. 6376 FCTD.

307 Since the event occurred in 1972 the section 94 non-resident trust rules did not exist to apply.

308 (1906) A.C. 455.

309 1960 A.C. 351

The Court found all of the Minister's submission invalid, that the Canadian trustee was found to have resigned properly, that the trust deed provided expressly a power allowing the transfer of assets and administration to Bermuda and thus the variation order wasn't needed. With respect to the Minister's contention that a trust can reside in more than one place the Judge provided:

"As to the submission that the Court in this case, even if it also finds that the trust has a residence in Bermuda, it should find that it has a residence in relation to the management of this trust was carried on in Canada applying by analogy the principles in the cited cases of determining residence for income tax purposes of corporations, in my view, such submission is also not valid. The judicial formula for this respecting a corporation, in my view, cannot apply to trustees because trustees cannot delegate any of their authority to co-trustees. A trustee cannot adopt a "policy of masterly inactivity" as commented upon in Underhill on the Law of Trusts and Trustees, 12th Ed. pg. 284; and on the evidence, none of the trustees did adopt such a policy."

Unfortunately Gibson, J. then went on to express the opinion that it is impossible for a trust to have dual residence³¹⁰. Taking two broad indicators for the first instance, the court found that the fact that the majority of the trustees were resident in Bermuda and that the trust document required a majority decision on all matters, was enough to cause the trust to be considered solely resident in Bermuda.

It's unfortunate that Judge Gibson did not attack the problem with more comprehensive reasoning; i.e., the fact that the control and the ownership resided with a majority of trustees who were non-resident however the collective residence of all the trustees of the trust (at the time of the question) was obviously considered. Clearly a trust can have dual or multiple residency when its trustees have a multitude of residences in different countries.

In *Jones Trust v. Commissioners*,³¹¹ the U.S. tax authorities were successful at assessing a U.K. trust in respect of capital gains on some shares of a domestic corporation as it were resident in the U.S.. Income was assessable if the individual held an office in the U.S., as per the clear terms of the statute, and this the trust clearly did through the efforts of one of its trustees. The other three trustees, resident in the U.K., had given him control of 90% of the trust fund situated in New York thus although control of the trust resided in the U.S. the tax authorities didn't even have to prove it, the provision captured the trust by virtue of its holding an office in the U.S. The Fourth Circuit Court of Appeals held:

"What is non-residence on the part of a trust, within the statutory meaning, is a question which in some instances may be difficult of determination: but we feel no hesitation in saying that it cannot be predicted of a trust, ninety percent of whose property consists of stocks and bonds of domestic corporations, held in this country in the possession of a trustee who is a citizen of the country, traded in by that trustee on the exchange of the country, and returning income which is collected by such trustee in the country and handled from an office maintained in the country for that purpose."

Administration was carried out from within the U.S. and more importantly the power to bind the trust and its control was also resident therein.

In *Dawson v. I.R.C.*³¹², the U.K. Court of Appeal had to ascertain whether a single resident trustee, under a trust with two non-resident trustees, was liable for tax on income that accrued to the benefit of non-resident beneficiaries from non-resident situated property. This English case was determined with respect to tax charging provisions substantially different from Sec. 104(1) however, the principles inherent in the reasoning are relevant to the Canadian context. Nicholas, L.J., commenting on the scope of the trustees' ownership individually with respect to the income received:

"The relevant income was trust income, and the entitlement of trustees to trust property **is joint, not joint and several**. Accordingly, this trust income accrued, not to the taxpayer alone, but to him jointly with his co-trustees: "each joint tenant holds the whole and holds nothing, that is, he holds the whole jointly and nothing separately" (Co. Litt 186a). Joint entitlement to income does not give rise to any difficulty where all those entitled are resident in the United Kingdom, because the singular 'person' in

³¹⁰ leaving himself open to criticism of the instance where a sole trustee is resident in two jurisdictions

³¹¹ 132 F.2d 914.

³¹² [1988] 3 All E.R. 753.

para. 1(a)(i) of Sch. D. is to be read as including the plural 'persons' by virtue of what is now 5.6(c) of the Interpretation Act 1978..."

Subsection 104(1) refers to trustees having ownership or control over the trust property but it does not indicate that the basis of such measurement is to include single joint owners. Since ownership of trust property is usually joint the resident of all of the joint owners must be considered in arriving at the residence of the trust. Judge Nicholls went on to provide with respect to the Crown's contention that a single resident joint owner would be sufficient to attract taxation:

"On a natural reading of para. 1(a)(i) the necessary qualification "residing in the United Kingdom" is a qualification which, when the income accrues to one person, applies to that person and, when the income accrues to persons jointly applies to all those persons, they must all possess the attribute of "residing in the United Kingdom". I can see no justification for reading the statutory provision as expanded by the Interpretation Act 1978, as satisfied, where the income accrues to more than one person jointly, if anyone of them possesses the necessary attributes of residing in the United Kingdom even though the other or others do not."

In closing it was held:

"In the instant case the Crown is, in effect, asserting the right to tax a person resident in the U.K. solely upon the ground of residence on income from property outside the U.K. in which he has no control, and to do so notwithstanding that he may have **no right of recourse to the income on which he is assessed to tax and no right of contribution or indemnity against the income or from the person beneficially entitled to it**. In my judgment the very clearest of language would be required to justify a claim as wide as that."

The House of Lords concurred with the Court of Appeal's decision³¹³ and denied the Crown's appeal. The Crown accepted that the revenue accrued to the trustees jointly and not jointly and severally, so that in law they were not entitled to individual shares and Lord Keith of Kinkel provided:

"There can be no justification for assessing to tax the respondent alone, on the ground that he is resident in the United Kingdom, because the income does not arise or accrue to him personally. He has no right of control over the income. His only interest in it is a right and duty to secure, in conjunction with his co-trustees, that it is applied in accordance with the directions of the trust deeds... It is sufficient to say that the enactments directly in point do not, upon a sound analysis, support the construction contended by Revenue. It can be perceived that there would be much to be said for making the liability to tax depend upon the center of administration of the trust and the place of residence of the majority of the trustees, as is the position with capital gains tax: see section 52 of the Capital Gains Tax Act 1979. But Parliament has not so far chosen to do that."³¹⁴

Since the Sec. 104(1) identification basis operates on **control or ownership** of the trust property, it could be argued that by virtue of the **dual basis use** Parliament recognized that trustee ownership is usually joint ownership and by use of the alternative identification base, "control", attempted to capture the instance where the majority of joint owners (trustees) resided outside of Canada but the resident joint owner had control over the trust property by virtue of specifications in the trust deed thus causing the trust to be subject to Canada taxation, unless there is another reason for this approach. This would exactly cause an exposure to Cdn. taxation those instances where a settlor sought to avoid taxation by placing all her trustees outside Canada except for one who had status here to act for the trust in respect of property situs here. If such is the proper interpretation of the scope of Sec. 104(1) then Dawson v. I.R.C. above is of no assistance in advancing that a majority of the residency of the trustees is where a trust lives since the statute clearly attends to the argument: a trust can have more than one country of residence, and the Act specifically targets those trustees

313 in 1989 2 W.L.R. 858.

314 The Report of the Royal Commission on Taxation, Vol. 4, pg. 209 conclusion and recommendation 18 recommended that a trust be taxed as resident if a majority or a controlling group of the trustees were resident in Canada, carried on a business in Canada, or if substantially all of the property situated in Canada. Of importance is the fact that only some of these recommendations were accepted and acted upon (carrying on a business in Canada inherent in Sec. 115(1)), while since the others were not it can be accepted as implied that the legislators wished a wider net to be cast than majority/control criteria which have not implicitly been enacted.

that merely have ownership or control of any portion of the trust property.

In *St. Michael Trust Corp. as Trustee of the Fundy Settlement*³¹⁵ the Fed. Ct. of Appeal had to consider the residence of a Bermuda trust when its Cdn. resident beneficiaries could almost completely undermine all discretions of the trustees and control them. Surprisingly this was a case, in the author's opinion, that should have been argued explicitly on the extent of Sec. 104(1) "control" over trust property – the second targeting - that attracts the application of the provision since the Cdn. beneficiaries could very effectively do this, regardless of ownership: the word in the provision isn't there for nothing.³¹⁶ Instead the arguments opened up the can of worms on residence of a trust based on where its trustees resided, though substantively, did recognize the control element. It opined:

"[25] The terms of the trust indentures that are relevant to these appeals are substantially the same except for the name of the trust and the identification of the beneficiaries. It is not necessary to recite all of the terms. A sufficiently accurate picture of the trust indentures emerges from the following summary:

- a. The trustee was required to keep the trust property invested until the "Division Date" (any date chosen by the trustee or 80 years from the date of settlement, whichever occurred first), subject to the absolute discretion of the trustee to distribute some or all of the income to one or more beneficiaries, with any undistributed or unallocated income to be added to the capital.
- b. The trustee had the absolute discretion to encroach on capital to or for the benefit of one or more of the beneficiaries, even to the extent of using all of the trust property.
- c. On the division date, the property was to be divided and distributed as follows:
 - (i) in the case of the Garron Trust, equally among the children of Myron and Berna Garron or their children (subject to certain conditions relating to the age of the child at the division date); and
 - (ii) in the case of the Dunin Trust, to Mr. Dunin or, if he was not then living, equally to his children or their children (subject to certain conditions relating to the age of the child at the division date).
- d. The trustee was precluded from distributing *in specie* the Class A shares of New Garron Co (in the case of the Garron Trust) or New Dunin Co (in the case of the Dunin Trust), but had the power at any time to convert those shares to cash or other property which could then be distributed in accordance with the general power of distribution.
- e. Except for the specific prohibition relating to distribution *in specie* of the Class A shares of New Garron Co and New Dunin Co, the trustee was given broad powers to invest and to make payments and distributions in money or other property of the trust, and the power to retain or sell any property in any manner and on any terms.
- f. The protector had the absolute discretion to remove a trustee and appoint a new trustee.
- g. The protector could be removed and a new protector appointed by the majority of beneficiaries who had attained a specified age.

...

[48] The Minister rejected the claims for exemption and assessed *St. Michael Trust Corp.* accordingly. *St. Michael Trust Corp.* objected to the assessments without success, and appealed to the Tax Court of Canada again without success. I summarize as follows the key conclusions reached by Justice Woods:

315 2010 FCA 309

316 The author knows of at least 1 Australian tax case where control of trust property by a non-trustee attracted demand to file and assessment.

- a. In determining residence for purposes of the *Income Tax Act*, the established test of residence applicable to corporations should be applied, so that a trust is resident in the country where its central management and control is exercised. In relation to the Trusts, the essential responsibility for decision making was intended from the outset to be exercised, and was in fact exercised, by Mr. Dunin and Mr. Garron, not St. Michael Trust Corp. Therefore, the central management and control of the Trusts was located in Canada, and the Trusts were resident in Canada.

...

[55] It remains the case to this day that, for income tax purposes, the residence of a corporation is determined primarily by finding the location of the corporation's central management and control, which is a question of fact. The relevant factors include the legal indicia of the place where the corporation's management and control should be exercised (as disclosed, for example, by the corporation's governing law and constating documents). Where a corporation is actually managed and controlled by its directors in the manner contemplated by its governing law, the residence of a corporation usually will be determined as the place where the corporate directors exercise their management and control responsibilities.

[56] However, that may not be the result if the facts disclose that the corporation is not in fact managed and controlled as its governing law requires. In that regard it is relevant to consider the nature of the decision making authority actually exercised by the directors. If significant management decisions are in fact taken by a person who is not a director, the place where that person resides or operates may be determined to be the residence of the corporation. Thus, for example, if it is established that management and control is exercised in fact by a shareholder operating out of another country, the corporation may be found to be resident where the shareholder resides: see *Unit Construction Co. Ltd. v. Bullock*, [1960] A.C. 351.

[57] There is very little jurisprudence relating to the determination of the residence of a trust for tax purposes. Justice Woods reviewed the jurisprudence and concluded, correctly in my view, that there is no case law establishing a single test for determining the residence of a trust. She also concluded that "the judge-made test of residence that has been established for corporations should also apply to trusts, with such modifications as are appropriate" (reasons, paragraph 162). I agree with her, substantially for the reasons she gave.

[58] Some learned writers on tax matters have expressed the opinion that the residence of a trust is determined solely by the residence of the trustee, citing cases where the residence of a trust has been found to be the place where the trustee resides (or, in one case, in the place where the majority of the trustees reside, the trust indenture having permitted the majority to act for the trust: see *Trustee of Thibodeau Family Trust v. Canada*, [1978] F.C.J. No. 607, 78 DTC 6376 (T.D.)).

[59] However, no case has established that the residence of the trustee is an invariable legal test for the residence of the trust. Nor has any case rejected conclusively the central management and control test as an appropriate legal test for the residence of a trust in a situation where it was found, for example, that someone other than the trustee exercised management and control of the trust property, or that the trustee resided in one place but exercised the management and control of the trust property in another place.

[60] Certain comments in *Thibodeau* have sometimes been taken as a rejection of the corporate test of residence for a trust. In fact the Crown had submitted in that case that the central management and control test should be applied, and that submission was rejected. However, the comments that are most often cited in support of a blanket rejection of the central management and control test for a trust were made in the context of a narrower submission to the effect that the trust could have been resident in two places because one trustee lived in Canada and two lived in Bermuda. What the judge said (at paragraph 22; DTC page 6385) is this:

As to the submission that the Court in this case, even if it also finds that the Trust has a residence in Bermuda, it should find that it has a residence in Canada in that part of the

paramount or supreme authority in relation to the management of this Trust was carried on in Canada applying by analogy the principles in the cited cases of determining residence for income tax purposes of corporations, in my view, such submission is also not valid. The judicial formula for this respecting a corporation, in my view, cannot apply to trustees because trustees cannot delegate any of their authority to co-trustees. A trustee cannot adopt a "policy of masterly inactivity" as commented upon in Underhill on the Law of Trusts and Trustees, 12th Edition, page 284; and on the evidence, none of the trustees did adopt such a policy. Therefore, it is not possible for a trust to have a dual residence for income tax purposes, and therefore it is not possible to find that part of the paramount of "superior and directing authority" of a Trust is and was in two places. In any event, a finding of dual residence of this Trust is not made in this case.

...

[62] By analogy from *DeBeers, supra*, the task is to determine where a trust "keeps house and does business", i.e. where the powers and discretions of the trustee are really being exercised. It may well be that in most cases, the residence of the appointed trustee is a sufficient basis in fact for determining the residence of the trust. This is the case where the trustee is given and actually exercises the powers and discretions regarding the management and control of the trust property, and does so where he resides. However, a rigid legal test that *necessarily* ties the residence of a trust to the residence of the trustee regardless of the facts is, in my view, not sound in principle because it denies the central theme of the jurisprudence on the determination of residence for tax purposes, which is that residence fundamentally is a question of fact. I conclude therefore that where a question arises as to the residence of a trust for tax purposes, it is appropriate to undertake a fact driven analysis with a view to determining the place where the central management and control of the trust is actually exercised.

...

[64] St. Michael Trust Corp. also argues that the residence of the trust must be determined as the residence of the trustee because section 104 of the *Income Tax Act* embodies the trust, as taxpayer, in the person of the trustee. In my view, that gives section 104 a meaning beyond its words and purpose. Section 104 was enacted to solve the practical problems of tax administration that would necessarily arise when it was determined that trusts were to be taxed despite the absence of legal personality. I do not read section 104 as a signal that Parliament intended that in all cases, the residence of the trust must be the residence of the trustee.

[65] Finally, St. Michael Trust Corp. argues that, even if the residence of the Garron Trust and the Dunin Trust in 2000 was the place where their central management and control was exercised at that time, Justice Woods made a palpable and overriding error in applying that test to the facts. To assess the validity of that argument, it is necessary to consider the factors that Justice Woods took into account in locating the central management and control of the Trusts in Canada, where Mr. Garron and Mr. Dunin resided.

[66] Justice Woods concluded that St. Michael Trust Corp. was not exercising the main powers and discretions of the trustees under the trust indentures. Rather its true role was "to execute documents as required, and to provide incidental administrative services", and it was not expected to "have responsibility for decision-making beyond that" (at paragraph 189). Rather than exercising its powers and discretions under the trust indentures, St. Michael Trust Corp. would default automatically to the recommendation of Mr. Dunin and Mr. Garron. This was "understood to be the arrangement from the outset" (at paragraph 194). She found that it was Mr. Dunin and Mr. Garron "who made the substantive decisions respecting the Trusts", not St. Michael Trust Corp. (at paragraph 252). In reaching these conclusions, Justice Wood relied on a number of facts which are fully stated in her reasons. I summarize as follows a number of these facts:

- a. Under the terms of the trust indentures, Mr. Garron and Mr. Dunin and their respective spouses alone could replace the protector, who in turn could replace the trustee, if the trustee acted against their wishes.

b. The limited role of St. Michael Trust Corp. was understood by all parties at the outset. In particular, it was understood that St. Michael Trust Corp. would have no decision making role in relation to the sale of the Trusts' interests in PMPL, the investment of the cash proceeds received on the sale, the making of distributions to the beneficiaries, and the taking of appropriate action to minimize the tax burden of the Trusts. It was further understood from the outset that decisions of that nature would be made by Mr. Garron and Mr. Dunin and implemented by St. Michael Trust Corp. under their direction.

c. The Trusts used the same investment advisers as the beneficiaries. This allowed the beneficiaries to deal directly with the Trusts' financial advisers and directly control the Trusts' investment activity without the involvement of St. Michael Trust Corp.

d. The tax advisers to Mr. Garron and Mr. Dunin were also used for the Trusts and when acting for the Trusts **were directed by Mr. Garron and Mr. Dunin.**

e. **There is no documentary evidence that St. Michael Trust Corp. took an active role in managing the Trusts, and the correspondence and other documents introduced by the Crown indicated that St. Michael Trust Corp. had no involvement in the affairs of the Trusts except the execution of documents and in administrative, accounting and tax matters.**

f. St. Michael Trust Corp. was an arm of an accounting firm and thus had significant expertise in tax and accounting matters, but there is no evidence that it had any expertise in the management of trust assets.

g. The oral evidence of Mr. Garron and Mr. Dunin did not provide a clear picture of how the Trusts operated, and was less than full and complete.

h. Mr. Dunin in particular was disingenuous when he testified that St. Michael Trust Corp. controlled the Trusts.

i. Mr. Dunin attempted to give the impression that he had little interest in what St. Michael Trust Corp. **was actually doing** vis-à-vis the Dunin Trust which, given his economic interest in the Dunin Trust, supports the conclusion that it was Mr. Dunin himself who was in effective control. The same can be said about the evidence of Mr. Garron that he had little interest in what St. Michael Trust Corp. was doing.

j. Other individuals who could have shed light on the relevant facts as to the operation of the Trusts were not called to give evidence. That included the various advisers who were involved in planning and implementing the relevant transactions, Mr. Gill who was the protector of both Trusts, Mr. Jesson who was in charge of St. Michael Trust Corp. when the Trusts were created and the person who prepared the memoranda of "trustee intentions" quoted above, Mr. Knott who had the day to day responsibility for the Trusts, Mr. Carroll who was the lead adviser on the sale of PMPL, and various other individuals who acted as investment advisers to the Trusts or who were involved in the selection of investment advisers.

k. The evidence of Mr. Hutchinson, an officer of St. Michael Trust Corp. who dealt with the Trusts, was not particularly helpful because of his lack of personal knowledge of events that occurred before his involvement in 2003. **In particular, Mr. Hutchinson could provide no useful information about the degree of due diligence undertaken by St. Michael Trust Corp. in relation to any of the relevant transactions.**

l. **Mr. Hutchinson testified that the directors of St. Michael Trust Corp. were required to ratify actions proposed to be taken or taken by the Trusts, but there is no evidence that they had much substantive information about the transactions, which tends to support the proposition that they knew that the role of St. Michael Trust Corp. was intended to be limited to administrative matters.**

[67] Some of the factors listed above are common characteristics of ordinary trusts and, considered in isolation, would not be sufficient to locate the management and control of the Trusts

anywhere but the residence of the St. Michael Trust Corp. For example, the fact that the beneficiaries have the right to appoint a protector who has the power to replace the St. Michael Trust Corp. as trustee is a common safeguard in a trust indenture and would not by itself be enough to find the beneficiaries to be in control of the property of the Trusts. The same could be said of the fact that St. Michael Trust Corp. and the beneficiaries employ common advisers, or the fact that the beneficiaries took it on themselves to advise the St. Michael Trust Corp. and even urged St. Michael Trust Corp., however strongly, to undertake a particular transaction. Indeed, the appointment of a trustee with little investment experience in a trust that requires the property to be invested might not be significant, provided that the trustee has the power to retain others for advice and, in the end, is the one making the decisions.

[68] However, there is a line to be drawn. On one side of the line are recommendations, even strong ones, by the beneficiaries to the trustee, leaving the trustee free to decide how to exercise the powers and discretions under the trust. In that case, the trustee is still managing and controlling the trust. On the other side of the line the beneficiaries are really exercising the powers and discretions under the trusts, managing and controlling the trusts, and displacing the appointed trustee. As mentioned above, on which side of the line a case falls is a factual question, requiring consideration of the evidence in its totality.

...

[70] Indeed, what else is to be made of the common understanding of the parties, as found by Justice Woods, that decisions in relation to the sale of the Trusts' interests in PMPL, the investment of the cash proceeds received on the sale, the making of distributions to the beneficiaries, and the taking of appropriate action to minimize the tax burden of the Trusts would be made by Mr. Garron and Mr. Dunin and implemented by St. Michael Trust Corp.? What else explains the lack of documentary or other evidence that St. Michael Trust Corp. took an active role in assessing any of the important decisions relation to the disposition of the property of the Trust? What is the explanation for the professed lack of interest on the part of Mr. Garron and Mr. Dunin of the capabilities of St. Michael Trust Corp. to manage trust assets, except in relation to the work ordinarily done by someone with accounting and tax expertise? What is the explanation for the paucity of evidence as to the formation and operation of the Trusts and the failure to call key witnesses?"

Without getting into it, is this also not an instance where the beneficiaries could be argued to have such a degree of control over the property, and the lack of substantive control by the "trustees", that **beneficial ownership** resided with the Cdn. residents?

On appeal to the SCC³¹⁷ that Court held:

Taxation — Income tax — Trusts — Residence — Trusts held by corporation resident in Barbados — Beneficiaries of trusts resident in Canada — Central management and control of trusts carried out by main trust beneficiaries in Canada — Trustee seeking return of amounts withheld on account of Canadian tax from capital gains realized by trusts on sale of shares in Canada — Whether trusts are resident in Canada for taxation purposes.

Held: The appeals should be dismissed.

The principal basis for imposing income tax in Canada is residency. As with corporations, the residence of a trust should be determined by the principle that a trust resides for the purposes of the *Income Tax Act* where its real business is carried on, which is where the central management and control of the trust actually takes place. The residence of the trust is not always that of the trustee. It will be so where the trustee carries out the central management and control of the trust where the trustee is resident. Here, however, the trusts are resident in Canada, since the central management and control of the trusts was exercised by the main beneficiaries in Canada and the trustee's limited role was to provide administrative services and it had little or no responsibility beyond that.

317 *Fundy Settlement v. Canada*, 2012 SCC 14, [2012] 1 S.C.R. 520

Cases Cited

Referred to: *De Beers Consolidated Mines, Ltd. v. Howe*, [1906] A.C. 455; *The King v. British Columbia Electric Railway Co.*, [1945] C.T.C. 162; *Crossley Carpets (Canada) Ltd. v. M.N.R.* (1967), 67 D.T.C. 522; *Unit Construction Co. v. Bullock*, [1960] A.C. 351.

Statutes and Regulations Cited

Canada-Barbados Income Tax Agreement Act, 1980, S.C. 1980-81-82-83, c. 44, s. 25.

Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), ss. 2(1), 94, 104(1), (2), 245.

Treaties and Other International Instruments

Agreement Between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, Can. T.S. 1980 No. 29.

Authors Cited

Krishna, Vern. *The Fundamentals of Income Tax Law*. Toronto: Carswell, 2009.

APPEALS from a judgment of the Federal Court of Appeal (Nadon, Sharlow and Stratas J.J.A.), 2010 FCA 309, 411 N.R. 125, [2011] 2 C.T.C. 7, 2010 D.T.C. 5189, 61 E.T.R. (3d) 168, [2010] F.C.J. No. 1457 (QL), 2010 CarswellNat 4259 (*sub nom. St. Michael Trust Corp. v. Minister of National Revenue; Garron Family Trust v. The Queen*), affirming a decision of Woods J., 2009 TCC 450, [2010] 2 C.T.C. 2346, 2009 D.T.C. 1287, 50 E.T.R. (3d) 241, [2009] T.C.J. No. 345 (QL), 2009 CarswellNat 2600 (*sub nom. Garron Family Trust v. The Queen*). Appeals dismissed.

Douglas H. Mathew, Matthew G. Williams and Mark A. Barbour, for the appellants.

Anne M. Turley and Daniel Bourgeois, for the respondent.

THE FOLLOWING IS THE JUDGMENT DELIVERED BY

[1] THE COURT — St. Michael Trust Corp. (“St. Michael”) is the trustee of two trusts, the Fundy Settlement and the Summersby Settlement. The trusts were settled by an individual resident in St. Vincent in the Caribbean. The beneficiaries are residents of Canada. St. Michael is a corporation resident in Barbados.

[2] When the trusts disposed of shares they owned in two Ontario corporations, the purchaser remitted some \$152 million to the Minister of National Revenue as withholding tax on account of Canadian tax from capital gains realized by the trusts on the sale of the shares.

[3] St. Michael sought return of the withheld amount based on an exemption from Canadian capital gains tax under the *Agreement Between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital*, Can. T.S. 1980 No. 29 (incorporated into Canadian law by the *Canada-Barbados Income Tax Agreement Act, 1980*, S.C. 1980-81-82-83, c. 44, s. 25). Under the treaty, tax would only be payable in the country in which the seller was resident. St. Michael claimed that because it was resident in Barbados, the trusts were resident in Barbados. As a result, there would be no basis for withholding tax in Canada.

[4] The Minister of National Revenue was of the opinion that the trusts were resident in Canada and that the withheld tax was properly payable.

[5] St. Michael’s appeal from the Minister’s reassessment to the Tax Court of Canada was unsuccessful (2009 TCC 450, [2010] 2 C.T.C. 2346), as was its further appeal to the Federal Court of Appeal (2010 FCA 309, 411 N.R. 125). It was granted leave to appeal to this Court.

[6] **The issue in this case is the residence of the Fundy and Summersby trusts. St. Michael says the residence of the trusts is the residence of the trustee, which is Barbados. The Minister says the trusts are resident in Canada because the central management and control of the trusts was carried out by the main beneficiaries, who were resident in Canada. On the facts as determined by Woods J., the Tax Court judge, St. Michael is resident in Barbados while the central management and control of the trusts was carried out in Canada by the main beneficiaries of the trusts.**

[7] As Sharlow J.A. in the Federal Court of Appeal explained, the principal basis for imposing income tax in Canada is residency (para. 52). Professor V. Krishna in *The*

***Fundamentals of Income Tax Law* (2009), noted, at p. 85, that the policy reason for this is to ensure that a person who enjoys the legal, political and economic benefits of associating with Canada will pay their appropriate share for the costs of this association. For an individual, factors such as nationality, physical presence, location of family home and social connections, among others, will be considered in determining residence. While the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (the “Act”), contains certain deeming rules with respect to residency, generally residence is a question of fact.**

[8] While there is a dearth of judicial authority on the question of the residency of a trust, the residency of a corporation has been determined to be where its central management and control actually abides. In *De Beers Consolidated Mines, Ltd. v. Howe*, [1906] A.C. 455 (H.L.), Lord Loreburn stated, at p. 458:

In applying the conception of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business. . . . [A] company resides for purposes of income tax where its real business is carried on. . . . I regard that as the true rule, and the real business is carried on where the central management and control actually abides.

The central management and control test for residency of a corporation has been adopted in Canada in a number of cases and is well established (see *The King v. British Columbia Electric Railway Co.*, [1945] C.T.C. 162 (Ex. Ct.); *Crossley Carpets (Canada) Ltd. v. M.N.R.* (1967), 67 D.T.C. 522 (T.A.B.)).

[9] In general, the central management and control of a corporation will be exercised where its board of directors exercises its responsibilities. However, as Sharlow J.A. pointed out (at para. 56), where the facts are that the central management and control is exercised by a shareholder who is resident and making decisions in another country, the corporation will be found to be resident where the shareholder resides. (See *Unit Construction Co. v. Bullock*, [1960] A.C. 351 (H.L.).)

[10] St. Michael says that the residence of the trust must be the residence of the trustee based on two fundamental propositions. First, the trust is not a person like a corporation, so the central management and control test is inapplicable to trusts. Sharlow J.A. disposed of St. Michael’s first argument summarily, as do we. While a trust is not a person at common law, it is deemed to be an individual under the Act. Section 104(2) provides:

A trust shall, for the purposes of this Act, and without affecting the liability of the trustee or legal representative for that person’s own income tax, be deemed to be in respect of the trust property an individual

We agree with the Minister that the fact that at common law a trust does not have an independent legal existence is irrelevant for the purposes of the Act.

[11] St. Michael’s second argument is that the Act links a trust to the trustee and therefore the residence of the trust must be the residence of the trustee. It bases this argument on s. 104(1), which provides:

In this Act, a reference to a trust or estate . . . shall, unless the context otherwise requires, be read to include a reference to the trustee, executor, administrator, liquidator of a succession, heir or other legal representative having ownership or control of the trust property

The Federal Court of Appeal found that the linkage in s. 104(1) was for the purposes of solving “the practical problems of tax administration that would necessarily arise when it was determined that trusts were to be taxed despite the absence of legal personality” (para. 64). However, this did not mean that in all cases, the residence of the trust must be the residence of the trustee.

[12] St. Michael argues that s. 104(1) links the trustee to the trust for all attributes of a trust, including residency. However, although the subsection provides that a reference to a trust in the Act shall be read to include a reference to a trustee, St. Michael points to no provision that

would link the trust and the trustee for purposes of determining the residency of the trust. The link that St. Michael asserts is not a principle of general application to trusts for all purposes, and there is nothing in the context of s. 104(1) that would suggest that there be a legal rule requiring that the residence of a trust must be the residence of the trustee.

[13] On the contrary, s. 2(1) is the basic charging provision of the Act, and its reference to a “person” must be read as a reference to the taxpayer whose taxable income is being subjected to income tax. This is the trust, *not* the trustee. This follows from s. 104(2), which separates the trust from the trustee in respect of trust property.

[14] On the other hand, there are many similarities between a trust and corporation that would, in our view, justify application of the central management and control test in determining the residence of a trust, just as it is used in determining the residence of a corporation. Some of these similarities include:

- (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 advisors; and
- (6) Both may distribute income, corporations by way of dividends and trusts by distributions.

As Woods J. noted: “The function of each is, at a basic level, the management of property” (para. 159).

[15] 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.

[16] We agree with Woods J. that adopting a similar test for trusts and corporations promotes “the important principles of consistency, predictability and fairness in the application of tax law” (para. 160). As she noted, if there were to be a totally different test for trusts than for corporations, there should be good reasons for it. No such reasons were offered here.

[17] For these reasons, we would dismiss the appeals with costs.

[18] In the alternative, the Minister argued that the trusts are deemed residents of Canada under s. 94, which provides a scheme for taxing non-resident trusts. Even if the trusts were found not to be resident in Canada under common law principles, the Minister submitted that their assessments were justified under s. 94 because the trusts were deemed to be Canadian residents for the purposes of the Act, and therefore Canadian residents for the purposes of the treaty exemption. In the case that this alternative argument failed, the Minister further argued that the tax benefit should be denied according to the general anti-avoidance rule under s. 245 of the Act because it would frustrate the purpose of relevant parts of the treaty.

[19] Given our conclusion that the trusts are resident in Canada under common law principles, it is not necessary to consider the arguments made about s. 94 or s. 245 of the Act. We should not be understood as endorsing the reasons of the Federal Court of Appeal on those matters.

In *Commissioners For Her Majesty's Revenue And Customs v. Smallwood & Anor.*³¹⁸ the UK Ct. of Appeal had to consider an instance where the taxpayer had been advised to temporarily send a trust off-shore temporarily to "wiggle between" the application of two provisions on the trust's disposition of property to access treaty tax rates. While the Court did examine, in detail, the parameters by which the relevant provisions applied to a trust, when on the superficial review the trust did access them, it determined the residence of the trust with:

"The question which this therefore raises (and critically in the present case) is how the DTA is intended to resolve residence/residence based conflicts when the liability under the relevant domestic legislation does not depend upon concurrent periods of residence.

...

With respect to the judge, I am not convinced about this. For the reasons I have explained, Article 13(4) must, I think, be construed as effective to deal with any liability to taxation for capital gains which either Contracting State may impose regardless of the basis of that charge under the domestic legislation in question. It seems to me unlikely that the draftsman of the Model Convention intended that capital gains which are to be taxable only on the basis of residence should depend exclusively on residence at the date of disposal and so exclude the rights of a Contracting State to tax gains by reference to residence within the same tax year. The definition of "resident of a Contracting State" in Article 4(1) re-inforces this view by making "liability to taxation" by reason of residence the criterion for the taxation of capital gains under Article 13(4). This, I think, must denote what the Special Commissioners described as chargeability and not simply physical residence. That view is, I think, consistent with the purpose of Article 13(4) and avoids descending into whether the UK or Mauritian requirements for residence are satisfied. The definition assumes that they are and allocates the right to tax on the basis that there is liability.

...

I therefore accept Mr Brennan's basic submission that the provisions of Article 13(4) are not to be read as incorporating a reference to the date of disposal but (for the reasons already given) I am not persuaded by his submission that one can construe Article 4(1) as meaning no more than tax resident and so avoid any application of the tie-breaker provisions in Article 4(3). The definition of "resident" in Article 4(1) is critical to the meaning of Article 13(4) and Article 4, once applied by the wording of Article 13(4), has to operate in its entirety. The definition of "resident" in Article 4(1) is expressly subject to Article 4(3) which therefore applies whenever the alienator is liable to taxation in both Contracting States in respect of the gain. Article 4(3), as I have explained, is focused on liability for tax regardless of the period of residence under national law which creates that liability. Looked at in this way it becomes meaningless and impermissible to draw a distinction between consecutive and concurrent periods of "residence".

...

It was also taken to be the correct test by the special commissioner (Mr David Shirley) in *Wensleydale's Settlement Trustees v IRC* [1996] STC 241. The Special Commissioners took as their formulation of the test a passage in the current Commentary on Article 4(3) of the Model Convention which is in these terms:-

"As a result of these considerations, the 'place of effective management' has been adopted as the preference criterion for persons other than individuals. The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made. The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only

318 [2010] BTC 637, [2010] STC 2045, [2010] STI 2174, 12 ITL Rep 1002, [2010] EWCA Civ 778

one place of effective management at any one time."

Mr Prosser accepts that this is the test to be applied and that what has to be identified is the place where the real top-level management of the trustee qua trustee occurred rather than the day-to-day administration of the trust. But he submits that the top-level management of a company is usually carried out by its board of directors (as the Commentary suggests) unless it can be shown that the control of the company's affairs was effectively usurped and exercised by some third party and that the directors were content merely to rubberstamp the decisions which were taken. In this case there was, he says, no evidence or finding that KPMG Bristol or Mr Smallwood dictated the decision to sell the shares.

...

In their decision they concentrated on the management of the trusts between 19th December 2000 (when Lutea retired) and 2nd March 2001 when PMIL retired and was replaced by Mr and Mrs Smallwood. They found in terms that all the actions of PMIL in Mauritius were carried out correctly and were properly documented. This meant that the appropriate meetings took place there and the necessary resolutions were passed. But (in paragraph 133) they said that:-

"Nevertheless during the Mauritius period the influence of Mr Smallwood, who was the settlor and who alone had the power to appoint new trustees, and the guiding hands of Mr Gadd and Mr Turbervill of KPMG Bristol, were evident throughout. We first consider the evidence about the role of KPMG Bristol."

The Special Commissioners heard evidence from Mr John Turbervill (a senior manager at KPMG Bristol) and Mr Roger Gadd, one of the directors of the private client department. They said that KPMG Bristol (which had recommended the use of the Round the World scheme to Mr Smallwood) were acting purely as tax advisers and could not tell the trustees what to do. They were in contact with PMIL throughout the tax planning exercise but in order to make sure that what was going on fitted within that exercise. There was a confident expectation that the scheme would be followed through but no more than an expectation. PMIL could still have decided not to sell the shares.

The Commissioners also heard evidence from Ms Taher, the departmental manager at PMIL who had responsibility for regulatory compliance, and from Mr Jaye Jingree, the managing director of PMIL. The effect of their evidence and the relevant findings of fact are contained in the following paragraphs of the Decision:-

"136. We accept the evidence of Ms Taher that there was no formal appointment by PMIL as trustee of the Trust for KPMG Bristol to advise PMIL "but then they were all part of the KPMG network, and they had introduced the [Trust] client to us, so it was normal practice for us to deal with another KPMG office; it was normal practice for us to take some advice from the other KPMG offices who were dealing with the particular company or trust". Mr Jingree told us that it was normal practice within his firm to get in touch with the person who had introduced a client and to keep the introducer briefed about progress.

137. In the light of this evidence we find that KPMG Bristol saw themselves as tax advisers to the trustees of the Trust, being first Lutea and then PMIL. **There was no formal appointment by PMIL but that was not regarded as necessary as both KPMG Bristol and KPMG Mauritius were "under the KPMG umbrella". With that conclusion in mind we turn to examine the facts relevant to the place of effective management.**

The relevant facts

138. The tax planning scheme was devised by KPMG Bristol as tax advisers to Lutea, the previous trustee of the Trust. Mr Smallwood had retired as Chairman of FirstGroup and any restrictions on the sale of the FirstGroup shares had been lifted. A tax efficient way of diversifying the portfolio of investments held for the Trust was needed. The appointment of trustees in Mauritius had been the idea of Mr Turbervill and the details were described to Mr Smallwood as early as August 2000. Mr Smallwood had the power to appoint new trustees. It was Mr Turbervill who approached PMIL and told them about the tax planning

proposals and set out the basis of their appointment in the email of 24 November 2000. That made it clear that the confident expectation was that the shares would be sold before 5 April 2001.

139. **We accept the evidence of Ms Taher that she did not understand "the basis" referred to in the email of 24 November 2000 as to mean that the sale of the shares was a condition for PMIL to accept the appointment as trustee; her evidence was that the trustees would wish to receive appropriate advice and recommendations. However, she accepted that eventually as part of the tax planning exercise the shares would be sold at some time. We accept the evidence of Mr Jingree that there was no agreement that PMIL would behave in a certain way or make certain decisions as a quid pro quo for the introduction of the Trust. PMIL's duties as trustee were laid down in legislation and in the trust deed and PMIL would only act within the context of what it was allowed to do. We also accept the evidence of Mr Jingree that the whole point of the tax planning exercise was to sell the shares and to realise the gain and to avoid tax on the gain.**

140. **The facts surrounding the appointment of PMIL lead us to the view that the real top level management, or the realistic, positive management of the Trust, remained in the United Kingdom. We accept that the administration of the Trust moved to Mauritius but in our view the "key" decisions were made in the United Kingdom.**

141. **This view is confirmed by subsequent events.** The sale of the FirstGroup shares was not an isolated decision taken by PMIL on 10 January 2001. It had been carefully arranged beforehand by the transfer of the shares to Quilter to be held in their nominee account. Further, Mr Bazzone of Quilter had been told of the tax planning exercise and that Quilter would be asked to dispose of the holding of FirstGroup shares after PMIL had been appointed. It was when Mr Bazzone of Quilter told Mr Gadd on 4 January 2001 that he needed instructions from the new trustees that Mr Turbervill prompted PMIL to get on with what they should be doing. At no time did Mr Bazzone recommend the sale of all the shares but the sale of all the shares fitted in with the tax planning scheme. When Mr Bazzone wrote on 6 January to PMIL about the sale of the shares Mr Jingree was away from the office and Mr Shah asked Mr Turbervill for advice. There was then a delay in PMIL receiving the deed of indemnity and Mr Turbervill sent his email of 8 January to PMIL, Lutea and Mr Bazzone that no instructions to sell the shares should be given until the deed had been received. PMIL also asked Mr Turbervill to help with the opening of the account with Quilter and Mr Turbervill suggested an investment objective of capital growth with medium risk. Even on the date of the decision to sell Mr Bazzone had to remind PMIL how many FirstGroup shares were to be sold. Mr James Baxter of Merchant took the initiative in obtaining a set of account opening forms for Merchant.

142. **We accept the evidence of Mr Jingree that the sale of the shares was motivated by United Kingdom tax planning reasons. The purpose of selling all the shares was to ensure that the tax planning which had been put in place worked to the best advantage of the Trust and it was vital that all of the shares were sold prior to the end of March in order to achieve this. The decision to sell all the shares was made in the hope that all the shares could be sold before the end of March. However, if it had not been in the interests of the beneficiaries and the Trust, the trustees would not have sold the shares; "if the funds which had been realised had to go away in taxes then it would not have been in the best interests of the beneficiaries". Also, if the share price dropped dramatically, and if the fund manager had advised against a sale, then the trustees would not have decided to sell. We also accept the evidence of Ms Taher that the decision to sell all the shares was based upon tax planning and the need for the shares to be sold by a particular date. The fact that the share price had gone up was not the "driver" for the sale of the shares.**

143. **We fully accept that the decision to sell the shares that day was taken by the directors**

of PMIL at the telephone meeting on 10 January 2001. We also accept that if, for example, the price of the shares had fallen to a level that meant that no gain would be realised on their disposal, the shares would not have been sold but would have been retained and perhaps sold later. Nevertheless, in our view this was a lower level management decision as there was no doubt that the shares would be sold; the real top level management decisions, or the realistic, positive management decisions of the Trust, to dispose of all the shares in a tax efficient way, had already been, and continued to be, taken in the United Kingdom. The "key" decisions were made in the United Kingdom.

144. Finally the events after the sale of the shares confirm our view. The tax planning exercise was completed by the appointment of United Kingdom trustees. We remark that PMIL's fee note was approved by Mr Turbervill.

145. We conclude that the state in which the real top level management, or the realistic, positive management of the Trust, or the place where key management and commercial decisions that were necessary for the conduct of the Trust's business were in substance made, and the place where the actions to be taken by the entity as a whole were, *in fact*, determined between 19 December 2000 and 2 March 2001 was the United Kingdom."

...

The importance of the case for present purposes lies in the analysis by Chadwick LJ of what is capable of constituting management and control of a company by persons who are not its directors. Referring to the treatment of this issue by Park J at first instance, he said this:-

"[26] At para [26] of his judgment the judge had examined four cases in which (as he said) the courts had recognised the considerations to which he had just alluded. Those cases were *Re Little Olympian Each Ways Ltd* [1995] 1 WLR 560, *Esquire Nominees Ltd v Comr of Taxation* (1971) 129 CLR 177, *New Zealand Forest Products Finance NV v Comr of Inland Revenue* [1995] 2 NZLR 357 and *Untelrab Ltd v McGregor (Inspector of Taxes)* [1996] STC (SCD) 1. He accepted, of course, that each of those cases was decided on its own facts; but 'they do have some common features which ... are relevant to the present case'. He identified those features at para [27]:

'[27] ... They all involved persons based in one jurisdiction (commonly a high tax jurisdiction) causing companies to be established in other jurisdictions (commonly low or no tax jurisdictions). In all the cases the companies so established were intended to fulfil particular purposes which were ancillary to the activities of the persons who caused them to be established. **In all the cases the local managements did not take initiatives, but responded to proposals (described in some passages in the judgments as instructions) which were presented to them. In all the cases they did implement the proposals, and it is obvious that, when the foreign companies had been established, the confident expectation was that they would implement the proposals. In general, although large amounts of money may have been involved, the functions which the companies were established to fulfil did not involve much regular activity, so there was no great need for frequent exercises of central management and control.**

...

In my view the judge was correct in his analysis of the law. In seeking to determine where 'central management and control' of a company incorporated outside the United Kingdom lies, it is essential to recognise the distinction between cases where management and control of the company is exercised through its own constitutional organs (the board of directors or the general meeting) and cases where the functions of those constitutional organs are 'usurped'—in the sense that management and control is exercised independently of, or without regard to, those constitutional organs. And, in cases which fall within the former class, it is essential to recognise the distinction (in concept, at least) between the role of an

'outsider' in proposing, advising and influencing the decisions which the constitutional organs take in fulfilling their functions and the role of an outsider who dictates the decisions which are to be taken. In that context an 'outsider' is a person who is not, himself, a participant in the formal process (a board meeting or a general meeting) through which the relevant constitutional organ fulfils its function."

...

The conclusion of the Special Commissioners (in paragraph 140 of their Decision) that the key decisions were made in the UK where the realistic, positive management of the trusts remained is said to be based on the facts surrounding the appointment of PMIL. It is clear that they were appointed as part of a pre-existing scheme which involved choosing Mauritius as the situs of the trust because of its favourable treatment of capital gains. It is equally clear that PMIL accepted the trusteeship on the basis that the shares would be sold as part of that tax planning exercise and that the shares were indeed sold in accordance with the scheme. But the Special Commissioners also accepted Mr Jingree's evidence that there was no agreement that PMIL would behave in a certain way or make certain decisions as a *quid pro quo* for the introduction of the trust and that had the sale of the shares not been in the interests of the beneficiaries as at the date of the sale then PMIL would not have agreed to sell.

I find it difficult to accept that on the basis of these findings the Special Commissioners could properly have concluded that the POEM of the trustees up to March 2001 lay in the UK rather than in Mauritius. The findings made do not go beyond saying that PMIL accepted the advice of KPMG to proceed with and implement the scheme in the interests of the beneficiaries. But they retained their right and duties as trustees to consider the matter at the time of alienation and did not (on the Special Commissioners' findings) agree merely to act on the instructions which they received from KPMG. **The function of the directors was *not* therefore usurped in the sense described in *Wood v Holden*. It seems to me to follow that the Special Commissioners' conclusions are not ones which were therefore open to them on the evidence or on the findings of fact which they made.** "

Leighton v Commissioner of Taxation³¹⁹ is an interesting recent Australian case whereby the tax authorities successfully contended that by virtue of the fact that the corpus of the trust (sale proceeds of shares) were held in an Aust. resident bank, and the account holders were acting as trustees, the otherwise non-resident office holders would be subject to income tax. It is a wonderful case that reflects the terms contained in our Sec. 104(1) references to both ownership and control.

This being said, one must distinguish, also, in the author's opinion, the difference between where the controlling/owning trustees reside and where they are capable of exercising that control or ownership rights. This is the proper approach in ascertaining corporate residence and in the author's opinion, although it wasn't dealt with in Thibodeau Family Trust the salient fact in that case was that the assets, the trustees, and the administration of the assets had been moved out of Canada thus the trustees did not have to return to Canada to apply to the courts in respect of administration questions and the beneficiaries rights would have been enforceable only by the foreign jurisdiction's legal system. By moving the assets out of Canada, as well as the control of those assets the Canadian legal system ceased to apply and control was exercisable only from within Bermuda.

If one examines this issue more in detail it would appear that a foreign resident trustee can exercise a multitude of powers and rights while being non-resident without ever having to petition the domestic courts for judicial opinion.³²⁰ In the case of estates and the passing of their accounts, the domestic courts would have on-going relevance throughout the administration, (probate would have to be obtained from them,

319 [2010] FCA 1086 (6 October 2010)

320 The proper law of the trust was implicitly held irrelevant in determining residency in Thibodeau Family Trust and Jones Trust.

beneficiary disputes would have to be heard, etc.). In the case of trusts, however, the courts, to an extent, may have significantly less involvement and the trust can be completely functional from a non-resident control base. A taxpayer doesn't cease to be a trustee if he resides in a foreign jurisdiction; domestic courts serve as a forum, primarily, in which the trust problems may be solved should they evolve and the fact that the non-resident trustee must apply thereto to solve questions of duty, etc., does not preclude him from dealing with the trust property principally unhindered while non-resident. The extent of the involvement of the domestic courts, determined primarily by the state of the trust/estate situation has significant importance since if the trustee cannot exercise control without the blessing of the domestic courts clearly control can only be exercised from within Canada and the actual residence of the trustee ceases to be relevant. The contrary would tend to result in the opposite.

In the author's opinion, the residence of the beneficiaries of a trust/estate substantively controlled elsewhere, as per the incidental comments in *Holden v. M.N.R.*³²¹ are and will continue to be, irrelevant in establishing residence of the trust/estate in Canada tax law. The situs of the trust property has the same effect on the residence of the trust in the same way as the involvement of the domestic courts.

In *Alworth v. Min. of Finance*³²² the Supreme Court paid special attention to both a bare trustee and a discharged executor in recognizing that they were captured for logging tax remittance under a provision very much like Sec. 104(1).

In respect of compelling CRA to bind itself to recognizing the residency of a trust there are at least two cases that illustrate instances where there have been hic-cups in the process. Such was the case in *Hugh William Perry, in his Capacity of Trustee of the 2005 Robert Julien Family Delaware Dynasty Trust v. Canada (The Minister of National Revenue) and Canada Revenue Agency*³²³ where the Fed. Trial Court was approached in an effort of writ of *mandamus* to compel CRA to make a decisive pronouncement on trust residency. The court refused. In the *Minister of National Revenue v. Robert M.O. Morris et. al.*³²⁴ the issue was whether the taxpayer could compel the Minister to make a determination of residency that would apply for Barbados Convention purposes that would pre-empt section 116 certificate process purposes on a disposition of trust property. The Fed. Appeal Court recognized that it hadn't the legal authority to usurp the scheme of the Act and the discretion of the Minister and compel her to make a decision. In the author's opinion, why didn't the taxpayers simply get a ruling first, rather than get a lawyer after the fact.

Income Tax Interpretation Bulletin

Residence of a Trust or Estate

IT-447

DATE: May 30, 1980

SUBJECT: INCOME TAX ACT

Residence of a Trust or Estate

REFERENCE: Subsection 2(1) (also subsections 75(2), 94(1), 104(1) and (2))

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1. The residence of a trust or estate (hereinafter referred to as a trust) in Canada, or in a particular province or territory within Canada, is a question of fact to be determined according to the circumstances in each case. However, a trust is generally considered to reside where the trustee, executor, administrator, heir or

321 1 D.T.C. 243.

322 [1978] 1 S.C.R. 447

323 T-2206-06

324 A-219-09

other legal representative (hereinafter referred to as the trustee) who manages the trust or controls the trust assets resides.

2. The trustee who has management and control of the trust, while he may not have physical possession of the trust assets, will be the person who has most or all of the following powers or responsibilities:

- (a) control over changes in the trust's investment portfolio,
- (b) responsibility for the management of any business or property owned by the trust,
- (c) responsibility for any banking, and financing, arrangements for the trust,
- (d) control over any other trust assets,
- (e) ultimate responsibility for preparation of the trust accounts and reporting to the beneficiaries of the trust, and
- (f) power to contract with and deal with trust advisors, e.g. auditors and lawyers.

3. In certain cases, more than one trustee may be involved in exercising the management and control over the trust. In one such trustee clearly exercises a more substantial portion of the management and control than the others, the trust will reside in the jurisdiction in which that trustee resides. Where two or more trustees exercise relatively equal portions of the management and control of the trust, and trustees exercising more than 50% of such management and control reside in one jurisdiction, the trust will reside in that jurisdiction.

4. In some cases it may not be clear who has management and control of the trust and in these situations the Department will examine other factors relating to the trust to determine residence. The most important of these factors are:

- (a) the location where the legal rights with respect to the trust assets are enforceable, and
- (b) the location of the trust assets.

The residence of the beneficiaries of a trust and domicile of the settlor are not considered to be relevant except in situations as described in 5 below.

5. Normally residence of a trust is dependent upon residence of the trustee or trustees who can exercise management and control of the trust. In some situations the facts may indicate that a substantial portion of the management and control rests with some other person such as the settlor or the beneficiaries. In these situations the residence of this other person may be considered to be the determining factor for the trust regardless of any contrary provisions in the trust agreement.

6. Where an individual exercises the management and control of a trust, the residence of that individual is determined based on the normal factual tests for determining the residence of an individual.

7. Where a corporation exercises the management and control of a trust, the residence of that corporation is determined based on the normal factual tests for determining residence of a corporation. An exception to the general rule may be encountered where the management and control of a trust is exercised by a branch office, for example, a branch of a trust company. In these circumstances, the trust may be determined resident in the jurisdiction where the branch office is located even though the corporation itself is resident outside that jurisdiction.

8. In some situations, after examination of all factors, it may be determined that a trust is resident in Canada notwithstanding that another country may consider the trust to be resident in that country.

9. Pursuant to paragraph 94(1)(c) a trust not otherwise resident in Canada may be deemed to be a resident in Canada for the purposes of Part I of the Act if the trust is such that the amount of the income or capital of the trust to be distributed at any time to any beneficiary of the trust depends upon the exercise by any person of, or the failure by any person to exercise, any discretionary power.

10. Subsection 75(2) provides that, where property is transferred by a person to a trust created after 1934 on condition that the property, or property substituted for it, may revert to that person or pass to persons designated by him or that during his lifetime the property may be disposed of only with his concurrence, any income or loss or taxable capital gain or allowable capital loss from the property, or property substituted for it, is attributable to that person during his lifetime while he is resident in Canada. In such situations attribution applies whether or not the trust is resident in Canada.

11. The foregoing are the considerations viewed as relevant in determining the residence of a trust or estate in ordinary situations. Regard may be had to other factors where the purported residence of a trust or estate appears to have been motivated by reasons of tax avoidance.

"But Your Honour, the ITA Does Recognize "Splintered Trusts" in Respect of the Incidents of Any Trust Property, and that Party is Resident!"

The Income Tax Act doesn't impose a tax on persons (it's not a "head-tax"): it identifies for collection of income tax targeted parties who have ownership of the economic aspects of the underlying property that is divisible between income or capital depending on how the "taxpayer" deals with that property. That being said, the underlying fact is that the party who owns or controls that property is assessed since how else can parties be responsible for tax remittance in respect of increases in its value.

In the case of trusts, per the opening remarks about the fact that Finance has provided statutorily for "splintered trusts" in an above subchapter, to be identified to be the following parties opening described in s. 104(1):

1. the trustee, executor, administrator, liquidator, succession heir or legal representative having ownership of **any** of the trust property
2. the trustee, executor, administrator, liquidator, succession heir or legal representative having control of **any** of the trust property
3. those not actual such parties since the provision refers to **only include, not "mean"**, having ownership of **any** of the trust property
4. those not actual such parties since the provision refers to **only include, not "mean"**, having control of **any** of the trust property³²⁵

did the SCC "get it right" in its statement in *St. Michael Trust Corp. as Trustee of the Fundy Settlement*? In that judgment that Court went into detail that the trust must be equated with the party identified in s. 104(1), that that party is indivisible to multiple parties and **that the POEM (point of effective management) test of the entire body of trustees/beneficiaries must apply**. With this the author **disagrees**. Clearly, when reading how "*open*" the targeting provision identifying "the taxpayer" is read in s. 104(1) it is clear that Finance sought to capture any instance where **any resident** taxpayer had **any of the stated characteristics** in respect of any of the trust's property. This then makes the POEM apply to each owning/controlling party and **not the centrality of all of the actors**, given that s. 104(1) has "splintered" them: Finance wanted to give CRA a very open hand to capture a very broad cast of actors while also prompting for the issue to drill down to the property by property basis **so the POEM should be applied on that individual level in respect of each property - rather than the mass of actors**. That's what the wording of the Act presently allows interpretation for.

This is directly supported by the reasoning in *Dawson v. I.R.C.*³²⁶ above noted where the UK Ct. of Appeal **refused to splinter the trust solely because the charging provision identifying "the taxpayer" did not provide for such**, instead choosing to evaluate the application of the Finance Act on, again, the "indivisible taxpayer" concept: it does, so far, in Canada as well.³²⁷

And then the argument comes back to, the underlying thrust of the Act is to tax those who have ownership or control of a property's increase in value and that the ITA does not, actually, bother to contemplate those

³²⁵ "Reference to trust or estate – Sec. 104(1)"

Sec. 104. (1) In this Act, a reference to a trust or estate (in this subdivision referred to as a "trust") shall, unless the context otherwise requires, **be read to include a reference to the trustee, executor, administrator, liquidator of a succession, heir or other legal representative having ownership or control of the trust property**, but, except for the purposes of this subsection, subsection (1.1), subparagraph (b)(v) of the definition "disposition" in subsection 248(1) and paragraph (k) of that definition, a trust is deemed not to include an arrangement under which **the trust can reasonably be considered to act as agent for all the beneficiaries under the trust with respect to all dealings with all of the trust's property** unless the trust is described in any of paragraphs (a) to (e.1) of the definition "trust" in subsection 108(1).

³²⁶ [1988] 3 All E.R. 753.

³²⁷ One can see the ever-present danger in the case of jointly named trustees owning the trust property in this regard since even if one is resident, the trust is too.

instances of the inter-play of trustee/trust obligations since all it is trying to do is ensure that income tax is collected, through the identified party, on the property's increase in wealth. Those owning or controlling the underlying property are exactly those who should be liable. While these parties are saddled with possibly a non-resident focused trust deed, they "breathe" the trust's functioning and may enjoy the benefits of the Canadian milieu that should prompt them to be subject to its taxation, in respect of property controlled/owned. While the trust must be resident somewhere it is represented in Canada through that targeted party in respect of its splintered property so there should be Canadian taxation of that aspect of it. Simply put, Finance deliberately cast an ever increased broad net to try and **capture any instance where anyone (trustee, beneficiary, etc.) exercises ownership OR control of any of the trust's underlying property** in effort to try and capture its incremental increase in value. That allows CRA to legally assess **multiple successive instances over all of the relevant properties through any and all of the relevant parties** where trustees are in disagreement of the interpretation and functioning of their trust since "the country isn't interested in their squabbling" and only wants to tax the underlying realized increases in value.

On this issue, by chance, the SCC did get it right since in *St. Michel's Trust* it was the Cdn. resident beneficiaries who exercised complete control over the trust's property and were to such an extent, beneficial owners outright. **But, even standing as beneficiaries, they fit within the non-listed parties in s. 104(1) on the criteria of control/beneficial ownership any way.** And herein lays the difficulty with the drill-down: all parties seem to have equal standing and then the person who decides has to simply take them on an individual basis. *What happens when a Cdn. resident controlling beneficiary(ies) is completely matched with a possible group of non-resident controlling trustees...? The test is still met* on residency since the beneficiary(ies), **as one of the parties**, satisfies the splintered basis. **Thus it can be said that if ANY party satisfying the elements of the s. 104(1), on a property by property basis, is resident, then that trust property, for ITA purposes is resident since even though the vast majority of all of the other actors reside outside the country, one, satisfying the definition, is, and that's all that's needed.** The trust property "breathes" through that Canadian resident party in Canada, regardless of how it also breathes through others non-resident.

Given this it should be clear, that even in the face of the present SCC recent decision, CRA could and should argue that an instance where a resident "included" party has *de facto or de jure control*, or, ownership of a trust's particular property, *even if shared with other stated trustees*³²⁸ etc., even when the vast majority of the ownership and control of other trust property is resident outside of Canada, can be assessed in respect of **that particular trust property. Where the property is situated is irrelevant: the residence of the party, who stands in relation to it, is.** And, Finance has specifically provided for such with its referencing in s. 104(1). *Note: that provision refers to the trust's property, any part of it, and not all of it as subsequently described in that same subsection. It also does not superficially refer to "the trust" as a shell of a fictional legal creature, but instead, with reference to the trust's actual subject property, thus causing the assessment focus to be on the property, in accompany to possibly multiple parties owning or controlling it, on an individual basis and not on the global instrument.*

While, per this argument, the "vast majority" of all trust **acting parties** may not be subject to Cdn. taxation on their owned or controlled properties, since they themselves may be non-resident, *those who are resident* should be in respect of their owned or controlled properties. *The latter satisfy the targeting identity in respect of "their" property proper under s. 104(1)*³²⁹.

And that should cause you to be very sensitive to ensure that this easy interpretation applies or doesn't to those who have qualifying dealings with any trust property. **(Can CRA change its mind on this issue, spontaneously "bringing hordes of trusts on-shore"?) Consider issues of determinative control or ownership of each trust/estate property always.**

328 Can this argument be used in the face of joint ownership of trust property by trustees: the fact that a single trustee owns jointly with others seems to still allow for such since the provision doesn't call for complete ownership and in law the trustee still stands as an owner. She of course has recourse to her other trustees with respect to this property and they, in the majority can bind her etc., however she is still one of joint owners.

329 This would allow some property not be captured for taxation when its acting parties are non-resident.

Changes of Residence.

Since the residence of a trust, for purposes of the ITA, generally depends collectively upon the residence of the majority of its trustees having control or ownership of trust property a fine line between non-resident or resident status may be difficult to ascertain once one or more of the controlling/owning trustees change their residence. In a simple case such as the case of three equal controlling and jointly owning trustees, where only one of them becomes a non-resident, the remaining two that are resident will allow the residency status to be maintained but the opposite will result when two of the three become non-resident. The simple principle is very difficult to apply where control or ownership isn't so equally subdivided amongst the trustees and thus it can prove particularly difficult to determine changes in residence of the trust when some or all of the trustees routinely change their place of residence.

A change in residence implies that the trust has ceased to be resident in one jurisdiction and taken on a residence in another however if the trust doesn't cease to be resident in one, but instead takes on dual residency, then the section 128.1 deemed disposition rules will not apply. Such is the case where a sole trustee corporation or individual is found to be resident in two or more jurisdictions and while the relevant tax treaty may provide relief for possible resulting double taxation, the trust will still not be considered to have terminated residency thus allowing it to avoid the section 128.1 rules. Where the trustee(s) which caused the trust to be considered resident are to become non-resident it may prove quite beneficial for the beneficiaries to vary the terms of the trust, (through common or statute law rules), so as to allow the existing trustees to appoint a new one, (or possibly by doing it themselves), such as a corporation incorporated in Canada after April 26, 1965 which is deemed by Sec. 250(4) to be resident in Canada, (wherein the existing trustees could be directors or the corporation could be controlled by a newly created trust). Unlike the appointment of a separate legal individual the appointment of a corporation will allow the existing trustees to retain their control over the trust, but through a different medium.

Trusts.

Subsection 128.1 provides that when a taxpayer, has after 1971, ceased to be resident in Canada he will be deemed to have disposed of each property of a certain nature immediately before that time for proceeds equal to the (Canadian) fair market value thereof at that time: Sec. 128.1 expressly opens with the phrase "for purposes of this Act". The change in residency rules are formulated to ensure Canada taxes only accretions in wealth when resident in Canada and that those accretions are taxed on departing.

The fair market value of the property will be that which is determined as if the property was disposed of in Canada at that time. The taxpayer will subsequently be deemed to have reacquired the property for its FMV that was recognized as proceeds.

Subsection 128.1 applies to cause deemed dispositions of property other than certain types of described property such as; a taxable Canadian property other than that elected by a "non-trust" individual to be treated as disposed, any right described in Sec. 212(1)(h), 212(1)(j) to (q) being certain pension benefits, annuity payments, retiring allowances, RRSP/DPSP payments etc, or a right to receive benefits under the CPP or certain other provincial pension plans or property other than that above in respect of which the "non-trust" taxpayer has furnished to the Minister acceptable security for the payment of the tax that would have resulted if the property had been deemed to have been disposed of. A trust holding taxable Canadian property will not recognize a deemed disposition in respect of it when it becomes non-resident and thus it will not be able to recognize accrued capital losses³³⁰. Since under para. 48(1)(c) a trust cannot elect to have certain property exempt from deemed dispositions upon the posting of acceptable security³³¹ it may prove advantageous to simply distribute it out to the appropriate capital beneficiary, (if the trust is a personal trust), thus avoiding early recognition of implicit tax liabilities if the trust is to become non-resident however this would depend upon

330. which will be limited in recognition by non-trust individuals by the closing phrase which operates to restrict recognition of capital losses from deemed dispositions of taxable Canadian property, to the amount of capital gains otherwise recognized from deemed dispositions of similar property

331 which as per Sec. 128.1(2) causes the property elected upon to be deemed taxable Canadian property until the time the taxpayer disposes of it or becomes resident again, whichever comes first

whether in fact an accrued gain, (and not a loss), is recognizable upon the deemed disposition, and the residency of the beneficiary.³³² It could prove more beneficial, when an accrued loss exists, to recognize the disposition thus having a loss to reduce effective taxation of gains recognized. If a distribution to the appropriate beneficiary isn't advisable then there are at least two broad options the trust has in order to avoid a "deemed" disposition; it can incorporate a taxable Canadian corporation and transfer the property to it, tax-free under Sec. 85(1), whereby the shares taken back as consideration will be a taxable Canadian property as per Sec. 115(1)(b)(iii), (regardless of Sec. 85(1)(i)), or it can transfer the property to another trust created through a general or special power of appointment, whereby as per Sec. 54(c)(v) a disposition will not be recognized if the beneficial ownership does not change. Both operations may require the variation in the trust deed to allow the trustees to execute such action however the result is that the property taken back(if any) will not be exposed to the deemed disposition, in order that it will be taxable Canadian property.³³³

“Returning trust beneficiary – Sec. 128.1(7)”

If an individual (other than a trust)

- (a) becomes resident in Canada at a particular time in a taxation year,**
- (b) owns at the particular time a property that the individual last acquired on a trust distribution to which subsection 107(2) would, but for subsection 107(5), have applied and at a time (in this subsection referred to as the “distribution time”) that was after October 1, 1996 and before the particular time, and**
- (c) was a beneficiary of the trust at the last time, before the particular time, at which the individual ceased to be resident in Canada, the following rules apply:**
 - (d) subject to paragraphs (e) and (f), if the individual and the trust jointly so elect in writing and file the election with the Minister on or before the earlier of their filing-due dates for their taxation years that include the particular time, subsection 107(2.1) does not apply to the distribution in respect of all properties acquired by the individual on the distribution that were taxable Canadian properties of the individual throughout the period that began at the distribution time and that ends at the particular time,**
 - (e) paragraph (f) applies in respect of the individual, the trust and a property in respect of which an election under paragraph (d) is made where, if the individual**
 - (i) had been resident in Canada at the distribution time,**
 - (ii) had acquired the property at the distribution time at a cost equal to its fair market value at that time,**
 - (iii) had ceased to be resident in Canada immediately after the distribution time, and**

³³² It should also be recognized that this applies only in the case of changes in residence of trusts and not changes in residences of **estates** in the midst of administration.

³³³ Subsection 104(21) cannot be used to designate out capital gains on account of the dispositions since the trust isn't resident throughout its tax year. The income caused by the gains may be designated out to the beneficiaries via Sec. 104(21) in a P.B. Election so as to utilize their tax rates.

(iv) had, immediately before the particular time, disposed of the property for proceeds of disposition equal to its fair market value immediately before the particular time, the application of subsection 40(3.7) would reduce the amount that would, but for that subsection and this subsection, have been the individual's loss from the disposition,

(f) where this paragraph applies in respect of an individual, a trust and a property

(i) notwithstanding paragraph 107(2.1)(a), the trust is deemed to have disposed of the property at the distribution time for proceeds of disposition equal to the total of

(A) the cost amount to the trust of the property immediately before the distribution time, and

(B) the amount, if any, by which the reduction under subsection 40(3.7) described in paragraph (e) exceeds the lesser of

(I) the cost amount to the trust of the property immediately before the distribution time, and

(II) the amount, if any, which the individual and the trust jointly specify for the purposes of this paragraph in the election under paragraph (d) in respect of the property, and

(ii) notwithstanding paragraph 107(2.1)(b), the individual is deemed to have acquired the property at the distribution time at a cost equal to the amount, if any, by which the amount otherwise determined under paragraph 107(2)(b) exceeds the lesser of the reduction under subsection 40(3.7) described in paragraph (e) and the amount specified under subclause (i)(B)(II),

(g) if the individual and the trust jointly so elect in writing and file the election with the Minister on or before the later of their filing due dates for their taxation years that include the particular time, in respect of each property that the individual owned throughout the period that began at the distribution time and that ends at the particular time and that is deemed by paragraph (1)(b) to have been disposed of because the individual became resident in Canada, notwithstanding paragraphs 107(2.1)(a) and (b), the trust's proceeds of disposition under paragraph 107(2.1)(a) at the distribution time, and the individual's cost of acquiring the property at the particular time, are deemed to be those proceeds and that cost determined without reference to this paragraph, minus the least of

(i) the amount that would, but for this paragraph, have been the trust's gain from the disposition of the property deemed by paragraph 107(2.1)(a) to have occurred,

(ii) the fair market value of the property at the particular time, and

(iii) the amount that the individual and the trust jointly specify for the purposes of this paragraph in the election,

(h) if the trust ceases to exist before the individual's filing-due date for the individual's taxation year that includes the particular time,

(i) an election or specification described in this subsection may be made by the individual alone in writing if the election is filed with the Minister on or before that filing-due date, and

(ii) if the individual alone makes such an election or specification, the individual and the trust are jointly and severally liable for any amount payable under this Act by the trust as a result of the election or specification, and

(i) notwithstanding subsections 152(4) to (5), such assessment of tax payable under the Act by the trust or the individual for any year that is before the year that includes the particular time and that is not before the year that includes the distribution time shall be made as is necessary to take an election under this subsection into account, except that no such assessment shall affect the computation of

(i) interest payable under this Act to or by the trust or the individual in respect of any period that is before the individual's filing-due date for the taxation year that includes the particular time, or

(ii) any penalty payable under this Act.

Beneficiaries.

Where the party becoming non-resident is a beneficiary under a trust, depending on where the trust is resident at the time and the nature of his interest, he may not have to recognize a deemed disposition in respect of her interest. Capital interests, within the technical meaning provided in Sec. 108(1), will usually be recognized as capital property when disposed of regardless of the residence of the trust however if the trust is resident in Canada at the time the beneficiary becomes non-resident, the capital interest will be considered a taxable Canadian property and thus be exempt from deemed disposition. A capital interest in an unadministered estate is capital property but as per Sec. 115(1)(b)(vi) it may not be a taxable Canadian property due to the specification expressed in that subparagraph and there may be, in the author's opinion, a very sound reason for this. If the beneficiary can be shown to carry on the business of trading in trust interests then the technically defined capital interest will be regarded as inventorial property and thus exempted from Sec. 128.1 application regardless of the residence of the trust.

If the taxpayer isn't a trust, he may also elect to have Sec. 128.1 apply upon providing acceptable security whereby a disposition will not be recognized. If the trust is a resident personal trust then Sec. 107(1)(a) will apply to severely reduce the tax consequences recognizable by the beneficiary upon a deemed disposition by allowing for an artificially recognized higher capital interest ACB than otherwise recognizable under the normal ACB provisions, which will thus reduce and possibly eliminate the recognition of a capital gain. If the trust isn't personal then an income right under it will be treated as a capital interest, as per Sec. 108(1)(c)(ii), while if the trust is personal, (as per the definition in Sec. 248(1)), then the income right will qualify as an income property interest within the Sec. 108(1)(e) technical definition and since it then represents an income property, (following the substance of Sec. 106(2)), it will be exempt from the Sec. 128.1(1) disposition rules, **regardless of the residence of the trust.**

Understandably income interests under a personal trust have a distinct advantage over capital interests when it comes to residency alterations, (though primarily when the trust is non-resident), and it should be further pointed out that Sec. 106(3) offers a provision that allows the beneficiary with an income interest to receive property (capital) in satisfaction of his interest and recognize a tax free disposition thereof, hence in limited instances where long term residency in Canada is questionable it may prove beneficial to grant a discretionary income interest to a beneficiary who may leave Canada, regardless of the residency of the trust.

This would allow him to receive capital in satisfaction of his interest after he becomes non-resident without recognizing any tax consequences. A power of appointment could grant the beneficiary another interest subsequently.³³⁴ Presently under Sec. 128.1(1), it isn't so much the residency of the trust that will affect application of the provision to an income right under a trust, but also the nature of the trust itself, (vis-a-vis personal or non-personal). If the trust is non-resident and the Canadian resident beneficiary will otherwise recognize a substantial gain on ceasing to be resident the non-resident trust could be varied to accept significant amounts of property subject to a power of appointment held by a non-resident; the tax cost of the resident's interest will be inflated by the underlying tax cost of the property but its fair market value will not be increased by the power.³³⁵

Avoiding the Ownership Target.

The section 128.1 disposition provisions apply only to property which was **owned** by the taxpayer, (and in this sense one can infer that legal ownership is the basis), and not property which has been **loaned** to the trust. A trust may be initially created solely with loaned property instead of a transfer of property (legal title) to the trust, and thus by lending property to the trust for a long term the provision will not apply to it if and when the trust becomes non-resident. If the trust was not originally created with loaned property, but instead holds legal title to it, (and if the trust is personal), it could prove advantageous to distribute the property, which would be affected by Sec. 128.1(1), to the resident beneficiaries and have them lend it back to the trust so as to allow the income therefrom to continue to be realized for the benefit of the income beneficiaries. The trust deed may have to be slightly varied to achieve this (which could affect the trust interests involved) while it may be necessary to pay the lending beneficiary interest on the loan at a prescribed rate so as to avoid the implementation of the attribution rules in Sec. 56(4.1) etc.. This could be of benefit when the property isn't taxable Canadian property and the recipient beneficiaries are Canadian residents. In the case of non-resident beneficiaries Sec. 107(5) would apply to cause identical tax consequences if the property distributed isn't taxable Canadian property however if the non-resident transfers his interest to a Canadian resident bare trust Sec. 54(c)(v) will apply to preclude the recognition of a taxable disposition and the Sec. 107(2) tax free distribution can occur. If the non-resident testamentary trust is newly formed and the Canadian resident beneficiary hasn't realized benefits from it the interest may be disclaimed prior to becoming non-resident. The disclaimer will not cause tax consequences to the beneficiary, (in the form of a disposition), and once non-resident he can retract the disclaimer if no other beneficiary has altered his position on the faith of its legitimacy. The foreign jurisdiction's trust law would have to be examined to ensure that a retraction could take place and inter beneficiary agreements may be executed to facilitate this.

Becoming Resident: Deemed FMV Acquisition.

Under subsection 128.1(1) a taxpayer will be deemed to have acquired, for purposes of subdivision C, each property owned by him at a time when he became resident in Canada other than property which is taxable Canadian property or property upon which he previously elected under Sec. 128.1(1)(c) to post security when previously changing residence, whereby that property will then have an initial cost equal to its fair market value at that time. As will be seen in later chapters a capital interest in a trust with a significant existing legitimate ACB, regardless of the possibility of the trust losing its personal status, is always better than one with none at all and with this in mind Sec. 128.1(1) may prove an effective way to inflate the ACB of a capital interest by altering residencies of the trust and capital beneficiary. Subsection 128.1(1) **does not deem the taxpayer to have paid consideration** for the interest thus the Sec. 53(2)(h) capital interest ACB adjustments cannot be activated on a change in residence although there will be a cost bump.

Subsection 128.1(1) doesn't apply to taxable Canadian property such as a capital interest in a trust

334. It should be pointed out that a discretionary interest isn't technically an "income interest" with respect to the technical definition thereof in Sec. 108(1)(e) however how successful would an argument be contending that a potential right solely enforceable (normally) in respect of income under a personal trust, is a capital property?

335 To be noted in this respect, however, is that subparagraph 108(1)(d) does not apply to interests in trusts that constitute subpara. 94(1)(d) foreign affiliates of the beneficiary: if it doesn't the Sec. 107(1)(a) cost amount of the interest deemed disposed of will be the a.c.b. of the interest which does not assimilate the tax cost of the trust's property to that of the capital interests.

resident in Canada hence in order to obtain the treatment of the provision the taxable Canadian property status must be removed via the ceasing of residence by the trust.³³⁶ This may be executed without severe tax consequences when the trust property otherwise consists of taxable Canadian property that is not subject to Sec. 128.1(1). Once the trust is non-resident the capital beneficiary may then become resident in Canada whereby his capital interest in the non-resident trust, will obtain the treatment afforded by Sec. 128.1(1) thus giving the interest a cost equal to its fair market value at that time,...tax-free.³³⁷ Once the beneficiary is resident the trust may itself become resident whereby Sec. 128.1(1) will not apply, however one must recognize that the trust and the beneficiary may themselves realize tax liabilities in the other tax jurisdiction when ceasing to be resident there, that will negate the advantage of any such arrangement. In general this arrangement works well in inflating the ACB of a capital interest in a trust which has substantial amounts of taxable Canadian property whereby after the trust becomes resident, and distributes the property to the Canadian resident beneficiary, the fair market value of the interest will bump the cost of the property to the beneficiary as per Sec. 107(2)(b). Not to be overlooked as well, when the trustees of a non-resident trust are not mobile, is the effect Sec. 94(1)(c) has on a trust whereunder any discretionary power could alter the entitlements of the capital or income beneficiaries. In such a case the trust would be deemed to be resident attracting the cost bumps which is the opinion of the Department as expressed in several private interpretations. See "ACB Bumping with Deemed Residency" in the "Non-Resident Trusts" chapter.

A Question of Beneficial Ownership.

The Interpretation Bulletins provide that the Act is to apply, generally, on the beneficial ownership rather than legal ownership basis however does this also apply when a trust holding legal title ceases to be resident and beneficial ownership resides with a Canadian resident thus precluding the section 128.1 rules from applying to the property? The author thinks that the opinion isn't always applicable when express language has been used in the provision or one related to it. If a Canadian resident trust could transfer its property that would otherwise be affected by Sec. 128.1(1) upon ceasing to be resident to a non-resident trust or beneficiary the deemed disposition thereof could be avoided. Under Sec. 54(c)(iii) and (v) a transfer of property to a trust or by a trust to a beneficiary is regarded as a disposition while under para. (v) any transfer in which there is a change in legal ownership but not a change in beneficial ownership, **other than a transfer by a Canadian resident trust to a trust not resident in Canada**, will not be regarded as a disposition. This results in the trust being unable, under para. (v), to transfer property to a foreign resident trust without realizing tax consequences consequential to the recognition of a disposition. Paragraph 54(c)(v) was altered in 1980 to cause a disposition to be recognizable when a Canadian resident trust "transfers" property to a non-resident trust **when there hasn't been a change in beneficial ownership**. A Canadian resident trust is thus precluded from transferring legal ownership of a property to a non-resident trust so as to avoid a deemed disposition if it becomes non-resident, regardless of where the beneficiary is resident.³³⁸ The provision was especially altered to preclude avoidance of section 128.1 effects via a transfer of legal title without a transfer of beneficial ownership and if this is the case how can the Department contend that **beneficial ownership** is relevant in respect of section 128.1 dispositions **by trusts**? By amending Sec. 54(c)(v) they've removed beneficial ownership and changes therein as a basis of disposition and replaced it with legal ownership **but only in respect of non-resident trust recipients**. Presently, **regardless** of where the beneficial ownership resides a shift in **legal ownership** out of the country in the particular manner will result in a disposition. (Subsection 107(5) attends to distributions to beneficiaries.) How can beneficial ownership be the target in the section 128.1 provisions in respect of alterations in the trust's residence? ...It can't be.

³³⁶ This can be done by appointment to non-resident trustees, or by having the resident trustees resign or become non-resident themselves. Understandably there would be consequences on-the-way-out for the trust unless it is already non-resident. Layering of trusts would be beneficial here so that the intermediate would be resident while the owning trust could be resident.

³³⁷ The applicability of Sec. 128.1(1) to the exclusion of Sec. 107(1.1) on a trust capital interest was precisely recognized by the Financial Industries Division on Oct. 2/Nov. 2 1990.

³³⁸ And this applies to taxable Canadian property, even though such could be rolled out tax free under Sec. 107(5) from a resident trust.

Some Distributions and Cost Bumps.

Under subsection 107(5), distributions to non-resident capital beneficiaries made by a personal trust will result in the trust recognizing a deemed disposition of the property for proceeds equal to the fair market value thereof, while the beneficiary will not recognize any tax consequences since he will be deemed to have disposed of the part of the interest satisfied for its adjusted cost base. This will not occur when the property distributed is taxable Canadian property or Canadian resource property, thus if the trust can "cleanse" its properties' "non-taxable Canadian property" nature through incorporation in Canada etc, the share then distributed would not be affected under Sec. 107(5) although upon holding such property the trust would itself not be exposed to resulting tax liabilities through the avoidance of the application of Sec. 128.1(1).

A distribution by a non-resident personal trust will cause the property to be subject to Sec. 107(2) and not Sec. 128.1(1) when the beneficiary is Canadian resident thus there will be a flow through of the tax cost of the property but the ACB thereof will not be bumped up to its FMV. If the Canadian resident beneficiary transfers legal ownership of his interest to a non-resident trust Sec. 54(c)(v) will preclude the recognition of a disposition thereof, (unless the beneficiary is a trust), if he continues to hold beneficial **ownership** of the interest. Subsection 75(2) will apply to the property and CRA has expressed that such a trust will be recognizable as a liability base. If the distribution is then made to the non-resident trust who brings legal ownership of the property back to Canada there will be a Sec. 128.1(1) cost bump and upon distribution to the resident beneficial owner a Sec. 107(2) flow through of that FMV will result.

Income Tax Interpretation Bulletin

Deemed Disposition and Acquisition on Ceasing to be or Becoming Resident in Canada
IT-451R

DATE: March 25, 1987

SUBJECT: INCOME TAX ACT

Deemed Disposition and Acquisition on Ceasing to be or Becoming Resident in Canada

REFERENCE: Sections 48, 88.1 and 219.1 (also sections 90 to 95, 110.6 and 250, subsections 115(1), 126(2.2) and 159(4), paragraphs 212(1)(h) and 212(1)(j) to (q) of the Act and section 1300 and subsection 5907(13) of the Regulations)

This bulletin replaces and cancels Interpretation Bulletin IT-451 dated June 13, 1980 and IT-451 ADDENDUM dated September 8, 1982. Current revisions are designated by vertical lines.

Introduction

1. This bulletin deals with the deemed disposition rules in subsection 128.1(1) and section 88.1, the deemed acquisition rules in subsection 128.1(1), and the rules in subsection 128.1(5) which include prescribed amounts in the foreign accrual property income of certain foreign affiliates.

2. The purpose of subsection 128.1(1) is to include in the computation of income of a taxpayer, for a taxation year in which the taxpayer ceases to be resident in Canada, certain capital gains or losses accrued prior to departure from Canada. On the other hand, subsection 128.1(1) is intended to exclude from the computation of income of a taxpayer who has become a resident of Canada that portion of any capital gain or loss that had accrued prior to becoming resident. Although subsections 48(1) and 48(3) refer to "any property" and "each property", they relate only to capital property since these subsections apply for purposes of subdivision c of Division B of Part I only. Furthermore, section 128.1 does not apply to deem either an acquisition or disposition for capital cost allowance purposes. Where a foreign affiliate of a taxpayer resident in Canada becomes resident in Canada after November 12, 1981, subsection 128.1(5) provides rules for the calculation of the affiliate's foreign accrual property income as discussed in 22 and 23 below. In addition, as discussed in 18 to 20 below, section 88.1 provides rules, applicable to certain corporations emigrating after August 28, 1980, which override section 128.1.

Becoming or Ceasing to be Resident in Canada

3. Whether or not a taxpayer has become or ceased to be resident in Canada is generally a question of fact. Where a person sojourns, (see IT-221R2, paragraph 15) in Canada for 183 days or more in a taxation

year, paragraph 250(1)(a) deems that person to have been resident in Canada throughout the year. Where this is the case, the person is considered to have become so resident at the commencement of that year and to have ceased to be so resident at the end of the year so that the provisions of section 128.1 apply. However, where that person is an individual, the relieving provision of subsection 128.1(4) (see 11 below) may apply to exempt the individual from the deemed disposition rules of subsection 128.1(1) (also see IT-221R2 for additional comments on an individual's residence status).

4. Where the taxpayer is a trust, the trust is generally considered to become resident or cease to be resident in Canada when the trustee who has ownership or control over the assets of the trust becomes or ceases to be resident. It is possible that a trust may be subject to the provisions of section 128.1 by virtue of the trustee becoming or ceasing to be a resident of Canada even though the trust property and/or the beneficiary were already located in or outside Canada.

5. Subject to the provisions of subsection 250(4) which deems residency in Canada throughout a particular taxation year, a corporation is normally resident in the country where its central management and control are located. Therefore the provisions of sections 48 or 88.1 may be applicable where such management and control moves out of or into Canada.

Deemed Disposition on Ceasing to be Resident

6. Where a taxpayer ceases to be resident in Canada at any particular time after 1971 in a taxation year, subject to the comments in 10 and 11 below, subsection 128.1(1) provides that the taxpayer is deemed to have disposed of certain capital properties owned immediately before that time (i.e., while still resident in Canada) for proceeds equal to fair market value. The taxpayer is also deemed to have reacquired the property immediately after ceasing to be resident in Canada at a cost of the same amount. Ownership is to be interpreted in the broadest sense, in accordance with Canadian judicial interpretation, no matter where the property is located. However, for valuation purposes the fair market value in the country or area of location of the property will usually govern.

7. The taxpayer is required to use the rules of subdivision c of Division B of Part I to calculate taxable capital gains, allowable capital losses and taxable net gains (listed personal property) on property deemed to be disposed of in computing income for Part I tax purposes for the taxation year in which the taxpayer ceased to be resident (see IT-193 Special Release). A capital gain from a deemed disposition under subsection 128.1(1) cannot be reduced by a reserve under paragraph 40(1)(a).

Capital Gains Deduction

8. In taxation years before 1985 (former) paragraph 48(1)(d) had the effect of exempting an individual, other than a trust, on the first \$5,000 of total capital gains from deemed dispositions of property other than listed personal property. To the extent that such capital gains were less than \$5,000, the balance of the exemption was applied under (former) paragraph 48(1)(e) to reduce the individual's gains from deemed dispositions of listed personal property. The taxpayer's "gains" from deemed dispositions of listed personal property were the amounts thereof determined under subparagraph 40(1)(a)(i) and not the "net gain" referred to in subsection 41(2). No part of the exemption could be applied against gains arising from actual dispositions of capital property.

9. In computing taxable income after 1984, section 110.6 permits an individual (other than a trust) who was resident in Canada throughout a taxation year to deduct an amount in respect of capital gains of that taxation year. For this purpose, subsection 110.6(5) provides that an individual who was resident in Canada at some time during a particular taxation year and throughout either the immediately preceding or following taxation year is deemed to have been resident in Canada throughout the particular taxation year. As a consequence such an individual who, for purposes other than subsection 110.6, has ceased to be resident in Canada at some time during a taxation year is eligible for the capital gains deduction to the extent provided by section 110.6. (see 12 below).

Exceptions

10. Subsection 128.1(1) does not apply to

(a) property that would be taxable Canadian property as described in paragraph 115(1)(b) if the taxpayer had not been resident in Canada at any time in the year, unless the taxpayer is an individual (other than a

trust) who has elected under paragraph 48(1)(a) to be deemed to have disposed of that property immediately before ceasing to be a resident of Canada (see 12 and 14 below),
(b) property that is deemed to be taxable Canadian property because of an election under paragraph 48(1)(c), (see 13 and 14 below),
(c) a right to receive payments described in paragraph 212(1)(h) and paragraphs 212(1)(j) to (q) (e.g., pension benefits, retiring allowances, payments from registered retirement savings plans, etc.), or
(d) a right to receive a payment of any benefit under the Canada Pension Plan or a provincial pension plan described in section 3 of that Plan.

In addition, as discussed in 18 to 20 below, subsection 128.1(1) is not applicable to a corporation that was incorporated in Canada where section 88.1 is applicable nor, as discussed in 11 below, to certain properties owned by an individual other than a trust.

Resident in Canada for Short Term Only

11. Subsection 128.1(4) excludes from the deemed disposition rule of subsection 128.1(1) any property owned by an individual (other than a trust) if the taxpayer either owned the property immediately before becoming resident or acquired it by inheritance or bequest after becoming resident, provided that during the 10-year period immediately before ceasing to be a resident the taxpayer was not resident in Canada for periods totalling more than 60 months. Property acquired in exchange for property owned when the individual last became resident, as may be the case as a result of a share exchange under section 85.1 or under the rollover provisions of section 85, is not excluded by subsection 128.1(4) and is deemed to be disposed of when the individual subsequently ceases to be resident. Where an individual who sojourned in Canada is deemed to be resident in Canada under paragraph 250(1)(a) throughout a calendar year, the full calendar year, as opposed to the actual period of sojourning, is required to be included in determining the 60-month period referred to in subsection 128.1(4).

Election to Include Property

12. For 1985 and subsequent taxation years an individual (other than a trust) who elects under paragraph 48(1)(a) in prescribed manner and within a prescribed time is deemed to have disposed of property described in 10(a) above immediately prior to departure from Canada for proceeds of disposition equal to the fair market value of the property immediately before the departure. By making such an election an individual may claim a capital gains deduction in respect of capital gains accrued at the time of departure. The capital gains deduction is not available to a non-resident except to the extent described in 9 above. Procedures for making an election under paragraph 48(1)(a) have not yet been prescribed.

Election to Exclude Property

13. A Canadian corporation or an individual other than a trust may elect under paragraph 48(1)(c) to exclude from the deemed disposition rule of subsection 128.1(1) any property to which that rule would otherwise apply. The election is made on form T2061 which must be filed not later than the time when the taxpayer is required under section 150 to file an income tax return for the year of ceasing to be resident. Regulation 1300 sets out the applicable requirements. Security acceptable to the Minister is required to be furnished (see 15 below). Subsection 128.1(2) deems any property in respect of which such an election is made to be taxable Canadian property from the time immediately after the taxpayer ceased to be resident until the earlier of the date that the property is sold and the date on which the taxpayer next becomes resident in Canada.

14. Where a taxpayer has elected under paragraph 48(1)(a) or (c) on one or more properties, subsection 128.1(1) limits the allowable capital losses from deemed dispositions of property other than listed personal property to the lesser of

- (a) the aggregate of such allowable capital losses, and
- (b) the amount deemed by subsection 128.1(1) to be the aggregate of the taxable capital gains from deemed dispositions of property other than listed personal property.

This limitation prevents a taxpayer from electing in respect of property (other than listed personal property) under paragraph 48(1)(a) or

(c) in such a manner as to defer deemed capital gains while claiming deemed capital losses. There is no similar provision in respect of listed personal property because losses from that source are not deductible except against gains from listed personal property.

Acceptable Security

15. An election under paragraph 48(1)(c) or subsection 159(4) (see 16 below) requires that the taxpayer furnish to the Minister security acceptable to the Minister for payment of any tax the payment of which is deferred by the election. Where such an election is to be made, the taxpayer should contact the local District Taxation Office to determine the security necessary in respect of the deferral.

Election to Pay Tax by Instalments

16. A taxpayer may elect under subsection 159(4) to pay the Part I tax arising from deemed dispositions under subsection 128.1(1) in up to six annual instalments, with interest, provided the Minister is furnished with acceptable security (see 15 above). The election must be made on form T2074 and be filed on or before the day when the taxpayer's last income tax return as a resident of Canada is required to be filed. Regulation 1301 sets out the requirements applicable to such elections.

Foreign Tax Deduction

17. Where a taxpayer who is not resident in Canada disposes of property that was deemed by subsection 128.1(2) to be taxable Canadian property of the taxpayer and the gain is taxed in a foreign country as well as in Canada, the Part I tax otherwise payable may, within the limitations of subsection 126(2.2), be reduced on account of foreign taxes paid.

Corporate Emigration

18. Section 128.1 does not have application in respect of a taxation year to which section 88.1 applies. Section 88.1 is somewhat similar to section 128.1 except that it deems a disposition of each property rather than certain capital properties and applies only to a corporation that was incorporated in Canada and was resident in Canada at some time and that has, after August 28, 1980, either

(a) been granted articles of continuance (or similar corporate constitutional documents) in a jurisdiction outside Canada, or

(b) become resident in a jurisdiction outside Canada and as a consequence becomes exempt from Part I tax on its subsequent income from non-Canadian sources by virtue of any Act of Parliament or anything approved, made or declared to have the force of law thereunder (generally a tax convention).

19. The corporation's taxation year is deemed to have ended immediately before the particular time that either of the two events described in 18 above occurs and a new taxation year is deemed to have commenced at the particular time. The corporation is deemed to have disposed of all the property that it owned immediately before the particular time for proceeds equal to fair market value at the time of such disposition. Unlike section 128.1, this rule applies for all purposes of the Act, including recapture of capital cost allowances. Such property is deemed to have been reacquired by the corporation immediately after the particular time at a cost equal to those deemed proceeds of disposition. The corporation is also deemed not to be a Canadian corporation at the particular time and all subsequent times. However, the corporation will continue to be a resident of Canada if the conditions described in subsection 250(4) are met, and will be subject to the tax consequences that ensue as a result of such residency.

20. Where a taxation year of a corporation is deemed by section 88.1 to have ended, section 219.1 provides that a tax of 25% shall be paid on the amount by which the deemed proceeds of disposition pursuant to the provisions of section 88.1 exceed the aggregate of

(a) the paid-up capital of all the issued and outstanding shares of the corporation immediately before the deemed end of its taxation year, and

(b) all amounts outstanding at the deemed year end, excluding dividends, of debts owing by the corporation, and other obligations of the corporation to pay an amount.

Demand Payment of Taxes

21. Where the Minister suspects that a taxpayer is about to leave Canada, he has the power under section 226 to demand payment of all taxes, interest and penalties before the day otherwise fixed for payment. If the taxpayer fails to comply with the demand, the Minister may direct that the taxpayer's goods and chattels be seized.

Corporate Immigration

22. Where, at any time after November 12, 1981, a corporation becomes resident in Canada and immediately before that time it was a foreign affiliate (as defined in paragraph 95(1)(d)) of a taxpayer resident in Canada, subsection 128.1(5) provides that for the purposes of sections 90 to 95

- (a) the corporation's taxation year is deemed to end immediately before that time,
- (b) the corporation is deemed to have commenced a new taxation year at that time,
- (c) the corporation is deemed to have been a controlled foreign affiliate, as defined in paragraph 95(1)(a), of the taxpayer at the end of the taxation year described in (a) above, and
- (d) the amounts determined under subsection 5907(13) of the Regulations are to be included in the corporation's foreign accrual property income for that year.

23. In essence, subsection 128.1(5) and Regulation 5907(13) provide that certain amounts that accrued to the foreign affiliate prior to becoming resident in Canada are deemed to be foreign accrual property income of a controlled foreign affiliate. Pursuant to the provisions of section 91 such amounts are therefore taxable in the hands of a shareholder resident in Canada in the shareholder's taxation year in which the foreign affiliate's taxation year is deemed to end.

Deemed Acquisition on Becoming Resident

24. Subject to 25 below, a taxpayer who becomes a resident of Canada at any particular time in a taxation year is deemed under subsection 128.1(1) to have acquired at that time each property owned at a cost equal to fair market value at that time. Property that is "taxable Canadian property" as described in paragraph 115(1)(b), or deemed to be taxable Canadian property because of an election under paragraph 48(1)(c), is excepted from subsection 128.1(1).

25. A taxpayer who became resident before 1972 and disposes of property after 1971 will compute capital gains or losses from original cost or V-day value, as the case may be. The same rule applies to a taxpayer who becomes a resident of Canada after 1971 and who later disposes of property that was excepted from the deemed acquisition rule (e.g., "taxable Canadian property").

26. Subsection 128.1(1) may apply to property that is cash located in a country where foreign exchange restrictions are in effect. Where this is so, it is the Department's view that in determining the fair market value of such blocked currency, the currency should be valued at its Canadian dollar equivalent at the normal exchange rate prevailing at the time the taxpayer becomes resident in Canada, discounted by a factor for premiums or other amounts which would be payable on conversion at that time even though the currency is, in fact, not converted.

The Treaties - Conventions and Residence.

Two of the treaties that Canada has with other countries concerning the taxation of income contain statutory exemptions that provide for either favorable or negligible taxation of the income of trusts or estates. Article XX of the Canada-U.K. Tax Convention (1978) provides that income received by a U.K. resident beneficiary from a Canadian resident trust or estate may be taxed in Canada by its law (as provided in Part XIII), but tax charged shall not exceed 15% of the gross amount. This will not apply if the beneficial recipient of the income resident in the U.K. carries on a business in Canada through a permanent establishment therein or performs professional services in Canada from a fixed base situated therein, and where the right or interest in the estate or trust in respect of which the income is paid is "**effectively connected**" with such permanent establishment or fixed base. If these conditions exist then Article VII and XIV concerning businesses carried on in, or professional services performed in, Canada will apply and these two articles generally provide that income "**attributable**" to the permanent establishment or fixed base will bear the tax of the Contracting State (Canada) and in this sense in being "effectively connected" to the establishment or base, the trust/estate income will be exempt from the 15% withholding but subject to the Sec. 115(1)(a) taxation, even though the taxpayer resident in the U.K. maybe receiving it directly.

Unlike the Canadian-U.K. Convention the Canada-U.S. Income Tax Convention (1980), under Article IV (1), provides that a trust or an estate is resident only to the extent that income derived by the estate or trust is liable in the State, either in its hands or in the hands of the beneficiaries while under para. (4) where due to the above an estate or trust is a resident of both States the competent authorities shall by mutual agreement

settle the question as to the mode of application of the Convention. Where a trust has a singular trustee who resides in Canada, regardless of where its beneficiaries are resident, it will for Canadian income tax purposes be considered resident in Canada by virtue of Sec. 104(1) however if the income beneficiaries reside in the U.S. the trust will take on a dual residency but only to the extent of the income that is taxable in the hands of the U.S. resident income beneficiaries. If the beneficiaries residing in the U.S. are only capital beneficiaries then the income normally will not be taxable in their hands hence the only jurisdiction in which the trust will be exposed to taxation is Canada. If the beneficiaries which are resident in the U.S. have discretionary income and capital interests then the year to year residence of the otherwise Canadian resident trust will result from the exercise of the discretion to pay either the income or capital out to the beneficiaries since the residency is determined on the basis of income liable for tax, not potential income rights. It should be recognized that the provision operates upon the necessity that the income be liable to tax in the Contracting State, be it in the hands of the trust or its beneficiaries thus a trust set up in Canada to receive capital dividends or certain Canadian exempt income, (such as that described in section 81), that would otherwise not be taxable in its hands or its Canadian beneficiaries, will cause the trust to incur the U.S. residence when such income is paid to the U.S. income beneficiaries, (to be taxed in their hands). Certain types of income receive special tax rates as is the case with dividends paid to non-residents **beneficial owners** being exposed to a maximum tax rate of 15% while if the beneficial owner is a company which owns 10% or more of the voting stock directly of the paying company a 10% rate will be applied, (while this rate will not apply if the beneficial owner carried on a business in the other state through a permanent establishment/fixed base, and the holding, (stock) was "effectively connected" with such an establishment/base whereby the Article VII or XIV Business profits or Independent Personal Services provisions would apply to allow higher rates of tax to be applied by the other state). Interest will be taxed in the state in which it arises but where the beneficial owner is a non-resident taxation will not exceed 15%.³³⁹ Interest will be exempt from taxation if it is owned beneficially by a non-resident and amongst others, the debt was issued at arm's length and was guaranteed or insured by the foreign State or any political subdivision. "Beneficial owner" in the context in which the treaty uses it should indicate those parties who have proprietary rights to the income from specific trust property and not those merely having rights to the income from the trust no matter how derived. The law of each relevant state is to be adhered to for the purposes of the treaties unfortunately and failing the existence of a universally applicable definition the local law of the jurisdictions may vary so as to disallow a recipient from being recognized as a beneficial owner even though under the recipient's local law he is.

339. Where a U.S. resident trust invests in the bonds of a Canadian corporation the Canadian corporation will withhold the 15% on the interest paid but once the trust distributes it to a Canadian resident beneficiary the beneficiary will not obtain any relief for that withholding: Memorandum for file A-7707 Feb. 1983.

Testamentary Transfers and Death.

Capital Property.

The importance of creating a trust that has the spousal characteristics described in Sec. 70(6) through a will or special power given to the executor to create such is obvious when compared to what will occur on death as otherwise required under Sec. 70(5), (5.1), or (5.2). As a last resort a Sec. 70(6) spousal trust can be created that will allow property to be deemed disposed of at its effective cost rather than its fair market value as is the norm.

Subsection 70(6), (and certain parts of (5.1) and (5.2)), provide favourable testamentary transfer treatment only when property of the estate of the deceased is transferred and indefeasibly vested in the spouse or a trust created by the taxpayer's will that was resident in Canada immediately after the property became indefeasibly vested in it, under which the spouse is entitled to receive all of the income of the trust arising before her death and under which no other person other than the spouse may receive or obtain the use of any capital or income of the trust before her death. The spousal trust need not be or remain testamentary in the technical sense of the term thus allowing it to have some flexibility to tuck further property into it. The Sec. 70(6) transfer provision applies only to capital property be it depreciable or not, that is not land inventory or resource property though subparagraphs 70(5.2)(d) & (f) provide tax-free roll-over provisions in respect of the latter two types of property. The transfer or distribution must occur upon and in consequence of the death of the taxpayer and while the will may grant the legal representative wide or extremely conditional power to choose property which will be transferred, those that are not will be treated under Sec. 70(5), (5.1), or (5.2) depending on the character of the property. When capital property is not transferred to a Sec. 70(6) spousal trust it instead suffers a fair market value deemed disposition with resulting recognition of accrued gains and consequential large income tax payment.

The applicability of Sec. 70(6) or (5), (5.1), (5.2) to testamentary transfers/distributions does not depend exclusively on whether the terms of the will or the executor acting on powers given to him, transfers or severs the property from the general estate in such a manner as to have it qualify for Sec. 70(6) treatment, in that if the spousal trust is "tainted" with non-spousal entitlements/claims, as a result of the "untainting" process in Sec. 70(7)-(8), the applicability of Sec. 70(6), and only Sec. 70(6), will be negated in respect of properties "listed".³⁴⁰ As well, Sec. 70(5) **only may** apply to property otherwise qualified to be treated under Sec. 70(6), if the executor elects under Sec. 70(6.2).³⁴¹ The Sec. 70(6.2) election negates the application of Sec. 70(6) only hence an election cannot be made in respect of land inventory or resource property that are the concern of Sec. 70(5.2)(d) and (f).

"Property", as described in *Jones v. Skinner* (1836)³⁴², consists of **"the most comprehensive of all the terms which can be used inasmuch as it is indicative and descriptive of every possible interest which the party can have."**

Subsection 70(5) applies to a taxpayer regardless of his residence wherein a tax year he has died and it provides that the taxpayer will be deemed to have disposed of each non-depreciable capital property immediately before his death for proceeds equal to its fair market value at that time while he will also be deemed to have disposed of immediately before his death³⁴³ all of his depreciable capital property of a prescribed class for proceeds equal to effectively half of the aggregate of the properties' fair market values and the class U.C.C. immediately before his death. Pursuant to Question 54 of the 1990 Roundtable discussions for the purposes of computing any capital gains on the disposition of depreciable capital property the deemed proceed of the class will be apportioned to the particular properties of the class on their relative fair market values so as to ascertain the proceeds of each individually.

Since it applies to any taxpayer the death of a non-resident taxpayer may cause him to recognize tax

³⁴⁰ See the following chapters.

³⁴¹ Since Sec. 70(5) causes deemed dispositions of property for proceeds equal to its fair market value, while Sec. 70(6) allows a tax-free cost roll-over, electing for the former will allow the early or needed recognition of capital gains or losses, recapture or terminal loss, and resulting cost adjustment to the recipient, which could prove favourable to both parties.

³⁴² 5 L.J. (N.S.) c. 87

³⁴³ See *Re: Silk*, 1976 V.R. 60, for an examination of the phrase "immediately before death" in a taxing statute though for different purposes.

consequences under Sec. 115(1)(b) on the deemed dispositions but only where the property is "taxable Canadian property" as listed in that subparagraph.³⁴⁴ Where any person, as a consequence of the taxpayer's death, has acquired non-depreciable capital property formerly of the taxpayer he will be deemed to have acquired it at a cost equal to its fair market value immediately before the taxpayer's death while if the capital property acquired is depreciable and of a prescribed class it will be deemed to have been acquired at a cost equal to the U.C.C. of the class of the deceased from which it came apportioned on the basis of its fair market value before the death that is of the aggregate fair market values of all of the property of the class immediately before the death. Where the depreciable property's deemed capital cost to the acquiror is **less than** the capital cost of the property to the taxpayer than the acquiror, for purposes of section 13 and 20 and accompanying C.C.A. regulations the acquiror will be deemed to have acquired the property at a capital cost equal to that recognized by the deceased taxpayer and the excess of the deceased taxpayer's actual capital cost over the acquiror's otherwise deemed capital cost will be deemed effectively to have been deducted by him as C.C.A. in previous years, thus exposing him to C.C.A. recapture when he disposes of the property.

Subsection 70(5) effectively just causes the taxation on death of all capital value appreciation or depreciation accrued to the taxpayer and it applies to both non-resident and resident taxpayers serving as a basis upon which Division B or Division D then follow to determine what amounts of taxable income to recognize.³⁴⁵

"Capital property of a deceased taxpayer – Sec. 70(5)"

(5) Where in a taxation year a taxpayer dies,

(a) the taxpayer shall be deemed to have, immediately before the taxpayer's death, disposed of each capital property of the taxpayer and received proceeds of disposition therefor equal to the fair market value of the property immediately before the death;

(b) any person who as a consequence of the taxpayer's death acquires any property that is deemed by paragraph 70(5)(a) to have been disposed of by the taxpayer shall be deemed to have acquired it at the time of the death at a cost equal to its fair market value immediately before the death;

(c) where any depreciable property of the taxpayer of a prescribed class that is deemed by paragraph 70(5)(a) to have been disposed of is acquired by any person as a consequence of the taxpayer's death (other than where the taxpayer's proceeds of disposition of the property under paragraph 70(5)(a) are redetermined under subsection 13(21.1)) and the amount that was the capital cost to the taxpayer of the property exceeds the amount determined under paragraph 70(5)(b) to be the cost to the person thereof, for the purposes of sections 13 and 20 and any regulations made for the purpose of paragraph 20(1)(a),

(i) the capital cost to the person of the property shall be deemed to be the amount that was the capital cost to the taxpayer of the property, and

(ii) the excess shall be deemed to have been allowed to the person in respect of the property under regulations made for the purpose of paragraph 20(1)(a) in computing income for taxation years that ended before the person acquired the property; and

(d) where a property of the taxpayer that was deemed by paragraph 70(5)(a) to have been disposed of is acquired by any person as a consequence of the taxpayer's death and the taxpayer's proceeds of disposition of the property under paragraph 70(5)(a) are redetermined under subsection 13(21.1), notwithstanding paragraph 70(5)(b),

(i) where the property was depreciable property of a prescribed class and the amount that was the capital cost to the taxpayer of the property exceeds the amount so redetermined under subsection 13(21.1), for the purposes of sections 13 and 20 and any regulations made for the purpose of paragraph 20(1)(a),

³⁴⁴ See I.T. 420R2

³⁴⁵ As per *May Estate v. M.N.R.*, 88 D.T.C. 1189 (TCC), a testator and his estate are not at arm's length due to the fact that both are directed by the same mind.

- (A) its capital cost to the person shall be deemed to be the amount that was its capital cost to the taxpayer, and
- (B) the excess shall be deemed to have been allowed to the person in respect of the property under regulations made for the purpose of paragraph 20(1)(a) in computing income for taxation years that ended before the person acquired the property, and
- (ii) where the property is land (other than land to which subparagraph 70(5)(d)(i) applies), its cost to the person shall be deemed to be the amount that was the taxpayer's proceeds of disposition of the land as redetermined under subsection 13(21.1).

Should you Send Capital Property Through a Sec. 70(5) Disposition?

There is only one of two possible streams of taxation that **capital** property will have on death of a Cdn. resident: either tax-free rolled to a spouse or spousal trust, or, as a deemed FMV disposition with capture of all tax consequences.

By rolling it to a spouse/spousal trust there is only a deferral of tax consequences though there is considerable length of time after to arrange for better absorption of those tax consequences inherent in the property. When there is an immediate FMV disposition everything hits at once and there is no room to plan.

This being said, it is not at all unbeneficial to attract a Sec. 70(5) FMV disposition if its effects are properly planned for and balanced against other fiscal events on the death. One would want to make sure however that the Sec. 70(7) spousal trust untainting trust rules are examined when setting up a will since it is important that the ownership of the particular property directly end up in the trust even though as a result of those rules the property suffers a Sec. 70(5) FMV disposition.

In the FLA/Dependant Relief environment there are close to an infinite number of arrangements that can be done so that seemingly disenfranchised descendants do not trigger various applications that can knock an estate plan out of swing. Capital interests in spousal trusts can be given to off-spring that can be basically sold without interfering with the trust while giving the off-spring immediate value, economic value of the ownership in the spousal trust can be hived off and incorporated with recognition of the fair market value of the components and by explaining to a seemingly disenfranchised party that there this plenty of opportunity to structure with a spousal trust when they may not even have the assets if none were used a FLA/Dependants Relief application trigger may be avoided.

As a point one would want to try and trigger enough capital losses to offset capital gains on a death if one can and had to, and, always absorb any life-time capital gains exemptions such as on Small Business Corporation shares and Qualified Farm Property, etc. by "going high" on valuation to set up costs for the descendant.

Valuing Capital Property.

Valuing shares of a company, partnership interests, or other property subject to a testamentary buy-sell agreement for purposes of Sec. 70(5) has been an interesting subject of debate that will most likely continue to be controversial until legislation is enacted to attend to it specifically. Subsection 70(5) causes a disposition to be recognizable immediately before death and although *Mastronardi Estate v. The Queen* put forward the dicta that the provision was to operate without regard to the imminence of death it did not create any Canadian jurisprudence as to how conditions attached to or inherent in the property making up its nature had effect on its FMV for these purposes. (In *Mastronardi Estate* the FMV exploded **upon** death.) A buy-sell agreement obliges the taxpayer or his executor to sell (or buy) the owned shares/interests for a price determined by the agreement though the FMV of the shares **not subject** to the buy-sell agreement is what is to be valued for purposes of Sec. 70(5). If the purpose of the provision is to target for disposition purposes "the value" of the property **to the taxpayer**, that which he would expect to realize on its disposition the diction

similar to that in Sec. 70(1)-(2) would have been employed.^{346 347}

Beament Estate illustrates how **the character of the property itself may be altered** to affect its fair market value upon the occurrence of an event. In *Beament Estate v. M.N.R.*³⁴⁸ a taxpayer's offspring subscribed for Class A 5% cumulative preferred shares of a corporation while the taxpayer subscribed for Class B shares which entitled him to dividends payable out of the earnings of the corporation not used to satisfy the preferred shares' entitlements. Each share had equal voting power while the offspring had subscribed only pursuant to a contract between themselves and the taxpayer under which upon his death the corporation was to be wound up while the company's charter provided that upon such the Class A shareholders would be entitled to the surplus assets, and the Class B shareholders could not participate. Upon the death of the Class B shareholder parent the executors valued his shares at \$10,700 taking into account the dividends payable upon them and their proposed redemption value but the tax assessors valued them at \$110,000, based on the assets of the

346. When capital gains taxation imposed on death was introduced the Estate Tax Act was repealed while under that Act the value at the time of death of the deceased's property was subject to tax, and this was necessary since the purpose of that Act was to tax property passing into the estate of the taxpayer. The capital gains tax however is intended to tax gains accrued prior to death however to do such it must cause a disposition to be recognizable without the effect of the death.

347 See also the recent UK case of *Watkins & Anor v Revenue & Customs* [2011] UKFTT 745 (TC) (17 November 2011) concerning testamentary valuation issues where cited jurisprudence provided:

12 The *locus classicus* in regard to the valuation criteria and their application to cases such as this is indeed the judgment of Hoffman LJ in *IRC v Gray*, which it is worth quoting at length since it sets the parameters for the task which we must undertake. At [1994] STC 371-372 he says this:

The hypothetical vendor is an anonymous but reasonable vendor, who goes about the sale as a prudent man of business, negotiating seriously without giving the impression of being either over-anxious or unduly reluctant. The hypothetical buyer is slightly less anonymous. He too is assumed to have behaved reasonably, making proper inquiries about the property and not appearing too eager to buy. But he also reflects reality in that he embodies whatever was actually the demand for that property at the relevant time.

It cannot be too strongly emphasised that although the sale is hypothetical, there is nothing hypothetical about the open market in which it is supposed to have taken place. The concept of the open market involves assuming that the whole world was free to bid, and then forming a view about what in those circumstances would in real life have been the best price reasonably obtainable. The practical nature of this exercise will usually mean that although in principle no one is excluded from consideration, most of the world will usually play no part in the calculation.

The inquiry will often focus on what a relatively small number of people would be likely to have paid. It may have to arrive at a figure within a range of prices which the evidence shows that various people would have been likely to pay, reflecting, for example, the fact that one person had a particular reason for paying a higher price than others, but taking into account, if appropriate, the possibility that through accident or whim he might not actually have bought. The valuation is thus a retrospective exercise in probabilities, wholly derived from the real world but rarely committed to the proposition that a sale to a particular purchaser would definitely have happened.

13 One aspect of these general principles appears in a further decision of the Court of Appeal in *Walton v IRC* [1966] STC 68. That case involved a decision of the Lands Tribunal on the valuation for capital transfer tax purposes of the share of a partner in a farming partnership, one of whose assets was an agricultural tenancy. The case seems to us authority for the proposition that the intentions of a known potential purchaser of the interest to be valued should be taken into account, and is a matter of fact to be established by the evidence. Giving the judgment of the court, Peter Gibson LJ held, at 86:

The open market hypothesis does not require as a necessary incident of it that the landlord [a potential purchaser] should be hypothetical. In my judgment the statute requires one to assume a sale but it should be assumed to take place in the real world.

14 In *Crossman v CIR* [1936] 1 All ER 762, the issue concerned the value to be put on shares for estate duty purposes where they were saleable in the open market, but only after pre-emption rights in favour of the existing shareholders at a reduced price had not been taken up. Following the Irish Court of Appeal in *Attorney-General v Jameson* [1905] 2 IR 218 and the Scottish Court of Session in *Salvesen's Trustees v. IRC* [1930] SLT 387, the House of Lords held, by a majority, that the value of the shares was the price they would fetch in the open market on the basis that the purchaser was entitled to be registered as the holder of them, but that he would be subject to the restrictions on sale which the company's articles provided for.

348 70 D.T.C. 6130 (SCC)

corporation that, pursuant to the wind-up directions, were to be distributed to the offspring. The Supreme Court found that no sensible person would pay anything more than the amount expected to be realized on the wind-up: \$10,700, and that the contract bound the parties to the wind-up.³⁴⁹ The "value" of the property passing on the death is to be taxed and if the fair market value of the property is reduced by obligations **specifically attached to or inherent in it** then the net value is the tax base. This is true only if the particular statute does not provide support provisions requiring such obligations-rights-agreements to be disregarded, **(which the ITA does not, and the E.T.A. did not)**.

J.J. West Estate illustrates arrangements that can be entered into to impose obligations on the particular property as compared to altering its very nature. In *J.J. West Estate v. Min. of Fin. (B.C.)*³⁵⁰ ascertaining the value of shares subject to a testamentary buy-sell agreement was at issue when on the application of the B.C. Succession Duty Act the duty assessors arrived at a substantially greater value than the deceased's executors did. The relevant shareholder agreement entered into required the firm to value the shares on the asset value of the firm discounted for transfer restrictions and that upon death/retirement etc. the shares had to be sold to the employees of the firm for such a value. The "value" was statutorily defined to be FMV. The Finance Minister contended that, following the reasoning in *A.G. v. Jameson*³⁵¹ and *C.I.R. v. Crossman and Mann*³⁵² the value of the shares was to be determined without regard to any conditions imposed upon their alienation and that the provision imported an open market based disposition. Andrews, J., appropriately held that both these cases were based on provisions **expressly** providing for such³⁵³ but that the B.C. Act did not provide for such, citing *Re: Harvey v. Walsh*³⁵⁴ as fundamentally identical support. Since the shareholders agreement set the maximum price at which the shares could be sold to "outside" parties, and since the agreement could not be disregarded due to the absence of statutory authority, the determined price of the shares was held to be fair market value for the purposes of the Act.³⁵⁵

A buy-sell agreement if properly expressed may not only prevent the shareholder from disposing of the shares unless to other shareholders due to the right of first refusal but may also require any purchaser if an outside party to enter into an identical buy-sell agreement with the initial remaining shareholders if they don't first exercise their rights to acquire. This was the case in *Smith v. The Queen*³⁵⁶ where it was held that the purchaser would take the requirement that a potentially detrimental contractual restriction may disallow him from subsequently disposing of the shares as a consideration in arriving at their fair market value. The nature of the buy-sell agreement compelling the parties to transfer the shares between each other may or may not prevent their sale to outside parties predominately depending on its scope and whether the prospect of exercising rights of first refusal was legitimate. The fact that the shares may contractually be required to be conveyed, pursuant to a buy-sell agreement entered into by the new purchaser, to the other shareholders for nominal amounts may not totally reduce the shares' FMV when the contingent triggering event is remote or the company is very much a going concern. In *I.T. 140R2* CRA takes the position that shares sold pursuant to a buy-sell agreement by the estate have a fair market value independent from the buy-sell agreement, for purposes of Sec. 70(5), if the parties were not dealing at arm's length when the agreement was executed. It is also of the opinion that Sec. 69(1)(b) applies to the estate when the shares are sold, (so as to cause the deemed proceeds of disposition), and again the agreement is not to have effect. The fact that the parties may not be at arm's length when the buy-sell agreement is entered into is irrelevant in most instances. If one adopts

349 See *Abrahams v. F.C.T.*, 70 C.L.R. 23, *Blackwood's Exors. v. Commr. of Stamps*, 17 S.R.(N.S.W.) 447, *Onslow v. Commr. of Stamps*, 13 S.R.(N.S.W.) 354, *Re: Tolley*, 1932 S.A.S.R. 10, as well as *Robertson v. F.C.T.*, 86 C.L.R. 463, for an interesting contractual reorganization that affected the value of the shares on death.

350 1976 C.T.C. 313 (BCSC)

351 1905 2 Ir. 218 (KB)

352 1937 A.C. 26 (HL)

353 such as in section 26 of the 1972 Manitobian Succession Duty Act.

354 1953 D.L.R. 257 (Nfld SC)

355 See also *Gregory v. Commr.*, 123 C.L.R. 547, *McCathie v. Commr.*, 69 C.L.R. 1, for post mortem conditions' relevance and *Tait v. Commr.*, 116 C.L.R. 620, for a partnership wind-up and the value of the interest. See also *Hatton v Revenue And Customs* [2010] UKUT 195 (LC) (23 June 2010) for property valuation issues on UK Inheritance tax instances as well as *Price v Revenue & Customs* [2010] UKFTT 474 (TC) (07 October 2010) for issues that the value should not be net of disposal costs and that various interests in the property must also be examined.

356 87 D.T.C. 5355 FCTD

the dicta of Judge Andrews in *J.J. West Estate* the buy-sell agreement does have effect on the value for purposes of Sec. 70(5) at least, since no statutory provision precludes it. If one adopts the premise that the Sec. 70(5) provision does not have to be supported by provisions requiring the elimination of the effect of conditions in which the property is held, which is not the statutory convention in this type of legislation, then the Department's opinion can be supported however the former appears more plausible.³⁵⁷

In *The Queen v. Mastronardi Estate*³⁵⁸ the court concurred with the Trial Court Judge's opinion that Sec. 70(5) "did not import a necessity of valuing capital property taking into account the imminence of death" and that "no premise of imminence of death of the deceased should form part of such valuations".³⁵⁹ In that case the taxpayer died suddenly from a heart attack which was obviously not foreseeable. The corporation in which the taxpayer had shares was the annuitant of a life insurance policy held on his life and it was held that the proceeds could not inflate the FMV of the shares for purposes of Sec. 70(5). The taxpayer had died suddenly; if there had been a protracted deterioration in health such would not be the case since the value of the policy would increase **while** the shareholder was alive and this condition, inherent in the property itself, would have an effect in determining the value of the shares. Another example of a condition inherent in the property which is not related to a condition which is imposed upon its ownership would definitely be where the corporation is to be wound up on the death.

IC89-3 Policy Statement on Business Equity Valuations

POLICY STATEMENT ON BUSINESS EQUITY VALUATIONS

IC 89-3 August 25, 1989

Purpose

1. This Information Circular outlines the valuation principles, practices and policies that the Department generally considers and follows in the valuation of securities and intangible property of closely-held corporations for income tax purposes.

Law

2. All valuations should be made in accordance with the provisions of the Canadian Income Tax Act and the Income Tax Regulations.

Definitions

3. (a) Fair market value is the highest price, expressed in terms of money or money's worth, obtainable in an open and unrestricted market between knowledgeable, informed and prudent parties acting at arm's length, neither party being under any compulsion to transact.

(b) Value, as found in paragraph 7(1)(a), is generally interpreted by the Department to mean fair market value.

(c) A closely-held corporation is a corporation whose shares are owned by a relatively limited number of shareholders. There is no established market for such shares, in that they are sold infrequently.

Valuation Approaches

4. The Circular discusses, in general, the approaches applicable to closely-held or private corporations, recognizing that the facts and circumstances of each case will be determinative of fair market value. The valuator must use reasonable judgment and objectivity in the selection and analysis of the relevant facts of each valuation.

Factors

³⁵⁷ In the author's opinion until the issue of whether a buy-sell is to be taken into consideration under Sec. 70(5) has been authoritatively concluded it would be preferable to structure the company's charter to allow for the same effect so as to alter the very nature of the property (shares or a partnership interest) rather than argue that the obligation attached to the property by its owners has affected the property's f.m.v.. The flexibility and end result of a buy-sell can just as easily be resolved into the corporate charter subsequent to its incorporation though such could cause f.m.v. dispositions of the shares due to a change in rights inherent therein: it would be preferable to incorporate all of the outstanding shares into a common holding company with the flexible charter with the initial shareholders taking back common shares under a Sec. 85(1) tax free roll-in.

³⁵⁸ 77 D.T.C. 5217 (FCA)

³⁵⁹ This does not contradict the dicta in *Beament Estate* and *J.J. West Estate*.

5. When dealing with the valuation of shares of closely-held corporations and of intangible assets, the effect on value of a number of fundamental factors, such as the following, should be considered and analyzed: (a) The nature of the business, and history of the business from its inception. (b) The general outlook, the specific outlook and condition of the particular industry and the company's position in the industry. (c) The balance sheet, the financial condition and the capital structure of the particular company. (d) The company's earnings record and its earnings power. (e) The dividend-paying capacity of the specific company. (f) The existence of goodwill and/or other intangible assets. (g) Sales of the company's stock. (h) The size of the specific shareholding to be valued. (i) The stock market prices of comparable stocks of reasonably similar corporations in the same line of business, where these shares are actively traded in an open, unrestricted and public market. (j) The value of the corporate assets underlying the shares.

6. There are also numerous factors and issues relevant to the valuation of specific shareholdings, apart from the fundamental factors considered in valuing the enterprise as a whole. These include the existence of (a) options, other buy-sell agreements or other contractual rights or obligations; (b) control or minority shareholder interests; (c) the rights and privileges of the various classes of shares under the company's letters patent, bylaws, or memorandum of association; and (d) corporate-owned life insurance.

Weighting of Various Factors

7. Depending on the nature of the corporation's business, certain of the relevant factors may be accorded greater weight. In some businesses, earnings may be the primary determinant of value, while in others it may be asset value. The valuator must consider a different combination of factors in each case in determining fair market value.

Methods

8. The earnings and asset value methods are the two most generally accepted bases for determining value. The earnings method is of primary concern when valuing shares of operating companies that manufacture or market products or services.

9. Asset value methods are useful where: (a) A reasonable and viable alternative to buying an existing business is to start one from scratch, such as small construction subcontractors operating on competitive bids, auto body repair shops, machine shops, some retail outlets. (b) A business sells largely on an asset basis, that is, it derives its income largely from the assets, either tangible or intangible, rather than from the personal efforts of the owners and personnel, e.g., real estate holding companies, equipment leasing or investment companies, franchise or dealership operations.

Approaches

10. Generally speaking, the fair market value of a business is usually the greater of (a) its liquidation value, and (b) its going concern value.

11. The liquidation value approach is generally used where (a) the business is not a viable ongoing operation and is consequently suitable only for liquidation; (b) the business is a going concern, but its value is related to the liquidation value of the company's underlying assets; and (c) it is an aid in the determination of fair market value on a going concern basis, as in determining risk.

12. The going concern value approach is normally used where the business is a continuing enterprise with the potential for earning a reasonable return on investment. Where there is adequate potential earning power in the form of economic future profits or discretionary cash flows, the determination of going concern value depends on the amount and quality of the earnings or cash flows, and the business and financial risk that these earnings or cash flows can be achieved and sustained.

Factors in Capitalization Rate Selection

13. The risk, expressed in a going concern value calculation as the capitalization rate, relates to a number of factors in the business, among which may be: (a) The tangible asset backing. (b) The liquidation value. (c) The nature and history of the business operations. (d) The general economic, money and stock market conditions and outlook. (e) Specific industry and market comparisons. (f) The financial condition of the specific business being valued. (g) The quality of the business operations, including such factors as its management depth, its marketing, research and development capabilities, the composition of its labour force and product mix, and the existence of major contracts. (h) The impact of inflation and foreign exchange fluctuations. (i) The specific risk as related to the stability or irregularity of the maintainable level of earnings

or cash flows of the particular business. (j) The general and specific political environment. (k) Opportunities for growth as related to the social environment of the business. (l) The existence and importance of competitors. (m) The cost or ease of entry into the particular industry being reviewed. (n) The choice of and rates of return on alternate investments.

It should be noted that the foregoing list is not exhaustive.

The valuator must exercise judgment in determining the extent to which these and other potential external and internal factors are relevant in the quantification of a capitalization rate.

14. The general approach, appropriate methods and relevant factors are applicable to the determination of fair market value of any type of business interest, incorporated or unincorporated and of intangible assets, for income tax purposes.

Procedures

15. The organization of the departmental business equity valuation function is outlined in the current version of Information Circular 72-25.

16. The Regional Valuation Officer may ask for documents, statements or other information, including the following: (a) Details and the basis of values filed, for Valuation Day or any other dates. (b) A balance sheet with supporting statements, schedules and notes as at the date of valuation. (c) Copies of any appraisals of the fixed assets and/or real estate. (d) Financial statements for the five most recent fiscal periods prior to the valuation date, or since the commencement of operations, whichever represents the shorter period. (e) If the business has been operating for five years or less, the financial statements should include an opening balance sheet. (f) Copies of all option, buy-sell or other shareholder agreements or partnership agreements. (g) Complete details of all acquisitions and dispositions of the taxpayer's interest in the entity, proposed or completed. (h) Copies of any arm's length offers for substantially all of either the company's shares or its fixed assets. (i) For small closely-held companies, a list of shareholders outlining the number of shares held and any family relationships. (j) For large closely-held companies and public companies, a list of major shareholders, outlining the number of shares held and any family relationships, if applicable. (k) For partnerships, a list of the partners outlining their profit and capital-sharing ratios. (l) If the property is a bond or other obligation, details of the series, face value, interest rate and maturity date. (m) Copies of extracts from the corporate letters patent, memorandum of association, or by-laws detailing the rights and privileges attaching to all classes of shares. (n) With regard to companies, details of any recent sales of similar securities. (o) A brief history of the business operation, including the area it serves, its relation to its competitors in the same industry, and the specific outlook and condition of the particular industry. (p) Any pertinent facts or opinions concerning such issues as the dependence of the company on key personnel, suppliers or customers, the taxpayer's role in the company, the company's potential for growth, the adequacy of its facilities, and the existence of contracts or leases. (q) Details of life insurance policies owned by a corporation or partnership on the lives of its key personnel. (r) Details of and comments on the adequacy of salaries and/or other benefits paid or credited to the principal shareholders, partners or proprietor and their families.

It should be noted that the foregoing list is not exhaustive.

Policies

Options and Buy-Sell Agreements

17. Options and buy-sell agreements affect fair market value determination as required by several sections of the Income Tax Act, notably section 69 and subsection 70(5).

18. In a closely-held corporation, fair market value must be determined by referring to share rights and restrictions, whether found in the company's articles, by-laws or valid contracts between shareholders. These rights or restrictions can have an appreciatory or a depreciatory effect on the price a willing purchaser would pay for the shares in the notional market.

19. Where these rights cannot be changed without incurring the possibility of minority shareholder court or breach of contract action, where such rights limit the amount that can be realized at the date of valuation and require the shares to be disposed of for a stipulated amount, their value must be determined according to the provisions of such agreement or article. In these circumstances, other relevant factors normally considered in valuing shares may not be relevant.

20. On the other hand, where a majority shareholder holds shares subject to rights and restrictions and can modify these same rights and restrictions without incurring the possibility of adverse minority action, the value of these shares should not be restricted to the amount prescribed by the terms of the arrangement.

21. It must be noted that an arrangement that restricts the value of the shares subject to it must be bona fide in nature. That is, there must be some primary legitimate business purpose, such as the orderly succession of management, control over the influx of outsiders and creation of an outside market for the shares.

22. In addition, for the provisions of any arrangement to be considered relevant to the valuation of shares, the contractual agreement must be validly constituted and binding (i.e., a legally enforceable arrangement), and there must be a reasonable estimate of fair market value made.

23. The following two types of restrictions will not render the agreement determinative of fair market value:

(a) Where a restriction on transfer is one only of consent by shareholders and/or directors, which does not stipulate a price at which shares can be transferred or does not specify events under which an obligation to transfer or option to purchase shares arises, it will not be determinative of fair market value. However, the restriction may be a depreciatory factor to consider in valuing the shares subject to the arrangement.

(b) Where a restriction is merely a right of first refusal at a stipulated price, it will not be determinative of fair market value, although it may be another depreciatory factor to consider.

24. In the situation where shares are subject to a bona fide commercial option at a specified or formula price at the time of valuation, the option price will likely represent the lowest (or "floor") price which a prospective and willing purchaser would pay and a willing vendor would accept. To be a bona fide commercial option, it must be a legally enforceable contract with a legitimate business purpose. Such an option would have a depreciatory effect on the fair market value of the shares.

25. The facts of a case would determine what amount, if any, a purchaser would pay in excess of that "floor" price and would depend on a number of factors including, when the option is exercisable; the likelihood that the option will be exercised; whether the option price is fixed, subject to periodic increases, or based on a formula which affects an increase in price as the company succeeds; and, the size of the particular shareholding.

26. An agreement may provide for a number of *inter vivos* events which will give rise to either an optional or a mandatory sale at a specific price, such as retirement, resignation, or disability. Such restrictions may have a depreciatory effect on share value. Where the terms of the agreement stipulate a mandatory sale when the shareholder wants to sell his shares, the price stipulated in the agreement should accordingly limit the value pursuant to subsection 70(5), because a prospective purchaser would not be willing to pay any more for the shares than he/she would be able to receive under the provisions of the agreement.

27. If the restrictions contained in agreements are not considered determinative of fair market value, normal valuation approaches will be used to determine the fair market value of the shares in question.

28. In order for a buy-sell agreement to be considered determinative of value pursuant to subsection 70(5), it must meet all the following requirements: (a) The agreement must obligate the estate to sell the shares at death either under a mandatory sales and purchase agreement or at the option of a designated purchaser. (b) The agreement must restrict the shareholder's right to dispose of his/her shares at any price during his/her lifetime. (c) The agreement must fix a price for the shares or set out a method for determining the price on a current basis. (d) The agreement must represent a bona fide business arrangement and not a device to pass the decedent's shares to his/her heirs for less than an adequate and full consideration.

29. If a buy-sell agreement, normally determinative of value, is executed between parties not acting at arm's length, its provisions should be determinative of value, as long as it meets the following criteria: (a) It is a bona fide business arrangement. (b) The stipulated price or formula price in the agreement provides full and adequate consideration, and represents the fair market value of shares determined without reference to the agreement at the time it is executed. (c) It is a legal and binding contract.

30. In order for an agreement to be considered bona fide, there must be no donative intent in the agreement. In other words, while the parties to the agreement may be related, they must transact as they would at arm's length with strangers.

31. Each case will be dealt with on the basis of the related facts. These facts will determine whether a specific buy-sell or option agreement is legally enforceable and whether its provisions should be determinative of value or should be some of the many relevant factors to be considered in arriving at fair market value of the shares subject to the agreement, in accordance with generally accepted valuation principles.

Reference should also be made to the current version of IT-140.

Family and Group Control

32. The Department recognizes that in certain situations either a related group or an unrelated group of shareholders may control a corporation if they owned amongst themselves at least 50% + 1 of the issued and outstanding voting shares of the corporation at the same time and if they have historically acted in concert as a group. It is a rebuttable presumption that a family group has acted in concert to control a corporation.

An assertion by a minority shareholder that he/she is part of a family control group must be considered in light of all relevant factors, including the rights and restrictions attributable to his/she particular shares.

In a situation where the existence of family control is recognized, the Department will employ a rateable valuation for each family group member's shares.

33. An assertion of group control by family members, such as those referred to in subsection 251(6) of the Income Tax Act, will be accepted, provided there is no contrary evidence that they did not act in concert. Groups of relatives other than those referred to in subsection 251(6), must provide proof that they were part of a controlling family group and acted in concert with that group.

34. With regard to control by a group of shareholders dealing at arm's length, the criteria necessary for acceptance of claims of group control will include (a) a written agreement under which all the shareholders in the group relinquish their rights to vote and to sell their shares independently at all times; or (b) provision in the corporate letters patent, memorandum of association or the bylaws restricting individual rights to vote and to sell their shares independently at all times; or (c) permanent release of the individual shareholder's rights by giving of an irrevocable proxy to a designated person to vote and to sell the shares as he/she sees fit on behalf of all the shareholders in the group; or (d) a pattern of conduct to demonstrate that the shareholders acted collusively in all matters relating to the control of the corporation.

35. In order to determine whether a certain pattern of conduct is indicative of collusive action in all matters relating to control, the following actions may be undertaken individually or in any combination: (a) Shareholders' and directors' minutes may be examined to determine the extent of consultation among the group. (b) A review of remuneration may be made to insure that all members of the group were treated fairly. (c) Interviews with members of the group may be held to determine the role played by each member. (d) Details of actual purchases and/or sales made by the claimants may be examined.

36. Where the Department is satisfied that the documentation provided indicates a consistent pattern of group control, it will apply a rateable valuation for each member's shares, and not apply a minority discount.

37. The Department also recognizes that effective control can exist in a public corporation where an individual or group has a large block of shares, where through unconditional proxies, a majority of votes at any shareholders' meeting controls management and where the remaining shares are widely dispersed. In these cases, satisfactory evidence of control must be provided.

Each case will be dealt with on its own merits.

Stock Option Benefits

38. The Department's policy concerning benefits received by employees under stock option plans pursuant to section 7 of the Income Tax Act revolves around a few key words contained therein.

With regard to the phrase "value of the shares" encountered in paragraph 7(1)(a), the Department generally interprets the term "value" to mean fair market value, as defined previously.

39. For purposes of determining the date upon which the corporation's shares are "acquired" pursuant to paragraph 7(1)(a), the Department considers that to be the date at which the taxpayer acquires the rights of a shareholder with regard to the purchased shares subject to the option.

The factual circumstances of each case will determine the date at which a taxpayer obtains legal ownership or the incidence of legal ownership in and to the shares subscribed, and thereby acquires the shares.

Reference should also be made to the current version of IT-113.

Corporate-Owned Life Insurance

40. According to subsection 70(5.3), in determining the subsection 70(5) value of a deceased's shares (for deaths occurring after December 1, 1982), the value of corporate owned life insurance is its cash surrender value. This applies to the deceased, but where there are two or more shareholders and corporate-owned life insurance is required to fund a stock purchase agreement, one must determine the value of the policies held by the corporation on the other shareholders.

The factors to be considered in determining the value of such policies held on the lives of shareholders other than the deceased, should include: (a) cash surrender value; (b) the policy's loan value; (c) face value; (d) the state of health of the insured and his/her life expectancy; (e) conversion privileges; (f) other policy terms, such as term riders, double indemnity provisions; and (g) replacement value.

Reference should also be made to the current version of IT-416.

41. If the death of one of the shareholders for which corporate life insurance is owned is considered "imminent" and it is proper to consider this factor in valuing a policy, the value may be greater than the policy's cash surrender value. However, one must also consider the following factors: (a) the possibility that the insured will recover and not die; (b) the effect that the loss of a key person would have on the business operations; (c) whether the share interest being valued represents a majority or minority of the outstanding shares; and (d) the importance attached to factors other than asset value in the circumstances, such as the future earnings expectations and the prospects for dividends.

Income Tax Interpretation Bulletin

Valuation of Shares of a Corporation Receiving Life Insurance Proceeds on Death of a Shareholder
IT-416R3

DATE: July 10, 1987

SUBJECT: INCOME TAX ACT

Valuation of Shares of a Corporation Receiving Life Insurance Proceeds on Death of a Shareholder

REFERENCE: Subsections 70(5) and 70(5.3)

This bulletin cancels and replaces IT-416R2 dated September 26, 1984. Current revisions are designated by vertical lines.

1. Paragraph 70(5)(a) deems the property of a deceased person to have been disposed of immediately before death for proceeds equal to the fair market value of the property at that time.

2. The property referred to in 1 may include shares of a corporation the value of which depends at least in part upon the value of a life insurance policy under which the decedent was the person whose life was insured. The corporation's interest in the policy may be direct or it may be through its ownership of shares of another corporation. In either case, for deaths occurring after December 1, 1982, subsection 70(5.3) provides that the value of the policy immediately before death shall be its cash surrender value at that time as determined under paragraph 148(9)(b) (see 3 below). Where the death occurred prior to December 2, 1982, the comments in paragraphs 4 and 5 below apply.

3. In determining the cash surrender value of a policy for the purposes of subsection 70(5.3), paragraph 148(9)(b) provides that policy loans outstanding, policy dividends payable and any interest payable upon such dividends shall be disregarded. In addition to those specific exclusions, the Department also considers that prepaid premiums and dividends left on deposit are not elements of the cash surrender value of a policy although their values, and the values of those elements specifically excluded, may affect the values of the shares of a corporation which is the owner and beneficiary of the policy.

Death of Shareholder before December 2, 1982

4. Where subsection 70(5.3) does not apply, the insurance policy, as a component of the assets underlying the shares, will be valued in accordance with normal valuation practices taking into consideration all facts relevant to the particular case. In this regard, the value established for the insurance policy immediately

before death should be based on relevant factors relating to the deceased shortly before death, e.g., the day prior to death (see 5 below).

5. Major factors that should be taken into account are

- (a) the cash surrender value, if any, of the policy,
- (b) the life expectancy of the insured based on mortality tables, and
- (c) the state of the health of the insured as it would be known to other persons.

For example, the value of an insurance policy could approach its face value if it were known that the insured had a terminal illness or was critically injured as a result of an accident and not expected to recover. Conversely, it would have little added value if a person in apparently excellent health were to die unexpectedly as a result of an accident or heart attack. For valuation purposes the state of health of the insured prior to death would override the effect of an unexpected death due to a cause not related to any known health problem. Therefore, if a person with terminal cancer died from an unexpected heart attack the actual cause of death would not be relevant in the valuation, but the fact that the person had terminal cancer would.

Income Tax Interpretation Bulletin

Capital Property Owned on December 31, 1971 - Actual Cost of Property Owned by a Testamentary Trust
IT-130

DATE: November 20, 1973

SUBJECT: INCOME TAX ACT

Capital Property Owned on December 31, 1971 - Actual Cost of Property Owned by a Testamentary Trust

REFERENCE: Subsection 26(3) of the Income Tax Application Rules, 1971 (ITAR)

1. The actual cost of capital property is a determinant of "cost" in the median rule computation under subsection 26(3) of the ITAR. The Department's view on the determination of actual cost in various situations is expressed in Interpretation Bulletin IT-93 dated March 12, 1973.

2. Interpretation Bulletin IT-93 states in paragraph 4(b) that the actual cost of a capital property acquired by a taxpayer prior to 1972 is

- (a) the fair market value of the property on the date of death of the deceased where the property was received as an outright bequest or inheritance, or
- (b) the fair market value of the property on the date of its actual delivery by the trustee to the taxpayer where the property was received in satisfaction of a capital interest or part thereof.

The Bulletin however, is silent as to the actual cost of property acquired by a trust established pursuant to a will which took effect prior to 1972.

3. In such event, where the trust arose at the date of the testator's death and the property was transferred to it out of the estate during or within a reasonable time after the "executor's year", the Department considers that the actual cost of the property to the trust for the purpose of subsection 26(3) of the ITAR is its fair market value at the date of the testator's death. This also applies even if the trust created prior to 1972 constitutes, after 1971, a spouse trust as defined in paragraph 70(6)(b) or 104(4)(a) of the Act. Where, however the trust holding the property on December 31, 1971 did not arise at the date of the testator's death, or where the property was not transferred to the trust within a reasonable time after the "executor's year", in the Department's view the actual cost of the property for the purpose of subsection 26(3) of the ITAR is its fair market value at the time of its actual transfer to the trust.

Who acquires under Sec. 70(5).

Subsection 70(5) is different implicitly from Sec. 70(6) and 70(3) in one significant way. The former provides that any person who has acquired the property of the deceased will have to recognize a tax cost thereof equal to the fair market value of the property at the time of death while the latter provides that the beneficiary will recognize the property to have a cost equal to the deceased's. Where is the estate in all of this? Obviously **the**

only person that can be referred to in Sec. 70(5) is the estate and no other taxpayer who is beneficially interested in the estate. The section 107 distribution provisions were not enacted for nothing and the subsection 70(5) provision sets up the cost of the property for the estate, (and obviously for section 107 purposes), but it is former that dictates how the beneficiaries of the estate will inherit the property.³⁶⁰³⁶¹

Usually the results of a direct effect of the Sec. 70(5) provision as if it refers to the ultimate recipient will be equivalent to that if it were read as if Sec. 70(5) **and** section 107 worked in unison however not always and it is important in this instance to point out that this is the way the provisions **must** interact. This **isn't** the case with subsection 70(6)(a), (the spouse recipient), since implicit in the mechanics of that provision is the **negation** of the effects of section 107 to the ultimate distribution by the estate to the spouse. Subsection 70(6) prescribes how the spouse, (or spousal trust), will **receive the property**, (ie tax cost as per the final two lines of subpara. 70(6)(d)), while apparently section 107 will not apply. The estate is to be ignored as a liability base. This is all lovely of course if subsection 70(6) is as technically solid at preserving the Canadian tax base as the section 107 provisions however it isn't as will be seen. (To elaborate; if a taxpayer purchases a beneficiary's interest in an estate that is in the midst of administration he will not benefit from the effect of Sec. 70(5) on the terminal distribution since the property has not technically been acquired "as a consequence of the death of the taxpayer", (the requirement of Sec. 70(5)(c) and (d)) and instead in the case of a personal trust(estate), Sec. 107(2) will apply to determine ultimate capital gains integration and cost flow-through. If then the interest isn't sold but instead is maintained by the specified beneficiary should Sec. 70(5) apply on a terminal distribution by the estate since the property is being acquired "as a consequence of the death of the taxpayer"? What happens when the executors, during the years in which the estate is being administered have the power and exercise it in taking capital cost allowance on the capital property that will be distributed? Will Sec. 70(5) apply or will it be Sec. 107(2) that applies to determine the cost of the property to the beneficiary on a terminal distribution? If Sec. 107(2) doesn't categorically apply then it would be possible to have the executors take C.C.A. in the years of administration thus reducing the tax cost of the property as well as income, and then have the beneficiary recognize the property to have a cost to him for subsequent C.C.A. purposes equal to its **fair market value** at the date of death, obviously an abnormality. **Subsection 70(5) and section 107 work in unison**³⁶². It was that when you examined Sec. 70(6) you didn't find that: the roll-over allowed the estate to deduct CCA on the property and then the spouse/spousal trust would pick it up at its ACB with no possible recapture of that CCA. Now, when the property is rolled to a spouse/spousal trust the draftsmen have left no room for such in that Sec. 70(6) specifies how **the beneficiaries are to pick up the property**.³⁶³)

Avoiding the Disposition.

Avoiding unplanned deemed dispositions of property upon death is of paramount concern in estate planning and if ownership of the property in a personal capacity can be avoided then Sec. 70(5) will not apply to the property upon death. Methods of doing just this include *inter vivos* spousal trust transfers where the property is subsequently loaned back to the contributor, or holding the property upon implied trust as in instances described in *G.M. Miller v. M.N.R.*³⁶⁴ or *E. Bouchard v. The Queen*³⁶⁵.

360. This was specifically recognized in a T.I. provided in Aug. 1977 by the Technical Interpretations Division.

361 If this were not the case then when a taxpayer purchased a beneficiary's interest in the estate there would be no way in which he could tack on the excess cost of the interest to the property ultimately received and cost integration would not follow, even more so if that purchaser had to also assume estate debt such as the case in Sec. 107(2).

362 There is absolutely no room for Sec. 69(1)(c) to apply to an instance where the deceased's property is acquired by the beneficiary in that the preamble of subsection 69(1) starts off with "**Except as expressly otherwise provided in this Act**" though this obviously didn't prevent the needless wasting of a question in the 1990 Roundtable Discussions:Q25. What subparagraph 69(1)(c) will apply to is that property which isn't subject to the section 107 mechanics and this would include all property which the taxpayer "creates" that cannot be distributed from his estate in satisfaction of a capital interest. See also Q49 in 1988 Roundtables.

363 Regardless of the type of bequest (specific or residuary) subsection 70(5) does not operate to provide the cost to **the beneficiary** of the property.

364. 88 D.T.C. 1488 See also *Gardner v. M.N.R.*, 88 D.T.C. 1649 TCC.

365 83 D.T.C. 5193. See also *I.R.C. v. Allan*, 9 T.C. 234, (income diversion), *I.R.C. v. Parsons*, 13 T.C. 700 (corpus diversion), *Glynn v. F.C.T.*, 111 C.L.R. 169, (undisclosed trust for offspring), *Re: Armstrong*, 1960 V.R. 202, (though *Re: McGuire*, 41 W.A.L.R. 120), *F.C.T. v. Purcell*, 29 C.L.R. 464, as well as *O.K. Murphy Estate v. The Queen*, 1974 C.T.C. 552, for a trust of shares pending a reorganization of a corporation that allowed avoidance of estate tax; beneficial ownership was not held at the time of the death of the taxpayer. See also *Minister of National Revenue v. National Trust*

Resulting Trusts.

Invoking a resulting trusts can be useful in avoiding the Sec. 70(5) provision if they can be proven.^{366 367} Property purchased by one and conveyed directly to the trustee or to the purchaser jointly for himself and another presumes a resulting trust.³⁶⁸ Rebutting the presumption of resulting trust can occur if evidence exists to establish that the intention of the purchaser was to pass equitable interest to the other party. The "natural" presumption of resulting trust can be rebutted by the special relationship otherwise existing between the purchaser and the "trustee" recipient and the presumption of advancement displaces it.³⁶⁹ The accurate rule would be that where such a relationship exists it serves as prima facie evidence that the conveyance was to be a gift though evidence can be introduced to rebut such and prove that the intention was that the recipient was not to take beneficially.³⁷⁰

The primary two special relationships exist between father/mother and offspring³⁷¹ and husband and wife (de facto or otherwise).

In the case of the former *Commr. of S.D. v. Byrnes*³⁷² serves as an illustration of how income can be continually realized from property that has been gifted without the creation of a resulting trust. In that case the deceased purchased property in the names of his offspring but received the income therefrom in his personal capacity. The fact that rent was continued to be paid to the parent did not rebut the presumption of advancement but was only an act of reverence and good manners. In such a case the property would not be subject to Sec. 70(5).³⁷³

In *Stuckey v. Trustees, Exors., & Agency Co. Ltd.*³⁷⁴ the fact that the parent retained a life interest in property that was purchased in the name of her offspring rebutted the presumption of advancement making the property subject to probate duty, given that her intention at the time of the transfer was to avoid the application of probate duty and not benefit her offspring.³⁷⁵

Co., [1949] S.C.R. 127, where a testator escaped succession duty when he shed assets into a trust before death though with some reversionary interest.

366. There are two general types of resulting trust: when the legal title is transferred to a person in a manner without the transferor intending that beneficial title also pass, and, when the intention is that beneficial interest pass, upon the conveyance of legal title to an expressly created trust but fails due to uncertainty of object or extent of interest. See *Re: Vandervell's Trusts, No 2*, 1974 Ch. 269. If the sole beneficiary under a trust refuses to accept her interest the trust will fail in the absence of alternative conveyance directions and due to an incomplete passage of equitable title the trustee will hold the property on resulting trust for the settlor. This was the case in *F.C.T. v. Cornell*, 73 C.L.R. 394, where dividends on shares were assessable in the settlor's hands when the beneficiary disclaimed her interest in the trust. Compare this with *Case Q17*, 1964 15 TBRD 94, where refusal came after the constitution of the trust. Legitimate loans do not create constructive/resulting trusts if they are to be repaid since such would allow the lender to get his money back twice: *Re: Sharp*, 1980 1 All E.R. 198. See *M. D. Donald Ltd. v. Brown*, [1933] S.C.R. 411 where shareholders transferred for free property to their corporation while continuing to enjoy its benefits personally, with the corporation disposing of it, and a resulting trust was found to exist.

367 For an instance where a deceased was found to own property on resulting trust see the Aust. case of *Neil v Jacovou* [2011] NSWSC 87 (28 February 2011), though see also from that country *Drayson v Drayson* [2011] NSWSC 965 (24 August 2011) where the opposite was the case. See the UK case of *Singh v Revenue & Customs* [2011] UKFTT 584 (TC) (08 September 2011) where the assertion failed on a hidden income assessment.

368 See *Pettitt v. Pettitt*, 1970 A.C. 777 (HL), & *Bateman T.V. Ltd. v. Bateman and Thomas*, 1971 N.Z.L.R. 453 (CA).

369 See the recent Aust. case of *Markoska & Markoska* [2011] FamCA 572 (19 July 2011) for a rebuttal of presumption of advancement.

370 See *Blochv. Bloch and Anor*, [1981] 180 C.L.R. 390, for an instance where a son was accepted to act as a resulting trust trustee in respect of property paid for by his parents, when an oral agreement existed to the effect. See also the Aust. case of *Tabtill Pty Ltd v Creswick; Creswick v Creswick & Ors* [2011] QCA 381 (23 December 2011) for the timing at which one comes into existence.

371 See the Aust. divorce case of *Liakos & Zervos and Anor* [2011] FamCA 547 (15 July 2011) for gifts between a father and son asserted to exist to shield the son's assets.

372 1911 A.C. 386 (PC)

373 There was an opposite conclusion in *Warren v. Gurney and Anor*, 1944 2 All E.R. 472 (CA), though the property did not produce income.

374 1910 V.L.R. 55

375 This case was questioned in *Davies v. Nat. Trustees, Exors., and Agency Co. of Aust. Ltd.*, 1912 V.L.R. 397. See also *Batsone v. Salter*, 1875 L.R. 10 Ch. 431.

In *Rider v. Kidder*³⁷⁶ Lord Eldon was of the opinion that a person buying property for himself and a stranger and causes the income therefrom to be paid to the stranger rebuts the presumption of resulting trust qua the income but not the corpus.

There is a difference between vesting beneficial interest on an advancement immediately and in the future.³⁷⁷ In *re: Kerrigan*³⁷⁸ a taxpayer advanced mortgages in the names of his offspring though received the interest thereupon personally. The children were not made aware that "they had assets" until a later date and when the Commissioner of Stamp Duty attempted to assess the principal for duty on the taxpayer's death the executors were unsuccessful at arguing that there had been an immediate advancement but the Court held that the principal was to be held on resulting trust for the taxpayer thus was subject to the duty.³⁷⁹ In *Shepherd v. Cartwright*³⁸⁰ a taxpayer purchased shares in the names of his children which increased in value subsequent to which they were sold with the proceeds being placed in separate bank accounts for the underaged and, at all material times, unknowlegable children. A power of attorney was secured from them by the parent to withdraw from the accounts which was used principally for the parent's benefit while the children reported the income from the shares in their respective tax returns. On the death of the taxpayer the children commenced actions against the executors for the depleted share proceeds and were successful when the court found an advancement had occurred and that subsequent conduct by **either** party was inadmissible to prove the intention at the time of the transfer. Viscount Simonds held:

"I think it well then to pause in this year 1919 and to ask what was the result in law of equity of the registration in the names of his children, of shares for which he supplied the cash, and I pause in order to examine the law, because it appears to me that the only two facts which are at this stage relied on to rebut the presumption of advancement, viz.: that the children were ignorant, and that certificates were not given to them, are of negligible value. My Lords, I do not distinguish between the purchase of shares and the acquisition of shares on allotment, and I think that the law is clear that, on the one hand, where a man purchases shares and they are registered in the name of a stranger, there is a resulting trust in favour of the purchaser; on the other hand, if they are registered in the name of a child *in loco parentis*, there is no such resulting trust but the presumption of advancement. Equally, it is clear that the presumption can be rebutted, but should not, as Lord Eldon said, give way to slight circumstances.

It must then be asked by what evidence can the presumption be rebutted, and it would, I think, be very unfortunate if any doubt were cast (as I think it has been in certain passages in the judgments in review) on the well settled law on this subject. It is, I think, correctly stated in substantially the same terms in every text-book that I have consulted and supported by authority extending over a long period of time. I will take, as an example, a passage from Snell's *Principles of Equity* (22nd Edn.), p. 122, which is as follows:

"The acts and declarations of the parties before or at the time of the purchase, or so immediately after it as to constitute a part of the transaction, are admissible in evidence either for or against the party who did the act or made the declaration; subsequent acts and declarations are only admissible as evidence against the party who did or made them, and not in his favour."

. I do not think it necessary to review the numerous cases of high authority on which this statement is founded. It is possible to find in some earlier judgments reference to "subsequent" events without the qualifications contained in the textbook statement: it may even be possible to wonder in some cases how, in the narration of facts, certain events were admitted to consideration. But the burden of authority in favour of the broad proposition as stated in the passage I have cited is overwhelming and should not be disturbed."

Mothers have been more usually held to create a resulting trust rather than give a gift via the acquisition in the

376 1805 10 Ves. Jr. 360

377 See *In re: Cochrane*, 1906 2 Ir. 200, and *Grey v. A.G.*, 1900 A.C. 124.

378 47 S.R. (N.S.W.) 76

379 *Stuckey* was disapproved of here as well. See also *Boulos v. Boulos*, 24 E.T.R. 56.

380 1954 3 All E.R. 649 (CA)

name of a child.³⁸¹ In *Dagle v. Dagle Estate*³⁸² there was a presumption of advancement when a mother conveyed property to one son but her will stated that the property was to be shared by her both sons. The frustrated son was not able to overcome the onus of disproving the presumption.³⁸³

381 See *Edwards v. Bardley*, 1957 9 D.L.R. (2d) 673, when a joint bank account arranged by the widowed parent did not produce a presumption of advancement. See also *Re: Mailman*, 1941 3 D.L.R. 449, *Niles v. Lake*, 1947 2 D.L.R. 248, *Lattimer v. Lattimer*, 1978 18 O.R. (2d) 375, *Cohen v. Cohen*, 24 E.T.R. 269, and *Klimashewski v. Klimashewski*, 28 E.T.R. 163.

382 1990 70 D.L.R. (4d) 201

383 See also *Madsen Estate v. Saylor*, 2007 SCC 18, [2007] 1 S.C.R. 838 where the Supreme Court held that when a father had transferred property to a joint account with his adult daughter giving her a right of survivor to the account, though the daughter did not actually use any of the account's funds that, per the head note:

P, an adult daughter, was made a joint account holder by her father following the death of her mother. The accounts had a right of survivorship. P's father also executed a power of attorney in her favour and she remained the named alternate executor under his will, which was never changed after her mother's death. P's father retained control of the bank accounts and the funds were used solely for his benefit during his life. He also declared and paid all taxes on income made from the accounts. There was conflicting evidence from P and her siblings as to their relationships with their father, P claiming to be the preferred child. Under her father's will, P and her two siblings were to share one half of her father's estate. Following the father's death litigation was commenced by P's siblings against P as executor because she did not include the accounts in the distribution of the estate. Applying a presumption of resulting trust, the trial judge found that there was no evidence to support P's position that her father intended to gift the joint accounts to her and held that they should be included in the father's estate. The Court of Appeal affirmed the decision. The majority concluded that the trial judge was incorrect in applying the law of resulting trust and should have applied the presumption of advancement, but added that she was not required to consider either presumption because the intention of the father at the time of the transfer was demonstrated on the evidence.

Held (Abella J. dissenting): The appeal should be dismissed.

Per McLachlin C.J. and Bastarache, Binnie, LeBel, Deschamps, Fish, Charron and Rothstein JJ.: A presumption of a resulting trust applies to the gratuitous transfer of assets by P's father into the joint accounts. The presumption of advancement has no application because P was not a minor child of her father. P therefore had the burden of rebutting the presumption of a resulting trust by showing that her father intended to gift the assets in the accounts to her on the balance of probabilities. The trial judge incorrectly found that there was no evidence to suggest that P's father intended for her alone to have the assets in the joint accounts. The financial institution documents and P's evidence that she and her father acknowledged that they understood at the time that the right of survivorship meant that on the death of one of the joint account holders the other would become the sole owner, did constitute some evidence that was relevant to the father's intention. In the circumstances of this appeal, it is both feasible on a practical level and within the interests of justice for this Court to take into consideration the evidence not considered by the trial judge and make a final determination rather than sending the case back to trial. The financial institution documents and P's testimony in relation to them do not satisfy P's burden of proof on the balance of probabilities. Little weight can be accorded to that evidence because of the lack of clarity in the bank documents and because of the trial judge's finding that P's testimony was evasive and conflicting. The conclusion that the presumption of resulting trust was not rebutted is consistent with the trial judge's finding, based on the evidence she did consider, that the father had not intended to make P a gift of the account proceeds. [17] [20] [22] [24] [27-29]

Per Abella J. (dissenting): The presumption of advancement should be applied in this case and a new trial ordered. This presumption should continue to apply to all gratuitous transfers from parents to their children, and not be restricted to transfers to non-adult children. The fact that the trial judge ignored or drew contrary inferences from certain factors which could be considered reflective of an intention to make a gift, illustrates how her error in applying the presumption of resulting trust may have influenced her findings of fact and credibility. The key finding made by the trial judge, a finding which reflects the erroneous assignment of the burden of proof to P, was that there is no evidence to support P's position that her father intended to gift the contents of his joint accounts to her. [33] [42]

In *Pecore v. Pecore*, 2007 SCC 17, [2007] 1 S.C.R. 795 it as further held:

An ageing father gratuitously placed the bulk of his assets in joint accounts with his daughter P, who was the closest to him of his three adult children. Unlike her siblings, who were financially secure, P worked at various low-paying jobs and took care of her quadriplegic husband, M. P's father helped P and her family financially, including buying them a van, making improvements to their home, and assisting her son while he was attending university. P's father alone deposited funds into the joint accounts. He continued to use and control the accounts, and declared and paid all the taxes on the income made from the assets in the accounts. In his will, P's father left specific bequests to P, M and her children but did not mention the accounts. The residue of the estate was to be divided equally between P and M. Upon the father's death, P redeemed the balance in the joint accounts on the basis of a right of survivorship. P and M later divorced, and a dispute over the accounts arose during their matrimonial property proceedings. M claimed that P held the balance in the accounts in trust for the benefit of her father's estate and, consequently, the assets formed part of the residue and should be distributed according to the will. The trial judge held that P's father intended to make a gift of the beneficial interest in the accounts upon his death to P alone, concluding that the evidence failed to rebut the presumption of advancement. The Court of Appeal dismissed M's appeal, but found that it was not necessary to rely on the presumption of advancement because the presumption is only relevant in the absence of evidence of actual intention or where the evidence is evenly balanced.

Held: The appeal should be dismissed.

The second special relationship consists of that of husband and wife and the common rule is property rights of the parties must be ascertained at the time of the purchase of the property and unless there is an agreement to then alter them they remain the same.³⁸⁴ Asper J. in *Re: Eykyn Trusts*³⁸⁵ provided:

Per McLachlin C.J. and Bastarache, Binnie, LeBel, Deschamps, Fish, Charron and Rothstein JJ.: The long-standing common law presumptions of advancement and resulting trust continue to play a role in disputes over gratuitous transfers. These presumptions provide a guide for courts where evidence as to the transferor's intent in making the transfer is unavailable or unpersuasive. They also provide a measure of certainty and predictability for individuals who put property in joint accounts or make other gratuitous transfers. The presumption of resulting trust is the general rule for gratuitous transfers and the onus is placed on the transferee to demonstrate that a gift was intended. However, depending on the nature of the relationship between the transferor and transferee, the presumption of advancement may apply and it will fall on the party challenging the transfer to rebut the presumption of a gift. The civil standard of proof is applicable to rebut the presumptions. The applicable presumption will only determine the result where there is insufficient evidence to rebut it on a balance of probabilities. [23-24] [27] [43-44]

In the context of a transfer to a child, the presumption of advancement, which applies equally to fathers and mothers, is limited in its application to gratuitous transfers made by parents to minor children. Given that a principal justification for the presumption of advancement is parental obligation to support dependent children, the presumption does not apply in respect of independent adult children. Moreover, since it is common nowadays for ageing parents to transfer their assets into joint accounts with their adult children in order to have that child assist them in managing their financial affairs, there should be a rebuttable presumption that the adult child is holding the property in trust for the ageing parent to facilitate the free and efficient management of that parent's affairs. The presumption of advancement is also not applicable to dependent adult children because it would be impossible to list the wide variety of the circumstances that make someone "dependent" for the purpose of applying the presumption. Courts would have to determine on a case-by-case basis whether or not a particular individual is "dependent", creating uncertainty and unpredictability in almost every instance. While dependency will not be a basis on which to apply the presumption, evidence as to the degree of dependency of an adult transferee child on the transferor parent may provide strong evidence to rebut the presumption of a resulting trust. [33] [36] [40-41]

With joint accounts, the rights of survivorship, both legal and equitable, vest when the account is opened. The gift of those rights is therefore *inter vivos* in nature. Since the nature of a joint account is that the balance will fluctuate over time, the gift in these circumstances is the transferee's survivorship interest in the account balance at the time of the transferor's death. The presumption of a resulting trust means in that context that it will fall to the surviving joint account holder to prove that the transferor intended to gift the right of survivorship to whatever assets are left in the account to the survivor. [48] [50] [53]

The types of evidence that should be considered in ascertaining a transferor's intent will depend on the facts of each case. The evidence considered by a court may include the wording used in bank documents, the control and use of the funds in the account, the granting of a power of attorney, the tax treatment of the joint account, and evidence subsequent to the transfer if such evidence is relevant to the transferor's intention at the time of the transfer. The weight to be placed on a particular piece of evidence in determining intent should be left to the discretion of the trial judge. [55] [59-62] [69]

In this case, the trial judge erred in applying the presumption of advancement. P, although financially insecure, was not a minor child. The presumption of a resulting trust should therefore have been applied. Nonetheless, this error does not affect the disposition of the appeal because the trial judge found that the evidence clearly demonstrated the intention on the part of the father that the balance left in the joint accounts was to go to P alone on his death through survivorship. This strong finding regarding the father's actual intention shows that the trial judge's conclusion would have been the same even if he had applied the presumption of a resulting trust. [75]

Per Abella J.: The trial judge properly applied the correct legal presumption to the facts of the case. Historically, the presumption of advancement has been applied to gratuitous transfers to children, regardless of the child's age, and there is no reason now to limit its application to non-adult children. The argument that a principal justification for the presumption was the parental obligation to support dependent children unduly narrows and contradicts the historical rationale for the presumption. Parental affection, no less than parental obligation, has always grounded the presumption of advancement. Furthermore, the intention to have an adult child manage a parent's financial affairs during his or her lifetime is hardly inconsistent with the intention to make a gift of money in a joint account to that child. Parents generally want to benefit their children out of love and affection. If children assist them with their affairs, this cannot logically be a reason for displacing the assumption that parents desire to benefit them. It is equally plausible that an elderly parent who gratuitously enters into a joint bank account with an adult child on whom he or she depends for assistance intends to make a gift in gratitude for this assistance. If the intention is merely to have assistance in financial management, a power of attorney would suffice, as would a bank account without survivorship rights. Accordingly, since the presumption of advancement emerged no less from affection than from dependency, and since parental affection flows from the inherent nature of the relationship not of the dependency, the presumption of advancement should logically apply to all gratuitous transfers from parents to their children, regardless of the age or dependency of the child or the parent. The natural affection parents are presumed to have for their adult children when both were younger should not be deemed to atrophy with age. [79] [89] [100] [102] [107]

In any event, bank account documents which, as in this case, specifically confirm a survivorship interest should be deemed to reflect an intention that what has been signed is sincerely meant. There is no justification for ignoring the presumptive relevance of clear language in banking documents in determining the transferor's intention. [104]

³⁸⁴ See *Pettitt v. Pettitt*, 1970 A.C. 777, & *Bingeman v. McLaughlin*, 78 1 S.C.R. 548.

³⁸⁵ 1877 6 Ch. D. 115

"The law of this Court is perfectly settled that when a husband transfers money or property into the name of his wife only, then the presumption is, that it is intended to be a gift or advancement to the wife absolutely at once... And if a husband invests money, stock or otherwise, in the names of himself and his wife, then it is an advancement for the benefit of the wife absolutely if she survives her husband, but if he survives her, then it reverts to him as joint tenant with his wife."

In *Tinker v. Tinker*³⁸⁶ the U.K. Court of Appeal relied upon the presumption of advancement without hesitation when the husband exclusively paid consideration for a house that was registered in his wife's name. In *Reaney v. Reaney*³⁸⁷ the financial considerations provided by the spouses in acquiring a property were considered and the disparity therein proved adequate grounds for considering a presumption of resulting trust when the wife had not contributed to the acquisition but had received the property registered in her name.

The presumption however has been statutorily eliminated for specified purposes in Canada with provincial family law reforms and replaced with the presumption of resulting trust pertaining to married couples as if to strangers.³⁸⁸

The existence of a resulting trust whereby the taxpayer holds **as a trustee** the property will preclude it from being captured by Sec. 70(5) when the taxpayer dies if the trust can be proven and subsequent declarations are admissible only against the party making them as per *Shepard v. Cartwright*. Where a resulting trust exists and the beneficiary dies the capital interest owned will be captured by Sec. 70(5) as well if the Department can establish that the taxpayer was a beneficiary of a resulting trust. Such could occur in numerous situations not just arising out of the situations created on the holding of legal title on an acquisition but also where there isn't a valid alienation of beneficial interest on an *inter vivos* trust creation/gift.

In *MacDonald Estate v. M.N.R.*³⁸⁹ the Exchequer Court had to decide whether a testatrix held property on a resulting trust for succession duty purposes when the property was legally owned by her but had as its source the husband who survived to be the sole beneficiary of her estate. Although the source of the wealth had been the husband directly she had managed the property herself though with some advice from the husband. The executors of her estate could not provide adequate documentation of such and the actions of the spouse beneficiary and not the actions of both prior to her death, did not indicate that a trust, resulting or otherwise, existed and subsequent acts could only be held against those making them, not for their benefit. The testatrix was subject to succession duty on the particular property upon death.³⁹⁰

In *Nelson et al. v. M.N.R.*³⁹¹ farmland was registered in the name of a taxpayer and disposed of subsequent to which the taxpayer and his spouse attempted to split the recognition of gain between them on the basis that there was either a resulting trust in respect of the property arising on the basis that it was their common intention when the property was acquired that both would have ownership, or, on the basis that there was a constructive trust when the spouse had expended considerable effort on the property and in the farming business. Since the property was conveyed to the taxpayer without any expression that the spouse was also to have joint ownership and it could not be found that she had provided any consideration towards the acquisition, a resulting trust was not recognized as created while her contribution of effort to the farm activities was not sufficient to warrant the presumption when such behavior she would otherwise have displayed, (as she previously did).³⁹² If she would have expended a sum towards the acquisition, devoted a separate amount of time and effort to the particular farm and had not otherwise carried on extensive general farm activities a resulting trust could be more easily proven. Common intention could not be proven at the time of the acquisition and the use of the proceeds after the sale was held not indicative of the intention at the earlier time.

In *Jake Harms v. M.N.R.*³⁹³ Taylor J. held that a husband would have to recognize all of the rental income

386 1970 1 All E.R. 540

387 1990 72 D.L.R. (4d) 532

388 See Family Law Act and *Riley v. Riley*, 27 E.T.R. 224, & "The Unsung Demise of The Presumption of Spousal Advancement", D.R. Klinck, E. & T.Q., pg. 6.

389 59 D.T.C. 1235

390 See also *Hanscomb Estate v. M.N.R.*, 64 D.T.C. 720.

391 91 D.T.C. 37 (TCC)

392 See *Burns v. Burns*, 1984 1 All E.R. 244 at 254.

393 1990 1 C.T.C. 2010 (TCC)

from a farm which was legally owned by him³⁹⁴ notwithstanding that his spouse had cooperated in operating the farm when he ran it and when both had discussed its acquisition. The "resulting trust" could not be substantiated when the spouse was coached to declare part of the income as hers though did nothing more to gain a more legally secure recognizable interest in the property while the husband did not offer any assurance that a resulting trust was agreed to. The taxpayer held himself out over 30 years as being the beneficial and legal owner of the farm and had not dismissed anyone's mind to that effect.

In *Kostiuk v. M.N.R.*³⁹⁵ a resulting trust in essence allowed the avoidance of a capital gain arising under the application of Sec. 69(1)(b) when parents incorporated an activity and one share was subscribed to in the name of their 10 year old offspring. No dividends were ever paid, the offspring wasn't made aware of her rights, informed of the company, etc., and upon the dissolution of the marriage of the parents the share was listed as matrimonial property and was used in the settlement. The Minister wasn't successful on assessing the offspring under Sec. 69(1)(b) on the transfer to the father of the share since beneficial ownership didn't reside with the offspring to begin with.³⁹⁶

If a trust fails for one of the three certainties the legal ownership of its property is held on resulting trust for its settlor. This causes you to be extremely careful in setting up a trust since if it can be found not to exist Sec. 75(2) applies to transfer all the recognition of income to its settlor while there is FMV dispositions of the property when legal title is transferred back to the settlor. It also causes the settlor to have ownership of interests in the trust that would be subject to the Sec. 70(5) if the trust can be proven to exist on death by CRA.³⁹⁷

In both *I.R.C. v. Sunnylands Trust*³⁹⁸ and *Innes v. Harrison*³⁹⁹ trusts were found to be void resulting from uncertainty of objects or infringement of the rule against perpetuities thereby creating a resulting trust for the settlor attributing income to him: if such were to occur in Canada under the present ITA by virtue of Sec. 75(2), (and possibly Sec. 104(13)), all of the income of the trust property would be attributed out to the settlor if he were resident.⁴⁰⁰ See also *Hood Barrs v. C.I.R. (#3)*⁴⁰¹ for an instance of how the tax authorities can demolish the presumption of advancement to a child with subsequent acts of both parties as evidence.⁴⁰²

Bare Trusts Arising on Sales.

In *Patterson Estate v. M.N.R.*⁴⁰³ a taxpayer, prior to death, agreed to sell shares of a personally controlled company to his sons whereby the consideration could be paid at any time but any outstanding would be payable upon his death. Legal title to the shares remained registered in the father's name until payment was made in full **while if the father chose**, the agreement could be terminated upon repayment of the sums

³⁹⁴ following a ten year period during which he did just this

³⁹⁵ 89 D.T.C. 541 (TCC)

³⁹⁶ Of little importance apparently was who had advanced consideration (1\$) for the share.

³⁹⁷ A trust can fail in so many ways I could go on and on here. I think firstly of failure to properly identify the beneficiaries and extent of their interests. And what happens if a beneficiary disclaims her one interest out off many that exist and the whole trust fails.

³⁹⁸ 35 T.C. 577

³⁹⁹ 35 T.C. 594

⁴⁰⁰ See also *Haworth v. C.I.R.*, 49 T.C. 489 (Ch), *Muir v. C.I.R.*, 43 T.C. 367 (CA), *Hannay's Exors. v. C.I.R.*, 37 T.C. 217, and *Aked v. Shaw*, 28 T.C. 286. There could be a transfer of beneficial ownership in the income without a passage of beneficial interest while it could be argued that if there isn't a change in beneficial ownership Sec. 75(2) applies regardless. The resulting trust can prove to be the greatest danger to an income splitting instance that avoids the Sec. 56(4.1) provision by legal title transfer whereafter it's transferred back after a term of years with the accumulated income. Beneficial interest can be said not to have passed. This is also of concern in attempting to access unused capital gains deductions by transferring property to a spouse/spousal trust/corporation without the use of a tax free roll-over: Question 20 of the 1990 Roundtable Discussions allowed the Department the chance to opine that it would look to ascertain if there had been a passage of beneficial ownership in such a situation, the result being that if there hadn't then a disposition would not be recognizable. This was exactly the case in *P. de Graaf v. The Queen*, 1985 1 C.T.C. 374, where property was purchased in a spouse's name but the husband financed it and the spouse signed the acquisition documentation under the taxpayer's dominion and influence when told to. Subsequently the property was transferred to a corporation owned by the taxpayer and the recognition of a Sec. 54(c) disposition was avoided by virtue of the applicability of para. (v) therein.

⁴⁰¹ 39 T.C. 209, as well as *Sinclair v. C.I.R.*, 24 T.C. 432

⁴⁰² though *Glynn & Ors. v. Commr. of S.D.*, 1977 2 N.S.W.L.R. 673, provides an example of a successful advancement in questionable circumstances. See also *Claverley v. Green*, 155 C.L.R. 242, and also *De Pol v. Cunningham*, 49 T.C. 445, for interpretation of loan or cash advancement creating resulting trust on partnership buy-out/incorporation, as well as *Soul v. Irving*, 41 T.C. 517 (CA).

⁴⁰³ 69 D.T.C. 711 TAB

received, any time prior to the full balance being received, to the sons who would have no recourse. Upon the father's death the Minister assessed the taxpayer as owning the shares and contended that the agreement provided for the transfer of the shares on the death thus until that time they remained the deceased's. The Tax Appeal Board thought otherwise providing:

"Dealing with the latter point first, I am firmly of the opinion that Exhibit A-1 effected an immediate sale of the shares to the two sons as of April 1, 1962, binding on the parties thereto on and from that date, and that in retaining the physical possession of the share certificates Patterson, Sr. was doing no more than maintaining a lien on these documents until such time as he was paid in full. Meanwhile his sons had an **equitable interest in the shares to the extent that they had given consideration therefore.**

The agreement gave the sons the right to pay for the shares in full at any time and in no sense should the transaction be regarded as coming into effect only on or after the death of Patterson, Sr."

Although this case involved a question of the existence of "competency to dispose", a concern of the Estate Tax Act at the time effective, the arrangement would be equally successful at avoiding/reducing the Sec. 70(5) deemed dispositions.⁴⁰⁴ (#40 v. M.N.R.⁴⁰⁵ is another instance where a trust was used to arrange a sale.⁴⁰⁶) If the shares were transferred to a trust company to be held in trust and distributed to the sons providing they paid consideration to the contributor with reversion back to him if they didn't, the sale would be recognized at the time of contribution while the consideration would be realized by the estate subsequently. The reversionary interest the original owner would have in such an instance would be subject to Sec. 70(5) however its value would be questionable.⁴⁰⁷

Lysaght v. Edwards⁴⁰⁸ illustrates the principle of a bare/constructive trust arising pending delivery of legal title when Lord Hardwicke provided:

"What is that doctrine? It is that the moment you have a valid contract for sale the vendor becomes in equity a trustee for the purchaser of the estate sold, and the beneficial ownership passes to the purchaser, the vendor having a right to the purchase-money, a charge or lien on the estate for the security of that purchase-money, and a right to retain possession of the estate until the purchase-money is paid, in the absence of express contract as to the time of delivering possession. In other words, the position of the vendor is something between what has been called a naked or bare trustee, or a mere trustee(that is, a person without beneficial interest), and a mortgagee who is not, in equity(any more than a vendor), the owner of the estate, but is, in certain events, entitled to what the unpaid vendor is, viz., possession of the estate and a charge upon the estate for his purchase-money. ...If anything happens to the estate between the time of sale and the time of completion of the purchase it is at the risk of the purchaser. If it is a house that is sold, and the house is burned down, the purchaser loses the house. He must insure it himself if he wants to provide against such an accident. If it is a garden, and a river overflows its banks without any fault of the vendor, the garden will be ruined, but the loss will be the purchaser's. In the same way there is a correlative liability on the part of the vendor in possession. He is not entitled to treat the estate as his own. If he willfully damages or injures it, he is liable to the purchaser; and more than that, he is liable if he does not take reasonable care of it. So far he is treated in all respects as a trustee, subject of course to his right to being paid the purchase-money, and his right to enforce his security against the estate."⁴⁰⁹

⁴⁰⁴ This particular type of arrangement would fully allow the testator to opt out and bequeath the shares to someone else. A sales agreement structured as such would allow this: see *Corlett v. Isle of Man Bank*, 1937 2 W.W.R. 209. The taxpayer would however be subject to reassessment in a previous year in which the purported sale occurred however the fair market value of the shares might have changed since then.

⁴⁰⁵ 52 D.T.C. 16

⁴⁰⁶ See also *Escoigue Prop. Ltd. v. I.R.C.*, 1958 A.C. 549, for constructive trusts incidental to sales pending delivery and *Parway Estates Ltd. v. I.R.C.*, 1958 37 T.C. 135 (CA), for passage of equitable interest on sale without passage of legal title. See also *Rich v. Krause*, 1975 1 W.W.R. 87, *Re: Aquarius T.V. Ltd.*, 1975 21 C.B.R. (NS) 144, *Bunny Ind. Ltd. v. F.S.W. Ent. Pty. Ltd.*, 1982 Qd. R. 712, *Lake v. Bayliss & Anor.*, 1974 1 W.L.R. 1073, *J.H. & S. Ltd. v. Quirk*, 48 T.C. 595, and *Clark v. Follett*, 48 T.C. 677.

⁴⁰⁷ If the shares produced income Sec. 75(2) would attribute it to the settlor.

⁴⁰⁸ 1876 2 Ch. D. 499

⁴⁰⁹ See *DeGroote v. The Queen*, 85 D.T.C. 5008 (FCTD), for an example of passage of equitable interest in dividends in shares sold awaiting completion that allowed the vendor to avoid being assessed in respect of them. See also *Comp. of Stamps v. Hutchins*, 1985 V.R. 599, at 610, for transfer of beneficial ownership upon creation of trust to execute sale of

Whether a constructive trust arises depends on the availability of specific performance as per *Central Trust and Safe Deposit Co. v. Snider*⁴¹⁰ while if the constructive trust relationship exists the vendor cannot declare an express trust in respect of anyone else other than the purchaser.⁴¹¹ Until the purchase price is paid the vendor retains a lien on the property and this lien is subject to the Sec. 70(5)-(6) disposition mechanics upon death and can be transferred via Sec. 73(1). The right to the proceeds of disposition would have an ACB equal to the FMV of the property conveyed. If payment is deferred for an extended period of time its FMV may be less than its face value possibly creating a capital loss under Sec. 70(5). Although in such a case the taxpayer will be able to take the Sec. 40(1)(a)(iii) reserve he'll more than likely suffer penalties and interest for failing to report the earlier disposition though adjusted for the reserve.

Buy-Sell Agreements as Trusts.

A contract in the form of a buy-sell agreement does not pass a beneficial interest in the subject property until its triggering event transpires which is substantiated through the actions of the parties so as to cause the sale to occur. Until the parties agree to effect a sale upon or after the triggering event upon which the agreement is based no beneficial interest is passed to the potential acquiror. Consequently the underlying property will be subject to Sec. 70(5).

This was the case in *Smith v. The Queen*⁴¹² where a business was to be passed from one generation to another. Shares were transferred by their owner to a corporation for 28% of the shares while his three sons each acquired 24% of the shares and then they entered into a buy-sell so that each shareholder would have a pre-emptive right to acquire any shares any one of them would at any time wish to sell. Upon the parent's death the 28% was to be transferred to the sons for 1\$ for each third of the holding. If shares were ultimately acquired by an outsider he would have to enter into an agreement identical to the buy-sell with the others. A restructuring occurred whereby the 28% was transferred to the three sons' wholly owned corporation for 3\$ and on condition that the father sit as director of the sons' corporation as long as he liked and drew a salary therefrom as well. Any taxes from the disposition of the particular shares were to be reimbursed by the corporation. The shareholder was assessed in respect of the disposition under Sec. 69(1)(b) as not having made a disposition in an arm's length environment while the taxpayer contended that the buy-sell created a trust (and the trust disposed of it). *McNair J.* held, with regard to the need of imperative expression in creating the trust:

"Applying these principles to the facts of the present case, I am bound to conclude that the 1970 buy-sell agreement did not create a trust of the plaintiff's shares in Amherst. While the agreement may have reflected something of a common intent that the shares would pass to the sons in the event of the plaintiff's death, this did not clearly bespeak an intention to transfer or vest the beneficial ownership of those shares in the three sons. Moreover, the interest of the sons with respect to the plaintiff's shares on the latter's death, if any, was contingent at best, depending as it did on the fact of their surviving the plaintiff and the further condition that neither company nor any of the parties to the agreement were adjudged bankrupt or insolvent. In my view, there are just too many "ifs" and "buts" militating against the construction that the 1970 agreement **effectuated an immediate vesting of a contingent interest** in the plaintiff's shares.

Indeed, I find that the evidence is inconsistent with the submission that the plaintiff was a trustee of his shares of Amherst, following the execution of the 1970 agreement. From this time until the execution of the triad agreements in 1981, **the plaintiff continued to regard himself as the owner of the shares.** The tripartite agreement of January 30, 1981 that assigned the sons' rights under the 1970 buy-sell agreement to Malden recited that the three assignors and the party of the third part, H. Murray Smith,

shares as well as *Wood Preservations Ltd. v. Prior*, 45 T.C. 112 (CA), and *J.H.S. Ltd. v. Quirk*, 48 T.C. 595 Ch. See also *Platinum Investment Management Limited v Chief Commissioner of State Revenue (No 2)* [2010] NSWSC 1 for whether establishment of trust pending delivery of proceeds is a dutiable transfer for Aust. tax purposes.

⁴¹⁰ 1916 A.C. 266, though see *Black v. Homersham*, 4 Ex. D. 24, as well as *Bell v. Guaranty Trust Co.*, 16 E.T.R. 113 (Sask CA).

⁴¹¹ *McCarthy & Stone Ltd. v. Julian S. Hodge & Co. Ltd.*, 1971 1 W.L.R. 1547. See *The Law of Trusts*, Keeton & Sheridan, P.B. Ltd., 1974 3rd. Ed., pg. 174 for an excellent discussion on the principles.

⁴¹² 87 D.T.C. 5355 FCTD

were registered **and beneficial owners** of all of the issued and outstanding shares of Amherst Quarries (1969) Limited. The 1981 sale agreement further corroborated this by reciting that the plaintiff owned "17,920 of the issued and fully paid common shares of Amherst, representing 28% of the issued and outstanding shares of that company; with the parties of the second part, and the third part, and the fourth part, each being the registered owner of 15,360 common shares of Amherst, representing 24% of the fully paid and issued capital of Amherst." There was, it is true, a further recital to the effect that the plaintiff was restricted by the company's charter and was estopped by verbal commitment to his sons from selling his shareholdings of Amherst to any other party during his lifetime but this falls short, in my view, of **stating an avowed intention that the 1970 shareholders' agreement created a trust in respect of the plaintiff's shares. Moreover, the plaintiff warranted in the 1981 sale agreement that he had full power and authority to sell his Amherst shares to Malden, the wholly owned company of his sons. Apart from this, the plaintiff acted at all times as though he were beneficial owner of the shares up until the time of sale in 1981. He voted his shares, he took what few dividends were declared, and he reported those dividends in his income tax returns.**

In my opinion, paragraph 4 of the 1970 buy-sell agreement **imported at best a conditional obligation to transfer the plaintiff's shares in Amherst at a future time.** In the result, the first question must be answered in the negative; the 1970 agreement did not create a trust of the plaintiff's shares."⁴¹³ If an accurate expression had been made as to recognize a transfer of beneficial interest with retention of legal ownership as a lien to secure the payment of the consideration on death with the dividends being payable to the transferor until death a trust would have been created though subsequent expressions would have to be consistently appropriate. Any subsequent dealings in the property would be by the trust and the property would be sheltered from Sec. 70(5).

"Fair market value – Sec. 70(5.3)"

(5.3) For the purposes of subsections (5) and 104(4) and section 128.1, the fair market value at any time of any property deemed to have been disposed of at that time as a consequence of a particular individual's death or as a consequence of the particular individual becoming or ceasing to be resident in Canada shall be determined as though the fair market value at that time of any life insurance policy, under which the particular individual (or any other individual not dealing at arm's length with the particular individual at that time or at the time the policy was issued) was a person whose life was insured, were the cash surrender value (as defined in subsection 148(9)) of the policy immediately before the particular individual died or became or ceased to be resident in Canada, as the case may be.

Avoiding Sec. 70(5.3).

Where the taxpayer owns capital stock of a company deemed to have been disposed of on his death as capital property the fair market value thereof will be deemed to be their fair market value as if the value of the life insurance policy held by the corporation under which the taxpayer is the person insured were its cash surrender value, as described in Sec. 148(9)(b) at the time. In such an instance the fair market value of the corporation's shares will explode and the taxpayer will be exposed to recognize a massive capital gain under Sec. 70(5).⁴¹⁴

The testator can insulate an insurance proceeds explosion by taking back preferred redeemable par-value shares in the policy holding corporation and having the corporate charter stream the value of any insurance proceeds to other share classes: the FMV explosion is funneled to other classes and the FMV of the deceased's shares remains the same, even though deemed disposed of. The property going through a Sec. 70(5) is not tagged to the actual proceeds realized and the legislative draughtsman sharpens his pencil a bit more next time. And your counsel has prepared the charter/share structure to do "marvelous things" with those

⁴¹³ See *Beyer v. Beyer*, 1960 V.R. 126, for another such very similar instance where similar issues had to be decided including whether the buy-sell agreement was testamentary.

⁴¹⁴ See "Estates and Trusts Holding Shares of Private Corporations: Selected Issues" by Sheila M. Crummey in *Estates, Trusts and Pensions*, Vol. 26 Pg. 302 for a balanced discussion of legal and tax issues.

insurance proceeds like buy descendants property, make loans to spousal trusts et cetera.

CRA Rulings has also given the author a private opinion that ..catch this one... a power of appointment is not "a property" subject to the Sec. 70(7)-(8) trust untainting rules even though in the author's opinion it fully qualifies under the Sec. 248(1) definition of property.⁴¹⁵ If a power of appointment isn't a property then it can't be owned: guess it's one of those things like...air. So a taxpayer can set up a holding trust of the policy that contains a testamentary general power of appointment, not bother with a capital interest since **that** would be captured by Sec. 70(5.3)-(5) (and we all wouldn't want that to happen), and on death the insurance proceeds are streamed off to where the deceased power-holder desires on exercise of the power via the will : here's to opinionated Rulings officers and not-so-drunk Whiskey-men.⁴¹⁶

Exit strategies out of these two positions if the statute changes are easy to formulate.⁴¹⁷

If he rolled the capital stock to his spouse or spousal trust under Sec. 70(6) he would avoid the recognition of the gain while if he rolled the stock to his offspring directly he would have to incur it. If he were to have transferred the shares before his death into an *inter vivos* non-spousal trust in which he took back an income interest he would have had to recognize a disposition of the shares under Sec. 69(1) conditions and consequently a possible capital gain unless they are loaded in immediately after acquisition.⁴¹⁸ If the beneficial ownership of the capital element did not change then he wouldn't recognize a disposition however the capital interest that he would take back as consideration would still be subject to Sec. 70(5)-95.3) with the same net effect, (regardless of if the trust is personal or not). If he took back a life income interest from the *inter vivos* trust and maintained a power of appointment over the capital shares which formed the basis of another's capital interest then he'd recognize an *inter vivos* disposition, and if the income interest were based upon the dividend receipt upon the shares he'd also retain ownership of the income stream and the ability to receive dividends. If he retained a specific power of appointment over the shares he'd also control them in the trust. The power of appointment would not be caught by Sec. 70(5)-(5.3) upon death since per Rulings privately, it's not a property.⁴¹⁹ If taxable dispositions occurred immediately after the property's acquisition due to the recent cost minimal tax consequences would result while with powers of appointment the capital element could be received back if needed perhaps after the death by his estate.⁴²⁰ With the power of appointment the testator can choose where the insurance proceeds are funneled to avoiding any form of FMV taxation to whomever she decides, at a later date: in the meantime they satisfy a loan's covenant's via the trust, or, encourage better family cohesiveness *inter vivos*.

God only knows where those insurance proceeds could end up tax-free when a power of appointment isn't "a property" that can be used in a Sec. 70(7)-(8) tainted spousal trust listing process thus not being a goose the other way, or, the FMV of the shares is stamped fixed inherent in its properties regardless what Sec. 70(5.3) says.

In some ways it is better that the testator not own shares in corporations or interests/powers in trusts but instead simply set up the proceed recipient with liquid cash to stream off exactly with foresight.

Question 33 of the 1988 CRA Roundtable Discussions recognized that when property is transferred to a trust and an income interest in the property's revenues is taken back a disposition of the remainder interest, (ultimate legal title of the shares), will be recognized by the transferor. The ACB of the remainder interest will

⁴¹⁵ I wish I could have the fun of ignoring our Income Tax Act, but hey, I don't invent the rules.

⁴¹⁶ And, like any Monty Python movie, watch what happens when CRA finally says that a power issss "a property", then we have a whole new legislation ball-game!

⁴¹⁷ See "Combining Trusts and Life Insurance in Estate Planning: Tricks and Traps" by Robin Goodman in The Canadian Tax Journal.

⁴¹⁸ To avoid a gain after a tax free Sec. 85(1) incorporation the trust as compared to the individual incorporator could receive cash without tax consequences to purchase its own shares.

⁴¹⁹ Subsection 75(2) would apply to attribute income from the shares out to the transferor but Sec. 4(4) could be relied upon to eliminate a double inclusion: Sec. 75(2) forces income from the particular property to be recognized while Sec. 108(5) causes such income to be from a trust interest: a different property, but from the same place. The subsection 104(19) dividend flow through could be used to obtain the Sec. 4(4) relief. If the power were to be held by the taxpayer's personal holding corporation it would not be captured by Sec. 70(5) and would allow Sec. 75(2) to be avoided.

⁴²⁰ See *Commr. v. Hedges*, 1935 3 A.T.D. 255, and *Perp. Trustee Co. Ltd. v. Commr. of S.D.*, 64 C.L.R. 492.

equal its fair market value divided by the fair market value of the total property, (capital and income rights), multiplied by the ACB of the total property. Where the capital stock has a history of producing significant dividend streams in relation to its residual value a disposition where only the remainder interest is disposed of, will attract less tax consequences than if the shares transferred produced more dividends: the proportionate value of the remainder would be larger. Since an income interest in the dividend streams of shares held in trust isn't a capital property, (unless the trust isn't personal), it will not be subject to the Sec. 70(5) rules upon death but could be favorably transferred under the Sec. 70(2)-(3) mechanism to be commented upon.⁴²¹

If the taxpayer transferred the shares to an *inter vivos* spousal trust then he would have to "lose control" of them until the spouse died in order for Sec. 73(1) to apply, (unless a power of appointment is varied in afterwards), however if dividends continued to be paid on them, through an Sec. 104(19) designation the spouse could recognize the dividend portion of the trust income as dividend income whereupon she could designate under Sec. 82(3), (if the corporation was a taxable Canadian corporation), whereby the original owner would continue to recognize the dividends paid out to his spouse.⁴²² In this way the tax result would be the same only he would have been sheltered from the possible application of Sec. 70(5).⁴²³ If his capital interest in the *inter vivos* spousal trust terminates upon death its fair market value immediately before death may still be large and tax consequences could be recognizable in respect of it under Sec. 70(5).⁴²⁴ (This isn't necessarily the case with discretionary capital interests that gain value only if the discretionary power is exercised. Again, this is very similar to a redeemable "capped" fair market value share when the actual characteristics of the property do not warrant a high FMV since that's the nature of the property: a discretionary capital interest has no value until the 3rd party power vesting it is played.)⁴²⁵

Where the corporation receives the proceeds of the policy, as per Sec. 89(1)(b)(iv), the excess thereof over the ACB of the policy as defined in Sec. 148(9)(a), will enter the corporation's capital dividend account which will be available to be paid out as a non-taxable capital dividend under Sec. 83(2). If the *inter vivos* spousal trust receives them the spouse need not be entitled to them, since they do not represent "income". They will not be taxed upon receipt by the spousal trust and can be flowed through to a non-spousal beneficiary upon her death, or, in the interim, be used to enhance the value of a capital interest allowing for it to have a larger collateral value for interim loan purposes.⁴²⁶ Subsection 75(2) would apply to attribute dividend interim income from the shares out to the transferor in the case of a spousal trust but by virtue of the last phrase of Sec. 108(5) the transferor would be able to negate the double income inclusion in respect of the dividends if the trust made

421 If the shares are to appreciate in value with increasing dividend streams as the incorporator ages a retention of a life interest in the shares only by the taxpayer will allow for the avoidance of Sec. 70(5) gains thereupon while Sec. 70(2) will not capture the life interest in the dividend potential if it is terminate upon the death (or rolled through under Sec. 70(3)). Dividend payout can be increased **after** the incorporator has recognized a disposition of the remainder estate to a trust or other party so as to allow for an increased proportional a.c.b. of the remainder interest upon its disposition. See *C.I.R. v. Sunnylands Trust*, 35 T.C. 576, for trust of capital but not of income arising from it. See *Ingram v. I.R.C.*, 1986 1 Ch. 585, where the Ramsay doctrine was applied to an instance where a taxpayer successively granted a lease in property and subsequently arranged for the residual interest to wind up in the same lessee's hands. A composite transaction was found to have been orchestrated and the taxpayer didn't recognize the beneficial tax consequences of the splitting in the dispositions. Could this dicta be applicable where, as above, the effects of Sec. 70(5)-(2) can be systematically reduced/avoided through the proper conveyances of property rights to the proper parties with the retention of proper powers or reversions?

422 See I.T. 295R.

423 The spousal *inter vivos* trust could be varied to grant him a power of appointment over the shares after the applicability of Sec. 73(1) has been accepted thus the transferor doesn't have to lose control over the long term however upon a varying in of a power one interest holder would recognize a disposition of his interest, (which can be avoided if the beneficiary and trust are non-resident or if the spousal trust is non-resident and the interest is held in another non-resident trust for the benefit of a resident beneficiary).

424 See *Weller v. Commr. of S.D. (NSW)*, 84 A.T.C. 4111 (SCNSW), where a capital interest's value was plunged prior to the exposure to stamp duties on death when advances were made to the other beneficiary to virtually terminate the trust. To be noted however is the difference between an advance and a distribution which isn't recouped in subsequent periods.

425 See *In re: Trafford's Settlement*, 1985 1 Ch. 32, for some related issues. Obviously it could be "less messy" to convey the remainder interest to the other party and simply retain a life interest in specie in the share's dividends subsequent to which the dividend rate is increased to allow a shift in the maximum amount of a.c.b. to the remainder interest for disposition purposes. Such a shifting is desirable even if the Sec. 73(1) roll is utilized since the shares will have to suffer a disposition some time.

426 They can also materially warp the relative f.m.v.s of the capital interests under the trust.

the Sec. 104(19) designation in respect of him.

A taxpayer could always transfer the shares to his spouse under Sec. 73(1) whereafter a period of years she could transfer them to a spousal trust described in Sec. 73(1) and whereunder the original transferor would be the spouse while the effect of Sec. 70(5.3) would be avoided upon the transferor's death⁴²⁷: he doesn't own a capital interest in the trust.

Subsection 70(5.3) does apply for purposes of Sec. 104(4) which causes a trust to recognize FMV deemed dispositions of its policy supported shares on the death of the underlying spouse so it is not possible to gain any advantage in placing policy-funded shares in the trust but that's a very small impediment to funneling insurance proceeds that it's not worth nothing when there are so many other ways to get it done.

Avoiding Sec. 70(5.3) and the Buy-Sell.

Shares held in an *inter vivos* trust are not exposed to deemed disposition when an incorporator and discretionary beneficiary in respect of them dies. In the interim, from the date they were acquired for cash by the trust to the date of death, the beneficiary can realize the dividend income while a buy-sell agreement may be structured in relation to the shares with regard to the trust to allow for their orderly transfer to the appropriate parties upon the settlor's death.⁴²⁸⁴²⁹ A buy-sell agreement can be entered into by either the trust and the other shareholders *inter vivos* to provide for a buy out of the positions on the death, or it can be structured between the to-be-vested beneficiaries of the trust if the shares are to be rolled to them. Since the original incorporator need only be interested in the income until death, with possible powers of appointment over the shares, Sec. 70(2) and Sec. 70(5)-(5.3) will be avoided. A capital interest in the trust will be subject to Sec. 70(5) and even though its Sec. 108(1)(d) cost may be inflated to reduce capital gain it may still be preferable to simply hold a power of appointment over the shares which has its cost determined by Sec. 69(1)(c) and the power will not be captured.⁴³⁰

How to finance the purchase of the shares or interests is always a concern: either the shareholders arrange financing outside the arrangement (such as to obtaining bank loans the interest upon which should be deductible) or can finance it through life insurance taken on the incorporator's life held personally, by the trust or by the corporation or by the beneficiaries. If the corporation receives the life insurance proceeds they will be included in its capital dividends account and either flowed down to the individual shareholders or the trust tax free once the above simple hurdles have been over-come. If interests in the trust are to be the object of the agreement the dividends may not be flowed favourably from the trust to the beneficiary immediately upon receipt: the interests will be purchased capital dividends suffering a Sec. 104(20) designation will reduce capital loss/increase capital gains exposure on a disposition of the interest or property distributed in satisfaction of it via the reduction in cost base under Sec. 53(2)(h) even if the trust doesn't lose its personal character. For this reason it is advisable that either the trust be varied or have the necessary characteristics that would prevent the dividends from being distributed in the year of receipt by the trust or have the beneficiary or trust themselves hold the insurance policy so that the proceeds do not have to be cascaded down from the corporation/trust. If the trust is the beneficiary of the policy the proceeds can be used to reverse finance the acquisition of the other interests by the acquiring beneficiary immediately following death without fear of the above however immediately after death, and before the execution of the agreement the proceeds will inflate the FMVs of the interests which could attract the application of Sec. 69(1) if the buy-out does not proceed between arm's length parties while if it does, and the pre-agreed price is less than the value of the interest a capital loss could not

⁴²⁷ since it doesn't apply to trust interests. Of prime importance is the actual passage of beneficial ownership of the shares.

⁴²⁸ See "Shareholders' Buy-Sell Agreements to operate on the Winding Up of a Trust" by J. E. Magee, 1991 C.T.J. Vol. 39 #4, pg. 983

⁴²⁹ Since the trust need not be spousal it will not undergo a deemed disposition on the death of the life tenant but over the long term the trust must distribute the shares to avoid their Sec. 104(4) disposal.

⁴³⁰ The interests of the trust rather than the shares themselves may be the subject of the agreement in which case their enforceability may be deferred pursuant to the trust deed until an agreement is reached or enforced. The interests can be disposed of by the beneficiaries in execution of the agreement with far less tax exposure, (with the use of powers of appointment inflations etc.) while if the agreement couldn't be reached the trust could compel the sale of the shares outright.

be produced since the interest disposed of would not otherwise have a legitimate ACB.⁴³¹

Can a trust pay for an insurance policy on the life of its settlor and have the proceeds be payable directly to a beneficiary without attracting a full Sec. 105(1) inclusion of "benefit" that is not otherwise cited in Sec. 53(2)(h) or subject to the section 107 mechanics? The author thinks of the fact that the beneficiary is realizing a benefit, even before death, that is not caught by the other sections of the Act that is under or in respect of a trust and thus leading to full income inclusion as detailed in the purpose of Sec. 105(1).

An alternative would be to have the trust receive the insurance proceeds either directly, or indirectly through the corporate dividend account, and distribute them in the following year pursuant to the exercise of a power of appointment/power of allocation operating in respect of immediate interests though contingent on an agreement between the beneficiaries as to the quantum of benefit. If the trust power must be exercised in respect of an agreement reached by the beneficiaries when their interests allow them to either receive an allotment of the trust's shares or of the proceeds (as well as possibly other cash pools) realized depending on an agreement reached with the other beneficiaries then interests are not being transferred: some are being satisfied in a certain manner with certain property and others differently. The beneficiaries would agree so that one or two etc. would be entitled to the shares and all others would be entitled to the cash. Of course the trust deed would have to be properly structured to allow for this and the quantum of benefits to be realized by a disengaging beneficiary would have to be accurately established pursuant to the trust's terms so as to avoid any litigation based on purported fraudulent exercise of powers/impartiality, etc.: the magnitude of the benefits could be referenced to the corporation's financial worth/earnings potential/off-spring involvement etc. at the time of execution to allow for the dynamics of the situation.

If planting controlling shares in a trust testamentarily, either non or spousal, exterior to the trust arrangement the beneficiaries could subscribe for shares in the corporation directly and the corporate charter could provide for a buy-out of the trust's shares immediately after death or on further subscription whereby control of the corporation would migrate to those shareholders who acquired shares as a predetermined plan. The incorporator in this case would otherwise determine who would be allowed to subscribe for shares while the insurance proceeds paid to the trust to redeem its shares could make up part of the consideration one shareholder would receive on selling his shares to another. Such an instance allows the trust to realize a capital loss when the shares have gone through a Sec. 70(5) (as compared to a Sec. 70(5.3)) disposition which can be carried back against the testator's income inclusions via Sec. 164(6) and though the unadministered estate must have its shares redeemed within the first executor's year in order for the carry-back to occur the proceeds. In effect, attract the application of Sec. 70(5)-(5.3) by sending the controlling shares through a terminal disposition, setting up their cost to the spouse/trust/estate, and carry-back the loss when they are redeemed post-mortum so that the net effect is negligible between the 2 parties (testator and recipient) and the insurance proceeds go to the relevant buy-out. The beneficiary-shareholder selling out gets some of the proceeds, and those not don't.

One concern in any buy-sell agreement is that of retaining any losses the corporation has booked that could be lost with a change in control while Sec. 256(7) provides some relief here. Where the shares are acquired by an executor or trustee which acquired the shares by virtue of the death of any other person or by anyone who received them by way of a distribution by an estate arising on the death of a **related** person the control of the corporation will not be recognized to have changed for purposes of section 111. If the incorporator exercises a power of appointment over the *inter vivos* trust's shares in his will to transfer the shares to his estate a change in control statutorily won't occur, (the shares don't have to be owned by the testator prior to death: all that is required is that they be acquired by virtue of his death), while if they are subsequently distributed from the testamentary trust to a beneficiary related to the testator control again won't change, even if they are distributed in satisfaction of a interest acquired in a buy-sell as a final step. Care must be taken here to confirm from CRA that for these purposes a spousal "trust" is equal to an "estate" since Sec. 256(7) lies outside subdivision k and it is only within that the two are equal: Sec. 256(7) refers exclusively to **estates** and not **trusts**, another instance where Finance Canada seems to have recognized that the two are not equal.

⁴³¹ The a.c.b. could be bumped however with the use of powers of appointment or alterations in residency by the interest holder.

Obviously there are "a thousand and one ways" to structure a testamentary buy-sell agreement with respect to corporation shares (or just as well partnership interests) with the use of an *inter vivos* or testamentary trust while advantages, in the form of Sec. 70(5.3) avoidance, could be obtained that would otherwise not be available.⁴³²

Powers of Appointment.

A power of appointment over property held in trust constitutes "a property" for purposes of the Act being a choice in action however valuing it for subsection 70(5) can be a very subjective exercise.⁴³³ **That's in the author's opinion, even though CRA seems to think that a power of appointment is not a property per se.**⁴³⁴ The power can be said to be "owned" for purposes of Sec. 70(5) since the trust deed grants it to the holder though alienation may be hindered by its mere nature.⁴³⁵ In the author's opinion the power will have its cost determined via Sec. 69(1)(c) since it's a property and it is acquired by way of gift etc.. This may reduce tax consequences upon its extinguishment depending on what the value of the subject property does.⁴³⁶

Melville & Ors v Inland Revenue⁴³⁷ is a UK Appeal Ct. case that specifically provides, concerning the application of inheritance tax to a power of appointment:

"This appeal gives rise to a short but difficult question of construction of the Inheritance Tax Act 1984 ("the Act"): is a general power of appointment exercisable by the holder over property comprised in a settlement "property" forming part of the estate of the holder? In the case of the settlement with which we are concerned the Commissioners of Inland Revenue ("the Revenue") claimed that it was not and by notices of determination dated 5 August 1999 under s. 222 of the Act informed the settlor of the settlement, Leslie Melville, and the settlement trustees, Philip Enoch and Lawrence Melville, that they had so determined. I shall call the settlor and the trustees "the taxpayers". On an appeal to the High Court by the taxpayers, Lightman J. on 20 June 2000 (in a judgment reported at [2000] STC 628) allowed the appeal, upholding their argument that the power was "property". The Revenue now appeal to this court with the leave of the judge.

...

The judge commenced his consideration of the arguments by looking at the meaning of the terms "property", "rights" and "interests" and the authorities relating thereto. It is unnecessary for me to rehearse the judge's review of the authorities because the judge's conclusion on this point is not challenged. The judge said ([2000] STC para. 13 at p. 634):

"In summary, whatever the technical meaning of the word 'property', it seems to me that the terms 'property', 'interest' and 'right' are capable of embracing a general power of appointment depending on the legislative context, for they are terms capable (as is such a general power) of embracing anything which is capable of producing value, being realised and turned into money, and a general power is capable of exactly this: it may be exercised to vest property in the appointor and it may be released for valuable consideration. Whether the words do bear this meaning in s 3(1) of the Act must depend upon the legislative scheme and purpose of the Act."

432 See also "Dispositions of Life Insurance Policies" by Joel Cuperfain, *Estates, Trusts and Pensions*, Vol. 23 Pg. 129 for ancillary instances where the insurance policy itself is the focus of the transaction, not the proceeds upon death.

433 A power is the ability to control the legal or beneficial interest in property legally or beneficially owned by another. See the chapter on Varying the Trust Setting and in particular issues related to powers-in-trust that do have some limitation on how they can be exercised – re: in regard to the intentions of the grantor for specific purposes. See the UK case of Melville & Ors. CIR [2001] STC 1271 specifically on this issue.

434 CRA Rulings has provided to the author a private technical opinion that for purposes of their use in the Sec. 70(7)-(8) property listing process a power isn't a property, even if it is alienable as requested by the author.

435 A power must be "a property", it's a right and even with limitations on alienation it still has a value. For the broadest definition of a property see *Jones v. Skinner* (1836), 5 L.J. (N.S.) c. 87 at 90 "the most comprehensive of all the terms which can be used inasmuch as it is indicative and descriptive of every possible interest which the party can have", cited in *Estate of Fasken v. M.N.R.* 49 DTC 491 at 496, *The Queen v. Kieboom* 92 DTC 6382 at 6386.

436 Is it possible for it to create a capital loss for its holder?

437 [2001] EWCA Civ 1247, [2001] STC 1271, [2001] NPC 132, 74 TC 372, [2001] EWCA Civ 1247, [2001] STI 1106, [2001] WTLR 887, [2001] BTC 8039, [2002] 1 WLR 407

...

The judge referred to two submissions made by the Revenue. One was the fact that the existence of powers under trusts does not diminish the value of the settled property in the hands of the life tenant, and should not constitute property in the hands of the donee of the power. The other was that a general power, if "property" within the meaning of s. 3 (1), will constitute a reversionary interest whilst a future interest, but once it is presently exercisable there will be double taxation on the death of the holder of the general power who exercises the power by will so as to terminate an interest in possession.⁴³⁸ The judge accepted that those were arguments in favour of the Revenue's construction. But, the judge said, the arguments were not all one way. He pointed to a number of other considerations, saying (para. 22 at p. 636):

"Further the reality is that a general power of appointment is something of a very real value vested in the appointor, and the definition of property in Section 272 is deliberately of the widest character. Looking at Section 3 (1) in the context of the [Act] as a whole I do not think that it can be held that the context requires that the statutory definition should not apply in case of Section 3 (1)."

...

Skilfully and attractively though these submissions were made, I am not persuaded by them. They seem to me to concentrate too much on the settled property in a settlement while ignoring the basic scheme of the Act to charge tax on chargeable transfers made, or deemed to be made, by individuals. The holder of a general power of appointment (in contrast with the holder of a special power which he cannot exercise in his own favour) unquestionably has a valuable right, the value of which must be taken into account in the value of the holder's estate under s. 5 (1) unless excluded by some provision of the Act. As Mr. Nugee submitted, the truly remarkable proposition is that put forward by the Revenue that although the holder of the general power has effective dominion over the settled property if he chooses to exercise it, nevertheless it is to be left out of account on the death of the holder. The nub of Mr. Furness' submissions is to assimilate a general power to a reversionary interest. A power is of a wholly different character from a reversionary interest, and whilst the cl. 4 (c) power was not presently exercisable during the first 90 days of the settlement, once that period was over the power became presently exercisable and even less like a reversionary interest. There is nothing which I can see in the Act to suggest that it was the draftsman's intention or thought that a general power is a reversionary interest. I do not accept that it is inappropriate or asymmetrical to recognise the reality that a general power of appointment is a valuable asset in the holder's estate, while at the same time recognising that, for example, the life tenant of settled property subject to an unexercised power of appointment can be deemed to be entitled to the settled property the income of which the life tenant enjoys. Mr. Nugee was right to say that the reason why the provisions relating to settled property do not include any reference to powers is that those provisions are designed to apply to the beneficial interests in settled property as they exist at any given time and to the persons for the time being entitled to them. In short there is nothing in the settled property provisions which causes or requires the cl. 4 (c) power to be excluded property or otherwise prevents it from being, as a valuable right or interest, property the value of which is to be included in the settlor's estate. I conclude, in agreement with the judge, that the context does not require "property" to have a meaning other than the statutory meaning."

In *Minister of Revenue (Ontario) v. McCreath*⁴³⁹ the Supreme Court of Canada had to consider whether a taxpayer had her power to appoint trust property captured for estate tax purposes, even when she failed to exercise it in her will. It held:

"On the death of Mrs. McCreath the primary duty of the trustee was to dispose of the trust fund among the issue of Mrs. McCreath or such of them as she might by will direct and subject to such terms and conditions as she might by will direct. In default of such direction, the capital of the fund was to be

⁴³⁸ Author's note: see "Testamentary Planning to Avoid Double Taxation" by H. Elise Rees in *The Canadian Tax Journal* where double taxation issues are discussed.

⁴³⁹ [1977] 1 S.C.R. 2

distributed among her issue in equal shares *per stirpes*. Although Mrs. McCreath retained the power by will to choose which of her issue should be the object of her bounty, she died without exercising that power.

Thus there were many "strings" attached to the property of which Mrs. McCreath purported to dispose. The appeal arises under *The Succession Duty Act* of Ontario R.S.O. 1960, c. 386, and the crucial questions to be answered are: (i) Did Mrs. McCreath, either expressly or by implication, reserve to herself an interest in the property passing under the trust so as to make it "property passing on the death of the deceased" as defined in s. 1(p) (viii) of the Act? (ii) Was actual and *bona fide* possession and enjoyment of the property assumed by the issue of Mrs. McCreath and retained to the entire exclusion of Mrs. McCreath so as to exempt the property from tax by the operation of s. 5(1) (g)? I would answer the first question in the affirmative, the second question in the negative and allow the appeal of the Minister.

...

Subject to ss. 4 and 5 of the Act, succession duty is payable on the death of any person domiciled in Ontario or elsewhere where any property situate in Ontario passes on his death. The Act is drafted so as to catch all forms of transactions which have the result of transferring property on death. Therefore "property passing on the death of the deceased" is broadly defined and is deemed to include, according to s. 1(p) (viii):

any property passing under any past or future settlement, including any trust, whether expressed in writing or otherwise and if contained in a deed or other instrument effecting the settlement, whether such deed or other instrument was made for valuable consideration or not, as between the settlor and any other person, made by deed or other instrument not taking effect as a will, whereby an interest in such property or the proceeds of sale thereof for life, or any other period determinable by reference to death, is reserved either expressly or by implication to the settlor, or whereby the settlor may have reserved to himself the right by the exercise of any power to restore to himself, or to reclaim the absolute interest in such property, or the proceeds of sale thereof, or to otherwise resettle the same or any part thereof,...

...

Reservation of an interest under s. 1 (p)(viii)

It is essential, I think, to identify with some precision the "property" which can be said to have passed in the settlement of 1948. This question usually presents difficulty, especially in an Act such as the present one which provides no statutory definition. In the present case the question of definition is of particular importance because counsel for the respondents submits in effect that Mrs. McCreath made two gifts, one a gift of the equitable interests in the net income from the trust fund and the other a gift of the equitable remainder in the corpus of the fund. With respect, I do not agree with this reading of the indenture. In my view the "property passing" under the settlement was the equitable interest in a voting trust certificate representing 99,986 common shares in the capital stock of Mount Royal Paving & Supplies Limited which were transferred by Mrs. McCreath to the trustee.

If the "property" for purposes of s. 1(p)(viii) is such equitable interest, the next question is whether Mrs. McCreath retained an "interest" therein. In all the circumstances it seems to me difficult to say that she did not reserve an interest in the property, the subject-matter of the trust. Collectively she and her children were entitled to all of the income.

...

There are no Canadian precedents to illuminate s. 1(p)(viii). Two English authorities construing tax legislation in almost identical wording may afford some guidance. In *Attorney General v. Heywood* (1887), 19 Q.B.D. 326, s. 38(2)(c) of the *Customs and Inland Revenue Act*, 1881 (U.K.) c. 12 was in issue. It taxed:

(c) Any property passing under any past or future voluntary settlement made by any person dying on or after such day [June 1, 1881] by deed or any other instrument not taking effect as a will, whereby an interest in such property for life, or any other period determinable by reference to death, is reserved either expressly or by implication to the settlor, or whereby the settlor may have reserved

to himself the right, by the exercise of any power, to restore to himself, or to reclaim the absolute interest in such property.

In *Heywood* the settlor created a trust fund of £43,000 held on the following trusts: to pay income to such of the settlor, his wife and children for the settlor's life as the trustee should choose and on the settlor's death to hold the property in trust for the widow and children. It was argued that all that was reserved to the settlor was a mere possibility or contingency, and not an interest. Stephen J. held that the settlor had retained an interest for life within the terms of the statute and Wills J. stated, p. 331:

The application of the word "interest" is not confined to a vested or a necessarily contingent interest. The Act was meant to cast a wider net than such a construction would imply. The settlor here could only be deprived of the benefit he would otherwise get under the settlement by the exercise of the power of depriving him of such benefit which was vested in the trustees, and unless the trustees so deprived him he would necessarily get a benefit.

The same interpretation of "interest" was adopted in *Attorney-General v. Farrell* [1931] 1 K.B. 81 (C.A.), where the settlor was also a discretionary object of income of a trust for his life with a gift over on his death and Lord Hanworth M.R. had this to say, p. 98:

However, even without the support which can be gathered from *Drummond v. Collins*, [1915] A.C. 1011, I think it is too late for us to reopen the question which was decided in *Attorney-General v. Heywood*; and I think that for the purposes of the interpretation of s. 38, sub-s. 2(c), it must be held that where there is a discretionary trust, a possible object of that trust holds an interest within sub-s. 2(c).

It is the respondents' contention that the term "interest" should have a more technical meaning than in *Heywood*. They rely on *Gartside v. Inland Revenue Commissioners* [1968] A.C. 553 (H.L.), where the discretionary object of a trust was held not to have an "interest in possession" for purposes of s. 43 of the *Finance Act, 1940* (U.K.), c. 29. In that case, the terms of the trust gave the trustee the power to distribute all or part of the income among a class comprising the settlor's son, wife and issue for the son's life or to accumulate the income and provided for a gift over on the son's death. Lord Reid (Lords Morris and Guest concurring) held at p. 607:

...an examination of the relevant provisions of this legislation leads to the clear conclusion that objects of a discretionary trust do not have interests extending to the whole or any part of the income of the trust fund and it must follow that they do not have interests in the fund within the meaning of section 2(1) (b).

While this quotation would seem to support the respondents' contention that the deceased did not have an interest here, in my opinion *Gartside* is inapplicable.

...
I conclude that Mrs. McCreath retained an interest in the settled property for purposes of s. 1(p) (viii) by making herself one of the possible objects of the discretionary trust. The primary objects of the donor's bounty are "the Settlor and her issue from time to time alive", and, in fact, the settlor did receive income pursuant to para. 1(a). Mrs. McCreath could apply to the Court to require the trustee to respect the terms of the trust if it refused to exercise its discretion. The fact that a discretionary object may have no interest in property law terms because she has no "right" to a definable amount of income is irrelevant. I do not believe that the niceties and arcana of ancient property law should be fastened upon with mechanical rigidity to determine the effect of a modern taxation statute whose purpose is plain."⁴⁴⁰

⁴⁴⁰ In the Aust. case of *Scaffidi -V- Montevento Holdings Pty Ltd* [2011] WASCA 146 (7 July 2011) citing the Aust. article of TW Magney, 'A Comparative Analysis of Estate Planning Vehicles', (1977-78) 12 *Taxation in Australia* 222 where it was opined, citing comprehensive jurisprudence:

71 Later in his article, Mr Magney made these comments about the death and estate duty consequences arising from the existence of a power of appointment in a discretionary trust deed:

A 'general power of appointment' is defined in section 100 of the *Stamp Duties Act* [1920 (NSW)] as a power which enables the holder thereof to appoint or dispose of any property as he thinks fit for his own benefit but does not include a power exercisable by a person in a fiduciary capacity for the benefit of others only arising under a disposition not made by himself. The definition of general power of appointment would

include many powers which apart from the definition would be only special powers of appointment. If the power of appointment contained in a discretionary trust falls within the above definition then the property the subject of the power may be included in the estate of the person possessing the power by virtue of section 102(2)(a), (b) or (j) - see *Hill, Stamp Death & Estate Duties*, page 234, and *Silk's case* (1976), *Aust Estate and Gift Duty Reporter*.

A sole trustee who is also one of the objects of the discretionary trust will clearly have a 'general power of appointment' as defined. It is for this reason that I advocate use of a corporate trustee and strongly advise against an object being a trustee of the trust. (emphasis added)

The *Estate Duty Assessment Act* [1914 (Cth)] only includes in the estate of a deceased person property over which he had a general power of appointment *exercised by will*. General power of appointment is not defined and would therefore have its ordinary meaning (245 - 246). (original emphasis)

72 In a 1978 supplement to *Discretionary Trusts*, Dr Hardingham and Professor Baxt included a 'draft settlement' of a discretionary trust. In the precedent, 'John Doe' is the settlor and 'Roe Nominees Pty Ltd' is the trustee. The controller of the trust is 'Donald Doe' (Don) and the deed recites that the settlor desires to make provision for Don and his family. Don is a beneficiary (cl 1.5) and the appointor (cl 8.1). As appointor, Don is given the power, exercisable at any time and from time to time, to remove any trustee and to appoint 'any person or persons to be new and additional Trustees hereof (*other than the Settlor or Don*)' (emphasis added).

73 As at 2 May 1977, being the date of execution of the Trust Deed, s 10(1) of the *Death Duty Assessment Act 1973* (WA) (the WA Act) provided that, for the purposes of the Act, the estate of a deceased person comprised:

(a) his real and personal property in the State; and

(b) his personal property situate outside the State if he was domiciled in the State at the time of his death.

74 By s 10(2)(i) of the WA Act, for the purposes of s 10(1), 'any property over which the deceased person had at the time of his death a general power of appointment, if that power is exercised by his will' was deemed to be property of the deceased person.

75 The WA Act did not define the term 'general power of appointment'.

76 As at 2 May 1977, the *Estate Duty Assessment Act 1914* (Cth) (the Commonwealth Act) contained provisions similar to s 10(1) and s 10(2)(i) of the WA Act. The provision in the Commonwealth Act with respect to personal property referred to the deceased being domiciled in Australia at the time of his death. See s 8(1) and s 8(3) of the Commonwealth Act. Like the WA Act, the Commonwealth Act did not contain a definition of 'general power of appointment'.

77 Powers of appointment over property can be divided into general powers, special powers and intermediate powers. A general power confers on the holder the right to appoint to anyone in the world (including himself or herself). A special power entitles the holder to appoint to anyone within a specified class of individuals. An intermediate power entitles the holder to appoint to anyone in the world except a specified class of individuals. See *Re Penrose* [1933] Ch 793, 805 - 808; *Re Triffitt's Settlement* [1958] Ch 852, 860; *Thompson v Commissioner of Stamp Duties* [1969] 1 AC 320, 337 - 339; *Re Manisty's Settlement* [1974] Ch 17, 21; *Re Hay's Settlement Trusts* [1982] 1 WLR 202, 208 - 209; *Schmidt v Rosewood Trust Ltd* [2003] UKPC 26; [2003] 2 AC 709 [35], [42]; *Snell's Equity*, 2010, (32nd ed), 11-001.

78 In *R & I Bank of Western Australia Ltd v Anchorage Investments Pty Ltd* (1993) 10 WAR 59, Owen J expressed the opinion, in the context of contempt proceedings for alleged breach of an interlocutory injunction, that it was 'clearly arguable' that a combination of powers held by a natural person (Lombardo) 'may amount to a general power of appointment' even though the class of beneficiaries did not comprise everyone in the world. His Honour summarised the powers in question, as follows:

[Lombardo] was a beneficiary and not a member of the 'excluded class' as that term is defined in cl 1(3) of the Trust Deed. Accordingly, he was eligible to be appointed as trustee of the Trust. Lombardo was the appointor of the Trust. Under cl 21 of the Trust Deed he could, as appointor, remove Anchorage as trustee and appoint himself as trustee in its place. As a trustee, Lombardo had the power to deal with the trust fund in any way authorised by the Trust Deed. Clause 10 indicates that the discretions vested in the trustee by the Trust Deed 'shall be absolute and uncontrolled and every power vested in [the trustee] shall be exercisable at [the trustee's] absolute and uncontrolled discretion.' There is an exception where a guardian is in office. That exception does not apply because prior to 9 August 1991, no guardian had been appointed. Once Lombardo had become trustee, or in any event through his ability to control the actions of Anchorage, Lombardo was in a position, counsel for R & I submitted, to use the trust fund for his own purposes. He could, for example, appoint income to himself (cl 3(1)(a)) or advance the vesting date and vest the whole or part of the trust fund to himself beneficially (cl 4(1)(a)). Even before the vesting date he could pay any sum from the capital of the trust fund for his own use and benefit (cl 6(1)) or permit any beneficiary (including himself) to have the custody or use of immovable property (cl 6(6)). Further wide ranging powers are set

Subsection 70(5) refers only to property owned by the testator, beneficially, and not solely legally, (such as in the capacity of a trustee), and since a power of appointment over property does not constitute ownership of the subject property the property itself is not subject to Sec. 70(5), though the power is. If the power is **a trust power and not a mere power**, and if it is instilled in the taxpayer by virtue of his holding the office of trustee and it isn't instilled in him in his personal capacity by naming him as the power holder without regard to his relationship to the trust, upon his death the power should not be captured by Sec. 70(5) since he doesn't own the power in a personal capacity.⁴⁴¹ In such an instance the trustee could exercise the power favorably in respect of a multitude of objects, though possibly be subject to question by legitimate beneficiaries, (though if the trust deed is properly structured to limit beneficiary recourse some flexibility could exist), and as long as the power is held **by virtue of being a trustee** Sec. 70(5) will not apply to it.⁴⁴² Thus, watch the language and scope by which you draft it.

If the power can be exercised so as to vest the power holder with the underlying property its value should equal the value of the underlying property thus the control of the ownership of the property is equated with that of actual ownership in a limited sense. If the power can be exercised only in respect of someone else other than the holder its value for purposes of Sec. 70(5) should again equal the value of the underlying property to which it relates regardless of its value to the deceased immediately before his death. That ability to control the ownership – beneficial or legal – of property should have a value to its exerciser even if it cannot be alienated or exercised in respect of him. This time the author tends to BENEFICIALLY disagree with CRA Rulings who have stated that it is not a property: but this is not the case with trust powers.

If the power terminates upon death then its fair market value technically doesn't decrease until that time but not if it terminates immediately before death. In the latter instance it would appear that a trust power to appoint property out from under a trust could prove valuable at insuring that the testator does not get caught by Sec. 70(5) in respect of property that he previously owned. If the power is exercisable under the will then the value of it still doesn't get caught by Sec. 70(5) since it is not owned in his personal capacity. The power of appointment will be caught by Sec. 75(2) in such an instance so as to cause income/gain/loss attribution if its holder is Canadian resident, and double taxation, but will not be subject to Sec. 70(5) on death.⁴⁴³

out in cl 7 including the power to borrow monies from the Trust, to use Trust assets as security for his own borrowings and to cause the trustee to give guarantees for his obligations. Lombardo also had the power to cause the Trust Deed to be varied or supplemented (cl 28) (80).

79 As at 2 May 1977, pt 4 of the *Stamp Duties Act 1920* (NSW) (the NSW Act) imposed death duties. By s 101, in the case of every person who died after the passing of the Act, whether in New South Wales or elsewhere, and wherever the deceased was domiciled, death duty was assessable and payable upon the final balance of the estate of the deceased, as determined in accordance with the Act.

80 In general, the estate of a person who died domiciled in New South Wales attracted duty on the whole of his or her real property in New South Wales and his or her personal property wherever situated as at the date of death. In general, the estate of a person who died domiciled outside New South Wales attracted duty on his or her real and personal property in New South Wales as at the date of death.

81 By s 102(2)(j) of the NSW Act, the property of a deceased was deemed to include any property over or in respect of which the deceased had at the time of his or her death 'a general power of appointment'. The term 'general power of appointment' was defined in s 100 to include 'any power or authority which enables the donee or other holder thereof ... to appoint or dispose of any property ... as he thinks fit for his own benefit, whether exercisable by instrument inter vivos or by will or otherwise'. This definition included within the concept of a general power of appointment numerous powers which would ordinarily be classified as special powers of appointment.

441 See Re: Edward's Will Trusts, 1947 2 All E.R. 521, as well as Re: Buckingham, 1915 1 Ch. 241, Paterson's Trustees v. Finlay, 1918 S.C.R. 713, Re: Smith, 1904 1 Ch. 139, Re: Robinson, 1912 1 Ir. 411, Kennedy v. Kennedy, 1914 A.C. 215 (PC), Innes v. Harrison, 1954 1 W.L.R. 668, Whishaw v. Stephenson, 1970 A.C. 508, Re: Symm's Will Trusts, 1936 3 All E.R. 236, Re: Will's Trust Deeds, 1964 Ch. 219, Re: Everd, 1910 2 Ch. 147, & Halsbury's Laws of England, 4th Ed., Vol. 36, para. 860 for discussions on powers held in individual capacity or virtue office.

442 If the power can be exercised to grant interests to its holder it doesn't necessarily cause it not to be held in a trustee capacity.

443 In Grey v. F.C.T., 62 C.L.R. 49, the **unexercisable** contingent power of appointment of a testator held on his death was not captured for death duty purposes though this doesn't preclude it from having a value. In Equity Trustees and Exors. & Agency Co. v. Commr. of Probate Duties, 10 A.L.R. 131, a power to compel the trustee to raise by mortgage proceeds to be distributed was held not a power to appoint though for Canadian income tax purposes the power would have a value

Since a power of appointment created via a will whether in trust, or mere, is a property gifted by the will and not in existence as such prior to death the testator will not recognize a disposition in respect of it under Sec. 70(5)-(6) but those subsections will also preclude the recipient from recognizing a cost thereof since they compute the cost of property disposed of by the testator under those subsections only. Subparagraph 69(1)(c) will, however, allow the power gifted by the testator to have a cost amount equal to its fair market value at the time it is acquired by the recipient, even if the recipient is a spousal trustee in that Sec. 70(5)-(6) does not attend to its cost set up. In such a case the power cannot be said to be a property owned by the testator subject to Sec. 70(5) etc. since it is created by the death. Since the power isn't "distributed in satisfaction of a capital interest" Sec. 107(2) cannot apply to provide the cost of the power to the recipient trustee or otherwise and no provision operates to prevent Sec. 69(1)(c) from creating the cost of the property.⁴⁴⁴ Another power fused to the actual ownership could subsist with the executors/trustees⁴⁴⁵. If the power terminates after a certain period of time or upon the occurrence of a certain event it would appear that its holder, trust or individual, could recognize a capital loss even if the power is held in trust. Obviously this abnormality arises due to the fact that the property is being literally created by the will (the same as a testamentary option), and although it did not cost the recipient anything, (though it could have), it will start off with a **deemed** cost.⁴⁴⁶ Does anyone want to test CRA Rulings on this: seed down mere powers all over the place through a will and have them expire?⁴⁴⁷ Is a mere power of appointment over trust property "a gift" that is not a capital/income interest thus exempting it from the section 107 mechanics?

Forgiving Debt.

If a taxpayer forgives debt owing to him on his death its value would still be caught by Sec. 70(5). Regardless of whether such bequest is made depending on the interest rate applied, the prospect of repayment, etc., may affect the FMV of the debt causing capital gains or losses. The fact that the debt is to be forgiven upon death is of no influence in computing its FMV. Subsection 80(1)(h) allows the borrower to avoid an income inclusion if the forgiving act is a bequest or inheritance, regardless of how and when it is actually canceled.⁴⁴⁸ If the cancellation is to occur upon death the estate doesn't receive the property and no Sec. 70(6) roll is available in respect of it while it will also not be available to list under a Sec. 70(7) untainting process if need be. If the debt is contingently enforceable by the estate/trust depending on a condition precedent or subsequent once it is canceled the estate/trust shouldn't recognize a capital loss since the cancellation operates as a bequest⁴⁴⁹ but is there a distribution within the context of Sec. 107(2) etc.?⁴⁵⁰

equal to the amount that could be validly raised. There is a difference between a contingent event precluding the exercise of a power and an event giving effect to its previous exercise: Re: Manning 2 E.T.R. 195.

444 If the power is received quo trustee can it be a gift within the context of Sec. 69(1)(c)?

445 Since the power isn't a capital or income interest Sec. 107(1.1) or 106(1.1) does not apply to preclude Sec. 69(1)(c) from applying. The control of the ownership of property can be argued to be a gift.

446 This is a complete area of the I.T.A. that is **dangerously lacking in attention and should be of immediate concern to the Department of Finance** and those wishing to structure very favourable arrangements. See abusive uses of powers of appointment in Variations.

447 Then again, according to Rulings a power of appointment isn't a property for tainted spousal trust purposes so if they ever decide to change their minds there's all sorts of hocus-pocus problems they could cause.

448 There will not be any gains reserve available in the year of death under Sec. 40(1) though if the terms provide for a substantial deferral in extinguishment a loss may be created on the deemed disposition.

449 See Bone v. Commr. of S.D., 3 A.L.R. 561, Dawes v. Exors., Trustees, and Agency Co. of S.Aust. Ltd., 52 C.L.R. 291, Re: Howlett, 1964 Tas. S.R. 63, for common law bequests.

450 It may be possible to structure a partial tax free cost bump in property sold before death, a capital loss on the Sec. 70(5) disposition of the note receivable taken as consideration on the sale, perhaps following a Sec. 70(7) listing, when the terms call for substantially deferred payment, preserve the Sec. 72(2) reserve. The note can be rolled to a spousal trust **not necessarily** using Sec. 70(6) but if the recipient is a Sec. 70(6) spousal trust, cause the note to have a reduced interest rate while held by the spousal trust, but will retain the availability of the reserve via a spousal trust variation allowing for the debt cancellation since such would cause Sec. 107(4) to recognize a f.m.v. disposition of the note bringing all of the proceeds into capital gains computation.

Subject: Debts Bequeathed or Forgiven on Death

IT-382 Date: June 20, 1977

Capital Property

1. Subsection 70(5), except when subsection 70(6) or 70(9) applies, deems a deceased taxpayer to have disposed of all non-depreciable capital property immediately before his death for fair market value. This, of course, includes debts that are capital property.
2. If the deceased has given property to the debtor with a provision that it, or part of it, is to be used to pay such a debt, or he bequeaths the debt to the debtor, specifically or as part of a general bequest, or he forgives the debt in his will, there is no change in the deceased's tax position set forth in 1 above. This is also the case when a debtor receives the debt as heir in an intestacy.
3. It is the practice of the Department not to apply section 80 to the debtor in the circumstances referred to in 2 above and therefore there are no tax consequences to him. The adjusted cost base of any property owned by the debtor is also unaffected by the transactions referred to in 2 above.

Rights and Things

4. Rights or things may include debts forgiven by will. The fair market value of these is included in the deceased's income for his last year, either in a separate return, or in the ordinary return (subsection 70(2)) unless they have been transferred to the beneficiary of them before the later of one year after death and 90 days after the issuance of the assessment notice for the year of death. In the event of such a transfer the liability for tax on the right or thing falls on the beneficiary instead of the deceased.

Creation of Legal Life Interests.

“Life estates in real property – Sec. 43.1(1)”

(1) Notwithstanding any other provision of this Act, where at any time a taxpayer disposes of a remainder interest in real property (except as a result of a transaction to which subsection 73(3) would otherwise apply or by way of a gift to a donee described in the definition “total charitable gifts” or “total Crown gifts” in subsection 118.1(1)) to a person or partnership and retains a life estate or an estate pur autre vie (in this section called the “estate”) in the property, the taxpayer shall be deemed

(a) to have disposed at that time of the life estate in the property for proceeds of disposition equal to its fair market value at that time; and

(b) to have reacquired the life estate immediately after that time at a cost equal to the proceeds of disposition referred to in paragraph 43.1(1)(a).

“Exchanges of property – Sec. 43.1(2)”

(2) Where, as a result of an individual's death, a life estate to which subsection 43.1(1) applied is terminated,

(a) the holder of the life estate immediately before the death shall be deemed to have disposed of the life estate immediately before the death for proceeds of disposition equal to the adjusted cost base to that person of the life estate immediately before the death; and

(b) where a person who is the holder of the remainder interest in the real property immediately before the death was not dealing at arm's length with the holder of the life estate, there shall, after the death, be added in computing the adjusted cost base to that person of the real property an amount equal to the lesser of

(i) the adjusted cost base of the life estate in the property immediately before the death, and

(ii) the amount, if any, by which the fair market value of the real property immediately after the death exceeds the adjusted cost base to that person of the remainder interest immediately before the death.

Subsection 43.1(2) states that when a life estate terminates on death the disposition is basically tax-free and **only if the remainderman is not-dealing at arm's length with the life-interest holder** there is a migration of cost to the remainderman.

Question 33 of the 1988 CRA Roundtable Discussions recognized that when property is transferred to a trust and an income interest in the property's revenues is taken back a disposition of the remainder interest, (ultimate legal title of the shares), will be recognized by the transferor. The ACB of the remainder interest will equal its fair market value divided by the fair market value of the total property, (capital and income rights), multiplied by the ACB of the total property.⁴⁵¹

⁴⁵¹ In *Commr off State Revenue (Victoria) v Pioneer Concrete (Vic) Pty Limited*, 2002 209 C.L.R. 651 HCA, an estate in fee simple was transferred and there was some issue as to what exactly its value was when there were certain additional non-property rights of use were attached to it.

See also the recent Cdn. case of *Darrell Frank Nauss v. Her Majesty The Queen*, 2005-785(IT)I, where the TCC considered valuation methods of the interests and held:

[17] Mr. Chappell did do some research and he set out what strikes me as a fairly reasonable starting point in valuing life interests and remainder interests. The valuation of such interests is at best an imprecise calculation. It is not like valuing a house in a subdivision where one can look to comparable sales. Life interests and remainder interests are, after all, not exactly a hot commodity on the real estate market. In any event, you either take the total value and deduct from it the value of the remainder interest to arrive at the value of the life interest or else you take the total value and deduct from it the value of the life interest to arrive at the value of the remainder interest. The latter method is difficult but the former is virtually impossible. A life interest has a finite and, at least in theory, an ascertainable value. You cannot determine a remainder interest in a vacuum or in the abstract. You have to determine the value of the life interest first and excise it out of the total value before you value the remainder interest.

[18] The virtual impossibility of determining the remainder interest in some manner other than by first valuing the life interest is illustrated by the following passage from Mr. Chappell's report:

3.2.4. Method 1 Remainderman Interest

In calculating the Remainderman Interest the first step is to forecast the total future value of the subject property at the date that the Life Estate is expected to expire (based on mortality tables). This total future value is then discounted back to the effective date of valuation to provide an indication of the total present worth of the value. This present value is representative of the Remainderman Interest and indicates the current value to the property owner. By deducting this Remainderman Interest from the total fair market at the effective date one can arrive at the value of the Life Interest as a residual value.

3.2.5 Method 2 Life Interest

The calculation of the Life Estate considers the present value of the potential net revenue that the property may be capable of producing. Only the Life Tenant has the right to receive rent from the property during the life tenancy. With this method, an estimate of the income the property can produce and the expenses it would incur must be estimated. The net income is then capitalized at an appropriate rate to provide a present value of the anticipated cash flow over the estimated term of the Life Interest based on mortality tables. By deducting this Life Interest from the total fair market at the effective date one can arrive at the value of the Remainderman Interest as a residual value.

In the case of the subject property, the Remainderman Interest is the interest that accrues to the grandchildren, Darrell Nauss and Leone Russell. It is the value of the right to own the property when the life estate is ultimately extinguished. A similar calculation was made for both dates. The first date is the date that the Life Interest was created and the second date is the date when the Life Interest was extinguished.

3.2.6 Remainderman Interest

In order to estimate the Remainderman Interest in the property at each date we must follow 3 steps as noted above:

Step 1. Estimate the fair market value of the property at the date the life estate was created – September 1997 and the date of the sale of the property in November 2002.

Step 2. Forecast the future value of the property when it is anticipated that the Life Interest will cease to exist and the grandchildren will gain the fee simple interest in the

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property. This must be done for each of the two dates.

Step 3. Discount that estimated future value back to provide a present value based on the expected duration of the life estate. This also must be done for each of the two dates.

In addressing the valuation issues we have broken the process into two sections. The first addresses the value allocation as of the date the Life Interest was created i.e. September 1997. The second addresses the value allocation as of the date the Life Interest was extinguished i.e. November 2002.

In the result we have to start by valuing the life interest at the two dates – December 15, 1997 and November 27, 2002.

[19] I come back to the Crown's calculations set out above. A few things strike me as interesting, if not peculiar. The first is that Mr. Nauss' taxable capital gain on the new calculations is \$34,245 whereas the capital gain on the old and erroneous assumption that Mr. Nauss and his sister got the entire fee simple in 1997 and sold it in 2002 results in a taxable capital gain for him of \$35,000 – a difference of only \$755. This despite the fact that Mr. Nauss' mother in 1997 at 70 had an actuarial life expectancy of 16.02 years and in 2002 of 12.44 years. Another thing that is somewhat odd is that according to the above calculations the fmV of the life interest in 1997 as calculated by the Minister's expert is \$108,180 whereas five years later in 2002 when Mrs. Nauss was 75 the fmV of her life interest was \$111,199. Now it is true that the overall value of the property rose by \$140,000 from \$245,000 to \$385,000. A purely mathematical calculation would look something like this, assuming the fmV of the life interest to be \$108,180 in 1997:

$$\frac{\$108,180 \times 385,000}{245,000} = 169,997 \times \frac{12.44}{16.02} = 132,007.76$$

[20] It should also be borne in mind that the use of any factor that increases the proportion of the entire value that is attributable to the remainder interest is a two-edged sword. In 1997 it increases the appellant's adjusted cost base of the remainder interest. In 2002 it also increases the proportion of \$385,000 that is attributable to the sale of the remainder interest so that the capital gain on the sale of the remainder interest is adjusted both ways and remains relatively constant.

[21] According to Mr. Chappell the life interest on September 15, 1997 was 44.15 percent of the total value whereas on November 22, 2002, it represented 35.55 percent of the total. This is roughly consistent with the fact that Mrs. Nauss' actuarial life expectancy had declined from 16.02 years to 12.44 years. It is interesting, albeit irrelevant, that statistically Mrs. Nauss was expected in 2002 to live for 12.44 years whereas she in fact died on November 12, 2003. It certainly proves the truth of the statement that we know neither the day nor the hour.

[22] The question of using the actual date of death rather than actuarial mortality tables arose in *Ithaca Trust Co. v. United States*, 279 U.S. 151. The answer seems obvious – the actuarial tables should be used. However, I am pleased that this view was confirmed by no less an authority than Justice Oliver Wendell Holmes, who said at pages 154-5:

The second question is raised by the accident of the widow having died within the year granted by the statute, section 404, and regulations, for filing the return showing the deductions allowed by section 403, the value of the net estate and the tax paid or payable thereon. By section 403(a)(3) the net estate taxed is ascertained by deducting among other things gifts to charity such as were made in this case. But as those gifts were subject to the life estate of the widow of course their value was diminished by the postponement that would last while the widow lived. The question is whether the amount of the diminution, that is, the length of the postponement, is to be determined by the event as it turned out, of the widow's death within six months, or by mortality tables showing the probabilities as they stood on the day when the testator died. The first impression is that it is absurd to resort to statistical probabilities when you know the fact. But this is due to inaccurate thinking. The estate so far as may be is settled as of the date of the testator's death. The tax is on the act of the testator not on the receipt of property by the legatees. Therefore the value of the thing to be taxed must be estimated as of the time when the act is done. But the value of property at a given time depends upon the relative intensity of the social desire for it at that time, expressed in the money that it would bring in the market. Like all values, as the word is used by the law, it depends largely on more or less certain prophecies of the future, and the value is no less real at that time if later the prophecy turns out false than when it comes out true. Tempting as it is to correct uncertain probabilities by the now certain fact, we are of opinion that it cannot be done, but that the value of the wife's life interest must be estimated by the mortality tables. Our opinion is not changed by the necessary exceptions to the general rule specifically made by the act.

(Case law citations omitted)

The same view was expressed by Frank, Circuit Judge in *Commissioner of Internal Revenue v. Marshall*, 141 A.L.R. 445, 125 F.2d 943 at 946. (Circuit Court of Appeals, Second Circuit.)

It is also argued that Congress could not have intended to be so unjust as to impose a tax based upon an estimate of value, taken from the mortality tables, which may turn out to be not in accordance with reality. Thus the Board refers to the fact that, under Section 510, the donee of a gift may be personally liable for a gift tax not otherwise paid 'to the extent of the value of such gift'; suppose, then, argues the Board, that the children, under that section, were required to pay a tax on the value of their remainders at the date of the gift, computed actuarially, and that the life tenants die while the donor still lives; in such circumstances, says the Board, 43 B.T.A. 99, 'the children would thus have paid a gift tax on something which they never received'.

That argument proves too much. It would preclude a tax on any 'value' which is not almost certain to correspond with actual enjoyment. But 'value' seldom does so correspond. The fallacy in that argument stems largely from lack of recognition of the eely character of the word 'value'. It is a bewitching word which, for years, has disturbed mental peace and caused numerous useless debates. Perhaps it would be better for the peace of men's minds if the word were abolished.⁷ Reams of good paper and gallons of good ink have been wasted by those who have tried to give it a constant and precise meaning. The truth is that it has different meanings in different contexts,⁸ even in the restricted field of 'tax law'.⁹ And there, as almost always, 'value' involves a conjecture, a guess, a prediction, a prophecy. With reference to the taxation of life estates, the Supreme Court has relied on educated guesses, as of a given date, based on the mortality tables, disregarding the fact that actually, in the particular case before it, the prophecy has turned out to be wrong because the life tenant did not live up to her life expectancy. 'Like all values, as the word is used by the law, it depends largely on more or less certain prophecies of the future; and the value is no less real * * * if later the prophecy turns out false than when it comes out true.' *Ithaca Trust Co. v. United States*, 279 U.S. 151, 155, 49 S.Ct. 291, 292, 73 L.Ed. 647. The rationale of that case is controlling here. Treasury Regs. 79, Art. 19 adopts the actuarial method of valuing remainders. That method is not so arbitrary as to be unreasonable and invalid.

It is immaterial that actuarial estimates may not accord with realities. Few estimates of value do, whether used by courts or laymen: For purposes of corporate reorganization, value, generally, is a reasonable capitalization of future earnings as reasonably foreseeable at the date of reorganization; reliance is had upon an educated guess or peering into the future, which, being a human conjecture, may be wrong. No one can foretell what changes in technology will do to the earnings of any business.¹⁰ Anyone who wants to eliminate uncertainties from 'value' will have a sad time getting along in this world. All aspects of living are chancy. We cannot, by the use of a symbol, 'value', convert the risky into risklessness, Canute restless change out of existence. Businessmen sometimes pay cash for value which exists only in 'moonshin or dreamland'.¹¹ That 'market value', for instance, in the case of city real estate, is often a mirage, has been strikingly shown by Abrams, *Revolution in Land* (1939) 198-200, cf. 132-133, 81-89. Accordingly, we reject the argument that, merely because the 'value' of the contingent remainders, measured actuarially, may be inaccurate, Congress must be deemed to have intended that such remainders should not be subject to a gift tax.

(Footnotes omitted)

[23] We all know the definition of fmV in *Henderson Estate v. M.N.R.*, 73 DTC 5471. Nonetheless the determination of the value of life interests and remainder interests is at best an imprecise exercise. It is based on a variety of imponderables not the least of which are actuarial mortality tables and capitalization rates. Mr. Chappell also looked at residential rental rates which he projected to 2013 and then discounted them at 12 percent to 1997 to arrive at a fmV for the life interest of \$89,869. Whether it is in 2005 possible to predict rental rates in Nova Scotia in 2013 while theoretically standing in 1997, or to use as appropriate a discount rate of 12 percent, or whether it is acceptable to use residential rental rates in valuing a 250 year old historic property is open to question. The assumptions upon which such calculations are based vary within a range of indeterminate magnitude. At all events the computation results in a fmV for the remainder interest of \$155,131 (\$245,000 - \$89,969 = \$155,131) on September 15, 1997. The exercise that I performed above would increase the fmV of the life interest in 2002 as follows:

\$ 89,869 X 385,000 = 141,222 X 12.44 = 109,663.00
245,000 16.02

[24] On this basis we would attribute \$275,337 to the remainder interest in 2002 (\$385,000 less \$109,663) and the

Eligible Capital Property and Resource Property.

Subsection 70(5.1) provides tax free roll-over treatment in respect of eligible capital property used in a business carried on by the testator immediately before his death and the main thrust of the new provision, like that of the former, is to place the beneficiary recipient in the same tax position as that of the testator with respect to the property. As per the provision the property must have been acquired as a consequence of the taxpayer's death and the business must have been carried on by the taxpayer immediately before his death. It does not apply where the E.C.P. is acquired via a distribution of property by a trust that has taken a Sec. 20(1)(b), (E.C.E.A.) deduction in respect of **the particular property distributed** or where the spouse of the testator or a corporation controlled by him has acquired the property in an instance where Sec. 24(2) applies.

capital gain would be \$275,337 minus \$155,131 = \$120,205 ÷ 2 = \$60,102.50. Mr. Nauss' taxable capital gain is \$30,051.25. I daresay I could do some more tinkering and fine tuning but it would not make an appreciable difference.

[25] This strikes me as a somewhat more reasonable result than that arrived at by the Minister. I do not think it is reasonable to base a valuation of the remainder interests on hypotheses and premises that result in the capital gain on the sale of the remainder interests being virtually identical to that realized on the sale of the entire fee simple. The result appeals as much to my common sense as to my sense of mathematical or logical congruity. As Viscount Simon said in *Gold Coast Selection Trust v. Humphrey*, [1948] A.C. 459 at 472:

In my view, the principle to be applied is the following. In cases such as this, when a trader in the course of his trade receives a new and valuable asset, not being money, as the result of sale or exchange, that asset, for the purpose of computing the annual profits or gains arising or accruing to him from his trade, should be valued as at the end of the accounting period in which it was received, even though it is neither realized nor realizable till later. The fact that it cannot be realized at once may reduce its present value, but that is no reason for treating it, for the purposes of income tax, as though it had no value until it could be realized. If the asset takes the form of fully paid shares, the valuation will take into account not only the terms of the agreement but a number of other factors, such as prospective yield, marketability, the general outlook for the type of business of the company which has allotted the shares, the result of a contemporary prospectus offering similar shares for subscription, the capital position of the company, and so forth. There may also be an element of value in the fact that the holding of the shares gives control of the company. *If the asset is difficult to value but is none the less of a money value, the best valuation possible must be made. Valuation is an art, not an exact science. Mathematical certainty is not demanded nor indeed is it possible. It is for the commissioners to express in the money value attributed by them to the asset their estimate, and this is a conclusion of fact to be drawn from the evidence before them.*

[Emphasis added]

This passage has frequently been cited and followed and it illustrates in my view the need to keep in mind some sense of reality and common sense in valuing property that is hard to value.

[26] In light of the paucity of helpful material in this area, I looked to foreign sources to see how other jurisdictions dealt with the matter of valuing life and remainder interests. The United States yielded a substantial amount of material but it was of no assistance because regulations under the Internal Revenue Code prescribe specific proportions to be ascribed to life estate and remainder interests. For example, for a person of 70 years the split between a life estate and a remainder interest is .36617 and .63383. For a person of 75 it would be .30375 and .69625. If I were required or entitled to use these figures the life estate and remainder interest in 1997 would have a value of \$89,711.65 and \$155,288.35, respectively. In 2002, when the mother was 75, they would be \$116,943.75 and \$268,056.25, respectively based on a fmV of the fee simple in 1997 of \$245,000 and in 2002, \$385,000.

[27] Thus the capital gain on the remainder interest would be \$112,767.90 and the taxable capital gain would be \$56,383.95 and Mr. Nauss' share of the taxable capital gain (before costs of disposition) would be \$28,191.98. I mention this simply to illustrate the discrepancy that may result from different methods. However, whatever value the tables prescribed by the IRS may have in the United States, they have none here and cannot be used without an evidentiary foundation being laid. Nonetheless, I suspect that the figures in the tables are actuarially sound although this conclusion is not based on anything presented in the evidence in this case. It is interesting however that the figure of \$28,191.98 arrived by the use of the United States tables is relatively close to my figure of \$30,051.25.

If the trust doesn't take a Sec. 20(1)(b) deduction in respect of the particular E.C.P. it distributes then Sec. 70(5.1) will apply to it.

The fact that Parliament has qualified the tax free roll over in respect of property upon which the trust has taken a E.C.E.A. deduction is critical in the author's opinion in that it establishes the premise that Sec. 107(2) shall apply to such a distribution if E.C.E.A. is deducted, and thus it follows only by specific expression in the Sec. 70(5.1) provision itself. Where the trust deducts E.C.E.A. on the property and distributes it new Sec. 107(2)(e) will apply allow an effective tax free roll-over from the trust with the beneficiary being exposed to E.C.E.A. recapture.⁴⁵²

Subsection 70(5.1) applies to allow the testator to recognize a tax free disposition of his E.C.P. for consideration equal to 4/3rds of the cumulative eligible capital balance in respect of the business that the fair market value of the E.C.P. acquired by the beneficiary is of the aggregate FMV of all of the E.C.P. in respect of the particular business. If all of the E.C.P. in respect of each particular business is not acquired by any beneficiary as a consequence of death the above proration will cause the testator to recognize a taxable disposition in respect of that part which isn't acquired. Under para. (b) and (c) the beneficiary will be deemed to have acquired the property as a capital property for the proceeds recognized by the testator and where the beneficiary continues to carry on the business of the testator he'll be deemed to have acquired the E.C.P. for a cost equal to the proceeds recognized plus 4/3rds of the aggregate E.C.E.A. deductions taken by the testator in respect of the business that the fair market value of the particular property acquired is of the aggregate FMV of all of the E.C.P. in respect of the business immediately before his death. The beneficiary's C.E.C. balance will be reduced by 3/4ths of the potential recapture amount described in Sec. 70(5.1)(c)(ii).

Subsection 70(5.1) does not apply where Sec. 24(2) does and subsection 24(2) provides an automatic roll-over of C.E.C. in respect of a business carried on by the taxpayer where immediately upon ceasing to carry it on the spouse or corporation controlled directly or indirectly by the testator continues to carry it on. With the 1990 amendments there will be an effective tax free roll-over of the E.C.P. in a manner similar to Sec. 70(5.1) **only if all of the E.C.P.** of the particular business is acquired by the spouse or corporation and only when the E.C.P. has **actual value** however the spouse **and** the corporation cannot acquire the property as joint owners and at the time of writing it is not known whether the value of the E.C.P. in the form of future Sec. 20(1)(b) deductions will be enough to allow it to have value for these purposes. Unlike the Sec. 70(5.1) roll-over the spouse or corporation need not acquire the property as a consequence of the death hence where there is a "splintering" of ownership of various E.C.P. in respect of various businesses it would appear that the parties may be able to consolidate receipt of the numerous E.C.P.s in respect of each business so as to allow Sec. 24(2) to apply, (however this may jeopardize the applicability Sec. 70(5.1)). Rolling property to a spousal trust will not allow it to qualify for Sec. 24(2) treatment while it would appear that Sec. 70(5.1) may provide roll-over treatment since such a tax entity is a person.

Subsection 24(1) has been amended to allow deduction of the full amount of the taxpayer's C.E.C. in computing his income in the taxation years **after** the time at which he ceased to carry on the business and since a testator ceases to carry on business at the time of death and does not have any subsequent taxation years the C.E.C. existing will not be deductible by the estate, the beneficiaries, or the testator unless the E.C.P. obtains some sort of roll through treatment.

If the E.C.P. is distributed to a taxpayer by the estate undergoing administration or the residuary trust Sec. 107(2)(e) applies, (unless the trust isn't personal), to allow tax free roll over of its grossed up cost amount but this doesn't apply if the trust hasn't taken a Sec. 20(1)(b) deduction in respect of it, (the application of Sec. 70(5.1) is mandatory if the beneficiary continues to carry on the business), however the application of Sec. 24(2) and Sec. 107(2) are not mutually exclusive and there would appear to be the possibility that Sec. 24(2) can apply where an estate takes Sec. 20(1)(b) deductions and rolls the property out to the spouse. Subsection 70(5.1) overrides the application of Sec. 24(1) only when amongst the other conditions Sec. 24(2) doesn't apply and the estate doesn't take a Sec. 20(1)(b) deduction while Sec. 24(2) overrides the terminal disposition

452. Section 70 is situated outside of subdivision k in the Act and only in the latter are estates and trusts equated as being the same tax entity. Will Sec. 70(5.1) be precluded from applying where an **estate** in the midst of administration takes a E.C.E.A. deduction and distributes the property?

described in Sec. 24(1).

“Eligible capital property of deceased – Sec. 70(5.1)”

(5.1) Notwithstanding subsection 24(1), where at any time a taxpayer dies and any person (in this subsection referred to as the beneficiary), as a consequence of the taxpayer’s death, acquires an eligible capital property of the taxpayer in respect of a business carried on by the taxpayer immediately before that time (otherwise than by way of a distribution of property by a trust that claimed a deduction under paragraph 20(1)(b) in respect of the property or in circumstances to which subsection 24(2) applies),

(a) the taxpayer shall be deemed to have disposed of the property, immediately before the taxpayer’s death, for proceeds equal to $\frac{4}{3}$ of that proportion of the cumulative eligible capital of the taxpayer in respect of the business that the fair market value immediately before that time of the property is of the fair market value immediately before that time of all of the eligible capital property of the taxpayer in respect of the business;

(b) subject to paragraph 70(5.1)(c), the beneficiary shall be deemed to have acquired a capital property at the time of the taxpayer’s death at a cost equal to the proceeds referred to in paragraph 70(5.1)(a);

(c) where the beneficiary continues to carry on the business previously carried on by the taxpayer, the beneficiary shall be deemed to have, at the time of the taxpayer’s death, acquired an eligible capital property and made an eligible capital expenditure at a cost equal to the total of

(i) the proceeds referred to in paragraph 70(5.1)(a), and

(ii) $\frac{4}{3}$ of that proportion of the amount, if any, determined for F in the definition “cumulative eligible capital” in subsection 14(5) in respect of the business of the taxpayer at that time that the fair market value immediately before that time of the particular property is of the fair market value immediately before that time of all eligible capital property of the taxpayer in respect of the business,

and for the purposes of determining at any time the beneficiary’s cumulative eligible capital in respect of the business, an amount equal to $\frac{3}{4}$ of the amount determined under subparagraph 70(5.1)(c)(ii) shall be added to the amount otherwise determined, in respect of the business, for P in the definition “cumulative eligible capital” in subsection 14(5); and

(d) for the purpose of determining, after that time, the amount required by paragraph 14(1)(b) to be included in computing the income of the beneficiary in respect of any subsequent disposition of the property of the business, there shall be added to the amount determined for Q in the definition “cumulative eligible capital” in subsection 14(5) the amount determined by the formula

$A \times B/C$

where

A is the amount, if any, determined for Q in that definition in respect of the business of the taxpayer immediately before that time,

B is the fair market value immediately before that time of the particular property, and

C is the fair market value immediately before that time of all eligible capital property of the taxpayer in respect of the business.

Under subsection 70(5.2)(a), for purposes of Sec. 59(1) (concerning the disposition of foreign resource property), Sec. 66.2(5)(b)(v)(A) and 66.4(5)(b)(v)(A), the taxpayer will be deemed to have disposed of in the year of death, each property owned that was a Canadian resource property or a foreign resource property and to have received proceeds of disposition equal to their fair market values at that time, thus causing recapture of resource allowances or possibly causing direct income inclusions (under Sec. 59(1)). Paragraph (e) of subsection 70(5.2) provides that immediately prior to death the deceased will be deemed to have disposed of each property that was land included in his business as inventory and to have received proceeds of disposition equal to the fair market thereof at that time. Under subpara. 70(5.2)(d) if the resource property is transferred

to the spouse or a spousal trust having the character described in Sec. 70(6) the legal representative of the testator will be able to elect the amount of proceeds that the testator will be deemed to have received, up to the property's fair market value, and the spouse or spousal trust will be deemed to have acquired the property at a cost equal to the amount included in the testator's income by virtue of Sec. 59(1) or amount determined under Sec. 66.2(5)(b)(v)(A) or 66.4(5)(b)(v)(A), all of which depend on the elected amount. Under subpara. 70(5.2)(f), if the land inventory is transferred to the spouse or spousal trust it will be deemed disposed of and acquired, by the testator and the recipient respectively, for its cost amount. In order for both tax free roll-overs to be available the major aspects of Sec. 70(6) transfer provision, as they would apply to the particular property, must be satisfied; (i.e.: vesting, residency, et cetera).

“Resource properties and land inventories of a deceased taxpayer – Sec. 70(5.2)”

(5.2) Where in a taxation year a taxpayer dies,

(a) the taxpayer is deemed to have, immediately before the taxpayer's death, disposed of each Canadian resource property and foreign resource property of the taxpayer and received proceeds of disposition for that property equal to its fair market value immediately before the death;

(a.1) subject to subparagraph (b)(ii), any particular person who as a consequence of the taxpayer's death acquires any property that is deemed by paragraph (a) to have been disposed of by the taxpayer is deemed to have acquired the property at the time of the death at a cost equal to the fair market value of the property immediately before the death;

(b) notwithstanding paragraph 70(5.2)(a), where the taxpayer was resident in Canada immediately before the taxpayer's death, any Canadian resource property or foreign resource property of the taxpayer that is, on or after the death and as a consequence of the death, transferred or distributed to a spouse or common-law partner of the taxpayer described in paragraph 70(6)(a) or a trust described in paragraph 70(6)(b) and it can be shown within the period ending 36 months after the death or, where written application therefor has been made to the Minister by the taxpayer's legal representative within that period, within such longer period as the Minister considers reasonable in the circumstances, that the property vested indefeasibly in the spouse or common-law partner or trust, as the case may be,

(i) the taxpayer shall be deemed to have, immediately before the death, disposed of the property and received proceeds of disposition therefor equal to such amount as is specified by the taxpayer's legal representative in the return of income of the taxpayer filed under paragraph 150(1)(b), not exceeding its fair market value immediately before the death, and

(ii) the spouse, common-law partner or trust, as the case may be, is deemed to have acquired the property at the time of the death at a cost equal to the amount determined in respect of the disposition under subparagraph (i);

(c) the taxpayer is deemed to have, immediately before the taxpayer's death, disposed of each property that was land included in the inventory of a business of the taxpayer and received proceeds of disposition for that property equal to its fair market value immediately before the death;

(c.1) subject to subparagraph (d)(ii), any particular person who as a consequence of the taxpayer's death acquires any property that is deemed by paragraph (c) to have been disposed of by the taxpayer is deemed to have acquired the property at the time of the death at a cost equal to the fair market value of the property immediately before the death; and

(d) notwithstanding paragraph 70(5.2)(c), where the taxpayer was resident in Canada immediately before the taxpayer's death, any property that is land included in the inventory of a business of the taxpayer is, on or after the death and as a consequence of the death, transferred or distributed to a spouse or common-law partner of the taxpayer described in paragraph 70(6)(a) or a trust described in paragraph 70(6)(b) and it can be shown within the period ending 36 months after the death of the taxpayer or, where written application therefor has been made to the Minister by the taxpayer's legal representative within that period, within such longer period as

the Minister considers reasonable in the circumstances, that the property vested indefeasibly in the spouse or common-law partner or trust, as the case may be,

(i) the taxpayer shall be deemed to have, immediately before the death, disposed of the land and received proceeds of disposition therefor equal to its cost amount to the taxpayer immediately before the death, and

(ii) the spouse or common-law partner or trust, as the case may be, shall be deemed to have acquired the property at the time of the death at a cost equal to those proceeds.

Subject: Eligible Capital Property - Deceased Persons

IT-344R Date: May 8, 1987

This bulletin replaces and cancels IT-344 dated September 7, 1976, and incorporates the comments in the Addendum dated April 27, 1981. Current revisions are designated by vertical lines.

1. Subsection 70(3.1) provides that where a taxpayer dies after May 6, 1974, eligible capital property of the deceased is excluded from the expression "rights or things" for the purposes of section 70.

2. Where, as a consequence of the death of a taxpayer (see 3 below) occurring after May 6, 1974, an eligible capital property of the deceased has been acquired by a person other than a spouse or a controlled corporation to whom subsection 24(2) applies, the following rules apply:

(a) . the deceased is deemed to have disposed, immediately before death, of the eligible capital property and to have received proceeds of disposition equal to twice the cumulative eligible capital in respect of a business carried on by the deceased immediately before death (paragraph 70(5.1)(a));

(b) . as a consequence of the deemed disposition of the eligible capital property by the deceased at twice the amount of the cumulative eligible capital, the deceased's cumulative eligible capital amount is reduced to nil and therefore no amount is included in the income of the deceased (paragraph 14(5)(a), subsection 14(1));

(c) . no amount is deductible by virtue of paragraph 20(1)(b) since the deceased's cumulative eligible capital amount is nil;

(d) . a person who acquires the property (the successor) as a consequence of the death but does not continue the deceased taxpayer's business is deemed to have acquired a capital property immediately after the death of the taxpayer at a cost equal to twice the cumulative eligible capital in respect of the business as determined immediately before the death of the taxpayer (paragraph 70(5.1)(b)). A subsequent disposition of this property may result in either a capital gain or capital loss to the successor; and

(e) . a successor who continues to carry on the business previously carried on by the deceased is deemed to have acquired an eligible capital property and to have made an eligible capital expenditure in an amount equal to twice the cumulative eligible capital (or portion thereof acquired) calculated immediately before the death of the taxpayer. Consequently, an amount may be deducted by the successor pursuant to paragraph 20(1)(b) and upon disposition of the eligible capital property the usual rules of section 14 will apply. However, subject to 4 below, the provisions of ITAR 21 will not apply, since the successor will not have carried on the business continuously since December 31, 1971.⁴⁵³

3. Subsections 248(8) and (9) provides rules for determining whether property has been acquired by a person as a consequence of the death of a taxpayer.

4. Although the provisions of ITAR 21(1) normally do not apply to a successor's proceeds of sale of eligible capital property acquired after 1971 in circumstances set out in 2 above, ITAR 21(2.1) provides an exception in the case of a government right acquired by the successor, either directly or indirectly, from a deceased person in a non-arm's length transaction. Under that provision, the successor and the deceased person are treated as one for purpose of ITAR 21(1) which imposes the requirement that the proceeds must be payable

⁴⁵³. In a technical interpretation rendered on July 12th, 1984, the Dept. held that an E.C.P. (milk quota) would not be recognized to have been acquired by a trust when trustee-beneficiaries would not be carrying on the farming business. See *Swift & Anor. v. Dairywise Farms Ltd. & Ors*, [2000] 1 All E.R. 320 ChD, where it was held that a milk quota could be held in trust even when mixed with other quota.

in respect of a business carried on continuously by the taxpayer since January 1, 1972. For the Department's interpretation of when a non-arm's length relationship exists with a trust, see 17 and 18 of IT-419.

Subject: Income of Deceased Persons - Resource Properties

IT-329R Date: September 26, 1983

This bulletin cancels and replaces IT-329 dated July 12, 1976. Current revisions are designated by vertical lines.

1. Subsection 70(3.1) and 70(5.2) have application where the death of the owner of a resource property occurred after May 6, 1974.
2. By virtue of subsection 70(3.1), "rights or things" otherwise included in income under subsection 70(2) or 70(3) do not include resource properties described in paragraphs 59(2)(a) to (e). For purposes of section 59 such properties are deemed by operation of subsection 70(5.2) to have been disposed of immediately before death by the deceased for proceeds equal to their fair market value at the time, subject to special rules discussed below where the properties are transferred to the deceased's spouse or a trust for the spouse as described in paragraph 70(6)(b). Interpretation Bulletin IT-125R3 deals generally with dispositions of resource properties described in section 59.
3. The proceeds of disposition deemed by subsection 70(5.2) to have been received by the taxpayer for the resource property in Canada are accounted for as a deduction in determining either the deceased's cumulative Canadian development expense by virtue of subsections 59(1.1) and 59(3.1) or cumulative Canadian oil and gas property expense by virtue of subsection 59(1.2). Where the deduction results in a credit balance in the cumulative Canadian oil and gas property expense, such balance is, by virtue of subparagraph 66.2(5)(b)(x), required to be deducted in the computation of the cumulative Canadian development expense. Any credit balance in the cumulative Canadian development expense must be included in income of the deceased for the year of death by virtue of paragraph 59(3.2)(c) and subsection 66.2(1). If the deceased has a debit balance in his cumulative Canadian development expense, a deduction in an amount not exceeding 30% of the residual cumulative Canadian development expense may be claimed in the year of death under subsection 66.2(2). No further deduction is allowed in respect of the balance. If a debit balance remains in the deceased's cumulative Canadian oil and gas property expense, an amount not exceeding 10% of the residual cumulative Canadian oil and gas property expense may be claimed in the year of death under subsection 66.4(2). Again, no further deduction is allowed in respect of the balance.
4. The proceeds of disposition deemed by subsection 70(5.2) to have been received for a resource property outside Canada are included in the deceased's income for the year of death pursuant to subsection 59(1) and 59(3). A deduction pursuant to subsection 66(4) is also available to the deceased in the year of death up to the full extent of the deceased's income from foreign resources including proceeds of disposition of such properties. Where this income is less than 10% of the available foreign exploration and development expenses, an amount not exceeding that 10% may be claimed in the year of death. No further deduction is allowed in respect of the balance.
5. If a resource property was owned by the deceased on December 31, 1971 and thereafter without interruption and this property would have been a Canadian resource property (or foreign resource property) had it been acquired after 1971, while it is deemed to be disposed of for proceeds equal to the fair market value immediately before death, the "relevant percentage" provisions in section 59 as described in Interpretation Bulletin IT-125R3 will apply to the proceeds. However, after 1979, the relevant percentage is always 100% for this rule and the rules in 7 and 8 below.
6. Where a resource property owned by the deceased on December 31, 1971 and thereafter without interruption (the disposition of which is subject to the provisions of subsection 59(3) or (3.1)) is acquired on or after death and as a consequence thereof by a person who was related to the deceased taxpayer, the cost of acquisition to such person is deemed to be the amount which is included in the deceased's income pursuant to paragraph 59(3)(a) if subsection 59(3) is applicable or, if subsection 59(3.1) is applicable, the amount referred to in clause 66.2(5)(b)(v)(A) (that is, the amount which is subtracted from the balance of the deceased's cumulative Canadian development expense account as a result of the deemed disposition

described in 5 above). For example, if the deceased died in 1976 owning a mining claim acquired in 1970, 80% of the value of this claim at the time of death would be treated as proceeds of disposition and would be accounted for as a deduction in computing the "cumulative Canadian development expense" account. Assuming no positive elements in the account, this amount would be included in the income of the deceased for the year of death (paragraph 59(3.2)(c)). If a child of the deceased inherits the claim, the child's cost is the amount so deducted in the account.

7. By virtue of subsection 59(3) and (3.1), the related person acquiring the property is also deemed to have owned it on December 31, 1971, and thereafter without interruption, and accordingly, the relevant percentage provisions in section 59 will apply to the proceeds of disposition if that person should subsequently dispose of the property.

Transfers to Spouse or Spouse Trust

8. Paragraph 70(5.2)(d) provides that where a resource property as described in paragraphs 59(2)(a) to (c) was owned by a taxpayer resident in Canada immediately before his death, and no later than 15 months after the taxpayer's death becomes vested indefeasibly in the spouse, or a trust for the spouse referred to in paragraph 70(6)(b), the following rules apply:

- (a). The deceased taxpayer's legal representatives may specify the amount of the proceeds deemed to have been received, but this amount may not exceed the fair market value of the property immediately before death.
- (b). The cost of acquisition to the spouse or trust is the portion of the amount specified by the deceased taxpayer's legal representatives which is included in the deceased's income or which is included in the amount referred to in clauses 66.2(5)(b)(v)(A) or 66.4(5)(b)(v)(A), as the case may be, by virtue of subsection 59(1), (1.1), (1.2), (3), or (3.1).
- (c). Where the spouse or trust subsequently disposes of property in respect of which subsection 59(3) or (3.1) applied, the spouse or trust is deemed to have owned the property on December 31, 1971 and thereafter without interruption until that subsequent disposition, and accordingly the relevant percentage provisions in section 59 apply to the proceeds from the disposition.

Payment of Tax in Installments

9. The additional tax payable where subsection 70(5.2) is applicable may be paid in up to ten equal consecutive annual installments when the conditions in subsection 159(5) are met and when the death occurs after 1977.

Periodic Payments and Rights and Things.

While subsections 70(5), (5.1), (5.2) cause dispositions of capital property of the testator to be recognized on death whereby the proceeds are determined and other provisions then apply to cause income computations subsections 70(1) and (2) apply upon the death of a taxpayer regardless of his residence, to cause him to include directly and fully in his income amounts in respect of property that when disposed of or satisfied *inter vivos* would have been directly included in his income. They do not specifically cause the testator to recognize a deemed disposition. Subsection 70(1) applies to cause the **value** of interest, rent, royalty, annuity, (other than described in Sec. 148(2)(b)), remuneration from office or employment or other "periodic payment" deemed accruing up to the day of death in equal daily amounts since the time it was last paid to be included in computing the deceased's income. The "value" in this case⁴⁵⁴ is that net of amounts that would be deductible had they been actually realized prior to death thus interest or other deductible amounts will reduce the amount of value to be included in the taxpayer's income under Sec. 70(1) in respect of royalties or interest revenue even if they haven't been paid.⁴⁵⁵

In I.T. 210R the Department is of the opinion, in para. 4, that it will allow excess expenses deductible against the periodic payment, after it has reduced its value to nil, to be applied to other sources of income. The Act, as well as the I.T.s to the author's best knowledge, are silent on whether such amounts included under Sec. 70(1)

454. as provided in the Department's opinion contained in I.T. 210R,

455 Where there is a question as to whether a certain asset has the nature of a periodic payment or a right or thing described and attended to be Sec. 70(2) the matter will be resolved, administratively, in the taxpayer's favor usually.

will be included again when realized by the beneficiaries of, or by, the estate. Technically such accrued income can not be the estate's income since it did not accrue as income during the time that the estate existed.

Subsection 70(1) was also amended in the 1988 reform to apply to investment tax credits deducted by the taxpayer in previous years that are, as per Sec. 12(1)(t), required to be included in computing income of a taxpayer **unless** they led to an adjustment in the capital cost of the property that formed the I.T.C.'s base (of that or a related property) or that were included previously in the taxpayer's income under Sec. 12(1)(t).

The Sec. 12(1)(t) inclusion is inapplicable if the I.T.C. led to a subject property cost adjustment under Sec. 13(7.1)(e), (21)(f)(viii), 37(1)(e), 66.1(6)(b)(vii), or 53(2)(h)(ii)⁴⁵⁶. The Sec. 70(1) provision doesn't include such amounts itself, but causes Sec. 12(1)(t) to be read as not referring to acquisitions or expenditures, (which rewarded an I.T.C.), in a **previous** tax year, (which it does), thus capturing I.T.C.'s taken in the terminal year in respect of qualified acquisitions or expenditures made **in the terminal year**. Thus if an I.T.C. in respect of a terminal year acquisition is deducted from taxes payable, and it doesn't cause an adjustment in the capital cost of the property it will be included in income and a circular computation will result.

On the issue of whether rights or things can include RRSP entitlements Estate of Peter A. Baak and Her Majesty the Queen⁴⁵⁷, a TCC, provides some interesting discussion with:

Legislation

[5] Subsection 70(1) sets out how a deceased taxpayer's income is to be calculated for the year of death and commonly referred to as the terminal return. Subsection 70(2) reads:

70(2) Where a taxpayer who has died had at the time of death **rights or things** (other than any capital property or any amount included in computing the taxpayer's income by virtue of subsection (1)), the amount of which when realized or disposed of would have been included in computing the taxpayer's income, the value thereof at the time **of death** shall be included in computing the taxpayer's income for the taxation year in which the taxpayer died, unless the taxpayer's legal representative has, not later than the day that is one year after the date of death of the taxpayer or the day that is 90 days after the mailing of any notice of assessment in respect of the tax of the taxpayer for the **year of death**, whichever is the later day, elected otherwise, in which case the legal representative shall file a separate return of income for the year under this Part and pay the tax for the year under this Part as if

- (a) the taxpayer were another person;
- (b) that other person's only income for the year were the value of the **rights or things**; and
- (c) subject to sections 114.2 and 118.93, that other person were entitled to the deductions to which the taxpayer was entitled under sections 110, 118 to 118.7 and 118.9 for the year in computing the taxpayer's taxable income or tax payable under this Part, as the case may be, for the year.

Other relevant provisions of the *Act* are as follows:

146(8) There shall be included in computing a taxpayer's income for a taxation year the total of all amounts received by the taxpayer in the year as benefits out of or under registered retirement savings plans, other than excluded withdrawals (as defined in subsection 146.01(1) or 146.02(1)) of the taxpayer and amounts that are included under paragraph (12)(b) in computing the taxpayer's income.

146(8.8) Where the annuitant under a registered retirement savings plan (other than a plan that had matured before June 30, 1978) dies after June 29, 1978, the annuitant **shall be deemed** to have received, **immediately** before the annuitant's **death**, an amount as a benefit out of or under a registered retirement savings plan equal to the amount, if any, by which

- (a) the fair market value of all the property of the plan at the **time of death** exceeds

⁴⁵⁶ the latter two concerning partnership interests and capital interests in trusts other than where they are personal and where the interest was not acquired for consideration

⁴⁵⁷ 2001-567(IT)l

(b) where the annuitant died after the maturity of the plan, the fair market value at the time of the death of the portion of the property described in paragraph (a) that, as a consequence of the death, becomes receivable by a person who was the annuitant's spouse or common-law partner **immediately before the death**, or would become so receivable should that person survive throughout all guaranteed terms contained in the plan.

[Emphasis added]

[6] The Appellant in his submissions devoted considerable time to defining certain words and phrases, including whether an RRSP was "rights or things", "deem or deemed", "immediately", "death" and "context". The subsection 15(1) *Charter* submissions appear to be the Appellant's primary argument.

Analysis

[7] I will first deal with whether, upon a taxpayer's death, RRSPs can be claimed as "rights or things" within the meaning of subsection 70(2). Subsection 70(1) sets out how a taxpayer's income shall be calculated for the year of death. Subsection 70(2) permits the taxpayer's legal representative to claim on a separate income return, the value of rights or things that the taxpayer had at the time of his death. Subsection 146(8) applies to this case. It requires the Appellant to include in income for the year, the total amount of benefits received out of his RRSPs during the year. Subsection 146(8.8) deems any amount of the RRSPs held by the taxpayer at the time of his death to have been received immediately before his death.

[8] I agree with the Minister of National Revenue's position that RRSPs are not "rights or things" within the meaning of subsection 70(2).

[9] Counsel for the Respondent referred me to *L. Lamash Estate v. M.N.R.*, [1990] 2 C.T.C. 2534. The facts in *Lamash* are similar to the present ones. The Minister denied the executor of the Lamash Estate's claim that RRSPs were "rights or things" and not to be included as income. The Tax Court upheld the Minister's decision. I agree with the decision and reasons for it set out by Christie J. I will not review his reasons in detail, but refer to his comments on page 2539:

I regard subsections 70(2) and 146(8.8) as being in the same context for the purposes of statutory interpretation and I agree that the late Lillian Lamash is deemed to have received, immediately before her death, the \$19,096.67 in dispute and consequently she could not have had rights, within the meaning attributable to that word in subsection 70(2), in relation to those funds at the time of her death. The subsection speaks of rights the amount whereof when realized or disposed of would have been included in computing the deceased's income. In *Cullity, Forbes, Brown, Taxation and Estate Planning*, 2d ed. Carswell, Toronto, this is said at pages 68-69:

Registered Retirement Savings Plans, Etc.

17. A taxpayer is not considered to have a right or thing in respect of a registered retirement savings plan, whether matured or not, of which he was, until his death, the annuitant. However, except in the case of a plan that had matured before June 30, 1978, where the annuitant dies after June 29, 1978, the fair market value of all the property of the plan at the time of death (less amounts receivable by the spouse of the deceased or received as a refund of premiums by a child, grandchild or other beneficiary of the deceased, as described in subsections 146(8.8) to (8.91)) must be included in the income of the deceased on his final return by virtue of subsection 146(8.8). Similarly, a taxpayer is not considered to have a right or thing in respect of a registered retirement income fund or a registered home ownership savings plan.

[10] I find the wording of subsections 70(2), 146(8) and 146(8.8) clear and unambiguous. Their plain and ordinary meaning is determinative with respect to their interpretation.[1] I do not find the phrase "immediately before death" ambiguous and do not accept the Appellant's argument. I accept the Respondent's reasons for concluding that Parliament intended that RRSP proceeds are income in the year of death unless they qualify under certain exceptions that do not apply to the present circumstances.

Income Tax Interpretation Bulletin

Income of Deceased Persons -- Periodic Payments and Investment Tax Credit

IT-210R2

DATE: November 22, 1996

SUBJECT: INCOME TAX ACT

Income of Deceased Persons -- Periodic Payments and Investment Tax Credit

REFERENCE: Subsection 70(1) (also subsections 70(2) and (3); and paragraphs 12(1)(t) and 148(2)(b) of the *Income Tax Act*)

Notice -- Bulletins do not have the force of law

This document is also available for download in PDF format.

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Explanation of Changes

Application

This bulletin cancels and replaces Interpretation Bulletin IT-210R, *Income of Deceased Persons -- Periodic Payments*, dated November 5, 1982.

Summary

The purpose of subsection 70(1) is to require certain amounts to be included in computing the income of a taxpayer for the year of death.

This bulletin discusses the tax treatment of certain amounts payable periodically that had accrued but were not received at the time of death. It also explains the tax treatment of any related accrued expenses. As well, the bulletin outlines the tax consequences when an amount of investment tax credit is claimed for the year of death or a previous year.

Discussion and Interpretation

General

¶ 1. Under paragraph 70(1)(a), an amount payable on a periodic basis that was not paid to a taxpayer before the taxpayer's death is deemed to have accrued in equal daily amounts in the period for which the amount was payable. The value of the portion that is deemed to have accrued to the date of death is required to be included in computing the taxpayer's income for the year of death. Paragraph 70(1)(a) applies to amounts of interest, rents, royalties, annuities (other than an interest in an annuity contract to which paragraph 148(2)(b) applies), remuneration from an office or employment, and other amounts payable periodically. This provision does not apply to amounts which had become payable before death.

Accrued interest

¶ 2. If a deceased taxpayer owned a term deposit or other similar investment on which interest was payable periodically, interest accrued from the last date on which interest was payable up to the date of death would

be included in income for the year of death under paragraph 70(1)(a). However, if the taxpayer also had on hand a matured investment (such as a matured Treasury Bill or uncashed matured bond interest coupons) at the date of death, any interest that was owing to the deceased taxpayer on the matured investment immediately before the date of death would be considered a right or thing for the purposes of subsection 70(2) to the extent the amount was not included or required to be included in the deceased's income for the year or a preceding year. For information about the tax treatment of "rights or things," refer to the current version of IT-212, *Income of Deceased Persons -- Rights or Things*.

Accrued salary or wages

¶ 3. Only the amount of salary or wages accrued from the beginning of the pay period in which an employee dies to the date of death is included in the employee's income under paragraph 70(1)(a). When the amount due and unpaid is in respect of a prior pay period, such amount would be included in income under subsection 70(2). If, prior to the death of an employee, the employer is committed (say because of union bargaining) to pay retroactive salary or wage adjustments, but these are unpaid at the date of the employee's death, the amount due to the employee is included in income under subsection 70(2).

Genuine doubt about the nature of income

¶ 4. Where there is genuine doubt about whether the nature of income earned before a taxpayer's death is a periodic payment or a right or thing, its treatment is generally resolved in favour of the taxpayer. As a result, the legal representative may report the income in question under paragraph 70(1)(a) or under subsection 70(2). In the latter case, depending upon the timing, an election under that provision may be made, or if the income has been transferred to beneficiaries, subsection 70(3) applies instead of subsection 70(2).

Deduction of related accrued expenses

¶ 5. Any accrued expenses related to the amount included in income under paragraph 70(1)(a) may be deducted provided that the expenses would have been deductible if paid (e.g., interest expense and property taxes). When such expenses exceed the gross amount included in income, the excess is deductible from other income of the taxpayer.

Reporting requirements

¶ 6. Amounts included in income under paragraph 70(1)(a) and any related accrued expenses that are deductible are reported in the taxpayer's "ordinary" income tax return for the year of death.

Investment tax credit

¶ 7. When an amount of investment tax credit has been deducted from a taxpayer's tax payable for the year of death or a previous year, the rule in paragraph 12(1)(t), as modified by paragraph 70(1)(b), applies. The amount is required to be included in the taxpayer's income for the year of death to the extent that the amount was not included in income under paragraph 12(1)(t) for a previous year or is not used to reduce the tax basis of the related expenditure (i.e., the undepreciated capital cost of depreciable property, the adjusted cost base of certain interests in a partnership or a trust, the amount of deductible scientific research expenditures, or the amount of qualified Canadian exploration expenditures).

Explanation of Changes

Introduction

The purpose of the *Explanation of Changes* is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised departmental interpretations.

Reasons for the Revision

We have revised bulletin IT-210R to clarify our position with respect to the deduction of accrued expenses and to reflect amendments to subsection 70(1) by S.C. 1980-81-82-83, c. 140 (formerly Bill C-139) and by S.C. 1988, c. 55 (formerly Bill C-139). The comments in the bulletin are not affected by any draft legislation released before July 29, 1996.

Legislative and Other Changes

¶s 1, 2 and 3 replace former ¶ 1. These paragraphs reflect the amendment to renumber the rule regarding periodic payments in subsection 70(1) as paragraph 70(1)(a) and to add new paragraph 70(1)(b) which is discussed in new ¶ 7. This amendment to subsection 70(1) took effect in 1988. ¶ 1 also reflects an amendment which clarifies that the reference to an annuity in subsection 70(1) (as it read before 1988) does not include an interest in those annuity contracts to which paragraph 148(2)(b) applies. This latter amendment took effect after November 12, 1981.

¶ 5 (former ¶s 3 and 4) is revised so that it only comments on the deduction of related accrued expenses. The deductibility of such expenses are determined under the relevant provision of the Act and the amounts claimed are reported in the appropriate places on the taxpayer's income tax return.

New ¶ 7 reflects the enactment of paragraph 70(1)(b) as a consequence of amendments to paragraph 12(1)(t) and other provisions of the Act relating to the investment tax credit.

Throughout the bulletin, we have changed some of the wording to improve readability.

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Interpretation bulletins (ITs) provide Revenue Canada's technical interpretations of income tax law. Due to their technical nature, ITs are used primarily by departmental staff, tax specialists, and other individuals who have an interest in tax matters. For those readers who prefer a less technical explanation of the law, the Department offers other publications, such as tax guides and pamphlets.

While the ITs do not have the force of law, they can generally be relied upon as reflecting the Department's interpretation of the law to be applied on a consistent basis by departmental staff. In cases where an IT has not yet been revised to reflect legislative changes, readers should refer to the amended legislation and its effective date. Similarly, court decisions subsequent to the date of the IT should be considered when determining the relevancy of the comments in the IT.

An interpretation described in an IT applies as of the date the IT is published, unless otherwise specified. When there is a change in a previous interpretation and the change is beneficial to taxpayers, it is usually effective for all future assessments and reassessments. If the change is not favourable to taxpayers, it will normally be effective for the current and subsequent taxation years or for transactions entered into after the date of the IT.

A change in a departmental interpretation may also be announced in the *Income Tax Technical News*.

If you have any comments regarding matters discussed in this IT, please send them to:

Director, Business and Publications Division

***Income Tax Rulings Directorate
Policy and Legislation Branch
Revenue Canada
Ottawa ON K1A 0L5***

Subsection 70(1) computes into income periodic payments that the deceased would have otherwise realized and recognized as income but that were at the time of his death not distributable to him while subsection 70(2) applies to "rights or things" other than capital property or that described in Sec. 70(3.1), which when realized or disposed of would be included in computing his income.⁴⁵⁸

The property to which the subsection doesn't apply includes an interest in a life insurance policy, eligible capital property, land inventory, or resource property commented on under Sec. 70(5.2), and, of course, capital

458. Examples of such property include farm crops, accounts receivable of cash based fishermen and farmers, unpaid salary, dividends that have been declared but not paid. Would a personal license to the use of trust property that is consequentially unassignable due to its very nature constitute a right or thing for these purposes when realized it would not lead to an income inclusion? A right to trust income has been held to be a capital property, (*Gadsden v. M.N.R.*, 83 D.T.C. 127), and an "income" property, (*Evans v. M.N.R.*, 60 D.T.C. 1047 (SCC), *Hall v. M.N.R.*, 71 D.T.C. 5217), however regardless of whether it is held income or capital Sec. 106(2) requires an income inclusion when it is realized thus it would be fully subject to Sec. 70(2). As per *Lamash Estate v. M.N.R.*, 1990 2 C.T.C. 2534 TCC, a right to receive the proceeds from a RRSP contract is not a right or thing for purposes of Sec. 70(2) but requires a Sec. 146(8.8) inclusion. It also isn't a death benefit.

property captured by the Sec. 70(5)-(6) mechanics⁴⁵⁹.

The subsection, like Sec. 70(1), includes in income only **the value** of the property (right or thing), net of expenses that would otherwise have been deductible while it is substantially different from Sec. 70(1) in that it allows the deceased to elect to have all of such possible inclusions recognized in one single separate additional return as if from a different person, (thus allowing them to possibly benefit from a lower effective tax rate). The legal representative of the deceased, (possibly acting upon the last testament), may also act through assent to transfers to the beneficiaries if so stated in the will, under Sec. 70(3), to have them taxed instead in the hands of the beneficiaries of the estate as they are ultimately realized or disposed of. Thus, they are includable in the terminal return, in a separate terminal return, or if assented to their dispositions cited in the will, they are recognizable by the beneficiaries.

“Amounts receivable – Sec. 70(2)”

(2) Where a taxpayer who has died had at the time of death rights or things (other than any capital property or any amount included in computing the taxpayer’s income by virtue of subsection 70(1)), the amount of which when realized or disposed of would have been included in computing the taxpayer’s income, the value thereof at the time of death shall be included in computing the taxpayer’s income for the taxation year in which the taxpayer died, unless the taxpayer’s legal representative has, not later than the day that is one year after the date of death of the taxpayer or the day that is 90 days after the mailing of any notice of assessment in respect of the tax of the taxpayer for the year of death, whichever is the later day, elected otherwise, in which case the legal representative shall file a separate return of income for the year under this Part and pay the tax for the year under this Part as if

(a) the taxpayer were another person;

(b) that other person’s only income for the year were the value of the rights or things; and

(c) subject to sections 114.2 and 118.93, that other person were entitled to the deductions to which the taxpayer was entitled under sections 110, 118 to 118.7 and 118.9 for the year in computing the taxpayer’s taxable income or tax payable under this Part, as the case may be, for the year.

The Election.

Under the election in respect of rights or things to have them reported on a separate return, the beneficiaries will not recognize an income inclusion. An election to report on a separate return should almost always be taken since there are additional separate return will result in lower bracket rates of taxation. There is a balancing act though since there are certain limitations one has when electing, below noted.

The election must be made within one year after the day of death or within 90 days of the mailing of a notice of assessment in respect of tax on the terminal year’s income, whichever is later.

Another advantage of the election⁴⁶⁰, is that the separate artificial person will be allowed the deductions under sections 110, 118 (charitable gifts), to 118.7, (U.I. & C.P.P. premium/contribution credit), as well as being allowed transfers to spouses under section 118.9 in computing his taxable income or tax payable, section 118.93 operates to disallow the aggregate of deductions in Sec. 118(3) and sections 118.1 to 118.7 and 118.9 taken through the four possible separate returns of a deceased from exceeding that amount that would be deducted had only one return been filed, while section 114.2, does the same with respect to section 110 Division C deductions only.

The separate return must include all of the Sec. 70(2) possible inclusions while if the legal representative acts within the same period of time, some of them may be affected under subsection 70(3) which will apply to roll them through to the beneficiaries.⁴⁶¹ If the election is erroneously made it can be revoked, via Sec. 70(4), by a notice to the Minister delivered within the time period for making the election if signed by the legal

⁴⁵⁹ as well as income averaging annuity contracts, matured or unmatured RRSPs, and RRIFs.

⁴⁶⁰ although limited by the effect of sections 114.2 or 118.93

⁴⁶¹ A good planing point is to have the executor selectively assent to the bequest of certain rights or things on a timely basis so as to cause Sec. 70(3) to apply to them and then have the alternative reporting apply to the balance.

representative who need not have originally made the election.⁴⁶²

Subsection 70(3) applies to rights that would otherwise be subject to Sec. 70(2) hence, the roll through and the separate return, or, the roll through and the ordinary terminal year return, can **share** the recognition, but not the separate return and the ordinary terminal year return. For the last, it's all or nothing.⁴⁶³

Subparagraphs 115(1)(a)-(b) will not cause Sec. 70(2) to apply to a non-resident while since a payment is not being made Part XIII will also not apply. The ultimate realization of the proceeds of the right or thing will be subject to withholding rates as applicable though.

"Rights or things transferred to beneficiaries – Sec. 70(3)"

(3) Where before the time for making an election under subsection 70(2) has expired, a right or thing to which that subsection would otherwise apply has been transferred or distributed to beneficiaries or other persons beneficially interested in the estate or trust,

(a) subsection 70(2) is not applicable to that right or thing; and

(b) an amount received by one of the beneficiaries or persons on the realization or disposition of the right or thing shall be included in computing the income of the beneficiary or person for the taxation year in which the beneficiary or person received it.

"Idem, where s. 70(3) applies – Sec. 69(1.1)"

(1.1) Where a taxpayer has acquired property that is a right or thing to which subsection 70(3) applies, the following rules apply:

(a) paragraph 69(1)(c) is not applicable to that property; and

(b) the taxpayer shall be deemed to have acquired the property at a cost equal to the total of

(i) such part, if any, of the cost thereof to the taxpayer who has died as had not been deducted by the taxpayer in computing the taxpayer's income for any year, and

(ii) any expenditures made or incurred by the taxpayer to acquire the property.

Income Tax Interpretation Bulletin

Returns of Deceased Persons as "Another Person"

IT-326R3

DATE: November 13, 1996

SUBJECT: INCOME TAX ACT

Returns of Deceased Persons as "Another Person"

REFERENCE: Sections 114.2 and 118.93 (also sections 110, 118, 118.1 to 118.9, and 180.2; subsections 70(2) and 150(4); and paragraph 104(23)(d) of the *Income Tax Act*)

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⁴⁶²

Sec. 70(4)

(4) Revocation of election. An election made under subsection (2) may be revoked by a notice of revocation signed by the legal representative of the taxpayer and filed with the Minister within the time that an election under that subsection may be made.

⁴⁶³ For jurisprudence on valuation of life interests see *In the Will of Tyson*, 1907 Q.S.R. 52, Re: Jaeger, 1961 V.R. 14, *Perpetual Trustee Co. Ltd. v. Shelly*, 1921 21 S.R.(N.S.W.) 426, *Chesterman v. F.C.T.*, 32 C.L.R. 362 & 37 C.L.R. 317, and value of life interest in accompany to obligation to use it to maintain children, Re: Botting, 10th May 1895 S.A. Advertiser (newspaper) (S.A. Sup. Ct. F.C.).

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Explanation of Changes

Application

This bulletin replaces and cancels Interpretation Bulletin IT-326R2 dated February 2, 1990.

Summary

The legal representative of a deceased person must file an income tax return (referred to in this bulletin as an "ordinary return") reporting the income of the deceased from January 1 of the year of death to the date of death. In certain circumstances the legal representative has the opportunity to exclude specific types of income from the "ordinary" return and report them on separate income tax returns as if the taxpayer were "another person." A separate return may be filed to report the value of the deceased person's rights or things. Similarly, where the fiscal period of a testamentary trust or unincorporated business ends in the year and before the taxpayer's death, the deceased person's share of the income from the testamentary trust or the business for the period from the end of the fiscal period to the date of death may be reported on a separate return.

The purpose of sections 114.2 and 118.93 is to limit the total of certain deductions and certain non-refundable tax credits claimed on the ordinary and separate returns to the amount that could be claimed if only the ordinary return were filed.

The age tax credit, the basic personal tax credit, the spousal tax credit, the equivalent-to-spouse tax credit, and the dependant tax credit that apply in the ordinary return for the year of death may also be deducted in each of the separate returns filed. Certain other tax credits, as well as certain deductions allowable in calculating taxable income, may be deductible in the separate returns or in the ordinary return. However, the total of these other tax credits and deductions may not exceed the amount that could be deducted if only the ordinary return were filed with all of the income, deductions and credits reported therein.

This bulletin identifies the income that can be reported in the separate returns and discusses the deductions from taxable income and tax credits that may be claimed when such returns are filed.

Discussion and Interpretation

Separate returns

¶ 1. Subsection 70(2), paragraph 104(23)(d) and subsection 150(4) each allow the filing of an income tax return for certain portions of a deceased person's income for the year of death as if the return were that of another person. Such a return is available upon election:

(a) under subsection 70(2), to report the value of rights or things which would normally enter into the computation of income on realization or disposition (see the current version of IT-212, *Income of Deceased Persons -- Rights or Things*);

(b) under paragraph 104(23)(d), where a beneficiary of a testamentary trust dies after the end of the taxation year of the trust but before the end of the calendar year in which the taxation year ended, to report any income from the trust during the period from the end of that taxation year to the date of death; and
(c) under subsection 150(4), where a partner or an individual proprietor of a business dies after the end of the fiscal period of the business but before the end of the calendar year in which the fiscal period ended, to report the income from that business pertaining to the period from the close of that fiscal period to the date of death (see the current version of IT-278, *Death of a Partner or a Retired Partner*).

The election in (a) must be made within one year after the date of death, or 90 days after the mailing of any notice of assessment or reassessment for the year of death, whichever is later.

In order to avoid possible late filing penalties the elections in (b) and (c) should be made by April 30 of the year following the year of death or six months after the date of death, whichever is later. However, for 1995 and later taxation years, the due date for making the elections in (b) and (c) above may be extended for a deceased person if the deceased person, or the deceased person's spouse, carried on a business in the year of death (except where the expenditures of the business are primarily the cost or capital cost of "tax shelters"). In such circumstances, the due date for making the elections is:

- on or before June 15 of the year following the year of death if the individual died during the period January 1 to December 15;
- within six months after the date of death if the individual died during the period December 16 to December 31 or during the period January 1 to June 14 of the following year (i.e. before the individual's filing due date for the previous year had the individual not died).

Note that although the due date for making the elections in (b) and (c) above may be extended as described above, interest at the prescribed rate will be assessed on any unpaid balance from the later of April 30 of the year following the year of death or six months after the date of death.

The appropriate flow-through rules for partnerships will apply in respect of the return described in (c) above (see the current version of IT-138, *Computation and Flow-through of Partnership Income*).

Credits and deductions allowed

Deductions in computing taxable income

¶ 2. Pursuant to section 114.2, the total of all deductions under section 110 that may be claimed on the ordinary and separate returns filed on behalf of the deceased person may not exceed the amount that could be claimed if only the ordinary return were filed with all income included therein. The deductions provided under section 110 include deductions in respect of:

- employee stock option benefits included in income -- paragraph 110(1)(d) or (d.1) (see the current version of IT-113, *Benefits to Employees -- Stock Options*);
- an amount included in income in respect of prospector's and grubstaker's shares -- paragraph 110(1)(d.2);
- income exempt under a tax treaty -- subparagraph 110(1)(f)(i);
- certain compensation amounts received under an employers' or workers' compensation law for injury, disability or death -- subparagraph 110(1)(f)(ii) (see the current version of IT-202, *Employees' or Workers' Compensation*);
- an amount included in income in respect of a home relocation loan -- paragraph 110(1)(j) (see the current version of IT-421, *Benefits to Individuals, Corporations and Shareholders from Loans or Debt*); and
- a vow of perpetual poverty -- subsection 110(2) (see the current version of IT-86, *Vow of Perpetual Poverty*).

¶ 3. The deductions under section 110 (such as under paragraphs 110(1)(d) and (f)) which relate to a particular source of income can be claimed on a given return only to the extent of the income from the particular source reported on that return.

Non-refundable tax credits

¶ 4. Where a portion of the income of a deceased person is reported on a separate return as though it were the income of "another person," the personal tax credits that applied to the deceased person's ordinary return for the year may also be claimed on each of the separate returns filed pursuant to subsection 70(2),

paragraph 104(23)(d) or subsection 150(4). The personal tax credits, which are provided by paragraphs 118(1)(a) to (d) and subsection 118(2), are the basic personal tax credit, the spousal tax credit, the equivalent-to-spouse tax credit, the dependant tax credit, and the age tax credit. See the current version of IT-513, *Personal Tax Credits*.

¶ 5. Pursuant to section 118.93, the total of all tax credits that may be claimed under subsection 118(3) and sections 118.1 to 118.7 and 118.9 on the ordinary and separate returns filed on behalf of the deceased person cannot exceed the amount that would be deducted under those provisions if no separate returns were filed (referred to in this bulletin as the "overall limitation rule"). In general terms these tax credits may be described as follows:

- (a) the tax credit for an individual who is in receipt of certain pension income -- subsection 118(3) (see the current version of IT-517, *Pension Tax Credit*);
- (b) the tax credit for total gifts -- section 118.1 (see ¶ 8 below and the current version of IT-110, *Deductible Gifts and Official Donation Receipts*);
- (c) the tax credit for medical expenses -- section 118.2 (see ¶ 7 below and the current version of IT-519, *Medical Expense and Disability Tax Credits and Attendant Care Expense Deduction*);
- (d) the tax credit for an individual who has a severe and prolonged mental or physical impairment -- section 118.3 (see the current version of IT-519);
- (e) the tax credit for tuition fees of a student who is enrolled at an appropriate educational institution -- section 118.5 (see the current version of IT-516, *Tuition Tax Credit*);
- (f) the tax credit for a student enrolled in a qualifying education program at a designated educational institution -- section 118.6 (see the current version of IT-515, *Education Tax Credit*);
- (g) the tax credit for employee premiums for Unemployment Insurance and employee contributions to the Canada Pension Plan or Quebec Pension Plan -- section 118.7; and
- (h) the tax credit in respect of unused tax credits for tuition or education (see (e) and (f) above) that are transferred to the student's parent or grandparent -- section 118.9.

¶ 6. The tax credits under sections 118.1, 118.2, 118.3, 118.5, 118.6 and 118.9 may be claimed on any of the returns regardless of the type of income reported on the return. However, the tax credits under section 118.7 and subsection 118(3) may only be claimed on those returns on which the related income is reported.

¶ 7. For the purpose of the overall limitation rule in section 118.93, in determining the maximum amount that may be claimed as a medical expense tax credit under section 118.2 (see the current version of IT-519), qualifying medical expenses are reduced by the lesser of the dollar amount specified in the T1 individual income tax return for the year for this purpose (\$1,614 for 1995) and 3% of the total net income reported on **all** of the returns.

¶ 8. As noted in ¶ 6 above, the tax credit for total gifts, as determined by the formula in subsection 118.1(3), may be claimed on any of the returns filed on behalf of a deceased person. Subject to the overall limitation rule in section 118.93, the tax credit is based on the total for the year of "total Crown gifts," "total cultural gifts," "total ecological gifts" (for ecological gifts made after February 27, 1995), and the lesser of "total charitable gifts" and 20% of the net income that is reported on that return.

Note: *The Federal Budget tabled by the Minister of Finance on March 6, 1996 contains a proposal to raise the limit for charitable donations, for 1996 and subsequent taxation years, to 100% of an individual donor's income for the year in which the individual dies and for the preceding year.*

Credits and deductions not allowed

Deductions in computing net income

¶ 9. When calculating the income of a deceased person on the separate returns filed as "another person" under subsection 70(2), paragraph 104(23)(d) or subsection 150(4), the following types of expenses cannot be deducted:

- child care expenses -- section 63 (see the current version of IT-495, *Child Care Expenses*); and
- attendant care expenses -- section 64 (see the current version of IT-519).

Deductions in computing taxable income

¶ 10. The following deductions are not applicable in determining the taxable income of a deceased person in any of the separate returns filed as "another person":

- capital gains deduction -- section 110.6;
- northern residents deductions -- section 110.7; and
- losses -- section 111.

Tax credits

¶ 11. The transfer of unused tax credits from a spouse under section 118.8 is not applicable in determining the tax payable of a deceased person on any of the separate returns filed as "another person."

¶ 12. The following tax credits cannot be deducted in calculating the income tax payable of a deceased person on any of the separate returns filed as "another person":

- the refundable goods and services tax credit -- section 122.5;
- the refundable child tax benefit -- sections 122.6 to 122.64; and
- the refundable investment tax credit -- section 127.1.

¶ 13. The election under subsection 127(8.4) to renounce investment tax credits which have been allocated to a partner pursuant to subsections 127(8) and (8.3), cannot be made on any of the separate returns filed as "another person."

Other considerations

¶ 14. Pursuant to subsection 110.4(5), the forward averaging amount brought into income under subsection 110.4(2) cannot be reported in any of the separate returns filed as "another person."

¶ 15. By virtue of section 127.55, minimum tax is not imposed on any of the separate returns filed as "another person." As well, subsection 120.2(4) provides that any minimum tax credits arising from another taxation year cannot be applied to reduce the tax payable in respect of the separate returns.

¶ 16. Section 180.2 (Part I.2) provides for the repayment of Old Age Security benefits when an individual's net income, as modified by that section, exceeds a base amount for a taxation year. In the case of a deceased person, the Part I.2 tax is applied separately to each tax return filed on the deceased person's behalf. Therefore, the income reported on a separate return would not be relevant in determining the Part I.2 tax payable on the ordinary return and vice versa.

Explanation of Changes

Introduction

The purpose of the *Explanation of Changes* is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised departmental interpretations.

Overview

This bulletin deals with the effect of sections 114.2 and 118.93 when a separate income tax return is filed under subsection 70(2), paragraph 104(23)(d) or subsection 150(4) in addition to the ordinary return filed on behalf of a deceased person. Sections 114.2 and 118.93 limit the total of certain non-refundable tax credits and deductions claimed on the ordinary and separate income tax returns to the amount that could be claimed if only the ordinary return were filed.

The bulletin reflects amendments by S.C. 1990, c. 39 (formerly Bill C-28); S.C. 1990, c. 45 (formerly Bill C-62); S.C. 1994, c. 7, Schedule II (1991, c. 49 -- formerly Bill C-18); S.C. 1994, c. 7, Schedule VII (1992, c. 48 -- formerly Bill C-80); S.C. 1995, c. 3 (formerly Bill C-59); and S.C. 1996, c.21 (formerly Bill C-36). The bulletin also reflects the Federal Budget tabled on March 6, 1996.

The comments in the bulletin are not affected by any other draft legislation released before September 3, 1996.

Legislative and Other Changes

¶ 1 reflects amendments to paragraphs 150(1)(b) and (d), applicable for 1995 and later taxation years, which in most cases will extend the due date for making the elections under paragraph 104(23)(d) and subsection 150(4) where the deceased or the deceased's spouse carried on business in the year of death.

New ¶ 2 (former ¶ 3) has been modified to replace the list of section 110 related IT bulletins with a current list of available section 110 deductions.

In new ¶ 3 (last part of former ¶ 5), we have removed the reference to paragraph 110(1)(i) which was repealed applicable to the 1989 and later taxation years.

Paragraph 110(1)(i) provided for a deduction for the repayment of unemployment insurance benefits in computing taxable income. This deduction has been replaced with a deduction under paragraph 60(v.1) in computing net income.

New ¶ 7 (second part of former ¶ 5) has been revised to replace the reference to \$1,500 with \$1,614 which is the applicable amount for 1995.

New ¶ 8 (third part of former ¶ 5) reflects the amendment to the definition of "total gifts" in subsection 118.1(1) to delete the words "computed without reference to subsection 137(2)," applicable after December 11, 1988 and to add "total ecological gifts" for such gifts made after February 27, 1995. In addition, we have removed the comments dealing with the calculation of the tax credit for total gifts since the calculation is included in the T1 individual income tax return.

New ¶ 9 (former ¶ 6) has been revised to add a reference to the deduction for attendant care expenses.

New ¶ 12 (former ¶ 9) has been revised to reflect the repeal of:

- the refundable federal sales tax credit, applicable to 1991 and later years; and
- the refundable child tax credit, applicable to 1993 and later years.

These credits were replaced by the refundable goods and services tax credit and the refundable child tax benefit, respectively.

New ¶ 15 (former ¶ 12) has been revised to add that the provisions of subsection 120.2(4) do not apply to separate returns filed on behalf of a deceased person.

New ¶ 16 has been added to reflect the Department's position on the application of section 180.2 when more than one tax return is filed on behalf of a deceased person.

Throughout the bulletin, we have changed some of the wording and the ordering of some paragraphs to improve clarity.

Notice -- Bulletins do not have the force of law

Interpretation bulletins (ITs) provide Revenue Canada's technical interpretations of income tax law. Due to their technical nature, ITs are used primarily by departmental staff, tax specialists, and other individuals who have an interest in tax matters. For those readers who prefer a less technical explanation of the law, the Department offers other publications, such as tax guides and pamphlets.

While the ITs do not have the force of law, they can generally be relied upon as reflecting the Department's interpretation of the law to be applied on a consistent basis by departmental staff. In cases where an IT has not yet been revised to reflect legislative changes, readers should refer to the amended legislation and its effective date. Similarly, court decisions subsequent to the date of the IT should be considered when determining the relevancy of the comments in the IT.

An interpretation described in an IT applies as of the date the IT is published, unless otherwise specified. When there is a change in a previous interpretation and the change is beneficial to taxpayers, it is usually effective for all future assessments and reassessments. If the change is not favourable to taxpayers, it will normally be effective for the current and subsequent taxation years or for transactions entered into after the date of the IT.

A change in a departmental interpretation may also be announced in the *Income Tax Technical News*.

If you have any comments regarding matters discussed in this IT, please send them to:

Director, Business and Publications Division

Income Tax Rulings Directorate

Policy and Legislation Branch

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The Roll-Through.

Subsection 70(3) provides that where, **within the time period described in Sec. 70(2)**, a right or thing has been transferred or distributed to beneficiaries under "the estate or trust"⁴⁶⁴ Sec. 70(2) will not apply to it and the amount received by such beneficiaries upon its realization or disposition will be included in computing their income for the year in which they **received it. The application of the provision is mandatory and not elective where the conditions exist.** In order to avoid it the executors may have to retain ownership via the withholding of assent until the time period lapses.⁴⁶⁵ The right or thing must be transferred or distributed to, **but not necessarily indefeasibly vested in**, the beneficiaries, not just of the estate but also of any trust arising on death, within one year of death or 90 days after the terminal year's notice of assessment whichever is later. The important note to make is that although the right or thing need not be indefeasibly vested in the beneficiary, (although the beneficiary himself couldn't have been the estate or the trust arising out of the estate or instantaneously upon the taxpayer's death), *inter vivos* trusts, corporations, or even other testamentary trusts may serve as eligible recipients if they are beneficiaries under the estate or trust however the initial estate or trust itself cannot.⁴⁶⁶ There is no equity allowed where the assent is too early and the beneficiary has to make good any short-fall in the estate assets. If assent had been withheld the same tax consequences could have occurred.

Under subsection 69(1.1) where any person has acquired the right or thing which was subject to Sec. 70(3) he shall not be deemed to have acquired it for consideration equal to its fair market value as that described in Sec. 69(1)(c), but instead for a cost equal to its cost to the deceased that was not **deducted** by him in computing his income for any year plus the amount of **"expenditures incurred or made"** by the recipient to acquire it. These fees could include legal representation, accountant's fees, title transfer charges, in the author's opinion trustee fees and probate, or any equitable charges/conditions precedent imposed upon such property by the deceased in his will/testament the **extinguishment** of which is conditional upon receipt of the property itself. **The recipient need not be resident in Canada.**

If the right/thing is recognized by the testator under Sec. 70(2) only the net value will be includable in computing his income while if it is rolled through to the beneficiaries **only** the deceased's deductible cost will be rolled through as well. Interest costs, expenses, etc. that could be deductible by the testator in a Sec. 70(2) recognition may not be able to be capitalized so as to form part of the deductible cost that is rolled through to the beneficiary as per Sec. 69(1.1) and may be lost due to the fact that they relate to an activity that does not produce income for the testator. Will the Department allow them, administratively, to be deducted from other terminal income when the revenue they were sustained in respect of is being recognized by another party? Either way, they will not gain roll through treatment under Sec. 69(1.1) and thus can only be deducted by the testator in his terminal return, if at all. If there isn't a Sec. 70(3) roll through Sec. 69(1)(c) will apply to determine the cost of the right or thing to the recipient to be its fair market value, but in the case of an income interest in a trust Sec. 106(1.1) will cause it to be nil regardless.⁴⁶⁷

"Idem, where s. 70(3) applies – Sec. 69(1.1)"

(1.1) Where a taxpayer has acquired property that is a right or thing to which subsection 70(3) applies, the following rules apply:

- (a) paragraph 69(1)(c) is not applicable to that property; and**
- (b) the taxpayer shall be deemed to have acquired the property at a cost equal to the total of**
 - (i) such part, if any, of the cost thereof to the taxpayer who has died as had not been deducted by the taxpayer in computing the taxpayer's income for any year, and**

⁴⁶⁴ Another instance where the legislators recognized that an estate and possible trust arising out of it are not equal.

⁴⁶⁵ This may be favourable where the testator's effective tax rate is less than the beneficiaries due to loss carry-forwards etc. and the rate on the elective alternate return is of consideration.

⁴⁶⁶ If the initial beneficiary is an individual he must receive it in the capacity of a beneficiary, (taking in some beneficial way), but this doesn't preclude the beneficiary from having to create a trust out of certain funds, not necessarily realized from the right or thing, as a condition of the bequest.

⁴⁶⁷ Subsection 106(1.1) notwithstanding Sec. 69(1)(c), not Sec. 69(1.1).

(ii) any expenditures made or incurred by the taxpayer to acquire the property.

Income Tax Interpretation Bulletin

Income of Deceased Persons - Rights or Things

IT-212R3

DATE: March 21, 1990

SUBJECT: INCOME TAX ACT

Income of Deceased Persons - Rights or Things

REFERENCE: Subsection 70(2) (also subsections 10(6), 61.1(2), 69(1.1), 70(1), 70(3), 70(3.1), 70(4), 70(5.2), 96(1.5), 110.4(5), 159(5) and 159(5.1) and paragraphs 34(a) and 69(1)(c) of the Act and section 23 of the Income Tax Application Rules, 1971 (ITAR))

Application

This bulletin replaces and cancels Interpretation Bulletin IT-212R2 dated June 29, 1987. Current revisions are designated by vertical lines.

Summary

The provisions of the Act discussed in this bulletin concern the tax treatment of "rights or things" that a taxpayer owns on death and that would have been included in income if the taxpayer had survived to realize or dispose of these properties. The amount of the rights or things that is brought into the income computation of the decedent for the year of death is the value of the rights or things at the time of death. Rights or things include, for example, dividends declared but unpaid, unused vacation leave credits and the inventory of a farmer who reports income on a cash basis. Rights or things do not include, for example, Canadian or foreign resource properties and the accrued portion of periodic payments. The legal representative of the decedent and the beneficiaries have three alternatives for reporting the income in respect of the decedent's rights or things. The alternatives are:

- (a) the income can be reported in the decedent's income tax return for the year of death along with the other income for that period,
- (b) the income can be reported in a separate income tax return for the rights or things of the decedent, or
- (c) the rights or things can be transferred to one or more of the beneficiaries of the decedent with the result that the beneficiaries rather than the decedent report the income.

Discussion and Interpretation

1. "Rights or things", as the term is used in subsection 70(2), and their taxation are discussed in this bulletin. Subsection 70(1), which discusses payments received on a periodic basis, is discussed in the current version of IT-210 "Income of Deceased Persons - Periodic Payments".

2. With certain exceptions, where a taxpayer at the time of death had rights or things which, when realized or disposed of, would have been included in computing income, subsection 70(2) requires the "value" (see 4 below) of such rights or things at the date of death to be included in computing income for the year of death. Subsection 70(2) includes in income amounts that have been earned but have not been included in income: dividends declared but unpaid, deferred cash purchase tickets (see subsection 76(4)), uncashed matured bond coupons and amounts in respect of which an amount has been deducted in computing income, such as a "cash basis" inventory. Excluded from the application of subsection 70(2) are capital property, amounts included in income under subsection 70(1), and, pursuant to subsection 70(3.1), life insurance policies (including annuity contracts other than those in respect of which an amount was deductible by the decedent under paragraph 60(l)), eligible capital property, land included in the inventory of a business and Canadian or foreign resource properties.

3. Where there is genuine doubt about whether income earned before a taxpayer's death is a periodic payment or a right or thing, its treatment is generally resolved in favour of the taxpayer. As a consequence, the legal representative may report the income in question under subsection 70(1) or under subsection 70(2). In the latter case, depending upon the timing, an election under that provision may be made, or if the income has been transferred to beneficiaries, subsection 70(3) applies instead of subsection 70(2) (see 20 and 25 below).

4. The value of a right or thing for purposes of subsection 70(2) depends upon the facts of each particular situation. In calculating this "value", there may be deducted from the gross amount of the right or thing certain amounts incurred but unpaid at the date of the taxpayer's death. To be deductible for this purpose, those amounts must be of such a nature that, had the taxpayer not died, they would have been deductible in computing the taxpayer's income. For example, amounts payable or accrued for items such as interest, property taxes or insurance premiums are deductible if they are in respect of rights or things included in income under subsection 70(2).

5. Where deductions allowable according to the foregoing exceed the gross amount of the rights or things, the excess is deductible from other income of the taxpayer. Where the aggregate of deductions allowable in computing rights or things exceeds the aggregate of the gross amount of rights or things, no amount can be reported on the separate return for rights or things. In this situation the rights or things may be reported on the final return of the deceased taxpayer. See 20 below for further comments on the separate return for rights or things.

Supplies on Hand and Inventory

6. Supplies on hand and inventories of taxpayers on the cash basis of reporting income for tax purposes (farmers and fishermen) are rights or things. The inventory of an artist that is valued at nil pursuant to subsection 10(6) is a right or thing (see the current version of IT-504 "Visual Artists and Writers").

Work in Progress of Professionals

7. Work in progress of a professional, who is a sole proprietor and who elects to exclude work in progress in computing income pursuant to paragraph 34(a), is a right or thing. Paragraph 34(a) applies to the professional practice of an accountant, dentist, lawyer (including a notary in the province of Quebec), medical doctor, veterinarian or chiropractor. The treatment of work in progress of a professional partnership on the death of a partner or a retired partner is discussed in the current version of IT-278 "Death of a Partner or a Retired Partner".

Livestock

8. Where a deceased farmer on the cash basis owned a "trading" herd, the value of the herd is a right or thing. If the herd includes a "basic" herd, the fair market value at December 31, 1971 of the basic herd at the time of death may be deducted from the value at date of death. See the current version of IT-427 "Livestock of Farmers" for further details.

Grain

9. The right to receive an interim or final payment for grain marketed through the Canadian Wheat Board is a right or thing. Where an announcement is made before a taxpayer's death that an interim or final payment will be made, the right or thing is to be valued at the amount fixed by the Canadian Wheat Board. Where an announcement of an interim or final payment is made after a taxpayer's death, the payment is considered to have no value for the purposes of subsection 70(2). Similarly an entitlement to receive a payment under the Western Grain Stabilization Act is a right or thing. Where it has been announced before a taxpayer's death that a Western Grain Stabilization payment will be made, the taxpayer's share of the payment is subject to the provisions of subsection 70(2). Where such announcements are made after the taxpayer's death, the taxpayer's share of such payments is not considered to have any value for the purposes of subsection 70(2).

10. The inventory of harvested grain of a deceased taxpayer who computed income using the cash basis is a right or thing. The value of the grain, for purposes of subsection 70(2), is considered to be not less than the open market feed grain prices less applicable deductions such as freight and elevator handling charges. See the current version of IT-234 "Income of Deceased Persons - Farm Crops" for comments on unharvested crops.

Debts Receivable

11. A right or thing may include a debt receivable. For example, a taxpayer has a debt receivable that is a right or thing where income is reported on the cash basis and an amount is owing to the taxpayer on the sale of livestock. Where such a debt is forgiven by the decedent by will, the debt is no less a right or thing but section 80 does not apply because of paragraph 80(1)(h).

Dividends

12. A dividend which was declared but not paid before the taxpayer's death is a right or thing if the ex-dividend date, (or, if none, the date of record) was prior to the date of death. A dividend which is a right or thing is subject to the normal "gross up and credit" provisions.

Leave Credits

13. Where an employee is entitled to be paid for unused vacation leave credits, the amounts thereof are rights or things which are brought into income under subsection 70(2).

Employee Compensation Plans

14. Where an employee has at the time of death a vested right to receive, though perhaps not immediately, additional compensation in respect of employment which is payable, in the event of death, to the estate or beneficiaries (but which had not accrued in the last pay period prior to death as contemplated in subsection 70(1)), the right to such payment is a right or thing. For instance, if under an employee benefit plan, certain amounts of compensation are payable on certain future dates to the employee or, in the event of death, to the employee's estate, the right to future payment at the time of death of the employee is a right or thing.

Lump-sum Payment out of a Pension Plan

15. Where a lump-sum payment out of a pension fund or plan in respect of a deceased employee's interest therein is made to an estate, trust or beneficiary (a recipient), no part of that amount is a right or thing within the meaning of subsection 70(2) in any case where the terms of the fund or plan were such that the employee could not have obtained a refund of contributions prior to death except in the event of retirement or other withdrawal from employment. This is by far the most usual situation, and where such is the case, the amount is income of the recipient pursuant to subparagraph 56(1)(a)(i). There may be exceptional cases where a pension fund or plan provides for voluntary withdrawal of contributions by an individual contributor (possibly with interest and/or employer's contributions) at a time or times other than on retirement or on leaving the employment. Where this is so, the portion of the lump-sum payment which would have been taxable had it been received by the decedent normally is still regarded as income of the estate or beneficiary; but if the executor desires, for any reason, to report that amount as income of the employee for the year of death pursuant to subsection 70(2), no objection will be made to that manner of reporting nor to any consequential election properly made under subsection 70(2).

Registered Retirement Savings Plans, etc.

16. A taxpayer is not considered to have a right or thing in respect of a registered retirement savings plan, whether matured or not, if the taxpayer was, until death, the annuitant thereunder. However, except in the case of a plan that had matured before June 30, 1978, where the annuitant dies after June 29, 1978, the fair market value of all the property of the plan at the time of death (less amounts receivable by the spouse of the decedent or received as a refund of premiums by an eligible child or grandchild of the decedent, as described in subsections 146(8.8) to (8.91)) must be included in the income of the decedent by virtue of subsection 146(8.8) in the ordinary return required to be filed by section 150. See the current version of IT-500 "Registered Retirement Savings Plans (maturing after June 29, 1978) Death of Annuitant after June 29, 1978" for further details. Similarly, a taxpayer is not considered to have a right or thing in respect of a registered retirement income fund.

Land Inventory

17. Land that is included in the inventory of a business of the deceased taxpayer is not a right or thing for purposes of subsection 70(2). However, such land is deemed to be disposed of, immediately before death, by the deceased taxpayer for proceeds equal to fair market value, pursuant to paragraph 70(5.2)(e). Paragraph 70(5.2)(f) contains special rules where the land is transferred to the spouse or to a trust for the spouse.

Income-Averaging Annuity Contracts

18. On death, an income-averaging annuity contract is not a right or thing to which subsection 70(2) is applicable. Pursuant to subsection 61.1(2), any amount paid out of an income-averaging annuity contract subsequent to the death of the original annuitant is deemed to be a payment out of an income-averaging annuity contract and will therefore be included in the income of the recipient with no deduction for any capital element.

1971 Receivables

19. Section 23 of the ITAR provides rules for taxing "1971 receivables" of a business that is a profession. Any such receivables not already brought into income at the date of death are included in the decedent's final return pursuant to paragraph 23(3)(c) of the ITAR and a further deduction is precluded by paragraph 23(4)(a) of the ITAR. They are not considered to be rights or things under subsection 70(2). By virtue of subsection 159(5.1), the tax incurred on such receivables may be paid in instalments, as described in 24 below.

Elections

20. Pursuant to subsection 70(2) the taxpayer's legal representative may elect to file a separate return of the value of the decedent's rights or things and pay tax thereon for the taxation year in which the taxpayer died as if the taxpayer were another person. To be valid, the election must be made not later than the later of one year after the date of death and 90 days after the mailing of any notice of assessment or reassessment for the year of death. If a separate return is filed, it must include the total value of all the decedent's rights or things other than those transferred to beneficiaries within the time provided by subsection 70(3) (see 25 below). For 1988 and subsequent taxation years, the personal tax credits provided in paragraphs 118(1)(a) to (d) and subsection 118(2) that apply to the decedent's ordinary income tax return for the year of death may also be claimed on the separate return filed pursuant to subsection 70(2). The personal tax credits are the married tax credit, the married equivalent tax credit, the basic personal tax credit, the dependant tax credit and the age tax credit. See the current version of IT-513 "Personal Tax Credits". The extent to which deductions under section 110 and tax credits under subsection 118(3) and sections 118.1 to 118.7 and 118.9 may be claimed on the separate return is discussed in IT-326R2 "Returns of Deceased Persons as 'Another Person'". (Prior to 1988, the personal exemptions provided by paragraphs 109(1)(a) to (h) that applied to the decedent's ordinary return for the year of death could also be claimed on the separate return filed pursuant to subsection 70(2). The extent to which deductions under sections 110, 110.1 and 110.2 could be claimed on the separate return is discussed in IT-326R.)

21. Pursuant to subsection 70(4), an election made under subsection 70(2) may be revoked if the notice of revocation is in writing, signed by the decedent's legal representative and filed within the time for making the election.

22. Pursuant to subsection 110.4(5), the forward averaged amount brought into income pursuant to subsection 110.4(2) cannot be reported in the separate return filed under subsection 70(2).

23. A sale of a right or thing for good and valuable consideration does not come within the meaning of the phrase "transferred or distributed" as used in subsection 70(3).

Payment of Tax in Instalments

24. The additional tax payable by virtue of subsection 70(2) may be paid in up to ten equal consecutive annual instalments when the conditions in subsection 159(5) are met. See T2075 "Election under subsection 159(5) by a deceased taxpayer's legal representative to defer payments of income tax".

Recipients of Rights or Things

25. Where an estate, trust or beneficiary (the recipient) acquires a right or thing upon a taxpayer's death, the tax consequences arising therefrom will depend on whether the value of that right or thing was included in the income of the deceased taxpayer's income tax return under subsection 70(2) or in the deceased taxpayer's income tax return for the year of death or in the hands of the recipient under subsection 70(3).

(a) Where subsection 70(2) applies or the rights or things are included in the deceased taxpayer's income tax return for the year of death, the recipient is deemed by paragraph 69(1)(c) to have acquired the asset at a cost equal to its fair market value. The fair market value is normally the gross amount (see 4 above) used in computing the income of the decedent. The disposition of the asset by the recipient will generally be on capital account unless the recipient's activities in relation to the asset are such that the asset constitutes a trading asset.

(b) Where a right or thing has been transferred or distributed to beneficiaries of the estate not later than one year after the date of death or 90 days after the date of mailing of any notice of assessment or reassessment in respect of the year of death, whichever is the later date, subsection 70(3) applies. Where subsection 70(3) applies, the disposition is always on income account and the tax liability arises when the beneficiary realizes or disposes of the asset. In addition where subsection 70(3) applies, paragraph 69(1)(c)

does not apply with the result that the recipient's cost is determined under subsection 69(1.1) as the aggregate of such part of the cost of the property to the deceased as was not deducted in computing the income of the deceased for any taxation year and any expenditures made or incurred by the recipient to acquire the property.

Trust Interests: Special Issues.

In respect of income interests in other *inter vivos* or testamentary trusts or estates income that accrued prior to death subsequently realized under Sec. 104(13) by the estate will not be negated with a Sec. 106(1) deduction since the income interest acquired will not have a cost pursuant to Sec. 106(1.1) unless the testator had one deductible. The income will be taxed under Sec. 70(2) as "value" and Sec. 104(13) when realized. Thus there will be double taxation of the value attributable to the stub period income prior to death. Income interests in trusts should **always** be rolled through, (if possible), otherwise double taxation could easily result. Subsection 70(2) **doesn't** cause a deemed disposition, only a realization of the value **as if** disposed of hence where a right or thing has a deductible cost it should be rolled through so as to maintain that deductible cost. Even though current expenses are **administratively** allowed to be deducted against a Sec. 70(2) inclusion, booked costs appear not to be provided for. In the case of income interests in trusts Sec. 106(1) offers a deduction of cost **only** against Sec. 104(13) inclusions and Sec. 106(1) **disposition** inclusions while Sec. 70(2) doesn't cause either. The general rule; income is not taxed in the hands of the testator **and** his estate is violated in this case. (Would Sec. 70(1) rather than 70(2) capture such stub year income? It's doubted.⁴⁶⁸⁴⁶⁹

The Testamentary Trust Income Beneficiary Separate Return.

Subparagraph 104(24)(d) allows a taxpayer's personal representative to file a separate return in respect of income of only a testamentary trust that would be payable to the taxpayer if the taxpayer dies before the end of the calendar year in which the trust's tax year ends. The stub period income, since the beginning of the trust's tax year, can be reported on a completely separate return operating within the same restrictions as those imposed under Sec. 70(2). Applicable **only in respect of testamentary trusts** the provision provides that the stub period income will be included in computing the beneficiary's income however it doesn't provide that income not yet paid but accrued will be deemed to be paid/payable to him and subsection 104(6)(b) doesn't technically offer the trust a deduction in respect of the amount recognized under Sec. 70(2).⁴⁷⁰

If income accrues and is payable to the beneficiary after the end of the trust's tax year after it is capitalized the Sec. 104(24)(d) election will not be available since at the date of death the taxpayer does not have income from the trust.⁴⁷¹ In this respect the provision is targeted, in the author's opinion, exclusively at income paid or payable at the moment of death and serves to preclude a possible deferral of the income recognition that would otherwise result under Sec. 104(24)(c)⁴⁷².

Income payable only at the end of the trust's tax year will be recognized by the estate via Sec. 104(13),

468. Would it be possible to argue that, since the income interest can be recognized as a capital property, pursuant to *Gadsden v. M.N.R.*, 1983 C.T.C. 2132 TRB, and the implicit need for legislative abolishment of its capital nature in Sec. 106(1), that the interest is a capital property and thus exempt from Sec. 70(2), even though when realized or disposed of would produce only an income inclusion? See Sec. 96(1.4) in respect of rights to partnership income **deemed** not to be capital property straight out while Sec. 106(2) deems only the capital gain/loss on the disposition of a trust income interest to be nil but doesn't comment on the type of property.

469 A beneficiary under an unadministered estate who is entitled to the income of the residue and that which accrues during the administration has a capital interest in the estate in respect of the income accruing and an income interest in respect of that to be realized once administration is complete. Should the beneficiary die while the estate is being administered the latter will be captured by Sec. 70(2) but not the former and thus the expected duration of administration, amount of debt and probability of the interest's ademption become relevant in ascertaining the value of the right for Sec. 70(2) purposes.

470 For some unfathomable reason Finance made this provision only applicable to testamentary trusts and not those *inter vivos*, though Heaven knows why.

471. The provision has been ambiguously phrased in this respect in that it is possible to construe the target as the taxpayer having income from the trust...at any time during the trust's tax year but regardless it would be unreasonable, in the face of the alternate elections and the general scheme of the death dispositions, to equate post mortem accounting with a pre mortem legal ability to enforce a payment.

472 which causes income recognition in the year in which the **trust's** tax year ends

however, that income right devolving to the executors, when and if realized by the testator would have caused an income inclusion and would thus also be recognized in the testator's income via Sec. 70(2), unless there is a roll through.⁴⁷³ The Sec. 104(23)(d) alternative election must be filed before April 30th of the calendar year following death or within 6 months of the death whichever is later in order to avoid late filing penalties.

"Testamentary trusts – Sec. 104(23)"

(23) In the case of a testamentary trust, notwithstanding any other provision of this Act, the following rules apply:

(a) the taxation year of the trust is the period for which the accounts of the trust are made up for purposes of assessment under this Act, but no such period may exceed 12 months and no change in the time when such a period ends may be made for the purposes of this Act without the concurrence of the Minister;

(b) when a taxation year is referred to by reference to a calendar year, the reference is to the taxation year or years coinciding with, or ending in, that year;

(c) the income of a person for a taxation year from the trust shall be deemed to be the person's benefits from or under the trust for the taxation year or years of the trust that ended in the year determined as provided by this section and section 105;

(d) where an individual having income from the trust died after the end of a taxation year of the trust but before the end of the calendar year in which the taxation year ended, the individual's income from the trust for the period commencing immediately after the end of the taxation year and ending at the time of death shall be included in computing the individual's income for the individual's taxation year in which the individual died unless the individual's legal representative has elected otherwise, in which case the legal representative shall file a separate return of income for the period under this Part and pay the tax for the period under this Part as if

(i) the individual were another person,

(ii) the period were a taxation year,

(iii) that other person's only income for the period were the individual's income from the trust for that period, and

(iv) subject to sections 114.2 and 118.93, that other person were entitled to the deductions to which the individual was entitled under sections 110, 118 to 118.7 and 118.9 for the period in computing the individual's taxable income or tax payable under this Part, as the case may be, for the period; and

(e) in lieu of making the payments required by sections 155, 156 and 156.1, the trust shall pay to the Receiver General within 90 days after the end of each taxation year, the tax payable under this Part by it for the year.

Conditions Precedent.

The will may provide that in order for a particular beneficiary to acquire the "right or thing" he must furnish the trust/estate with a capital sum which may be passed on to other beneficiaries who would otherwise have received the "right or thing". Such an expenditure would be added on to the cost of the "right or thing" as per Sec. 69(1.1)(b)(ii) while causing the estate to only possibly **lose its testamentary status**. Since the Sec. 70(3) provision is applicable the testator will avoid the recognition of a taxable disposition, (in the form of a testamentary sale). The funds can then be distributed, as capital, to other beneficiaries and the acquiror will recognize a deductible cost that will reduce the amount of income inclusions when the "right or thing" is

⁴⁷³ Subsection 4(4) would not operate in the instance where the testator recognizes a Sec. 70(2) inclusion in respect of a current year trust's income not payable until the end of the trust's tax year and the estate subsequently recognizes that income under Sec. 104(13) since there are two taxpayers recognizing the income. If instead the income interest is rolled through to a beneficiary in such a way that the Sec. 70(3) provision applies Sec. 4(4) can be relied on by the beneficiary to negate a double inclusion. In IT 278R para 14 the Department administratively allows a Sec. 96(1.1) partnership income right to have a cost to a beneficiary equal to the Sec. 70(2) inclusion when it suffers such upon the death of the testator: this should also be the administrative policy of the Department in this respect so as to allow for a Sec. 106(1) deduction.

realized. If the payment is made directly to a beneficiary Sec. 105(1) may apply. The only requirement that must be met for the bump up in cost is that the expenditure must have been **made** or **incurred** (not payable or "incurable"), by the taxpayer in order for him to acquire the property and if the deceased explicitly provides in his will that certain beneficiaries are to receive the rights or things only after paying a capital sum to another person other than the general estate, (the conditional bequest), then that capital sum will be paid so as to acquire the property (which the will could provide will be bequeathed to someone else if not accepted by the former).^{474 475}

Such a condition precedent will allow the deceased to extend the scope and meticulously arrange the benefits to be realized from his death by the parties however the **direct** beneficiary recipient of the payment just cited would be required to recognize it in income fully under Sec. 105(1) without a deduction to the trust, or the recipient of the right or thing **if it wasn't** as a condition of the acceptance of the property. By matching it to, and making it conditional upon, the acquisition of the right or thing at least there is some tax equity in that a deduction is allowed for an otherwise non-deductible income inclusion.⁴⁷⁶ The better route would be then to have the payment made to the trust/estate and then to the beneficiary since how can an estate/trust realize a benefit in respect of itself.

If the condition precedent calls for the payment of consideration to a taxpayer who does not recognize Part I income⁴⁷⁷ then Sec. 105(1) will not apply and the Sec. 69(1.1) cost bump will be "tax free". Such an instance occurs where the payment is to be made to "y'er Aunt 'Calypso' Betty getting together and feeling alright" in Jamaica since Auntie 'Cal' would then be non-resident and Sec. 105(1) does not apply to non-residents nor does it give rise to withholding tax as per Sec. 212(1)(c).⁴⁷⁸

The transfer of the right or thing could be made conditional on the payment by the recipient of an amount, to an offspring of his immediate family, that would lead to a Sec. 105(1) inclusion but which would be negated by the minor's unused personal tax credits. If the terms of the will provide that the recipient is to set up a trust with deferred entitlements for the benefit of the offspring then the Sec. 105(1) provision may apply to those entitlements, in the author's opinion, in that they are benefits to be realized under and in respect of an estate or trust, even though the subdivision k rules will apply to beneficiaries of the second trust since Sec. 105(1) targets their benefit that is not otherwise includable in income for that year. The benefit they realize will, however, only be in the future when the trust makes distributions or when they sell their interest or realize any other form of benefit independent from the trust hence the advantage of a time deferred inclusion though present deduction is available, unless CRA can invent a way to say that the mere holding of an interest in a trust is an annual benefit when its holder receives nothing for it.⁴⁷⁹

474. The connection between the payment and the receipt may have to be direct being a payment to qualify as a participant in a discretionary class or a beneficiary whom receives the property upon an exercise of a dispositive power may not be considered "to acquire the right" but instead to be considered as a possible recipient.

475 Can CRA argue that a trust arising out of property part of which comprise proceeds received as a condition precedent by the originating estate not be "testamentary" by virtue of the fact that the end trust is receiving property not by virtue of death? Is it important when the definition of testamentary trust explicitly recognizes that the trust can receive property other than by virtue of the death of the settling testator? Does CRA Rulings, when it's not giving fractured opinion, consider an estate and the trust that arises out of it distinct given that the Act makes multiple references to both and in many cases jointly? See *Wilson v. Minister of National Revenue*, [1955] S.C.R. 352 where an annuity was treated as a business expense against a business premise devised to a resident, under the IWTA..

476 This can also only be done equitably with rights or things and not property subject to the Sec. 70(5)-(6)-107(2) mechanics: if a conditional devise based on a condition precedent is linked to the devolution of capital property Sec. 107(2) will not offer equitable treatment to the beneficiaries in a situation where one will be required to recognize a Sec. 105(1) inclusion, if resident, and the other no income/gain deduction. If the interest being satisfied has been acquired for consideration payable there **may be** some degree of capital loss creation if there is an equitable charge placed on the property but not where there must be a payment made to receive it from the trust. See *Baradosh et al. v M.N.R.*, 93 D.T.C. 1436.

477 See *Cowan v. Allen*, 26 S.C.R. 292.

478 Subsection 214(3) does not cause the benefit recognizable under Sec. 105(1) to be a deemed dividend as it does to Sec. 15(1) benefits as per paragraph 214(3)(a). There is no targeting of subsection 105(1) benefits for non-resident withholding tax rates.

479 Where the payment is made to the estate/trust could the Department successfully argue that the transfer was a sale initiated by the testator and carried through by his executors? See "Testamentary Options" in Testamentary Spousal Roll-overs. In T.I. 910214/910786 provided Apr. 1991 by the Business and General Section it was held with respect to whether a taxable benefit could accrue to employees under Sec. 149(1)(l), 105(1), or 6(1)(a) when amounts were contributed to a training fund for them:

Once the right or thing is realized or disposed of the cost under Sec. 69(1.1) will be deductible against the income inclusion, which, depending on the amount and cost deductible, could result in a significant net income reduction. If the beneficiary recognizes the proceeds of the right or thing as per Sec. 70(3) he will always do so on an income basis while if the right or thing is recognized under Sec. 70(2) by the deceased in either of the two possible returns the ultimate recipient of the right or thing, being the estate or trust will recognize the proceeds as capital regardless of whether the deceased's business etc. is carried on by the estate/trust. Income rights under existing trusts are "rights or things" however if the trust deed provides that the right is to terminate on death (forgiven), instead of being distributable to an estate beneficiary and continuing to be enforceable by the subsequent person, the value of the "right" upon death will be significantly reduced and the effect of Sec. 70(2) will be seriously negated. Subsection 70(2) targets property the taxpayer had at the time of death however only the value **at the time of death** will be includable.⁴⁸⁰

If the trust deed provides that excess depreciation/incorporation may occur and thus reduce the income to which the right pertains following the continuity of it through to the beneficiary at least the deceased's beneficiaries will be able to deduct any undeducted cost upon subsequent discretionary income allocations, possibly pursuant to a condition that a certain percentage thereof be contributed to a trust for a specified beneficiary's benefit, while if the interest were to terminate upon death any unabsorbed cost would be lost.⁴⁸¹

It would appear that the beneficiary could receive the beneficial ownership of the right and realize the income tax free absorbing a Sec. 106(1) deductible cost while within 36 months pursuant to Sec. 248(8)(c) & (a) he could release the right back to the estate without recognizing a Sec. 106(1) taxable disposition.

A bump in the tax cost of the property results where the taxpayer has made "any expenditures...to acquire the property" as compared to expenditures made **to receive** it. The distinction in the terminology is arguably indicative. As per Sec. 44(3) compensation for property unlawfully taken, for property destroyed and any amount payable under a policy of insurance in respect of loss or destruction of property, or property taken under statutory authority etc. will not be eligible for Sec. 70(3) treatment and instead must be recognized by the testator for purposes of capital cost allowance and capital gains taxation.

Given that Finance Canada feels comfortable leaving the possible recognition of "any [unqualified] expenditures" to be off-set against the realization of a right or thing it's a hell ova way to knit non-deductible estate expenses directly against a full income inclusion. The author thinks of probate fees, executrix fees and all those other things on CRA's no-go list if required to be satisfied or assumed as a condition of receiving the right or thing specifically as stated by the will.

Distributions to Non-Residents.

Qualified recipients may be non-resident and thus ultimate realizations of the "rights or things" may be subject to either Sec. 115(1) or section 212 inclusions and withholdings. If the right relates to an income amount the source of which is in a foreign jurisdiction then when that amount is realized neither of the above set of provisions will apply to it to cause Canadian tax imposition. If the resident trust were to realize the "right" and then distribute the proceeds they would usually be caught for withholding tax under Sec. 212(1)(c), (unless they were capitalized), while some relief could be available under the international tax treaties. If the assent to

"It is our further opinion that a taxable benefit is not enjoyed by an employee at the time of contribution to a TTF by either an employer, an employee association or by Employment and Immigration Canada. Further, it would appear unlikely that a benefit accrues to an employee at the time that the employee receives training sponsored or funded by a TTF. We believe that, in most cases, the primary beneficiary of training may be the employer rather than the employee. A definitive response may only be given on a case by case basis as obviously course objectives, content and so forth determines whether training is to primarily benefit the employer, industry in general or an individual employee."

480 See *Trustees, Exors., & Agency Co. v. Commr.*, 65 C.L.R. 33, for an example of where the value of a life interest was seriously reduced.

481 There should be no problem in bumping the deductible cost of an income interest passing through Sec. 70(3) by imposing a condition precedent, in the form of a requirement to make a payment to a third party, upon its vesting. Subsection 106(1.1) notwithstanding the application of Sec. 69(1)(c) only but the provision allows a deductible cost for purposes of Sec. 106(1) **if the interest was acquired from a beneficiary**; it does not require **that the deductible cost actually be limited to the amount paid to that beneficiary**. This allows Sec. 69(1.1) expenditures to bump the Sec. 106(1) deductible cost.

the transfer of non-resident based rights or things occurs so as to cause them to be transferred to a non-resident Part I tax well be avoided thereupon if the recipient is an *inter vivos* trust resident in a tax free jurisdiction that is to capitalize the realizations and distribute them to Canadian residents.⁴⁸² If the trust doesn't contain discretionary distributive powers Sec. 94(1)(d) will apply while by virtue of Sec. 95(1)(e)(i) the trust can receive up to \$5,000 in income without exposing its Canadian resident beneficiary to a F.A.P.I. inclusion.⁴⁸³ Section 94.1 should not apply to the trust since the purpose of the trust isn't to derive a benefit from portfolio investments but is simply to capitalize a dividend or interest stream temporarily, (the share/bond property generating the right or thing doesn't necessarily have to be transferred to it as well). Depending on the rate of Canadian withholding tax on the dividend/interest and the immediate effective rate of taxation of those ultimately to derive the benefit it may be beneficial to have Canadian source rights or things transferred out of the country in the same way. The deductible cost of the right or thing as well as the unused tax credits of the potential beneficiaries should be thoroughly examined in contemplating any such strategy.

Reintroduction of Inter Vivos Trust Income Interest Cost?

An income interest in a trust is a right or thing subject to Sec. 70(2) the cost of which, recognizable under Sec. 106(1.1), with cost which may be deducted under Sec. 106(1) against Sec. 104(13) income inclusions however under that provision the cost of the interest that may be deducted in any given year cannot exceed the cost thereof net of any **deductible** cost in a previous period thus if a Sec. 106(1) deduction **isn't taken the deductible cost will none-the-less be reduced**. Subsection 106(1.1) does not provide that the Sec. 69(1.1) resulting cost will be recognized as the deductible cost for beneficiaries who receive the right under the pretence of Sec. 70(3) however the provision **does not operate to preclude such from occurring**.⁴⁸⁴ Subparagraph 69(1.1)(b)(i) recognizes that the cost of the income interest to the beneficiary by virtue of the Sec. 70(3) roll through will be based on "the cost thereof to the taxpayer who has died as had not been **deducted** by him in computing his income for any year..." and with this one has to ask; if the testator did not take the Sec. 106(1) deductions when available previously, will such a cost, which as per Sec. 106(1) ceased to be deductible, become deductible by the beneficiary? Such amounts were not **deducted** by the taxpayer although they did reduce his **deductible** cost in his hands and the provision does not specifically pass through the **deductible** cost of the interest, only the cost that was not actually deducted by the deceased taxpayer.

Since subsection 106(1.1) doesn't prescribe that the deductible cost of an interest acquired from a beneficiary will be restricted to amounts included in computing that beneficiary's income, acting in concert with the fact that only Sec. 69(1)(c) is precluded from applying, it would seem plausible that the above recreation of deductible cost was at least recognized by the draftsmen.⁴⁸⁵

482. Whether or not the Department can attack the distribution from the unadministered estate of the right or thing with Sec. 107(5) depends on whether the beneficiary can be recognized to have a right to trust capital within the context of Sec. 108(1)(c) as based on the right to **trust** law capital as implied by the Sec. 108(1)(e) and 108(3) basis of the income interest. There may be authority to argue that rights or things to income accrued to the date of death become rights to capital in fact since the estate does not realize those amounts as income having instead been income *inter vivos*. In such a case Sec. 107(5) could apply to cause a disposition of the right the conveyance of which is assented to so as to tax any accrued gain. (It's to be noted that Sec. 70(2) refers to property other than capital property to the deceased, not property that becomes capital property to the estate.) It could be argued that the Sec. 70(2)-(3) mechanics concern only who recognizes the income accrued to the date of death and that the section 107 distribution provisions concern distributions of capital property created upon death **even** in the face of the Sec. 70(3)(b) explicit roll through to the beneficiaries. Where the right/thing passes through a personal estate Sec. 107(2) would not create any tax consequences to anyone but where Sec. 107(5) applied what a.c.b. would the property have..Nil? This is only of concern when the right or thing would not otherwise become taxable Canadian property within the Sec. 115(1)(b) & 248(1) definitions and it's to be noted that inventory/non-capital property can be distributed under Sec. 107(5).

483 In a T.I. provided in April 1984 by the Specialty Corporations Rulings Division it was held that when a non-resident testamentary trust is created under a will and Sec. 94(1) applies to it the resident beneficiary's capital interest's a.c.b. will suffer "bumps" and "grinds" under section 53 while Sec. 108(1)(d) will prevent the interest from having an a.c.b. for purposes of disposition and commutations attended to under Sec. 107(1)-(1.1)-(2) though in the author's opinion if the trust corpus is distributed to the beneficiary Sec. 107(2) will apply to prevent tax consequences to the trust but Sec. 108(1)(d) working in unison with Sec. 107(1)(a) and the closing amble of Sec. 107(1) will cause the beneficiary a capital gain.

484. Bequests under Sec. 69(1)(c) are specifically precluded however this is due to the fact that if otherwise the tax cost of the interest would be inflated to its fair market value, while the testator would have to recognize only its **net** market value in his income under Sec. 70(2).

485 The Sec. 248(1) definition of "cost amount" is inapplicable in this case. Do mere words mean anything here? This

Not only that, a taxpayer can directly tack on costs to his secondary trusts' income interest realized through a Sec. 70(3)-69(1.1) roll-through by incurring any "unqualified" "expenditure" cited in Sec. 69(1.1)(b) such as payment of probate, conditions precedent payments, et, cet, er, a.⁴⁸⁶

Avoidance.

One of the best ways to avoid a Sec. 70(2) inclusion is simply not to have the taxpayer own the right or thing in a personal capacity but instead as a trustee. Such was the case in *Tunley v. Commr.*⁴⁸⁷ where a taxpayer declared *inter vivos* to hold the income of shares recently subscribed for on trust for a religious institution while the remainder interest in the shares remained his personally.⁴⁸⁸ The income potential was not assessable for succession duty upon his death and if such were structured in Canada Sec. 70(2) would not apply to the income right.⁴⁸⁹ The income could be accumulated and be considered payable to a minor but for his age thus allowing Sec. 104(18) to operate so as to preclude the trust from recognizing the income while assessing the minor's unused personal tax credits, (...if he has any left by the time I'd finish with him). The settlor could retain a power of appointment over the accumulated income without having Sec. 75(2) cause any damage and appoint it to himself as he needs it.⁴⁹⁰ Subsection 70(2) refers to rights or things that when realized or disposed of would produce an income inclusion and in this respect powers of appointment over income interests **as such** will be captured by it. This was the case in *Commr. of S. D. v. Donaldson*⁴⁹¹ where an income interest terminated but the taxpayer could extend it simply by asking. The interest wasn't extended in the year of death

is an Act, not an act: maybe Finance should be more verbal with the term "deductible" since that one set of syllables knocks down two birds here.

⁴⁸⁶ Keep up: on approaching death taxpayers hive off ownership of income producing properties to *inter vivos* trusts giving to-be-testator income interests therein, on contract, that once he dies he passes income interests to settlors' non-arm's lengths, with specification that payments also be made by the to non-residents for various purposes including to establish non-resident trusts by the rights or things beneficiaries. Taxpayer dies, the rights 'n things are bequeathed to specified parties who make the payments. Any previously deducted income interest cost is reestablished and is added on to the "expenditures" incurred by the beneficiaries and just how much Cdn. exposed income is eliminated. One word missed ("deductible" cost, Sec. 69(1.1), one word missing ("deductible" expenditure", Sec. 69(1.1)(b)). And Sec. 105(1) doesn't cause withholding on payments going out. And life, is like that.

Income interest in trust - Sec. 106(1)

(1) Where an amount in respect of a taxpayer's income interest in a trust has been included in computing the taxpayer's income for a taxation year by reason of subsection 106(2) or 104(13), except to the extent that an amount in respect of that income interest has been deducted in computing the taxpayer's taxable income pursuant to subsection 112(1) or 138(6), there may be deducted in computing the taxpayer's income for the year the lesser of

- (a) the amount so included in computing the taxpayer's income for the year, and
- (b) the amount, if any, by which the cost to the taxpayer of the income interest exceeds the total of all amounts in respect of the interest that were deductible under this subsection in computing the taxpayer's income for previous taxation years.

Idem, where s. 70(3) applies – Sec. 69(1.1)

(1.1) Where a taxpayer has acquired property that is a right or thing to which subsection 70(3) applies, the following rules apply:

- (a) paragraph 69(1)(c) is not applicable to that property; and
- (b) the taxpayer shall be deemed to have acquired the property at a cost equal to the total of
 - (i) such part, if any, of **the cost** thereof to the taxpayer who has died as had not been deducted by the taxpayer in computing the taxpayer's income for any year, and
 - (ii) **any expenditures** made or incurred by the taxpayer to acquire the property.

⁴⁸⁷ 39 C.L.R. 528,

⁴⁸⁸ What is even more interesting is that the income interest was contingent and upon his death it was to revert to is estate. This is highly valuable in the ITA context.

⁴⁸⁹ Attention must be paid so as to impose a trust on the income right and not the income from the right. Subjecting a legal life interest to a trust will cause the initial holder or grantor to incur a capital disposition. The fact that the right to income is held on trust for an offspring and all income is attributed back to the settlor does not negate the fact that there is a trust in respect of the right and the settlor doesn't hold it in his personal capacity.

⁴⁹⁰ The power would not preclude vesting: *Public Trustee v. Wolf*, 1923 A.C. 544 (HL). It has not, in the author's opinion, been conclusively determined whether Sec. 104(18) requires indefeasible vesting. The Department has expressed a non-binding opinion in I.T. 286R para. 7 but the Australian courts have produced jurisprudence to the contrary in respect of a very similarly worded and purposed provision. See "Minor Income Entitlements" in the Chapter Income Recognition Mechanics.

⁴⁹¹ 39 C.L.R. 539

but the power was captured for succession duty upon death. In the author's opinion such a power would definitely be subject to Sec. 70(2) upon the death of its holder, however, if it only relates to capitalized income then it would not be.⁴⁹² It is a property that has, as its base, a stream of income and would be recognizable as income when realized.

Some Case Law on Sales of Rights or Things.

The most authoritative of cases concerning the Sec. 70(2)-(3) roll through mechanism consists of *Tory Estate v. M.N.R.*⁴⁹³ when accounts receivable were transferred from an estate, (essentially in the midst of administration), to a beneficiary in return for her payment of \$380,000 and surrender of a \$90,000 legacy claim to the estate. The value of the A.R. was approx \$483,350 and when the executors attempted to recognize Sec. 70(3) roll-through treatment the Minister contended that \$90,000 worth of book receivables had been transferred in satisfaction of the \$90,000 balance of the legacy owing, and that the \$380,000 amount of the A.R. transferred was by virtue of a sale and not a "distribution" within the context of Sec. 70(3). **It's important to note that the transfers were the consequence of an agreement made between the beneficiary and the executors and were not prescribed by the will.** Speaking for the majority of the Appeal Court, Bastin, D.J. provided:

"In the case at bar, the assignment to Mrs. Denton of \$90,000 of the accounts receivable was a distribution pursuant to the terms of the will but the assignment of the balance of the accounts receivable was, in fact, a sale to Mrs. Denton for valuable consideration. To the extent of \$90,000 the assignment was made in satisfaction of the balance of her bequest... The value of the rights or things is therefore restricted to the amount of the inheritance of the beneficiary. If he acquires more than that he takes as a purchaser for value and the estate is taxable on the amount so transferred."

While previously he had held:

"...The words "distributed to beneficiaries" clearly restrict the value of the rights or things to be conveyed to each beneficiary to the amount of the bequest to which he is entitled.⁴⁹⁴ If what was contemplated by Parliament was a sale of accounts receivable or similar things, to a person who happened to be a beneficiary, the word "distributed" would be quite inappropriate."⁴⁹⁵

The "sale" in *Tory Estate* was performed through an agreement entered into by the executors and the legatee while had the provision for such a transfer been made in the will by the testator potentially different results would have occurred. The entire balance of the A.R. could be recognized to be purchased for consideration approximately equal to its value however what would occur if the testator had required, as per the terms of his will, that the beneficiary receive the entirety of the A.R. upon the payment of a certain percentage of its value to the trust, while if that particular beneficiary did not make such a payment the A.R.

492 See also *Public Trustee v. I.R.C.*, 1960 1 All E.R. 1 (HL).

493. 73 D.T.C. 5354, (aff'd by S.C. at 76 D.T.C. 6312)

494 To make sense in light of the fact that Sec. 107(2) also uses the term "distribute" in a testamentary context when debt is to be assumed this comment would be appropriate in respect of the gross value of the estate to which beneficial entitlement exists, not net of conditions precedent or subsequent.

495 Similar opinions were expressed in *Passant v. Jackson*, 1985 S.T.C. 133 ChD, where to realize a particular property from an estate as a residuary legatee the taxpayer mortgaged it after the executor assented to its unencumbered disposition to the taxpayer whereafter the proceeds were given directly to the executor with which to satisfy the estate's liabilities. The testator contended to no avail that the cost of the property to him for subsequent disposition purposes of the property amounted to both its fair market value under a Sec. 70(5) cost bump-like provision extracting estate taxes plus the amount he paid to the estate by way of the mortgage but only the former was recognized as a cost. Speaking of the assent the court held:

"Although the executor, as a matter of form and convenience, transferred the property to the taxpayer by an assent, the resulting position was just the same as if the taxpayer had paid the executor 6000 pounds for the property, that being the agreed value a little over a year before, and had borrowed the purchase price, as to part on a short term loan, and had then repaid the short term loan on the distribution of the net balance of the estate, being a sum of 3160 pounds or thereabouts. It was not in truth a bare assent but machinery for giving effect to what was in substance a sale."

The issue in the case exclusively concerned the cost of the property and not how it was acquired though it is expected that this reasoning could be equally applicable to cases involving the use of testamentary debt to fine tune the Sec. 70(3) recognition to be discussed subsequently.

would be realized, taxed in the hands of the trust, and capitalized for the ultimate benefit of **that** particular beneficiary. If the payment wasn't made the particular beneficiary would exclusively eventually realize the benefit of the bequest, equal to the value of the A.R., while if the payment, say of 30% of the value etc., was made he would receive the balance, and eventually the amount he paid. (The paid amount could then be used to generate income for other beneficiaries before it is returned to the payor.)

Following the reasoning in *Tory Estate* the value of the bequest to the beneficiary would equal the gross amount of the income right, however in the instance where she pays as a condition a returnable sum to the trust some of that value will be a return of capital while in the case where she doesn't pay anything the entire sum will be distributed as capital. If the will provides that \$100,000 worth of A.R. will be distributed to a particular beneficiary immediately provided she pay \$20,000 which will be returned to her in five years a "sale for value" cannot be recognizable since the transfer of the value is aggregately gratuitous however, the \$20,000 she pays as a condition could be added on to the cost of the A.R. (rights) by virtue of Sec. 69(1.1)(ii), as an expenditure made or incurred to acquire the property, and will thus reduce the net income inclusion when the right is realized subsequently. Creating cost out of a condition precedent to receive the right and then have the net proceeds transferred back out of the estate to the same beneficiary as out of the estate's general account seems to be plausible within the workings of the statutes, merely because its possibility hasn't been closed off. Subparagraph 69(1.1)(ii) requires that the expenditure be made to acquire the rights while it doesn't preclude from effect expenditures the substance of which **may** be returned. If the Minister argues the point then the return of the capital paid could be expressed in some form of contingency clause. If this isn't sufficient to make the sum expended qualify the trust deed could provide a power of appointment exercisable in respect of the sum, instead of providing the payer a capital interest contingent or otherwise, which when exercised would allow the sum to be distributable to the payer. The payment will reduce income realized, will not be included in the trust's income as consideration for a sale for value, and will be returned to the payor subsequently thus insuring that the cumulative effect is a gratuitous distribution of the right or things. The important factors to recognize are that the will should specify that absolutely no amount of the rights (A.R.) can be distributed unless by virtue of the deposit of the expressed amount whereby the entire amount is distributed, while these factors should be set out in the will/trust agreement and **should not be** the product of executor-beneficiary negotiations. If the indivisible conveyance of the above as a condition is not expressed then the Minister may be successful at contending that part of the conveyance was a sale and the other part a transfer.⁴⁹⁶

In *Driol v. M.N.R.*⁴⁹⁷ a taxpayer paid \$26,045 to the executrices in respect of an agreement under which the executrices of the estate withdrew their claim to a pension plan benefit that was in dispute. As a result of the withdrawal the taxpayer was able to receive the pension benefit without her right thereto being contested. *Rip. T.C.J.* concluded with respect to the payment:

"It is obvious that the payment to the executrices of Mr. George's estate did not bring her right to be paid income from the estate or any other asset or advantage into existence. Contributions had been made to the pension plan over the years by Mr. George and the City of Regina. The aggregate of these amounts constitutes the assets of the pension plan which entitled Ms. Driol to a pension. Her right to a pension was not derived from any judgment of a court or the settlement of a dispute between her and the executrices of the estate. Her right was derived from her capacity as widow of Mr. George. The dispute between Ms. Driol and the executrices of Mr. George's estate was to which of them had a valid right to payment under the pension plan. Because of the payment by Ms. Driol to the executrices, the executrices ceased to prosecute their claim; the City of Regina accepted Ms. Driol's claim for a pension as a valid one under the pension plan and she received income from the pension plan."

This was a case where the right was the subject of the Matrimonial Property Act which allowed the taxpayer

496 See *Coleman Trust v. M.N.R.*, 87 D.T.C. 664 (TCC). In the author's opinion the Sec. 70(3) transfer need not be made solely in respect of a beneficiary's interest: if it were there would be dictum similar to that in Sec. 107(2), ("in satisfaction of all or any part of his capital interest"). If the rights or things are transferred to the "wrong" beneficiary Sec. 70(3) should apply while the same holds for where the trust is wound up within the roll through period and the property is transferred to any beneficiary. The provision doesn't require that the recipient be beneficially interested in the right or thing, only the estate or trust. A variation of the will in respect of the right or thing could occur. See *Hawk Estate*.

497 89 D.T.C. 122 (TCC)

to have a right to the pension regardless of the agreement reached. The Minister's counsel, in arguing that the payment wasn't deductible under Sec. 18(1)(a) contended that the payment was a **gift** but the judge found otherwise. The pension right in this case would not be considerable as a "right or thing" described under Sec. 70(2) since the deceased taxpayer would not recognize it as receivable before death, however the principles involved can definitely be applied to the Sec. 70(3) mechanics. If the taxpayer has a right as provided by the will to a "right or thing" and that will was contested, and payment was made so as to settle the dispute would the payment not be recognized as an expenditure of the taxpayer needed to acquire the right and thus bump up the cost of the right or thing as per Sec. 69(1.1)(b)? If it wasn't then what possible reason would Parliament have for implementing the Sec. 69(1.1)(b) bump up? More importantly what is the nature of the payment in the hands of the recipient and can it be subject to a Sec. 105(1) income inclusion of a benefit? In *A. Sigerstrom v. M.N.R.*⁴⁹⁸ a taxpayer launched a claim in respect of a capital asset held in an estate the legal title of which was bequeathed to another taxpayer and rather than have the will contested the executors finally paid the man \$10,000 to settle his claim. The Minister attempted to assess the amount in the recipient's hands as income but the Income Tax Appeal Board found that it had the nature of a capital receipt since the right being contested could only be enforceable in respect of a capital property. This case has very little relevance in the present tax environment since Sec. 105(1) could easily have been applied to cause the full amount to be included in the recipient's income unless the frustrated heir was non-resident: the recipient was not a capital or income beneficiary and there was a realization of a benefit.

The Extinguishment of Debt on Rights or Things as a Condition Precedent.

If a trust deed/will allows a trustee/executor to use the **rights or things** acquired by him as collateral to secure loans the substance of which will be expressly allowed to be distributed to capital beneficiaries then the trustee has not overstepped his powers in raising the loans however he may be compelled to extinguish them out of the substance which forms the basis of the capital beneficiary's entitlement. If the will/trust agreement provides that certain beneficiaries will receive the rights or things and be required to extinguish any loans that have been obtained using them as collateral there is a specific bequest of the property though encumbered with a charge. The trust deed could even allow the trustee some latitude in determining what amount of debt will have to be assumed while on the other hand the trustee could be restricted from raising too much debt with respect to the property.

In order for this to be successful at getting a cost bump the beneficiary must extinguish the debt while the trust is liable for it since the Sec. 69(1.1) bump up does not provide treatment in respect of debt **assumed** as does section 107 in respect of capital interests.⁴⁹⁹ With this in mind is it possible for the trust to be exposed to a Sec. 105(1) benefit inclusion in respect of the debt extinguishment? It seems unlikely due to the fact that such would not occur in respect of section 107. In either case the rights or things are to be "distributed or transferred to the beneficiary" and if the recipient extinguishes the loans then such an expenditure will have been made by him to acquire the property since if he didn't agree to pay off the loans he wouldn't have received the property.⁵⁰⁰

Such amounts will inflate the cost of the right or thing under Sec. 69(1.1)(b)(ii) and will reduce the ultimate income inclusion when it is realized. Such property has also been "transferred or distributed" within the context of Sec. 70(3) since the recipient did not acquire it through a purchase negotiated with the trustees after the death or through an exercise of an option and one only has to look to section 107 to find an example of the use of the term "distribute" to a beneficiary in light of that beneficiary's need to assume debt and thus reduce the value of his inheritance. The loan proceeds raised by the trustees could be distributed out to capital beneficiaries through the section 107 mechanics where they could be received tax free, while understandably the loans would actually have to be extinguished by the recipient of the rights in order to bump the cost thereof in that Sec. 69(1.1) refers only to expenditures made or incurred and not incurable. Since a payment on account of the extinguishment of a debt is a payment of capital it will not be taxed in the hands of its recipient

498 56 D.T.C. 117 (ITAB)

499. See *Passant v. Jackson*, 1985 S.T.C. 133, for a case on issue.

500 See paragraph 7(d) of IT 349R2 for the recognition of this type of instance.

as income while since the creditor is not realizing a benefit in respect of a trust/estate, contrary to the T.A.B. opinion expressed in *Lyons v. M.N.R.*, he will not recognize a Sec. 105(1) inclusion in respect of the payment.⁵⁰¹ Structuring debt in such a way offers the advantage of not being tax neutral such as is the case in respect of condition precedent payments directly to alternate beneficiaries. The payer gets the full Sec. 69(1.1)(b) bump-up while the recipient doesn't recognize any tax consequences.

The trustee need not do the above mortgaging and the testator could actually arrange it himself. The cash received on the loan by a non-arm's length party could be distributed to the beneficiary who is to primarily receive the rights or things without the testator recognizing substantial tax consequences under Sec. 70(5). The beneficiary could then use the funds to satisfy the loan and receive the Sec. 69(1.1)(b) cost bump up while if the funds are bequeathed to the beneficiary's spouse or offspring the economic receipt will be passed on in the same direction but the beneficiary would not have to be concerned with the possible application of section 245.

Variations.

The Sec. 70(3) provision recognizes eligible recipients of the rights or things as those beneficially interested under the estate or trust but if the legal ownership of the right or thing remains held by the trust for the benefit of the beneficiary there may be grounds to say that the right or thing has not been legally transferred or distributed to the beneficiary within the context of Sec. 70(3).⁵⁰²

501 See Brown and Secretary, Department of Family and Community Services [2004] AATA 48 (22 January 2004) for an interesting case.

502 "Rights or things transferred to beneficiaries – Sec. 70(3)"

(3) Where before the time for making an election under subsection 70(2) has expired, a right or thing to which that subsection would otherwise apply has been transferred or distributed to beneficiaries **or other persons beneficially interested in the estate** or trust,

(a) subsection 70(2) is not applicable to that right or thing; and

(b) an amount received by one of the beneficiaries or persons on the realization or disposition of the right or thing shall be included in computing the income of the beneficiary or person for the taxation year in which the beneficiary or person received it.

"Beneficially interested – Sec. 248(25)"

(25) For the purposes of this Act,

(a) a person or partnership beneficially interested in a particular trust includes any person or partnership that has any right (whether immediate or future, whether absolute or contingent or whether conditional on or subject to the exercise of any discretion by any person or partnership) as a beneficiary under a trust to receive any of the income or capital of the particular trust either directly from the particular trust or indirectly through one or more trusts or partnerships;

(b) except for the purpose of this paragraph, a particular person or partnership is deemed to be beneficially interested in a particular trust at a particular time where

(i) the particular person or partnership is not beneficially interested in the particular trust at the particular time,

(ii) because of the terms or conditions of the particular trust or any arrangement in respect of the particular trust at the particular time, the particular person or partnership might, because of the exercise of any discretion by any person or partnership, become beneficially interested in the particular trust at the particular time or at a later time, and

(iii) at or before the particular time, either

(A) the particular trust has acquired property, directly or indirectly in any manner whatever, from

(I) the particular person or partnership,

(II) another person with whom the particular person or partnership, or a member of the particular partnership, does not deal at arm's length,

(III) a person or partnership with whom the other person referred to in subclause 248(25)(b)(iii)(A)(II) does not deal at arm's length,

(IV) a controlled foreign affiliate of the particular person or of another person with whom the particular person or partnership, or a member of the particular partnership, does not deal at arm's length, or

(V) a non-resident corporation that would, if the particular partnership were a corporation resident in Canada, be a controlled foreign affiliate of the particular partnership, or

(B) a person or partnership described in any of subclauses 248(25)(b)(iii)(A)(I) to 248(25)(b)(iii)(A)(V) has given a guarantee on behalf of the particular trust or provided any other financial assistance whatever to the particular trust; and

(c) a member of a partnership that is beneficially interested in a trust is deemed to be beneficially interested in the trust.

In *Hawk Estate v. M.N.R.*⁵⁰³ a testator left rights or things in trust for his wife while upon her death the residue was to be transferred to his offspring. The widow and the offspring entered into an agreement with respect to the cattle and grain whereby the offspring began to treat such as their own and came into de facto control of them. While the agreement wasn't in writing the Appeal Board found that it was validated through performance and acceptance and found that the rights/things had been transferred to the beneficiaries for purposes of the former provisions identical to Sec. 70(3). Subsection 70(3) **doesn't require that the rights/things be transferred/distributed as a consequence of death**⁵⁰⁴ and in *Hawk* the reason that they were transferred to the offspring was due to the variation agreement reached by the parties. In this respect a variation within the time limits imposed upon the Sec. 70(3) roll through will not affect the applicability of that provision.

More Trust Rights.

If the beneficiary dies while the right held by the trust has not been realized, and he is the only person beneficially entitled to the income when realized, as per the reasoning in *Tait Estate et al. v. M.N.R.*⁵⁰⁵ the deceased and his estate will benefit from the Sec. 70(2) election. In that case the deceased was the spouse in respect of a spousal trust and the estate had yet to realize substantial earnings on a harvest of grain, the income of which would be payable to the deceased. When the deceased died the Sec. 70(2) election was attempted in respect of the amount of grain that had not been realized and the Minister contended that it was not available in that the "right or thing" was owned by the spousal trust which could not avail itself of the Sec. 70(2) alternate reporting election, and evidence was not provided as to who actually performed the farming. Brulé, T.C.J., provided:

"If the spousal trust through the executor was responsible for the farming then I agree that a rights and things return could not be filed respecting the grain according to the provisions of Subsection 70(2) of the Income Tax Act as pointed out by counsel for the Minister."

"**The determination of the ownership of the grain**, if the estate farmed the property, is to be made based on the rights of a life tenant as opposed to a remainderman."

"In either case the grain on hand was produced. If it had been sold then Christina Tait would have received the proceeds, but it was not. I cannot conceive that this makes any difference. If I may hypothesis, suppose a bond case coming due on say a Monday and the life tenant's estate is still entitled to the proceeds. In each estate the trustee prepares on the death of a life tenant a statement of "net paid and accrued income" representing what has been paid and what owned at the date of death."⁵⁰⁶

He concluded that since the underlying spouse would be exclusively entitled to the income when it was realized the Sec. 70(2) alternate return election should be available to her in respect of the grain owned by the trust. The interesting aspect about this case is that there appeared to be no evaluation of whether in fact, in the particular instance, the income when realized would be payable to her, which would not occur if the trustee had to make good out of that income revenue losses previously incurred or use it to replenish capital drawn upon under a power of encroachment. The "right or thing" the spouse had in this case was a right under a trust agreement/will which is not the same as a right of legal ownership to receive the income itself. Under subsection 70(3) will only the transfer or distribution of the rights to income in specie be allowed roll-through treatment? In the above case that subsection would not apply to the right to the income from the grain since that is retained by the trustee but the Sec. 70(3) roll-through would be available in respect of the right to receive that income **from the estate** if it was transferred or distributed accordingly. If the beneficiary has full beneficial ownership of the rights transferred to the trust upon death it would seem unnecessary that legal title also be registered in his name as well.

503. 57 D.T.C. 207

504 There cannot be a sale, there must be a transfer as a consequence of testamentary devolution

505. 89 D.T.C. 309 (TCC)

506 Recognizing that the estate in this instance is a spousal trust, one should infer that Brulé T.C.J. understood the Sec. 70(6)(b)(i) phrase; "income of the trust that arises before the spouse's death", to mean income realized **or accrued**.

The Question of Assent.

In *Dushinsky Estate v. M.N.R.*⁵⁰⁷ it was held by the Tax Court that the Sec. 70(3) roll over did not apply where the executor had not assented to the bequest when the beneficiary directed that the right or thing was to be disposed of. The assent and thus creation of beneficial ownership in specie is critical to an agent(executor) disposition. If beneficial ownership of the right becomes instilled in the beneficiary it would appear that the roll through would be available.⁵⁰⁸ *Re: Campbell*⁵⁰⁹ provides an excellent discussion of the importance of an assent, express or implied by the conduct, in order for favourable testamentary roll over provisions to be applicable. In that case the executor liquidated the roll over property to gain funds to satisfy substantial estate liabilities and passed the excess proceeds to the beneficiaries and the court held that a beneficial estate or interest must be acquired by the qualifying recipient in order for the roll over to be available-though this requirement was termed-"passes or is deemed to have passed to" the taxpayer-perhaps as nebulous as "transferred or distributed".⁵¹⁰ Assent in this case was doubted due to the nature of the accounts kept by the executor, (which reflected the fact that an assent had not occurred with respect to its disposition and that the property was still considered part of the unadministered estate), the on-going advertising, and how the sale was executed and proceeds used, (they were credited to the executor directly and then used to satisfy the estate's fiscal liabilities).⁵¹¹ The fact that the residuary beneficiary was to a certain degree actively involved with the sale did not give rise to an implied assent while it was held by the court that it is the will **and** the assent that create the proprietary interest acquired once administration is completed and assent forthcoming.

In *Boger Estate v. The Queen*⁵¹² it was held that "transferred" in the context of Sec. 70(9) meant the vesting of legal title of the property in the executrix and trustee pursuant to the will regardless of the fact that the legal title was not transferred to the beneficiaries before the property was sold. Beneficial title vested immediately upon the death and the fact that property in specie was not stated to be bequeathed but only "the residue" did not prevent the transfer in specie from occurring. The fact that an application under the Family Relief Act was made did not prevent the offspring beneficiaries' interests from being vested while property **unaffected** by orders made under that legislation was found to have been transferred at the time of death. In this case the property was disposed of by the executor **as agent** for the beneficial owner-beneficiary as is established Alberta estate practice rather than have legal title registered in the beneficiaries' names then disposed of.

Partnership Interests on Death, Separate Returns.

A partnership is determinable upon the death of one of its partners unless the contract provides otherwise and consequently its tax year terminates and the accounts are taken and the partner recognizes the income under Sec. 96(1). If the partnership isn't determined⁵¹³ the partner could recognize a Sec. 70(2) inclusion in respect of partnership income accrued to date⁵¹⁴. It must be noted that if the partnership doesn't determine on the death there will be double taxation of the value of the right or thing in respect of the partner's share of the revenue net of expenses to the date of death: such will be included in computing his terminal income under Sec. 70(2) **and** when the partnership year closes the estate will recognize a Sec. 96(1)(f) inclusion. Regardless of whether or not the partnership is dissolved the ACB of the partnership interest is increased **immediately**

507. 90 D.T.C. 1391 commented upon subsequently,

508 See *Cochrane v. I.R.C.*, 1974 S.T.C. 335.

509 1968 V.R. 46 (SCV)

510 See also *Trustees, Exors., and Agency Co. Ltd. v. F.C.T.*, 65 C.L.R. 134 at 140, *A.G. v. Milne*, 1914 A.C. 765, *Nevill v. I.R.C.*, 1924 A.C. 385.

511 As per *Doe v. Harris*, 1847 16 M. & W. 517, an ambiguous statement will not evidence an assent on itself while as per *Cray v. Willis*, 1729 2 P. Wms. 531, assent will be presumed when there is a lack of evidence to support the presumption that the executors have additional duties to perform, while as per *Daw v. I.R.C.*, 14 T.C. 58, and *Carlish v. I.R.C.*, 38 T.C. 37, if the beneficiary takes possession or control of the estate property without the complaint of the executor assent will be presumed. The rule where there is ambiguity is to look to the acts of the executor and if they are consistent with that on an executor assent cannot be inferred. See also "Assents", E. & T. Q., 1988-89, Vol. 9, pg. 83, Practice Note by "A.H.O."

512 91 D.T.C. 5506 FCTD

513. which may be the case where the contract provides for such and the provincial legislation allows it

514 It must be assumed that the disposal cited in Sec. 70(2) refers to an assignment under which the assignee ascends to being a partner thus dissolving the partnership: otherwise the stub period income may not be recognizable, hypothetically, by the testator upon the disposal.

before death by the value cited in Sec. 70(2) via Sec. 53(1)(e)(v) thus reducing a Sec. 70(5) capital gain on the deemed disposition of the interest. If a Sec. 70(2) inclusion isn't recognized it appears that there is a bump in the cost of the interest anyway since Sec. 53(1)(e)(v) doesn't require an income inclusion under Sec. 70(2); only the value to be established. In I.T. 278R the Department takes the opinion that if before the right to partnership income has been transferred to a beneficiary the income is accredited to the partner's(estate's) capital account the Sec. 70(3) roll-over isn't available. The right to income of a partnership isn't severable from the partnership interest itself though if the partnership continues and the will provides that a beneficiary is to receive the income therefrom equitable ownership may arise upon the assent so as to allow the Sec. 70(3) roll to operate notwithstanding the beneficiary may not ascend to the status of partner.⁵¹⁵ The fact that the income is accredited to the capital account within the period of the roll over, in the author's opinion, is of no relevance in taxing the right **at the date of death** and since this is the particular targeting of Sec. 70(2) and upon which Sec. 70(3) focuses the fact that the accounts are ascertained in the interim does not preclude the roll over. Subsection 70(3) targets the transfer of rights at the date of death that would have been recognized in income; it doesn't target how those rights are received.

On aspect that should be noted here is the break-down in the cost/income integration in respect of the partnership interest. The interest is deemed disposed of **immediately** before death and if the partnership year terminates upon death there will not be an ACB bump under Sec. 53(1)(e) for the interest in respect of the income recognized thus that income will also increase a capital gain. Until this weakness is corrected with the appropriate statutory amendment it could prove favourable to have the partnership suffer a termination upon the death if a loss is otherwise recognizable by the deceased partner since in such an instance the ACB of the partnership interest **is not reduced** by the loss immediately before death and thus the loss can be effectively recognized one and three-quarter times rather than just once. The partnership deed could provide that this isn't to occur if the deceased would otherwise suffer income while it is to be noted that a loss could be created by having the deed call for excessive C.C.A./E.C.E.A. deductions etc. in the year of death.

"Death of partner or proprietor – Sec. 150(4)"

(4) Where

(a) subsection 34.1(9) or 34.2(8) applies in computing an individual's income for a taxation year from a business, or

(b) an individual who carries on a business in a taxation year dies in the year and after the end of a fiscal period of the business that ends in the year, another fiscal period of the business (in this subsection referred to as the "short period") ends in the year because of the individual's death, and the individual's legal representative elects that this subsection apply, the individual's income from businesses for short periods, if any, shall not be included in computing the individual's income for the year and the individual's legal representative shall file an additional return of income for the year in respect of the individual as if the return were filed in respect of another person and shall pay the tax payable under this Part by that other person for the year computed as if

(c) the other person's only income for the year were the amount determined by the formula

A + B - C

where

A is the total of all amounts each of which is the individual's income from a business for a short fiscal period,

⁵¹⁵ One technicality is interesting in respect of the roll through of a continuing partnership interest when the partnership doesn't dissolve: the Sec. 70(2) recognition can be avoided with a Sec. 70(3) assent and the a.c.b. of the partnership interest is bumped immediately before death via Sec. 53(1)(e)(v). The beneficiary receives the partnership interest and ascends to being a partner whereby he'll recognize the Sec. 96(1) inclusion in respect of income all the way back to the last partnership year end which includes the value rolled through under Sec. 70(3). Technically the beneficiary will recognize a Sec. 70(3) and Sec. 96(1) inclusion **but** he **may** rely on Sec. 4(4) to eliminate the double inclusion of the income from the same source **but** the Sec. 53(1)(e)(v) cost bump will still have occurred reducing any capital gain/increasing capital loss on the Sec. 70(5) disposition of the interests, though it is doubted that there will be a double a.c.b. bump as well.

B is the total of all amounts each of which is an amount deducted under subsection 34.2(8) in computing the individual's income for the taxation year in which the individual dies, and
C is the total of all amounts each of which is an amount included under subsection 34.1(9) in computing the individual's income for the taxation year in which the individual dies, and
(d) subject to sections 114.2 and 118.93, that other person were entitled to the deductions to which the individual is entitled under sections 110, 118 to 118.7 and 118.9 for the year in computing the individual's taxable income or tax payable under this Part, as the case may be, for the year.

Dispositions during the Executor's Year

Subsection 164(6) allows the transfer of the consequences of capital dispositions by an unadministered estate during its first year – the statutory executor's year recognized in various provincial estate devolution/administration Acts, to the testator. It also allows for the taking into account of various estate administration fees such as probate, executor will-reading, transfer costs etc., to be taken into consideration in arriving at the testator's to-be-adjusted terminal tax return. This is an elemental feature that should be considered when dealing with an estate since it only lasts for the first year after death and it should cause you to focus on where the property is going and be expeditious in the dealing of the interests that arise in the will.

Subsection 164(6) interacts completely with the section 107 trust property roll-out provisions so that any costs incurred to transfer property within the executor's year, to any beneficiary, are affected back to the testator's terminal return. It's interesting that as recently as *Estate of Jean White v. The Queen*⁵¹⁶ the "trap" in respect of the deductibility of these fees against the testator's income was recognized. Given the interaction with the section 107 estate/trust roll-out mechanics, which causes estate/trust cost amount dispositions of its property this provision allows for the carry-back of consequential capital loss/terminal loss carry-back to the testator's return, if they occur in the executor's year. **Unfortunately, in the case of spousal recipients (spouse and/or spousal trust) the ITA deems the testator's property not to have "gone near the estate" under Sec. 70(6) to be commented on but directly to the recipient hence there is considerable disparity here – the property doesn't go through a section 107 roll-out to cause taxable dispositions: in such a case there should be planning for which testator assets are to be spousal and those not and calculation of financial and legal consequences.**

Given this provision, and its ability to transfer back the tax affects of dispositions that are not chargeable on a terminal return, given that they relate to title transfer that happens after death, with the testator ceasing to statutorily own the property immediately before death, depending on the property being dealt with, it's prudent to accelerate transfers, if possible, to draw down a deceased's tax. While estate fees etc. described in Pappas Estate are costs incurred to make distributions of estate property which are dispositions under section 107 they can get locked in an estate to no effect if **all of the property** is to be transferred out to beneficiaries: by making indemnifications to the executrix when all property is to be directly bequeathed and **accelerating the transfers within the first year** testator tax is recoverable on the terminal return.

As previously noted is there any merit to drawing attention to the fact that an estate and trust are not to be treated as equivalent given the Sec. 70(7)-(8) tainted spousal trust mechanics and the underlying numerous references in various other articles of the ITA of both: **can argument be made here that when an estate is crystallized into an enduring trust there is a recognizable disposition (solidification of**

516 T-875-93 where the Tax Court held, considering subsequent charges incurred by the estate outside of the executor's year:

"[7] Mr. White contended that the costs regarding the sale of the lots from the time of death to the sale dates should be included. This would result in costs of \$43,152.21 thereby reducing the value of the lots from \$35,000.00 to \$29,849.56. Mr. White is concerned with the notion of double taxation. However, the *Income Tax Act* provides for a deemed disposition on death. While there is a deemed disposition on death, it must also be recognized that the estate is taxed separately, and there is no authority for the proposition that Mr. White takes."

in specie title in the hands of the beneficiaries in the trust's property) that would draw the application of the provision on the estate's "disposition"? Clearly Parliament recognized the relevancy of the common-law executor's year during which prevents the beneficiary to call for clear crystallized title but if such occurs through assent to a will's dispositions that cause legal title transfer to settle an enduring trust, and resulting interests thereunder, does that warrant application of the provision? Is there "a disposition" within the meaning of the Sec. 248(1) definition – paragraph (e), for these purposes, from general estate to the enduring trust and in order for the beneficial availability of the subsection does legal title actually have to be transferred to an end beneficiary under an estate to begin with but merely assented to be held clear, in trust, instead?^{517 518} **When the executor transfers legal title of a property in specie to a trustee per the will has he not equally "disposed of it", as described in the subsection, in the exact same manner that he has to a 3rd party or a beneficiary: there is no qualification on who the recipient has to be?** Is this an instance where s. 107(2) could apply to cause a tax-free roll-out to the trust of the estate property? Can the estate even then elect under s. 107(2.001) to cause FMV disposition in its hands?

Does the enduring trust qualify as a beneficiary for purposes of s. 164(6) when there is no qualification as to who that recipient can be?

Is it possible to shift capital losses/gains in this environment: when the estate gains the benefit of recognition of a disposition within the meaning of the subsection what proceeds are realized from the enduring trust? **Do they have any alienable value to any one?** And if the proceeds are legally recognizable as "nil", allowing the testator to completely eliminate any gain recognition under s. 70(5), then the property in the enduring trust's hands equally have that cost amount. This can really upset the transfer of cost recognition in this nebulous situation since the testator's terminal reporting can be materially warped and the surviving trust's tax exposure significantly deferred and/or transferred to an end beneficiary thereunder per s. 107(2) for further deferral.

Has this provision kept abreast of other evolution in the Act, since even the subs. 248(1) definition of "disposition" can be argued to exempt this "disposition" as **having occurred**, it lies outside subdivision k only where the two are legally "equal", and refers exclusively to inter-trust transfers, **not between estate and trust**, thus doesn't apply?

Equally, clearly the provision applies only to **estates** during administration: if debt ascertainment has reached a point at which the quantum of beneficial title to the estate property has crystallized and is measurable then "the estate" is not any more and the trust comes into being, regardless of whether such happens in the executor's year. The provision lies outside of subdivision k: only therein an estate is equal to a trust and vice versa. And based on the argument above, is this then not an instance where all of the estate's property is "disposed of" between "estate" and "trust", differentiated throughout the Act, allowing all to benefit from s. 164(6), if occurring within the first year of the estate?

The author is of the opinion that there should be an entire set of supporting provisions that match this environment to what happens in the actual environment so that, in the present situation, s. 164(6) cannot be improperly accessed given its "loose" wording.

Where disposition of property by legal representative of deceased taxpayer – Sec. 164(6)

(6) Where in the course of administering the estate of a deceased taxpayer, the taxpayer's legal representative has, within the first taxation year of the estate,

(a) disposed of capital property of the estate so that the total of all amounts each of which is

⁵¹⁷ In the author's opinion there should be 4 ownership bases through which property flows in a testamentary tax setting: testator to, estate, to trust (if not but for tiny amount of time pending distribution to) then to, beneficiary as opposed to in many instances what exists now which is the 3 of, testator to, estate **OR** trust, to beneficiary.

⁵¹⁸ See "Testamentary Planning to Avoid Double Taxation" by H. Elise Rees in *Estates, Trusts and Pensions*, Vol. 20 Pg. 11 for some further discussion regarding Sec. 164(6) in the estate planning environment.

a capital loss from the disposition of a property exceeds the total of all amounts each of which is a capital gain from the disposition of a property, or

(b) disposed of all of the depreciable property of a prescribed class of the estate so that the undepreciated capital cost to the estate of property of that class at the end of the first taxation year of the estate is, by virtue of subsection 20(16) or any regulation made under paragraph 20(1)(a), deductible in computing the income of the estate for that year,

notwithstanding any other provision of this Act, the following rules apply:

(c) such parts of one or more capital losses of the estate from the disposition of properties in the year (the total of which is not to exceed the excess referred to in paragraph 164(6)(a)) as the legal representative so elects, in prescribed manner and within a prescribed time, are deemed (except for the purpose of subsection 112(3) and this paragraph) to be capital losses of the deceased taxpayer from the disposition of the properties by the taxpayer in the taxpayer's last taxation year and not to be capital losses of the estate from the disposition of those properties,

(d) such part of the amount of any deduction described in paragraph 16(6)(b) (not exceeding the amount that, but for this subsection, would be the total of the non-capital loss and the farm loss of the estate for its first taxation year) as the legal representative so elects, in prescribed manner and within a prescribed time, shall be deductible in computing the income of the taxpayer for the taxpayer's taxation year in which the taxpayer died and shall not be an amount deductible in computing any loss of the estate for its first taxation year,

(e) the legal representative shall, at or before the time prescribed for filing the election referred to in paragraphs 164(6)(c) and 164(6)(d), file an amended return of income for the deceased taxpayer for the taxpayer's taxation year in which the taxpayer died to give effect to the rules in those paragraphs, and

(f) in computing the taxable income of the deceased taxpayer for a taxation year preceding the year in which the taxpayer died, no amount may be deducted in respect of an amount referred to in paragraph 164(6)(c) or 164(6)(d).⁵¹⁹

519 Subsection 164(6.1) further provides a provision applicable to the testamentary exercise of stock options that allows some consideration of the economic effect.

Realization of deceased employees' options

(6.1) Notwithstanding any other provision of this Act, if a right to acquire securities (as defined in subsection 7(7)) under an agreement in respect of which a benefit was deemed by paragraph 7(1)(e) to have been received by a taxpayer (in this subsection referred to as "the right") is exercised or disposed of by the taxpayer's legal representative within the first taxation year of the estate of the taxpayer and the representative so elects in prescribed manner and on or before a prescribed day,

(a) the amount, if any, by which

(i) the amount of the benefit deemed by paragraph 7(1)(e) to have been received by the taxpayer in respect of the right

exceeds the total of

(ii) the amount, if any, by which the value of the right immediately before the time it was exercised or disposed of exceeds the amount, if any, paid by the taxpayer to acquire the right, and

(iii) where in computing the taxpayer's taxable income for the taxation year in which the taxpayer died an amount was deducted under paragraph 110(1)(d) in respect of the benefit deemed by paragraph 7(1)(e) to have been received by the taxpayer in that year by reason of paragraph 7(1)(e) in respect of that right, 1/2 of the amount, if any, by which the amount determined under subparagraph 164(6.1)(a)(i) exceeds the amount determined under subparagraph 164(6.1)(a)(ii),

shall be deemed to be a loss of the taxpayer from employment for the year in which the taxpayer died;

Non-Residents.

Subsection 70(5), 70(5.1), 70(5.2), as well as Sec. 70(2) and (1) apply where a taxpayer dies regardless of his residence and thus if the deceased was non-resident, through the effect of the testamentary provisions, he may have to recognize income etc. under the Division D rules, Sec. 115(1) in particular. Though the latter subsections of section 70 cause deemed dispositions of property that may be taxable Canadian property Sec. 70(1)-(2) do not cause deemed dispositions just income inclusions.

Division D regulates how a non-resident is taxed and subsection 115(1) does not target Sec. 70(1)-(2) inclusions consequently rights or things held by a non-resident do not cause Part I tax consequences upon the taxpayer's death. This isn't the case with deemed property dispositions since such property may be described as Sec. 115(1)(b) taxable Canadian property. The tax treaties prevailing between the Canadian and foreign governments may however cause the negation of the possible application of the provisions. This was the case in *Gladden Estate v. The Queen*⁵²⁰ where the Federal Court-Trial Division had to decide whether the effect of Sec. 70(5), as it could apply to an American resident's deemed disposition of shares of a Canadian corporation, could be overridden by the Canada-U.S. 1942 Convention and Protocol, (in particular Article VIII therein causing "sales or exchanges" to be exempt under the ITA in that they would be taxed under the I.R.C.). Judge Addy concluded upon a review of the history of the applicable treaty provision and Sec. 70(5) that:

"As to the surrounding circumstances when the treaty was signed, Canada had no capital gains tax legislation and the U.S. legislation at the time used the term "sale or exchange". This accounts for the reason why those very words were used in the treaty. There seems to be little doubt, however, that the general intention was to exempt non-residents of each of the contracting countries from capital gain taxes generally. With regard to paragraph (6) of Article 32 of the Vienna Convention, (concerning the interpretation of treaties), regarding the avoidance of a result which might be manifestly unreasonable or absurd, to hold that a deemed disposition would, as acclaimed by the Minister, be taxable as a capital gain while a true sale or exchange would not, would be both unreasonable and absurd. Real commercial transactions would be taxable while artificially created ones would not. In the case at bar, for instance, it is abundantly clear that had the deceased disposed of the shares immediately before his death in consideration of payment of the full market value thereof, his estate would not have been taxable in any way on a capital gain. Yet, because he died and there is deemed to be a disposition of the shares, the result would be that his estate would be taxable although no real "sale or exchange" or other disposition actually took place."

He found the deemed disposition non-taxable under the 1942 Convention.

In *Krafve v. M.N.R.*⁵²¹ the opposite conclusion was reached by the Tax Court with respect to a deemed disposition prescribed to have occurred under Sec. 69(1) when a non-resident gifted shares to a Canadian resident trust. In direct opposition to *Gladden Estate*, (occurring at a later date), the gift was found not to have been a "sale or exchange" and thus the disposition was not exempt from Part I tax treatment.

The Canada-U.S. Income Tax Convention 1980 with respect to the Sec. 70(5) provision (as well as all of the others under section 70), is quite different from 1942 version mainly because the former refers to gains from "the alienation" of property, real or personal, while the latter referred to only "sales or exchanges". Although the latter is a subset of the former category of actions the diction that causes section 70 deemed dispositions to be taxed in Canada in respect of a non-resident's death is the term "alienation" which as

(b) there shall be deducted in computing the adjusted cost base to the estate of the right at any time the amount of the loss that would be determined under paragraph 164(6.1)(a) if that paragraph were read without reference to subparagraph 164(6.1)(a)(iii); and

(c) the legal representative shall, at or before the time prescribed for filing the election under this subsection, file an amended return of income for the taxpayer for the taxation year in which the taxpayer died to give effect to paragraph 164(6.1)(a).

See *The Estate of Carl Edward Miller and Her Majesty The Queen*, 1999-2987(IT)G, for further detail.

520. 85 D.T.C. 5188

521 84 D.T.C. 1002

recognized for tax statute interpretation in this sense includes dispositions deemed to have occurred. This is also the case in respect of the Canada-U.K. Tax Convention (1978), Art XIII para. (1).

Paragraph 4 of Article XIII of the Canada-U.S. Convention 1980 recognizes that gains from the alienation of property other than that having the real property or business property characteristics described in para. (1)-(3) will be taxed in the alienator's country of residence only. Real property is taxed in the country in which it is situated while under para. (3) an interest in a trust or estate, the value of the interest being derived principally from real property situated in Canada, will be considered real property, regardless of the residence of the trust or estate. This targeting does not necessitate the trust/estate to actually hold legal title to the real property in order for the interest to be subject. The same holds true under Article XIII para. (1) and (5) of the Canada-U.K. Convention (1978) in respect of non-residents however under para.(6)(b) if the testator, solely or with related or connected persons, is interested in less than 10% of the income **and** capital of a trust the interest will not be subject to Canadian taxation while the value of the interest need not be derived from that real property. The provision does not describe where the related or connected parties may reside, where the trust may reside, nor does it define "income" or "capital" of the trust, nor does it differentiate between trusts **and estates**. This last aspect is interesting since there isn't a single reference to "estates" under Art. XIII of the Can.-U.K. 78 Convention while Art. XX, concerning income of non-residents from estates and trusts, refers, consistently, **to both**. Apparently if the U.K. resident dies holding an interest in an estate resident in Canada which is in the midst of being administered he will not be caught by Sec. 70(5), (especially when one recognizes that Sec. 115(1)(b) refers to disposition of capital interest **in trusts only, not in estates**).

The Sec. 248(1) definition of taxable Canadian property **includes** but doesn't **mean** the four types of property specified while subparagraph 115(1)(b) describes taxable Canadian property for purposes of Division D. The latter includes specific types of property and interests in the property specified but with respect to estates in the midst of administration the rights the beneficiaries have are not interests in the estate property, but are only choices in action enforceable against the executor. While a choice in action is definitely a "property", as per Sec. 248(1), it is not a property that is statutorily targeted by Sec. 248(1) or 115(1)(b) as taxable Canadian property.⁵²² Rights to specific bequests may include interest in the property since technically the property can be looked upon as being held both in trust and subject to the estate and subsequent liabilities. As per Ex parte. Dr. Barnardo's Homes⁵²³ income received from a **specific bequest** of specific property that has not yet been transferred to the beneficiary may be received as income when paid to him, while the property is still subject to the administration of the estate. This isn't the case with **residual bequests**.

Both major tax conventions refer to the alienation of real or immoveable property situated in Canada however it would seem that the particular Canadian situated property would also need to be a taxable Canadian property within the definition in Sec. 248(1) and 115(1)(b); otherwise upon death of the non-resident Sec. 115(1)(b) could not be applied properly. (This was an underlying factor in *Gladden Estate v. The Queen*, supra.) The situs of the legatee's choice in action in respect of the estate and whether that estate had been fully administered were the issue of *The Queen v. Eide Estate*⁵²⁴. In the author's opinion the situs of the choice in action, though relevant for purposes of the Estate Tax Act is not to be equated with taxable Canadian property status under the I.T.A..

The tax treaties offer relief from double income taxation where the legal title of the property disposed of was held by the non-resident, not if he holds a beneficial interest therein. If he holds beneficial **ownership** then the treaty's protections will be available but not so if he is merely beneficially interested by way of being a beneficiary under a trust.⁵²⁵ This was proven in *Kelly Estate v. M.N.R.*⁵²⁶ when a trust residing in Alberta with

⁵²² Perhaps this is one of the purposes that the Sec. 115(1)(b)(vi) taxable Canadian property target doesn't capture interests in estates. Due to this technicality, regardless of the actual residence of the estate, the non-resident may suffer foreign jurisdiction taxation when the interest is disposed of, as well as Canadian "departure tax" under section 48 when he becomes non-resident while owning the estate interest. This would be a good question for a future Roundtable Discussion.

⁵²³ 7 T.C. 646

⁵²⁴ 74 D.T.C. 6286

⁵²⁵ See T.I. 5-0051 of Apr. 1980 by the Non-Corporate Rulings Division to the Ottawa District Office Source Deductions Section.

⁵²⁶ 87 D.T.C. 160

U.S. resident beneficiaries disposed of **foreign** situated land and recognized capital gains. The Tax Court of Canada recognized that the U.S. resident beneficiaries were contingently interested, (though presently vested), in the funds but that it was the executors who had disposed of the land, not the beneficiaries and although they indirectly benefitted from the property they did not have **beneficial ownership** and were thus not able to obtain treaty protection.

"If Counsel for the appellant is correct one must determine the beneficiary of the gain. This person must be the absolute owner of the lands, that is, his right of ownership in the lands is unrestricted; his right of ownership is unfettered and he can enjoy and dispose of the Lands in the most absolute manner. Article VIII cannot contemplate a situation where a person's ownership of an asset may be taken away on the happening of a future event, for example."⁵²⁷

In this particular case the gain had to be recognized by the trust under Part I. If the proceeds are distributable to the non-resident beneficiaries in the year of disposition or recognition of the gain the taxable capital gain portion will constitute income subject to Sec. 212(1)(c) of Part I upon which withholding tax must be withheld.⁵²⁸

Testamentary Spousal Transfers and Trusts

A General Overview.

Subsection 70(6), (and (5.2)(d) and (f)) allow for effective tax-free transfers of **depreciable and non-depreciable capital property, Canadian and foreign resource property and land inventory used in a business of the deceased**, by the deceased, to either a spouse who was resident in Canada immediately before his death or to a trust created by his will whereunder his spouse is entitled to receive all of the trust law trust income that arises before her death and under which no one but the spouse may obtain the use of or receive income or capital of the trust while she's living. Since the provision is one of the only two which offers a tax-free method to the deceased of transferring non-farm property (even if not principally for the benefit of the spouse) upon his death eligibility for its treatment should always be a target in terminal tax planning, though with some balance for the properties being dealt with.⁵²⁹

There are five basic conditions that have to be in existence immediately before or after the time of death in order for the provision to apply and depending on which one doesn't exist either the applicability of the provision to the particular property may not prevail, or, inapplicability due to the recipients, regardless of how they receive the property may result. Where Sec. 70(6) isn't applicable Sec. 70(5) will apply while since Sec. 70(5.2)(d) and (f) apply only if the conditions described in Sec. 70(6) exist, Sec. 70(5.2)(a) and (e) will apply to cause fair market value basis dispositions if they don't.

"Where transfer or distribution to spouse or spouse trust – Sec. 70(6)"

(6) Where any property of a taxpayer who was resident in Canada immediately before the taxpayer's death that is a property to which subsection 70(5) would otherwise apply is, as a consequence of the death, transferred or distributed to

(a) the taxpayer's spouse or common-law partner who was resident in Canada immediately before the taxpayer's death, or

(b) a trust, created by the taxpayer's will, that was resident in Canada immediately after the time the property vested indefeasibly in the trust and under which

⁵²⁷ See also *Frampton v. I.R.C.*, 1985 S.T.C. 186, for similar a case where beneficiaries did not recognize disposition against which a capital gains exemption could be applied when the trust disposed of the property to which they were not absolutely entitled.

⁵²⁸ See T.I. provided March 1980 by the Non-Corporate Rulings Division where it was provided that non-Canadian source income in the form of capital gain will not attract Canadian Part XIII tax when flowed through a Canadian trust to U.S. beneficiaries and that the geographic source of the gain arising from the jurisdiction of the transaction is generally determinative.

⁵²⁹ For an appreciation of how well our ITA is phrased to attend to this scenario one needs to consider *Frankland v Inland Revenue*, [1997] EWCA Civ 2674 where the UK Ct. of Appeal had to consider the intricacies of spousal roll-over provisions in their Inheritance Tax legislation.

- (i) the taxpayer's spouse or common-law partner is entitled to receive all of the income of the trust that arises before the spouse's or common-law partner's death, and
- (ii) no person except the spouse or common-law partner may, before the spouse's or common-law partner's death, receive or otherwise obtain the use of any of the income or capital of the trust,

if it can be shown, within the period ending 36 months after the death of the taxpayer or, where written application therefor has been made to the Minister by the taxpayer's legal representative within that period, within such longer period as the Minister considers reasonable in the circumstances, that the property has become vested indefeasibly in the spouse or common-law partner or trust, as the case may be, the following rules apply:

(c) paragraphs 70(5)(a) and 70(5)(b) do not apply in respect of the property,

(d) subject to paragraph 70(6)(d.1), the taxpayer shall be deemed to have, immediately before the taxpayer's death, disposed of the property and received proceeds of disposition therefor equal to

(i) where the property was depreciable property of a prescribed class, the lesser of the capital cost and the cost amount to the taxpayer of the property immediately before the death, and

(ii) in any other case, its adjusted cost base to the taxpayer immediately before the death, and the spouse or common-law partner or trust, as the case may be, shall be deemed to have acquired the property at the time of the death at a cost equal to those proceeds,

(d.1) where the property is an interest in a partnership (other than an interest in a partnership to which subsection 100(3) applies),

(i) the taxpayer shall, except for the purposes of paragraph 98(5)(g), be deemed not to have disposed of the property as a consequence of the taxpayer's death,

(ii) the spouse or common-law partner or the trust, as the case may be, shall be deemed to have acquired the property at the time of the death at a cost equal to its cost to the taxpayer, and

(iii) each amount added or deducted in computing the adjusted cost base to the taxpayer of the property shall be deemed to be required by subsection 53(1) or 53(2) to be added or deducted, as the case may be, in computing the adjusted cost base to the spouse or common-law partner or the trust, as the case may be, of the property; and

(e) where the property was depreciable property of the taxpayer of a prescribed class, paragraph (5)(c) applies as if the references therein to "paragraph 70(6)(a)" and to "paragraph 70(6)(b)" were read as references to "paragraph 70(6)(d)".

The five conditions are obviously:

1. . that the taxpayer who died was resident in Canada immediately before her death, but not necessarily throughout her tax year,
2. . that **on or after and as a consequence of her death** capital property owned by her before her death was transferred or distributed to certain parties,
3. . that those parties could have been; her spouse (and not spouse-to-be or former spouse) who was resident in Canada **immediately before her death regardless of where she is resident when she receives the legal title to the property**, or, a trust **created under the taxpayer's will**, that was **resident in Canada immediately after** the property became indefeasibly vested in it,
4. . the trust must have been **created** under which the deceased's spouse is entitled **to receive** all of the trust's income arising before her death **and** under which no person other than the spouse **may**, before her death, receive or obtain the use of any of the income or capital of the trust, while such a creation can either be as a result of the will or the application of certain provincial dependant relief statutes,
5. . and that the legal representative must, within 36 months after the death, (or such longer period as the Minister considers reasonable upon written application to him within the 3 year period), be able to show that the property has indefeasibly vested in the spouse or the trust as the case may be.

Where these conditions can be shown to exist the deceased taxpayer will be able to enjoy the tax-free

dispositions of his capital property (and the other property cited in Sec. 70(5.2), as per para. (d) and (f)). It should be recognized however that if the spouse chooses to accept an equalization payment under the appropriate provincial Family Law Act, (as is the case in Ontario and Sec. 6(1) therein), or Matrimonial Property Act, the will provisions with respect to the spouse will be overridden and thus a spousal trust may not have a chance to be constituted.⁵³⁰

The property transferred or distributed to the spouse or trust (held under residuary estate) need not be situated in Canada and thus the deceased may still recognize a disposition under a foreign jurisdiction's tax law when he dies, (the same as Sec. 70(5) applies to non-resident), however in order for Sec. 70(6) to be available the deceased must have at least been resident in Canada immediately before his death, which doesn't preclude him from also being resident in another country. By becoming resident in Canada just prior to death and retaining residency in the U.S. through the retention of common law residency characteristics the taxpayer would then be able to avoid deemed dispositions of taxable Canadian property under Sec. 70(5) that would subject him to Sec. 115(1)(b) income inclusions however he would also be caught by the foreign country's testamentary disposition provisions. Depending on the composition of the property he owned situated in either country dual residency on death could prove favorable.⁵³¹ ⁵³² Deemed dispositions under Part I of property upon death do not give rise to foreign tax liabilities but do in Canada.

The property described under Sec. 70(6), (or (5.2)), must have been transferred or distributed "**on or after his death**" but necessarily as a consequence of the death and in this case there appears to be some leverage allowed to the executors of the will as a necessity so as to allow them to settle the estate through the extinguishment of debts, free from possible personal exposure due to an early distribution. One does have to ask oneself however, (and it is extremely important as will be seen), how long after the death the applicability of the provision ceases if the property isn't transferred. In the author's opinion the property need not be transferred or distributed within 36 months after death if it can be shown to be **vested indefeasibly** in the spouse /trust as required but this is only if there are not any reasonable hindrances encountered in winding-up the estate, for which the Minister can give an extension upon application.⁵³³ Obviously the cause of the transfer after his death must be because of the taxpayer's death and in this regard testamentary based buy-sell agreements will function as a consequence of the death but will not cause a transfer or distribution to occur within the context of Sec. 70(6) and will thus not gain Sec. 70(6) treatment due to their contractual foundation while the property that is transferred to the parties as a consequence of the death must be that **owned by the taxpayer** in his personal capacity immediately before.⁵³⁴

Once the spouse under a spousal trust dies the trust ceases to be a spousal trust described in Sec. 73(1) or 70(6) but continues to be such under Sec. 104(4). This is entirely due to the structuring of the phrases in Sec. 70(6)(b) and 73(1)(c) which require not only that the trust have the spousal characteristics when the property is received but that she continue to have such entitlements. If subsequently she doesn't, due to their sale, renunciation, disclaiming, etc. the trust will cease to be of the nature described in the two subsections but will continue to be such under Sec. 104(4)(a). The difference is critical when one examines numerous targeting preambles throughout the Act, such as once the underlying spouse dies the trust is deemed to have disposed of for FMV all of its capital property.

Disclaimers, Renunciations and Allocation Powers.

If a will sets out that property is to be transferred to and vested indefeasibly in an offspring and if disclaimed,

⁵³⁰ The FLA/MPA may be used to demolish a tainted spousal trust however the roll to the spouse will not benefit from Sec. 70(6).

⁵³¹ while perhaps the best approach would be *inter vivos* incorporation of the property so as to preclude him from owning it.

⁵³² In order to be resident at the time immediately before his death the taxpayer must be able to satisfy at that time a residency definition under Sec. 250(1)(a) etc, or (3). As Kim Neufeld CA LLB BCL opened her Tax I class with.

⁵³³ This was also the opinion of the Small Business and General Division of Specialty Rulings (5-5002) in Jan. 1988 when it held citing IT 449 that the property need not be actually transferred within the 36 month period.

⁵³⁴ There may be some advantage in streaming ownership of some types of property to a testator immediately before death to have them go through a Sec. 70(6) roll-over in the context of a larger estate planning scenario. The property need not be free of mortgages and other conditions strapped to it.

to a spouse will a transfer to a spouse be considered as a consequence of a taxpayer's death if his offspring, evaluating the equitable charges attached to the bequest, disclaims it? Clearly it is a result of the disclaiming of the bequest that causes the property to be transferred to the spouse/spousal trust, not as a result of the death, however, subsection 248(8) deems the consequences as that resulting from the death for purposes of the Act even when at common law they are not.⁵³⁵

“Occurrences as a consequence of death. - Sec. 248(8)”

(8) For the purposes of this Act,

- (a) a transfer, distribution or acquisition of property under or as a consequence of the terms of the will or other testamentary instrument of a taxpayer or his spouse or as a consequence of the law governing the intestacy of a taxpayer or his spouse shall be considered to be a transfer, distribution or acquisition of the property as a consequence of the death of the taxpayer or the taxpayer's death, as the case may be;**
- (b) a transfer, distribution or acquisition of property as a consequence of a disclaimer, release or surrender by a person who was a beneficiary under the will or other testamentary instrument or on the intestacy of a taxpayer or his spouse shall be considered to be a transfer, distribution or acquisition of the property as a consequence of the death of the taxpayer or the taxpayer's spouse, as the case may be; and**
- (c) a release or surrender by a beneficiary under the will or other testamentary instrument or on the intestacy of a taxpayer with respect to any property that was property of the taxpayer immediately before his death shall be considered not to be a disposition of the property by the beneficiary.**

Sec. 248(9)

(9) Definition. In subsection (8),

"disclaimer" - "disclaimer" includes a renunciation of a succession under Quebec Civil Law as long as it is not made in favour of any person.

"release or surrender" - "release or surrender" means

(a) a release or surrender made under the laws of a province (other than the Province of Quebec) that does not direct in any manner who is entitled to benefit therefrom, or,

(b) a gift inter vivos made under the laws of the Province of Quebec of an interest in, or right to property of, a succession that is made to the person or persons who would have benefitted if the donor had made a renunciation of the succession that was not made in favour of any person,

and that is made within the period ending 36 months after the death of the taxpayer or, where written application therefor has been made to the Minister by the taxpayer's legal representative within that period, within such longer period as the Minister considers reasonable in the circumstances.

Subparagraph 248(8)(a) provides effectively that a transfer, distribution or acquisition of property under **or as a consequence** of the terms of the will (or other testamentary instrument) or as a consequence of intestacy law governing the taxpayer shall be considered to be a transfer, distribution or acquisition of property as a consequence of the death of the taxpayer while paragraph (b) effectively provides that a transfer, distribution, or acquisition as a consequence of **a disclaimer, release, or surrender** by a beneficiary under a will (or other testamentary document), **or on the intestacy of the taxpayer** shall be considered as a transfer, distribution or acquisition of the property as a consequence of the death of the taxpayer for purposes of the Act. Paragraph (a) effectively allows the granting of testamentary options to the spouse so as to allow Sec. 70(6) to apply to the property upon the option's exercise⁵³⁶. In order for Sec. 70(6) to apply the former must be recognized to be the case. Paragraph (c) of Sec. 248(8) provides that where a beneficiary has made such a release or

⁵³⁵ See "Dealing with Disclaimers and Forfeitures", Barry S. Corbin, *Estates, Trusts and Pensions*, Vol. 24, Pg. 70 for additional commentary of planning for disclaimers and other "monkey-wrenches" in testamentary planning.

⁵³⁶ regardless of whether Canadian tax jurisprudence evolves to the extent that it recognizes an acquisition by a beneficiary or as a purchaser upon the exercise, see subsequently

surrender as cited above he will not be considered to have disposed of the property while implicit in the fact that a disclaimer isn't mentioned is the fact that a disclaimer cannot be a disposition by its very nature, while a renunciation or release is just that.

The 36 month time period is given to settle the estate and if a disclaimer of an interest is made after the 36 month period and the Minister has not authorized an extension then even if it causes the legal or beneficial title of the subject property to fall back to the spouse or spousal trust it will not allow it to qualify for Sec. 70(6) treatment. So, you have 36 mths post-mortum to settle the issues of what goes where when an estate plan has gone off track before the "disclaimer window" closes down and you're "fixed in place". It is obvious that a properly drafted will/estate plan will incorporate a large list of possible out-comes attending to a dynamic environment that has numerous outcomes depending on disclaimers occurring. It is to be noted that the disclaimer can actually trigger other streaming of ownership when the interest disclaimed is in no relation to the property being disclaimed: there is no statutory connection between the recognition of a transfer as a consequence of death and the interest being disclaimed: only that a disclaimer that prompts a redirection of beneficial interest will allow any property to be a transfer, distribution or acquisition as a consequence of death so if a will is structured it can set off multiple and recurring shifts of interests within the 36 mth period.⁵³⁷

If the taxpayer dies intestate and the courts have to decide who gets what then the Sec. 248(8)(a) provision will still cause resulting distributions to spouse or spousal trust to be recognized as a consequence of the death and thus allow them to qualify for Sec. 70(6) treatment. If through a disclaimer, release or surrender the executor of the deed has **directed** that the property or the interest therein will then become another person's, regardless of whether such an expression is contrary or not to the then operative auxiliary will provisions or court orders, the deed will not be recognized as such and the deceased will recognize a disposition and the property will not qualify for Sec. 70(6) treatment. If the former beneficiary renounces or releases an interest in a property **after** the 36 month period and it reverts to the spousal trust as per the terms of the will or intestate court order then the trust **may** be disqualified from being a testamentary by virtue of the fact that it has received a contribution from a person other than on and as a consequence of his death.⁵³⁸ (This is not the case where it is disclaimed.) If he makes it within the prescribed time limits then he cannot be considered a contributor for purposes of the Act since, as per Sec. 248(8)(c), he has not disposed of anything previously owned which if done is the very essence of a contribution. If the testamentary status is lost the trust will be exposed to the higher *inter vivos* trust tax rate but will still retain its spousal characteristic.

Since the disclaiming/renouncing party is probably not receiving any consideration for her act the estate/trust to which the property reverts and becomes subject to the personal character of the trust will remain but if the renouncer receives consideration is it possible that CRA can argue that a contributor to the trust has received consideration for an interest and thus make the estate/trust non-personal subjecting it to harsh income recognition/distribution mechanics?

If the spouse renounces but doesn't disclaim her interest under the spousal trust properly constituted within 36 months the trust **will continue** to be spousal⁵³⁹ but the spouse will not avoid tax consequences on ceasing to be a beneficiary. She can renounce for consideration and if the interests in the spousal trust or estate are splintered up enough she can be selective in what she renounces and what the consideration can be.⁵⁴⁰ This assumes that the trust was fully constituted as spousal prior to the renunciation⁵⁴¹ and the property vested indefeasibly in it since in such an instance the Sec. 70(6) provisions would be satisfied though maybe not subsequently.⁵⁴² Subparagraph 248(8)(c) provides that a release or surrender with respect to the devise of

⁵³⁷ Sort of like the Joker testator getting his beneficial parties to "disclaim for the meat". And live with each other!

⁵³⁸ See *Stannus v. C.S.D.*, 1947 N.Z.L.R. 1, for an instance where a release was recognized to be a gift.

⁵³⁹ under Sec. 104(4)(a) only

⁵⁴⁰ In the case of the general estate the spouse could choose which property she renounces or receives directly and consequently which is transferred to the spousal trust, or, in respect of a spousal trust under which she must be entitled, the other general characteristics thereof must be ensured to exist before she renounces and accelerates an interest that would disqualify the trust. "Good draftsman needed"

541 and it continues to exist

⁵⁴² In *Re: Metcalfe*, 1972 3 O.R. 598, a disclaimer was given retroactive effect to the date of death but in *A.N. Gilbert*

property owned by a testator will not cause the party releasing to be recognized to have disposed of the property however the property in this case does not include the interest in it or the right to receive it. On a surrender of an interest in an unadministered estate or residuary trust the beneficiary will recognize a disposition of the interest and may recognize taxable capital gains but he will not be recognized to have disposed of the property interested in. The value of the income interest that the spouse may surrender may be artificially adjusted through excessive discretionary depreciation powers held by the trustee, incorporation of income property with accumulation of income in the corporate shell, etc.. If the spouse can avoid her principal interest through the disclaimer the trust will not be spousal: she must be entitled with the particular characteristics in order for Sec. 70(6) to be available and her disclaiming which arguably relates back to the creation of the trust, would prevent this. A disclaimer may not operate with retroactive effect to the date of death⁵⁴³ it has been argued and in fact up until the spouse disclaims the interest in the spousal trust upon first becoming aware of it the trust will be spousal.⁵⁴⁴ Is this reasoning material in applying the roll over provision? It should also be noted that the Sec. 248(8) provision applies for purposes of the Act.⁵⁴⁵

If the spouse disclaims her capital interests in the spousal trust the FMV of those given to non-resident beneficiaries may explode whereby subsequently they could become resident and benefit from the Sec. 128.1(1) cost bump, (only if the spousal trust becomes temporarily non-resident). If the trust interest is reacquired through retraction of the disclaimer by the spouse there may not be tax consequences under Sec. 107(1)(a) to the beneficiary and the FMV cost will flow through to the trust property's cost when it is distributed ultimately under Sec. 107(2).⁵⁴⁶ If the trust contains a power to appoint additional capital to the spouse an exercise thereof may create ultimate capital losses for the newly resident capital beneficiaries when the trust property is depleted and the cost of the interest has been bumped.

Unfortunately subsections 248(8)-(9) do not comment on where an executor or legal representative is granted a power to decide which assets will go to which parties and in respect of such transfers one has to rely on common law principles to determine the source and force of the transfer being; if a will provides a special power of allocation to an executor/personal representative, whereby he will decide whether a particular property is to be transferred to a particular party (spousal or not) both particular details of which are addressed in the will **explicitly**, once the executor exercises his power the result should be "read back" into the will and **not be recognized as having as its source the executor's decision**. (The beneficiary's rights however will not relate back to the death but only to the time at which the power is exercised for it is only at that time that the executor has assented to the bequest.⁵⁴⁷) If the will however allows the executor to decide, out of all of the

v. M.N.R., 83 D.T.C. 645, a disclaiming of benefits realizable under a power of advancement was held not to have changed the terms of the will setting out the trust. As per the reasoning in Gilbert it would appear possible for the spouse to disclaim and still have the trust recognized to have the spousal characteristics as **created under the will**. **Renunciations** do not operate ab initio.

543 See Hillis in "Timing of Vesting" in Testamentary Spousal Transfers for one such Canadian example.

544 The fact that she isn't aware of her rights under a secret trust does not detract from it being spousal and she may disclaim the interest substantially after the creation of the trust as spousal.

545 For an interesting case of "going the other way" see MSPNominées Pty Limited and Anor v. CMMR Of Stamps (SA), [1999] 198 C.L.R. 494 HCA, where a trustee unilaterally chose to terminate interests and they were not recognized to be transferred statutorily by the beneficiaries.

546. This will allow the testator to create a tax free cost bump in respect of taxable Canadian property passed to the spousal trust: Sec. 128.1(1) doesn't apply to it when the trust ceases to be resident: the spouse doesn't recognize tax consequences on the renunciation/disclaimer, the non-spousal beneficiaries recognize no tax consequences on a Sec. 107(1)(a) disposal of their capital interests to the spouse: the consideration is paid to the offspring beneficiary by the spouse and she receives the property with a f.m.v. cost transferred through via Sec. 107(2). The offspring does have to become resident when the trust is non-resident in order for this to operate effectively and the consideration paid effectively is the substance disclaimed.

547 Pursuant to Muir v. Muir, 1943 A.C. 468, citing Stewart's Trustees v. Whitelaw, 1926 S.C. 701, which referred to In re: Fane, 1913 1 Ch. 404 at 413, the result of the exercise of the power does not relate back to the time the power was created though the interest created does in testing the validity of the gift:

"It is very material to note with regard to the proposition which Lord Sands derives from Fane v. Fane that it appears to be contradicted, or at any rate qualified, by another rule laid down by Farwell [on Powers] at p. 313, namely, that; "although the appointment is to be read into the instrument creating the power as part of that instrument, it is not to be so read in as to relate back in point of time to the creation of the power (Duke of Marlborough v. Lord Godolphin, 1750 2 Ves. Sen. 61, 78), and again at p. 331 where it is laid down that 'the appointee's estate, though derived from the power, vests not at the time of the creation of the power, but at the

estate, **at his own discretion**, which property will go to a particular beneficiary, even though the testator has expressed that a minimum amount must be set aside for a trust, it is still the executor who is deciding which property should be received by which particular beneficiary thus it is the actions of the executor which are causing the particular property to be transferred, not the will.⁵⁴⁸ As per I.T. 305R3, para. 8, the Department takes a very lenient position on this issue allowing the trust to constitute a spousal trust for purposes of Sec. 70(6). Paragraph 6 of I.T. 449R expresses more or less the same point. In the author's opinion a special power of appointment can effect a qualifying transfer while a general one cannot, though this contradicts the Department's opinion in I.T. 449R, para. 6.⁵⁴⁹ If the tax consequences of the power are expressed to be of major motivation in the allocation of the property the executor will know which trustee concerns are of importance and the will can even provide that he shall be immune from actions by disgruntled beneficiaries if a certain majority thereof agree to a certain allocation, thus ensuring unhindered allocation.

Until the Transfer is Made: Questions of Spousal Residency, Interest Acquisitions and C.C.A.

The first possible recipient under Sec. 70(6)(or 70(5.2)(d) & (f)) which allows a transfer to be eligible for Sec. 70(6) treatment is the taxpayer's "spouse who was resident in Canada immediately **before the taxpayer's death**..." but the property must have been transferred or distributed to her "on or after his death and as a consequence thereof...", while it must also be proven that the property has been vested indefeasibly in her within the 36 months (or more).⁵⁵⁰ The very first aspect that one should notice about this targeting is that it would appear that the spouse need not be resident in Canada when the property is actually received by her. While the second possible recipient, the trust, is specifically caught by "a trust, created by the taxpayer's will, **that was resident in Canada immediately after the time the property vested indefeasibly**" therein which requires that it be resident when the title is vested, there is no such requirement imposed in respect of the spouse as to the time at which the property becomes vested.

time when it its execution takes effect'."

See also *Pedley-Smith v. Pedley-Smith*, 88 C.L.R. 177.

⁵⁴⁸ In *Long v. Comp. of Stamps*, 1964 V.R. 796, an executor with the consent of the beneficiaries apportioned certain estate assets for the exclusive use/benefit of the widow's income rights however the estate as a whole was to be the source of the income. The future interests of the offspring were accelerated and the Stamp Duties authority contended that such was a resettlement when powers of apportionment exercisable prior to terminal distributions were not implicitly instilled in the executor via the will or statute. Citing numerous instances where appropriation powers were validly exercised: *Re: Beverley*, 1901 1 Ch. 681, *Re: Richardson*, 1896 1 Ch. 512, the court held that such amounted to a resettlement of the beneficiaries' interests and stamp duty was assessable in respect of it. Also noted was that the deed operated to destroy the widow's life tenancy in certain property indicative of more than a mere apportionment. Concluding the court held that the argument that the appropriations were a result of a special power of appointment exercisable under the will derived from a statutory appropriation provision was invalid since the statute didn't provide for such a use/effect. Since the deed varied the whole of the estate the whole was assessable for stamp duty. *Buzza and Others v. Comp. of Stamps*, 83 C.L.R. 286 (HCA), is also an instance where an indenture between executor and beneficiary operated to vary the trust and resettle it exposing it to stamp duty, while *Austin Mack Estate*, 1956 73 W.N. 218, illustrates drafting narrowness disallowing certain appropriations to be outside the terms of the will. See also *Re: Lepine*, 1892 1 Ch. 210, *Pughe and Qd. Trustees Ltd. v. Brodribb*, 1921 St. R. Qd. 163, *Davidson v. Armytage*, 4 C.L.R. 205, *Davidson v. Chirside*, 7 C.L.R. 324, and *Scott v. Comp. of Stamps*, 1967 V.R. 122. In *Bowman v. Commr. of S.D.*, 1981 12 A.T.C. 446, a special power of appointment was exercised so as to transfer property to a widow to gain stamp duty exemptions but the N.S.W. Sup. Ct. held that the property was not "passed under the will" within the context of the Act which made exemption in the case of Testator's Family Maintenance Act arrangements. The power was exercised well later than the death and the legislation was targeted to provide exemption to gifts which could be established at the time of death under the will, not under a power of appointment exercised well after it.

⁵⁴⁹ In *Re: Pilkington's Will Trusts*, 1964 A.C. 612, the House of Lords had to ascertain, amongst other issues, who created a trust created via power of advancement treated in the same way as a special power of appointment and it held: "When one asks what person can be regarded as the settlor of Miss Penelope's proposed settlement, I do not see how it is possible to say that she is herself or that the trustees are. She is the passive recipient of the benefit extracted for her from the original trusts; the trustees are merely exercising a fiduciary power in arranging for the desired limitations. It is not their property that constitutes the funds of Miss Penelope's settlement; it is the property subjected to the trusts by the will of the testator and passed over into the new settlement through the instrumentality of a power which by statute is made appendant to those trusts."

This passage was cited in *Minden Trust (Cayman) Ltd. v. I.R.C.*, 1984 S.T.C. 434, where it was held that "a settlement" under U.K. capital transfer tax legislation could be effected by both the original disposition and a power drawing from that disposition to arrange the interests.

⁵⁵⁰ If there is to be habitual changes in residence by the spouse the will should provide that the property will be rolled to a spousal trust, if the spouse is non-resident at the time of death, and then to her so as to preserve the availability of the roll-over.

From the language used concerning the timing of the property transfer, (ie; "on **or after** his death..."), one concludes that the Department recognized that property is not transferable instantaneously upon death and it will allow three years to go by without denying the application and although it expressly provided a residency requirement in respect of the trust it did not feel such an expressed residency requirement applied to the spouse. In effect, all the provision calls for is that the spouse be resident immediately before the taxpayer's death, **nothing more**. Hence it would appear that Sec. 70(6) applies to transfers of property to a spouse resident in a foreign jurisdiction as long as she was resident in Canada at this critical time. In the case of specific bequests unless the will provides that the property is to be held for a certain length of time such as 30 days, or one year etc. before it is actually distributable to the spouse, the will will usually be read as transferring the property that she ultimately receives, at the time of death but if she becomes non-resident as a general or residual beneficiary under a will under which the property is to be transferred immediately after the liabilities have been extinguished and is not to be held, she will not be regarded as owning whatever property she received at the later time, at the time of ceasing to be resident.

In respect of the applicability of the concept of relation back in respect of residuary or specific bequests one has to examine perhaps the landmark case, *Ex. parte Barnardo's Homes National Incorporated Association*⁵⁵¹ where Atkin L.J., concurred with by Lord Sterndale and Younger L.J. as well as all of the House of Lords on appeal, held that, with respect to **residual** beneficiaries:

"They were left the residue of this estate; and it appears to me plain that they did not become entitled to that residue until the residue came into existence, and was ascertained, in other words, until the estate was administered so that the executors were able to know what fund was which they were eventually bound to hand over to the Association. On that simple ground I think that the claim must fail.

It is said, however, that though that might have been so at the particular moment at which the interest was deducted, and the dividends were received by the executors, yet the title of the Association related back to the testator's death as soon as the executors had fully administered the estate, and had intimated to the beneficiaries that they had so administered the estate, and pointed out to them what the exact amount of the residue was, in other words, said they assented to the legacy. Now in respect of that matter there has been no authority produced before us at all to establish that the doctrine of relation back of the legatee's title upon the assent by the executors to the legacy in the case of a specific legacy, applies in the case of a residuary bequest, and on principle one is not surprised that there should be that lack of authority. **The two things appear to differ, and differ in the very root of things, because whereas in the one case of a specific legacy there is something which has existed at the date of death, and which the testator intended the legatee to receive in that form; on the other hand in the case of a residue there is something which did not exist at the date of death, and which the testator did not intend the legatee to receive in any form in which he possessed it or at that particular time. It is not merely that the amount of the legacy is not ascertained but that the legacy is not even in existence in the form in which it is bequeathed to the legatee. It appears to me that there is no authority for the proposition that the title of a residuary legatee relates back to the death as soon as the executor has ascertained the amount and has intimated to the legatee what that amount is.**

I think on principle there should be no relation back."

The exception to the relation back rule arises only in respect of non-specific bequests of property, regardless of whether there has been conversion or not and the distinction between specific and residuary bequests can usually be drawn from the structuring of the will.⁵⁵² The particular form of property of the residue as cash verses property owned by the testator isn't important since the residue could consist of the testator's property that have not been converted to satisfy debts. In the instance that particular property isn't converted but is to be treated as residue and potentially convertible to cover debt the residuary beneficiary, (the spouse), would still

⁵⁵¹ 7 T.C. 646

⁵⁵² *Hillis v. M.N.R.*, 83 D.T.C. 5365, concerned the time of vesting of property under the Saskatchewan Intestate Succession Act and a court order made under that province's Dependant's Relief Act so as to vest the spouse with more property but the gist of the Appeal Court reasoning seems to endorse the inapplicability of the relation back principle to residuary bequests.

not obtain specific equitable title until the executor assents after the provision for, or extinguishment of, debt.

Paragraph 6 of I.T. 449R provides that the fact that the legal representative may wield power over which beneficiary acquires which asset doesn't restrict the fact that the property that is ultimately acquired was acquired as a consequence of the death but the interesting question remains whether, until that discretionary allocation power is exercised, the spouse can be found to have beneficial or equitable ownership of the property that is ultimately transferred to her thus causing it to be subject to the subsection 128.1(1) mechanics when she becomes non-resident while holding it. Paragraph 2 of the same Interpretation Bulletin provides, accordingly, that the ownership of property of a **specific** bequest will vest immediately after the death of the testator⁵⁵³ however it goes on to provide, again accordingly, that the ownership of a non-specific bequest will vest when such property has been identified and the beneficiary has a binding right to receive it restating the essence of Dr. Barnardo's and it could easily be argued that until that time, should she become non-resident, Sec. 128.1(1) cannot apply to property that only after becoming non-resident she gained beneficial ownership of. This can occur in the case of executor discretionary allocation powers and in the case where disclaimers exercised by other beneficiaries within the 36 month period previously cited operate to change the course of beneficial ownership of the subject property and cause it to vest in the spouse, by that time non-resident.⁵⁵⁴ If the capital interest is taxable Canadian property then she need not recognize a Sec. 128.1(1) disposition in respect of it although she could elect to do so and realize a capital gain since the estate property's fair market value would most likely exceed the interest's cost amount as determined under Sec. 108(1)(d)(ii) which usually forms the basis of it's ACB as per Sec. 107(1), if disposed of. By the very fact that capital interests in unadministered estates are not expressly recognized as taxable Canadian property it would seem that such are to be captured by Sec. 128.1(1) when the spouse ceases to reside in Canada though establishing the interest's fair market value may be a subjective exercise. The right the spouse has in the unadministered estate will be a capital interest by virtue of Sec. 108(1)(c)(ii) even if the estate ceases to be testamentary as per Sec. 108(1)(i). Since it is a capital interest Sec. 107(1)(a) will apply if the estate is personal to artificially boost the interest's ACB so as to reduce tax consequences under Sec. 128.1(1).⁵⁵⁵ If the estate ceases to be personal then the right will have a nil cost and may cause a whopping capital gain via Sec. 128.1(1).

Subsection 70(6) refers to transfers or distributions on **or after** the death to the qualifying parties while section 107, in particular Sec. 107(5), describes rules that are applicable when an estate or trust transfers property to a beneficiary in satisfaction of his capital interest and in this particular case one must derive Parliament's intent as to how the distribution of the property to the spouse/spousal trust will be effected under the Act. Subsection 70(6) doesn't just prescribe rules applicable to how the deceased will be deemed to have disposed of the property on his death; it also prescribes rules as to how that property will be **ultimately** received by the spouse/spousal trust. The word "ultimately" is used due to the fact that upon death the deceased's will will take effect spelling out the technicalities of the administration of his estate and Parliament has made full recognition of the fact that the property will pass through the estate and after the death be transferred to the spouse. With these mechanics can it be reasonably argued that Sec. 107(5) can apply to estate distribution to spouses after they have become non-resident? In the author's opinion definitely not, especially when one considers the diction that Parliament has used to expressly require that the spousal trust be resident in Canada immediately after being indefeasibly vested with the property but is conspicuously silent on the requirements imposed on the spouse. It could be reasonable to say, with respect to the spirit of the Act as a whole and especially the purpose of Sec. 70(6), that if the spouse receives property on or after the death of her spouse,

⁵⁵³ In *Re: Neeld*, [1962] 2 All E.R. 335, the Court of Appeal found that a beneficiary under an estate obtained immediately upon the testator's death a beneficial interest in the specific bequest.

⁵⁵⁴ Even though the spouse may be argued to have only a right to force the administration of the estate that right is a capital interest within the Sec. 108(1)(c) definition though not subject to Sec. 128.1(1). Are there adequate grounds to argue that a capital interest in an estate is not considered a taxable Canadian property since the Sec. 115(1)(b) definition, lying outside of subdivision k, refers only to capital interests in trusts resident in Canada? It would seem so since the phrase "...in a trust" is qualified so as to refer only to trusts and thus Parliament made special note to various forms of agreement referred to as "trust" in subdivision K so as to qualify them but did not expressly qualify "estates" outside of subdivision K, in particular Sec. 115(1)(b). See *Fletcher v. M.N.R.*, [1987] 2 C.T.C. 2341.

⁵⁵⁵ This may be affected by estate debt claims yet to be established as valid that will reduce the Sec. 108(1)(d) "cost amount" of the interest: will the Department reassess where they are recognized and reduce the cost latently?

when she is non-resident, she will not suffer the effect of Sec. 107(5). Is it reasonable to assume that Sec. 107(2) applies to the testamentary distribution of property to a spouse when Sec. 70(6) also applies? Can it? Subsection 70(6) allows plenty of room for a spouse to acquire other estate beneficiaries' equitable rights to her husband's estate and have the property which is subsequently transferred gain Sec. 70(6) treatment. The will need not transfer it to her initially and she can acquire the rights so that the property is distributed to her. All the provision requires is that the title thereto vest indefeasibly in the spouse within 36 months, not that it vest under her initial stated entitlements. It does get transferred or distributed to her as a direct consequence of his death and she does receive as a beneficiary.

One must distinguish between the right in respect of the transfer or distribution and the subject of that distribution or transfer itself. If the spouse acquires additional rights other than that which she is initially given under the will the property is distributed as a consequence of those rights arising under the will though distributed to her. The property has been distributed or transferred as a consequence of the death of the taxpayer and it has been transferred or distributed to the spouse though she did not receive the rights thereto under the will directly.⁵⁵⁶ In the author's opinion, as the provision now stands, if the spouse acquires the rights to the property in specie from other beneficiaries, even though she hasn't been named as expressed recipient thereof, the property should still be allowed Sec. 70(6) treatment since it is still being "transferred or distributed" in response to rights given under the will thereto, thus satisfying present judicial dicta on how the provision must operate. The fact that she has subsequently acquired the rights not initially given to her does not reflect on why the property is being transferred in the first place.⁵⁵⁷ If the provision is not to operate as such then perhaps the draughtsman should have specified how the spouse was to have acquired the qualifying rights instead of leaving it open to question. On the other hand if the provision is to be read as only allowing the rights acquired as a consequence of the death to qualify rather than cause the property to be transferred or distributed then this approach is in error however the provisions and the cases don't seem to contradict it.⁵⁵⁸

Subparagraph 70(6)(d) provides that if the conditions specified are satisfied the deceased will be **deemed** to have disposed of, immediately before his death, his particular property for proceeds equal those described while the last two lines of para. (d) provide that the spouse or spousal trust will be **deemed** to have acquired the property for consideration equal to those proceeds **but it does go on to deem the property to have been acquired at that time of death.** Compare this to Sec. 70(5) and then the other "tax free" roll over provisions in section 70 as well as instances where deemed dispositions are to be recognized such as in section 128.1. Subsection 70(6) describes how the spouse, (or spousal trust), is to acquire the property, and it leaves no room for the application of Sec. 107(2), and the strength is that the former does deem the spousal recipient to have acquired the property immediately at the time of death. This is also the case with all of the other "tax free" roll-overs in the latter subsections of section 70. If this is not the case, and Sec. 107(2) applies, then when the capital interest in an unadministered estate is caught by Sec. 128.1(1) on a cessation in residency a subsequent distribution of taxable Canadian property would allow the spouse to tack on the excess ACB of the interest to the property. The same would occur if a Canadian resident spouse has purchased interests in the estate from other beneficiaries.

If the spouse pays consideration for the interest directly in the estate as per Sec. 107(1)(a) the disposer may not be required to recognize an eventual capital gain while if the spouse subsequently assumes outstanding estate debt as a condition of receiving legal title to the property the Sec. 107(2)(c) provision could not be applicable to allow her to recognize a capital loss at the same time realizing the property under the Sec. 70(6) provision. Subsection 70(6) and the section 107 roll-through mechanics do not jointly apply: the former ranks and the latter has no effect.

⁵⁵⁶ "As a consequence" of the death relates to the transfer, not who acquires the rights.

⁵⁵⁷ The transaction is not a purchase of the property, it is a purchase of the rights arising out of the will that will eventually be satisfied upon residue establishment. If the right is in the form of a specific bequest this may not be valid argument.

⁵⁵⁸ The Director of the Rulings Directorate has taken the latter view in Technical Interpretation 5-2267 provided in Dec. 1986 where he held that property transferred as a consequence of its assignment by another beneficiary cannot benefit from Sec. 70(6) since it wasn't transferred as a consequence of death, but again, there is a difference between acquiring the property and acquiring another beneficiary's rights to receive the property once administration is completed.

There are two types of property to consider here: the property transferred to the trust, the trust interest held by the spouse. If the property recognizes a Sec. 70(6) roll-over the spouse under the trust need not be resident in order for the roll-over to occur while the trust must be resident. If the trust severs residency and incurs some tax consequences it can manage, the spouse can then become resident under a non-resident trust and have FMV statutorily ascribed to her interest's cost so that when property is transferred out to her she gets a tax-free cost bump. The section 107 roll-out mechanics on trust property operate between the spouse and her trust, but not between the estate and the trust set-up under the will. Obviously the global tax exposure must be calculated here on the relevant properties.

In *Hillis v. The Queen*⁵⁵⁹ a question of indefeasible vesting existed when two sons disclaimed their interests and a court order was made under a Dependant's Relief Act. The spouse contended that as a consequence of both actions the estate vested indefeasibly in the spouse upon the death, although one son disclaimed and the court order was made after the vesting period ended. The court order vested the estate **retroactively** at the time of death. Clements D.J. and especially Pratte J. of the Appeal Court found that although the order was to have retroactive effect it could still not cause, when issued after the end of the vesting period, the spouse to be regarded as vested indefeasibly with the necessary rights, within the vesting period. As per Clement D.J.:

"There is no justification or need to assign to these disclaimers a retrospective operation, they took effect in reality upon their execution which was posterior to the prescribed 15 month period.⁵⁶⁰ The effect, in my view, was an accretion to the interest of the spouse of whatever net estate might then be left."

Pratte J., held with respect to the effect of the disclaimers:

"It is only when the disclaimers were executed and a court order was pronounced that Mrs. Hillis became entitled to the whole of her husband's estate with retroactive effect to the date of his death. If therefor, the disclaimers and the Court order had as contended by the Appellants, the effect of vesting the estate in Mrs. Hillis, the effect did not take place within the 15 months after the death of Mr. Hillis."

Subsection 252(3) has been amended to define the term "spouse" for purposes of Sec. 70(6) to be only spouses that are parties to a voidable marriage.

The second potential recipient, other than the spouse directly, consists of a spousal trust that was resident in Canada **immediately after** the property vested indefeasibly in it and which had the spousal characteristics. If the property vests, possibly defeasibly, in a non-resident trustee that becomes resident in Canada then the Sec. 128.1(1) bump-up in the cost of the property will apply to bump the cost of the property to its FMV however if the property vests indefeasibly when the trust is resident, as a consequence of obtaining the Sec. 70(6) roll-over, the property's cost to the trust will be deemed to be equivalent to that of the testator. If the legal representative makes the Sec. 70(6.2) election⁵⁶¹ so as to preclude the Sec. 70(6) roll-over from applying then the cost bump will occur but the testator will recognize a Sec. 70(5) disposition. An election may thus be advantageously contemplated when there has been a substantial increase in the FMV of the property **after death** though the Sec. 70(6.2) election must be made in the deceased's terminal return hence planned alterations in f.m.v and residency must occur quickly. If the election isn't made and Sec. 70(6) subsequently automatically applies due to vesting and residency there will not be a cost bump in the underlying property. If the property vests fairly quickly in a non-resident trust, and that trust becomes resident obtaining the Sec. 128.1(1) bump in the cost of the property, a subsequent divesting of the property from the non-spousal trust, due to any legitimate reason, will allow the recognition of a capital loss, (if no proceeds are received), if the trust is dealing at arm's length with the party in whom the property subsequently vests – this is the case where the trust fails due to a disclaimer/renunciation. Such a divesting will not be a distribution in respect of a capital

⁵⁵⁹ 83 D.T.C. 5365 (FCA)

⁵⁶⁰ See also footnote "Disclaimers and Renunciations" in the chapter "Variations" for lack of retroactivity in certain instances.

⁵⁶¹ and the property would normally qualify for Sec. 70(6) treatment

interest but since it vested indefeasibly when the trust was non-resident Sec. 70(6) will not apply to it.⁵⁶²

If the spouse under a resident trust becomes resident there is no disposition of his interest in the estate or trust to allow it to have its cost set at its FMV since the trust/estate is resident: if the executors are non-resident it is still possible to get a cost-bump in the estate interest by becoming resident, but, is the interest in an (non-resident) estate in the midst of administration the same as an interest in the (resident) spousal trust that arises out of it within the realm of our ITA?

Indefeasible vesting occurs at a certain point in time either in law or in fact possibly regardless of the appearance of the actions of the executor/trustee and since the roll over is available only if the trust is resident immediately after it occurs one would want to play it safe and get any relevant non-resident trustees resident as quickly as possible, probably through office transfer, so as to obtain the roll over.⁵⁶³

A basic definition of indefeasibly vesting is that the legal or beneficial ownership of a property has crystallized to a point where no legal or equitable events can occur to undermine it.⁵⁶⁴

Creation of the Trust.

Serial transfers of property to a spousal trust described in the subsection by the executors/administrators are a completely separate activity from the proper constituting of the trust so that it will qualify as spousal.

Under paragraph 70(6)(b) the trust must have been created by the taxpayer's will, must have been resident in Canada immediately after the transferred property vested indefeasibly in it, must have had the meticulously described spousal characteristics at the moment it was created, and finally, only then if it receives the property on or after and as a consequence of the death of a taxpayer will Sec. 70(6) apply to the property. By virtue of the provisions related to disclaimers trusts **created** by way of a disclaimer by a beneficiary under the will **will not qualify: those provisions do not express that the trust has been set-up, they comment as a focus only on transfers as a consequence of death.** This was expressly commented on in *A.N. Gilbert v. M.N.R.*⁵⁶⁵ where under the will a trust was to be set up under which the benefits, (income and capital rights), were to be primarily paid to the testator's spouse however over which the trustees had a discretionary power of advancement whereupon its exercise the son of the testator could benefit from the trust **before the spouse died**. Once the Minister reassessed the estate as not qualifying under Sec. 70(6) as a spousal trust the son disclaimed the beneficial "interest" he had, (to receive the capital allocations upon exercise of the discretionary power), however Bonner M.J. of the Tax Review Board held that such an action was ineffective at qualifying a tainted spousal trust:

"The trust, as we have seen, was tainted because it permitted Bruce Gilbert to receive capital before the

⁵⁶² A taxpayer states that a certain property is to be held in a non-resident trust, the fmV explodes on death due to various possible conditions that trigger it, and the trust immigrates realizing a tax-free cost bump to fmV merely for being owned by an immigrating trustee. With its inflated cost a power is exercised over it, a beneficiary "upstream" disclaims and divests the property from the trust and a capital loss is realized in the trust.

⁵⁶³ Alternative Canadian resident trustee appointments would alleviate this problem. See previous notes on issues regarding trust residency.

⁵⁶⁴ See *Guaranty Trust Company of Canada v. Minister of National Revenue*, [1967] S.C.R. 133, for a Supreme Ct. analysis of the term "indefeasible" in the context of estate tax legislation. It held:

"In my respectful opinion, the reasons for judgment of Thurlow J. in *Halley Estate v. M.N.R.*[20] which were endorsed without further comment by this Court[21] appear to me to be entirely relevant to the present case and I adopt them as explaining the true meaning of the word "absolute" as used in s. 7(1)(d). Mr. Justice Thurlow there said of the provisions of s. 7(1)(d) as it then read:

The intention of this provision is apparently to permit the deduction of the value of what is given to the particular recipients and with this in mind it seems to me that it is more natural to interpret the word 'absolute' in the paragraph from the point of view of the recipient than from the point of view of the deceased and as referring to the irrevocable and undefeatable vesting of the subject matter of the gift in the recipient rather than to the unlimited extent of the interest given to the recipient... Moreover while I can see no reason why Parliament should have intended to draw a distinction between a gift of an unlimited interest and an indefeasible gift for a lesser interest and to permit deduction of the value in the one case but not in the other it is not difficult to understand that in authorizing the deduction of the value of a gift to such a body Parliament would be concerned to ensure that the deduction should not be permitted when because of the provisions attaching to the gift, the body referred to in s. 7(1)(d) might never receive it. The word used is an apt one to make such a distinction and secure this object. I am accordingly of the opinion that the word 'absolute' in s. 7(1)(d) should be interpreted as meaning vested and indefeasible."

⁵⁶⁵ 83 D.T.C. 645 (TRB)

death of his mother (the spouse). **The disclaimer does not change that feature of the trust.** While it is true that s donee need not accept a gift, as was reiterated in the Cossitt case, (Cossitt v. M.N.R. 49 D.T.C. 617), that principle has no application to clause 7 of the will. The trustees did not exercise their discretion to make any payment out of capital to the son. Had they done so, B.G. could have refused to accept that gift. **What B. Gilbert could not do, by disclaimer or otherwise, was to change the terms of the trust.**⁵⁶⁶

From Sec. 248(8) it can clearly be seen that a direct devise may be disclaimed by its initial beneficiary whereby if the will is structured properly, it will qualify for Sec. 70(6) treatment if it ends up then being transferred to the spouse or the spousal trust. If a non-spousal trust is structured unfavorably with respect to a particular beneficiary causing him to disclaim his interest which in effect causes the trust to fail and be unconstitutable, then its property may qualify for Sec. 70(6) treatment if they roll through, as a result of the construction of the will, to a spouse or spousal trust.⁵⁶⁷ If a spousal trust is **created under the terms** of the taxpayer's will it will qualify as a spousal trust for purposes of Sec. 70(6) however if it is effectively varied through the disclaiming of interests so that it has the ultimate character of a spousal trust but was not created as such under the will then it will not qualify. If a spousal trust is created by the taxpayer's will it will lose its spousal nature if the spouse executes a Sec. 248(8) disclaimer of her interest so it's important to attend to possible variations in the parties actions post-mortum, otherwise it could easily mess-up your handiwork. Such an event could be to take property under a matrimonial property act by the spouse directly.⁵⁶⁸

Not with Variations.

The effective **application** of a trust agreement may be altered through disclaimer/releases et cetera by the beneficiaries but the **agreement itself** may be altered under an application to court under the relevant provincial Variation of Trusts statute law (where all of the ascertained beneficiaries under the trust are of one, sound and legally competent mind). But will the resulting trust after the variation be treated as having been created, as a spousal trust, under the taxpayer's will? First of all a court order made pursuant to provincial statute law focused at providing relief to or support of a dependant under a will is substantially different from a variation of trust court **endorsement** in that the former can be made regardless of any of the beneficiaries opposition while the variation can only be **endorsed, and not enforced** by a court only after all of the beneficiaries thereunder agree.⁵⁶⁹ By a review of the commentary on the variations of trusts through court acknowledgements in the chapter on Trust Variations and Disclaimers it can be ascertained that such alterations may cause the recognition of a cessation of one trust and a creation of a distinct separate other (if the conditions are right) or it may cause only a variation in the one on-going trust however the trust resulting from the execution is almost always seen to have come into existence either at the time of the order or at the time of the initial trust creation **however the resulting trusts in their final form were not created under the**

⁵⁶⁶ See F.C.T. v. Vegners, 89 A.T.C. 5274, for similar jurisprudence concerning disclaimers of interests under powers, as well as A.G. v. Brackenbury, 1863 1 H. & C. 782, H.M. Advocate v. Routledge's Trustees, 1907 44 Sc. L.R. 305, for attempts to avoid estate duty. It is possible to destroy a power with the disclaimer of any benefit arising out of it though a clear expression must be made that this is to be one of the intended effects of the disclaimer: I.R.C. v. Cookson, 1977 1 W.L.R. 962 & Re: Stone's Estate, 1869 3 Ir. Eq. 621. The power in Gilbert was exercisable in respect of both spouse and offspring and could not be destroyed by a disclaimer of only one of the parties. Regardless of the manner used to terminate the power (trustee release, beneficiary disclaimer of benefit, removal through variation, determination or satisfaction of purpose or exercise), the fact that the trust was created under the will as having the power precludes favorable roll-over treatment, unless the trust can be made to fail and the property becomes subject to a new trust.

⁵⁶⁷ If however the disclaimers are not executed within **36 months from time of death this will not occur.**

⁵⁶⁸ **The effect of Sec. 248(8) does not cause the spousal trust to lose its status as per Gilbert v. M.N.R.. The disclaimer will operate retroactively to cause the will to be read as creating a trust underwhich the spouse is not entitled to the income. A release/surrender however does not cause such to happen ab initio but only from the date of the release/surrender.** Since a disposition is not prevented from being recognized under Sec. 248(8) the spouse could receive income from the trust for the three years, renounce the right but not avoid a Sec. 106(2) disposition. As long as the income or capital is not payable to a non-spousal party before her death the trust will remain spousal and Sec. 70(6) applicable. After the right is renounced the trust could be varied to accelerate the interest or be wound up though Sec. 107(4) will cause a recognition of the accrued tax liabilities on the dissolution.

⁵⁶⁹ Under a Dependant's Relief Act application a court will act against a testator's wishes explicitly in rearranging his testament while under Variation of Trust statutes the court will partially protect the settlor's intention and it is the beneficiaries who initiate the action against it.

terms of the taxpayer's will and thus *unless variation statutes can be successfully argued to be dependant support/relief statutes, (which they are not due to the very basic difference in their purpose and application), a variation of a tainted testamentary spousal trust will not suffice to allow it to qualify for Sec. 70(6) treatment.*⁵⁷⁰

A special power of appointment is not a variation of a trust hence it may give some flexibility to add one to create a spousal trust and have it qualify. See one of the following chapters for the nature of special powers of appointment over estate/trust property.

Subsections 248(22)-(23.1) attends to situations where the spouse chooses to take property directly under a matrimonial property regime that recognizes his property rights and thus allows the property to benefit from a Sec. 70(6) roll-through. It does not, however, go the distance in creating a trust recognizable as created by the deceased, if the court so directs in the case of the creation of a trust in respect of the spouse.

Indefeasibly Vest.

In the case of a testamentary spousal trust the property transferred to the spousal trust it must "indefeasibly vest" in the trust, and immediately after that time the trust must be resident in Canada, however it need not have been resident throughout the time since its creation nor need it remain resident afterwards. The Department provides an opinion, on what it comprehends to be "indefeasibly vested", in I.T. 449R, which is that property becomes vested indefeasibly at a time in a spouse or spousal trust when such a person obtains a right to absolute ownership thereof which cannot be defeated by any subsequent event or action, regardless of whether such a right carries with it a right to possession (or immediate enjoyment of the benefits coming from the property), or whether the right is immediately enforceable or not. The I.T. then goes on to provide that the Department will consider that property is vested indefeasibly in the person to whom it is bequeathed when that person has an unassailable right to ownership that is enforceable, even when the formal legal conveyance and registration of ownership of the property is not executed. In *Sachs v. The Queen*⁵⁷¹ Thurlow C.J. describes seven different manners in which a trust interest could simply be held to be "vested"; vested in possession, vested in remainder, vested in interest, vested absolutely, vested but subject to defeasance, and contingently or suspensively vested.

In the author's opinion the fact that the trust upon receipt of the property must then operate to convey it to certain parties or must convert it to cash does not cause the property to vest contingently. The indefeasible vesting of the property relates to what can happen to it so as to divest it from the trust after, as per the will, it has been transferred to it **as due to the conditions of the transfer and the environment that existed when it occurred**. Estate debt, quantum meruit claims, beneficiary disputes can all operate to preclude the property from vesting in the trust indefeasibly but the two above transactions relate to **how the trust operates, not how it receives the property**. Subsection 70(6) concerns the receipt of the property, not how the trust operates after it receives it.

There is a difference in the direction to the executors to dispose of the property in order to ascertain the

⁵⁷⁰ The inapplicability of a variation to qualify a spousal trust was recognized in a Technical Interpretation provided in April 1991 by the Financial Industries Division (5-910290). The same occurred in March 1990 (5-9610) where the same Division held: "We question whether a transfer of property under a court ordered variation of a will made at the request of any beneficiary of an estate, and for his benefit, would satisfy (the transfer as a consequence of the death)." T.I. 5-7677 addressed the situation where a consensual variation was informally pursued by estate beneficiaries to adjust their entitlements to avoid a F.L.A. application where shares were to be distributed as a result to the spouse. The same Division specifically held that the shares wouldn't devolve as a consequence of death but as a result of a separate beneficiary agreement. In the same opinion it was held that a F.L.A. payment which resulted in the same would so qualify for Sec. 70(6) treatment. In a T.I. provided in Feb. 1983 by the same Division it was held that a variation to remove an direction to the executors to sell the estate property at the first opportune time, though allowing the property to consequently vest indefeasibly in the beneficiaries, would not satisfy the "as a consequence of death" requirements. The property would vest as a consequence of the variation. A variation of a trust has as its source the beneficiaries themselves. See *Re: Holmden's Settlement Trusts*, [1968] A.C. 685 (HL), where Lord Reid held: "... So the arrangement must be regarded as an arrangement made by the beneficiaries themselves." See *Russell and Another v. I.R.C.*, 1988 1 W.L.R. 834, for an example of where a variation subsequent to the death of a U.K. resident taxpayer was effective at altering his will for capital tax purposes imposed upon death though where such was expressly provided for in the legislation. In *Williams and Another v. Commr. of S.D.*, 1943 N.Z.L.R. 88, an executor was to make dispositions pursuant to the expressed wishes of the testator known to him but not expressed in the will. An agreement to establish certain testamentary dispositions was held valid at reducing death duties when favorable roll-over provisions were accessed.

⁵⁷¹ 80 D.T.C. 6291 (FCA)

residue of the estate and a direction to the trustees of the residuary estate (trust) to dispose of the property following the ascertainment of the residue. Under the former Sec. 70(6) will not apply to the disposed property since it is not vesting indefeasibly in the residuary trust while under the latter it will since the trust arises and its terms operate to cause the disposition - assent to the vesting in the office of trustee has occurred though may be subject to a latently arising/to-be-extinguished debt. That is exactly why the tainted spousal trust rules were formulated in Sec. 70(7)-(8).

In *Dontigny v. The Queen*⁵⁷² a bequest was conditional upon the beneficiary remaining a widow and if she remarried the property would then devolve to her children. Pratte, J. of the Federal Court held with respect to the defeasibility of her interest:

"As I interpret the law, the property is not vested indefeasibly in a spouse when it is bequeathed under the condition that the spouse not remarry."

Thus the right of the spouse to the property was contingent, (or conditional), upon her remaining a widow and if she didn't and remarried her right would be defeated. In *Devitt Estate v. M.N.R.*⁵⁷³ the deceased bequeathed 50% of his residual estate to his wife "for her own use absolutely" while in another clause the testator "created a trust" from "all" of his estate under which the spouse would be able to use the house and accompanying lands until she remarried, notified the trustees that she no longer wanted to benefit from the arrangement, or died, whichever occurred first. The Minister contended that the property consisting of 50% of the residual estate had not become indefeasibly vested due to the fact that the will went further to qualify "all" of the estate's use by the spouse, while M. Boisvert, Q.C. of the Tax Review Board held that it had vested indefeasibly (absolutely), by expressing:

"I am of the opinion that upon Mr. Devitt's death, the above property passed from Mr. Devitt to Mrs. Devitt absolutely and indefeasibly through the trustees who were appointed by the testator to carry out the directions and request in his will. The trustees had only the administration of the estate for the benefit of the heirs. **They had no power to make defeasible the property given by the deceased to his wife. It is not in vain that the testator twice in his will, used the word "absolutely".**"

If the trust agreement granted a power of appointment or advancement or encroachment et cetera with which through its use, depending on the discretion of the exercisor, could allocate the trust property to another beneficiary other than the spouse during her life quite likely its mere existence could disqualify the otherwise absolute right held by the spouse to the particular property although if that power ceased to exist **35 months** after the death then any property which was not affected by a previous exercise to which the spouse had an absolute right, would receive Sec. 70(6) treatment. Having the powers collapse within 35 months of death is thus an interesting incidental tool to create some flexibility while availing oneself of the roll-over.

In *Devitt Estate v. M.N.R.* the judge cited *Halley Estate v. M.N.R.*⁵⁷⁴ when evaluating the indefeasibility of the spousal right while in that case Thurlow J. provided two methods of measuring the absolute nature of the vesting of a right in possession or interest being; the lack of limitation of the extent or duration of the interest or the freedom of the interest from dependence on other "things" or persons. He then went on, after giving examples of each, to provide that an "absolute" gift should be taken to be a vested and indefeasible gift, (and that it indicated a certainty that the gift would **come into possession**)⁵⁷⁵. From the criteria cited by Thurlow J. in *Halley Estate* it would appear that property becomes vested indefeasibly when it cannot be reacquired by a right by the giftor, nor is it to be vested only for a specific period of time which would in substance make it contingent without "an event". It must be independent from other "things" or "persons" thus discretionary powers, powers of appointment, advancement, encroachment held by anyone affecting the particular property could cause it to be vested subject to defeasance, temporarily or permanently.⁵⁷⁶

572 73 D.T.C. 5398 (FCTD)

573 72 D.T.C. 1337

574 63 D.T.C. 1090 (ExC)

575 See also *Towle Estate v. M.N.R.*, 67 D.T.C. 5003 (S.C.), for similar dicta as well as *Boles et al. v. M.N.R.*, 13 E.T.R. 6, for further issues.

576 A distinction must be drawn between dispositive powers vested in the executors under the will and those granted to trustees under the trust created under the will out of the residue etc.. The former affects the residuary estate and must cease to exist within the 36 month period in order for the roll over to apply but it ceases to apply to property transferred to the trust, and severed from the estate. The latter is operative after the property vests indefeasibly in the trust and can taint

If an interest/right in a trust's income is exclusively granted to the spouse but is to divest upon her remarriage, bankruptcy etc. it cannot be said that she is entitled to receive all of the trust's income that arises prior to her death since her interest is defeasible. If her rights to the trust capital are defeasible only if other beneficiaries have **immediately enforceable** interests to the capital before she dies, regardless of if they are acted upon, will the trust lose its spousal character. If she lost rights to the trust capital then Sec. 70(6) will continue to apply however the trust deed could go even further; it could grant the trustees a power **in trust** to convert the income producing property held by the trust into capital appreciating property if the spouse were to remarry thus severely reducing the amount of trust income to which she will have sole interest in and this would not offend the spousal trust character. If only capital appreciating property is held then there won't be too much income for her to have rights to.⁵⁷⁷ In the author's opinion such contingency clauses do not operate to render the vesting of title in the spousal trust defeasible within the context of Sec. 70(6) since they relate only to how the trust is to operate after title has vested indefeasibly.

An interesting note should be made concerning the Department's opinion as expressed in para. 1 of I.T. 449 where it held that:

"Where property is held in trust for the benefit of one or more persons it is the Department's view that such property normally vests in the trust and not the beneficiary thereof. **However**, where the Department is satisfied where a property is held in trust solely to carry out the terms of a will under which the ultimate and absolute ownership of that property is bequeathed to a particular individual and the trust arrangement is such that the individual's ownership rights cannot be defeated by any future event and no other person has any right whatsoever to an immediate or future benefit from that property or that trust, the property will be considered to vest indefeasibly in that individual."

Is this to say that property rolled to an otherwise fully qualifying spousal trust that has as its sole trustee a non-resident person, (thus making it non-resident), whereunder the sole beneficiary of that trust has an absolute vested interest in the property, is the spouse, **and is resident immediately before the death**, will qualify for Sec. 70(6) treatment by virtue of the fact that the Department will consider the property to vest indefeasibly in the spouse, regardless of the trust? The roll-over will thus qualify, as per that opinion, on the grounds that the recipient is a spouse resident in Canada immediately before the death of the taxpayer. Since the trust is disregarded as a vesting base its residency immediately after the time of vesting "in the spouse" will also be irrelevant. If the spouse becomes non-resident after the death she will still not own the property for purposes of Sec. 128.1(1) by virtue of the fact that the trust owns it however if the trust is non-resident her interest therein will be subject to Sec. 128.1(1) with the same effect.⁵⁷⁸ The I.T. should obviously be properly qualified.

The indefeasible vesting of property in a spousal trust was the critical issue in *Hrycej Estate v. M.N.R.*⁵⁷⁹ where the testator bequeathed certain farm property to trustees to be held upon certain trusts however his will extended a testamentary option to an offspring allowing her to purchase the property within 60 days after the death from the estate while the residual estate was to form the spousal trust, if the spouse(widow) survived 30 days after death. The daughter exercised the option and purchased from the estate, (which was still being administered), the property and the widow survived hence the spousal estate resulted while what came into question was the fact that the executors of the estate wanted the Sec. 70(6) provision to apply to provide roll-over treatment to the deceased in respect of the farm property and have the net estate recognize the sale to the offspring, which was denied by the Minister. Taylor, T.C.J. of the Tax Court of Canada decided that the equipment had never vested in the spouse, (spousal trust), because it could do so only after the spouse survived the thirty day period and after the daughter **didn't** exercise the option but allowed it to expire. If the daughter had done so there would have been no question as to the indefeasible vesting of the property which would allow it to gain Sec. 70(6) treatment. If the spouse didn't survive the thirty day period then again the

the trust if allowed to be exercised in respect of a non-spousal party.

⁵⁷⁷ The power in trust to dispose need not be used but instead the trustees may be compelled by the trust deed to alter the accounting methods to be used in computing the income with the same result or possibly to incorporate and capitalize income. Compulsory inflated depreciation charges may have limited usage.

⁵⁷⁸ What would be the Department's response to loaded questions in the form of advanced tax rulings possibly, in respect of this topic?

⁵⁷⁹ 84 D.T.C. 1089

vesting wouldn't have been held to be indefeasible and the testator would not be able to benefit from Sec. 70(6). If the daughter would have purchased the property on the 61st day after death through a voluntary sale by the estate then there wouldn't have been any problem since indefeasible vesting would have occurred.

In *Mr. Lucky v. M.N.R.*⁵⁸⁰ *Mr. Lucky*⁵⁸¹, a 47 year old gentleman, married an 84 year old woman one month prior to her death, but, a few days after the marriage⁵⁸² the deceased made a will whereby Mr. Lucky was to receive the entirety of her estate as executor and beneficiary, whereafter she "passed away". The deceased's two cousins wished to have the validity of the will challenged on the presumption that Mr. Lucky had exerted "undue influence" on the deceased when she made her will.⁵⁸³ The negotiations between the solicitors of Mr. Lucky and the cousins resulted in the cousins dropping the allegations reported in the affidavits filed in Surrogate Court against the will, after they had received \$225,000 from Mr. Lucky. The Minister charged that the estate had thus not been indefeasibly vested in Mr. Lucky, a requirement of Sec. 7(1)(b) of the Estate Tax Act in that Mr. Lucky had to pay the \$225,000 to secure claim and escape the "shark attack". Maurice Boisvert Q.C., of the Tax Review Board provided that:

"The fact that persons, by way of affidavits were threatening to attack the validity of the marriage and of the will does not preclude the sole heir from being vested with the property which passed at the death of his wife. From the moment the will was probated the appellant had an absolute title to the estate. He had the right to use it at his discretion. It was vested indefeasibly and he did not need to wait six months before establishing his title. **There was nothing in the will which could render his vested property defeasible.** He took possession of the property. Since his property could have been alienated for any purpose he was free to compromise with the frustrated heirs who were living in the United States. **That compromise consisted not in a deal from the estate's property but from his own property...**", thus the whole estate gained the Sec. 7(1)(b) exemption. The exemption was gained by the sole reason that the transfer of \$225,000 was a voluntary payment made by Mr L. that was **not** an equitable charge placed on the estate becoming vested in the sole heir. The fact that the provision for such a payment was not foreseen in the will is critical in that it did not place an obligation upon the spouse, as a condition of acceptance of the devise, to make a payment to the other heirs which would have resulted in only the net amount (net of the \$225,000) of the estate gaining the Sec. 7(1)(b) exemption. Subsection 105(1) would most likely be applied if this situation occurred today since the frustrated heirs could be found not to have an interest in the estate and what they received was a benefit in respect of an estate other than which related to a capital interest held by them or that had not yet been included in computing their income. If they are not resident Sec. 105(1) would not apply while if they were the taxation of that receipt, at full inclusion, would be harsh. If a condition precedent or subsequent is placed on the vesting of the bequest then it is only when that condition is extinguished that vesting indefeasibly will occur.

Is there a requirement that the beneficial title to the testamentary property vest indefeasibly in the spousal party within the 36 month period or is the requirement only that the spousal party must have acquired an indefeasible right to that legal title within that time period? Obviously on a strict reading of the provision in Sec. 70(6) the property must have been transferred to the spousal party however is it the **legal or beneficial ownership** that must be transferred and recognized as indefeasibly vested? In I.T. 437 the Department is of the opinion that the Act applies on beneficial rather than legal ownership basis and thus in respect of Sec. 70(6) is it possible for only the beneficial ownership of a property to be transferred to the spouse or spousal trust, with the legal ownership held by some other party and still have the subsection apply, (if the beneficial ownership is indefeasibly vested)? In the author's opinion surely such an arrangement will not run afoul of Sec. 70(6) requirements, especially given the Department's opinion expressed in I.T. 449, para. 1, previously

580 72 D.T.C. 1369

581 who was so in two respects and not in one

582 being apparently the first available time

583 Try not to think about how. ...and you thought a book on income taxation of trusts was going to be boring, well "You'll never know what you'll find!"

commented on.⁵⁸⁴ If this is the case, as the author thinks it is given the expression of Departmental opinion, then it would be possible, under a will, to transfer legal ownership of property to one party and beneficial ownership to the spousal party, satisfying the Sec. 70(6) provision, and thus utilize a non-spousal trust setting. If the holding trust was personal then the spousal party could dispose of its beneficial ownership, (as a form of a capital interest), and through playing around with the composition of the property in the trust, in light of Sec. 108(1)(d), adjust the beneficial ownership/capital interest cost amount arbitrarily thus allowing the spousal party to greatly benefit from the application of Sec. 107(1) and reduce its capital gain otherwise recognizable, had it disposed of the legal title to the property.

If the Department flags this as offensive due to the fact that the legal title hasn't been transferred to the spousal trust in this case, then the will could create a spousal trust which instills a special power of appointment in a trustee allowing him to set up a sub-trust out of trust property, again having the spousal characteristics. Since such a transfer may not cause a change in beneficial ownership with respect to the particular property the recognition of a disposition could be avoided when property is transferred via an exercise. There may be solid grounds to argue that the exercise of a special power of appointment will create a capital interest the distribution in satisfaction of which would be subject to Sec. 107(4).

The interest in the sub-trust taken back by the spouse could be disposed of in the same way; the reduction of the tax consequences of which would depend on the nature of the property appointed to the trust. In both instances indefeasible vesting has occurred while in the latter, legal and beneficial title has been transferred to the spousal trust, though in respect of certain appointed property, obviously it has not been retained.

Whether or not a property vests indefeasibly in a spouse or a spousal trust where there is an implied contingency in the gift is a question of fact measured from the intention of the testator. It is possible for the trust to provide for the accumulation of income for a period of years however the spouse must be entitled to receive it during her life and the basis of her entitlement may be deferred and contingent on various events. In *The Queen v. Green Estate*⁵⁸⁵, a case involving Sec. 7(1)(c) of the Estate Tax Act⁵⁸⁶, a testatrix set up a trust whereunder the trustees were given discretionary power to use capital or income for the advancement and education of the offspring while it also provided:

"When there shall no longer be any child of mine living and under the age of 21 years, to divide the said residue of my estate or the amount thereof remaining among my children then alive in equal shares per stirpes."

With respect to the above clause the Minister contended that the gifts were contingent and conditional on the children attaining the age when the personal representatives attempted to elect for Sec. 7(1)(c), (similar to 70(6)), treatment. The trust property did not vest indefeasibly in the children within 6 months as required by the statute. Smith, D.J., of the Trial Division commented on one of the primary rules of interpretation, quoting from *Williams on Executors and Administrators*, 12 ed. pg. 791:

"Where the bequest is in terms immediate, and the payment alone postponed, the legacy is vested." and then went on to provide:

"There are no words of immediate gift to the children. There is a provision for the trustees to use the income from the residue of the estate of the testatrix any amount or amounts of the capital that their trustees deem advisable for the advancement and education of the children or of one or more of them, in such proportions and in such manner as the trustees in their absolute discretion consider advisable. This does not vest any ascertainable parts of the income, nor any share of the capital in any child. In fact there are no words of gift to the children at any time until the youngest of them who survives to the age of 21 attains that age. At that date the trustees are directed to divide the residue, including accumulation of unused income, among the children then surviving in equal shares." "...As the will contains no immediate gift to the children I am unable to say that the first rule, quoted above from *Williams*, can be invoked to hold that the children's rights to the residue became vested on the death of the testatrix."

Continuing on with the second rule of determining immediate or postponement of vesting Smith D.J. quoted

584 Property will be considered to vest indefeasibly in a beneficiary under a trust, as per the terms of a will, where ultimate and absolute ownership is that of the beneficiary and cannot be defeated in any way.

585 78 D.T.C. 6324 (FCTD)

586 being considerably similar to Sec. 70(6) of the ITA with respect to vesting requirements

from Williams:

"If the words "payable" or "to be paid" are omitted, and the legacy is given **at** twenty-one, or **if, when, in case**, or **provided** the legatee attains twenty-one, or **"on"** his attaining that age, or any other future definite period, this confers on him a contingent interest, which depends for its vesting, and its transmissibility to his executors or administrators, on his being alive at the period specified."

"This rule states conditions very similar to what is said in clause 3(c) of the will in the present case. As we have seen, in this case there is no word of gift, such as "bequest" or "give", in relation to the children with payment to take place at a later date. The only words from which a gift to them can be discovered are found in the direction to divide the residue among the children in equal shares at the time indicated in the clause, viz: "when there shall be no longer be any children of mine living and under the age of twenty-one years." To my mind these words have precisely the same meaning as "when the youngest of my children who survive to the age of twenty-one years has attained that age." Stated in this form the legacy would seem clearly to fall within the rule."

As per Williams as quoted by Smith D.J.:

"When a testator bequeaths a legacy to a person at a future time, and either gives him an intermediate interest, or directs it to be applied for his benefit, the Court then considers the disposition of the interest to be an indication of the testator's intention that the legatee should at all events have the principle, and on this ground holds such legacies to be vested."

However the Judge could not find an indication of how this exception could apply in the case. After examining applicable case law authority on interpretation of wills concerning early vesting he concluded, appropriately:

"There is no gift of anything to all or any of the children prior to the date at which distribution is to take place, except for what the trustees in their absolute discretion may use, of income or capital, for the advancement and education of the children or one or more of them. Until the date of distribution the residuary estate is to remain one whole fund, to which any unused income is to be added...The date for dividing the residue among the children is "when there shall be no longer any child of mine living under the age of twenty-one years". There is further contingency, because the division is to be in equal shares to the children then alive who are to share and who they will be cannot be determined until the time for division has arrived."

When the trust is created the spouse must be entitled to receive the income accumulated or otherwise and her right thereto must be vested and indefeasible at that time.

In *Lewis Estate v. M.N.R.*⁵⁸⁷ a testator directed under his will:

"(6) To give my wife all the rents and profits from my farm on Lot 8 and part of Lot 9, Concession 11, Township of McGillvray, until my grandson Todd Lewis reaches the age of twenty years old.

(7) To convey my farm on Lot 8 and part of Lot 9, Concession 11 Township of McGillvray, to my grandsons Terry David Lewis and Todd Lewis when Todd Lewis reaches the age of twenty years on the condition that they pay the sum of \$1000 to their sister Bonnie."

and the when executors attempted to claim the Sec. 70(9) tax free testamentary roll-over treatment, which is identical with Sec. 70(6) with respect to indefeasible vesting, the Minister contended that such vesting in the grandsons had not occurred due to their interest being contingent, not only on the grounds that they were not to receive it until that time but also incidentally that the \$1,000 payment would have to be made in order for the conveyancing to occur. They also contended that "vested indefeasibly" in the Sec. 70(9) context (identical to the use in Sec. 70(6)), means vested **in possession** and not simply vested in interest or transmissibility. The executors contended that the property had vested indefeasibly in the grandsons within the 36 month time limit, and that vesting in possession was not required. They also contended that in any case vesting occurred in the grandsons without contingency as per subsection 9(1) of the Ontario Estate Administration Act, R.S.O. 1980, Ch. 143 within three years of death by virtue of them being beneficially entitled irrespective of whether the legal title vested in the personal representatives in common law or devolved directly to them. *Kempo, T.C.J.* was unable to interpret the grandsons' rights as laid out in the will as being contingent upon their attaining any

age: quoting from Re: Traill⁵⁸⁸ he provided:

"Each gift begins with these words: "I bequeath also the following sums viz," which words are followed by such words as "May Hamilton one thousand dollars their only son one thousand dollars on his becoming of age." Without any great stretching of interpretation in favour of immediate vesting, may it not be considered that the first words make an immediate gift and that the subsequent limiting words have reference to the time when the legatee shall receive the gift?"

"... **There is no expressed gift-over in contemplation of Todd's death** before he attains 20 years of age, and accordingly it has been shown by the terms and words used in the Will that the vested interest acquired by the grandsons on the testator's death was intended to be divested upon Todd's demise prior to the conveyance date. In this situation if either of the grandsons died before Todd reached 20 years of age had he lived, their respective interests would descend to their respective heirs-in-law."

The Judge further commented upon the appellant's contention that under Sec. 9(1) of the Estate Administration Act vesting had occurred spontaneously within three years in the grandsons:

"Dealing with Appellant Counsel's argument that Subsection 9(1) of the Estates Administration Act supra, would resolve the vesting matter, it is my opinion that it is not applicable here. The opening words of that provision encompass real property "not disposed of". However here there has been a disposition of the farm property by the Will itself. That disposition was as to an indefeasible vesting of an interest in fee simple to the grandsons, the disposition being one in civil law as a vested legacy *debitum in praesenti, solvendum in futuro*, subject only to a fixed-term tenancy in favour of the widow."

With respect to the Minister's submission that the property must both vest indefeasibly and in possession the Court held:

" Further, I am unable to rule out the conclusion that an indefeasible vesting of an interest in real property given by a will is sufficient to satisfy Parliament's intent in subsection 70(9) of the Act given the terminology "devolus irrevocablement" used in the French text. I believe this phraseology incorporates the aforesaid classic meaning to be that of vested indefeasibly **in interest** in circumstances where that vesting is not defeasible under the terms of the Will by any other person having a right, contingent or otherwise, to the subject farm property. This is especially so where there is no gift-over provision in the Will.⁵⁸⁹

If Respondent's counsel's further interpretative argument is correct concerning the coexistence of two circumstances, that is of conveyance (ie; transfer or distribution) and of vesting indefeasibly (ie; in possession), then no fiscal roll-over could be had where a trust will for infants was involved, with the exception perhaps of where a trust is terminable under the principles of Saunders v. Vautier, (1841) Cr. & Ph. 240, 41 E.R. 482, and then only when such was accomplished within the prescribed fiscal time constraints because the winding up of a trust is not normally regarded as an administrative act or function qua the beneficiaries."⁵⁹⁰

588 (1927) 32 O.W.N. 449

589 English law provides that "vest" means "vested in interest" though not necessarily in possession: See Halsbury's 4th Ed., Vol. 50, para. 588, though as per Marks v. Trustees, Exors. and Agency Co. Ltd., 77 C.L.R. 497, the context in which the word is used determines how it will be construed. The Law of Real Property, (1975) 4th Ed. by Megarry and Wade provides:

"An interest is "vested in possession" when it gives the right of present enjoyment; but of course it is not then a future interest. If it is vested in interest but not in possession (for which situation the term "vested" is ordinarily used by itself) it is a "future interest", since the right of enjoyment is postponed, yet it is also an already subsisting right in property vested in its owner: it is a present right to future enjoyment. By contrast with a vested interest, a contingent interest is one which will give no right at all unless some future event happens".

In Re: Legh's Settlement Trusts, 1938 1 Ch. 39, at 52, McKinnon J. held:

"...a future estate or interest is vested when there is person who has an immediate right to that interest upon the cessation of the present or previous interest. But a future interest is contingent if the person to whom it is limited remains uncertain until the cessation of the previous interest."

590 One of the most surprising opinions of the Court came by way of the finding that the condition of the payment of the ancillary bequest to "Bonnie", (the \$1,000 amount), was not a condition on the gift itself rather only on its ultimate delivery of legal title:

"There being no specific divestiture to be found in the will itself, expressly or by implication, it is reasonable to infer from a contextual reading of the testator's words in light of the will as a whole, that the payment of the bequest to Bonnie was intended merely as a condition precedent to the conveyance of the legal title to the grandsons and that it was not intended to operate as a condition precedent to the very gift itself such as to render it contingent on its entirety, either ab initio or at the date of distribution or transfer of the legal title by the

There must be an indefeasible vesting of the interest in the property in its ultimate recipient only, in the author's opinion, in order for Sec. 70(6) to apply.

A Very Limited and Focused Definition of Indefeasibly Vested for Spousal Capture

"Vested indefeasibly – Sec. 248(9.2)"

248 (9.2) For the purposes of this Act, property shall be deemed not to have vested indefeasibly

(a) in a trust under which a taxpayer's spouse or common-law partner is a beneficiary, where the trust is created by the will of the taxpayer, unless the property vested indefeasibly in the trust before the death of the spouse or common-law partner; and

(b) in an individual (other than a trust), unless the property vested indefeasibly in the individual before the death of the individual.⁵⁹¹

Subsection 248(9.2) now captures instances where the spouse under a spousal trust dies out from underneath it before the property vests in it thus allowing the property to avoid a FMV deemed disposition under Sec. 104(4). Without it it would be possible to argue that the property is still being transferred to a spousal trust under the pretence of Sec. 70(6) allowing it for tax-free roll-over though if the spouse died under the trust the trust would still not own the property at that time subjecting it to a Sec. 104(4) FMV disposition, allowing it to be owned for a considerable period of time before accrued tax consequences are recognized. The provision recognizes only trusts created by wills since a court order made under a family maintenance Act et cetera can be read as being read back into the will and thus allows it to qualify.

"Narrow" Indefeasible Vesting and the Relief Acts.

Boger Estate v. The Queen⁵⁹² provides excellent analysis of the effect of relief - family law legislation in respect of general and specific devises directed at alternate parties. In this case farm property was bequeathed, as a residue, to offspring and the spouse made an application under the Alberta Family Relief Act for a larger chunk of the estate. The court order granting her more property was made 29 months after the date of death and the Minister contended that the offsprings' interest in the property was not indefeasibly vested until the application under the Relief Act had been settled since until that time an order to redirect the ownership of the property to the spouse could be made. The submissions by the parties as stated by Jerome A.C.J. are:

"The plaintiff submits that the Property had "vested indefeasibly" in the children, notwithstanding the spouse's application under the Family Relief Act. As "vesting" is a concept known in Equity, equitable concepts must be applied to determine its meaning. Accordingly, the Plaintiff submits that an interest is "vested indefeasibly" if the gift is not contingent upon a condition precedent or subject to a condition subsequent or determining event. The statutory power to re-arrange beneficial interests as found in the Family Relief Act is irrelevant to the concept of "vested indefeasibly" in that, according to the common law of real property, an interest which has vested can only be defeasible if there is a condition subsequent **contained in the document creating the interest**. The Plaintiff submits that if this were not the case, the mere existence of dependent relief legislation, or any other statutory power to re-arrange beneficial interests (such as expropriation and municipal taxation statutes which provide for the forfeit of property in the event of a failure to pay municipal property taxes), would defeat the vested interest whether or not an application is made. Thus no roll-over would ever be available to a deceased taxpayer.

The Plaintiff states that the fact that in Hillis the widow's interest under the provincial succession legislation

personal representatives."

For the Green and Tait cases it should be obvious that when bequeathing property the terms used should definitely avoid the inference of a contingent gift, while there is room to structure a contingency, if need be, in that a 3 year vesting period is provided for.

591 See "Vested Indefeasibly: Its Importance for Tax Purposes" by Catherine Brown in The Canadian Tax Journal.

592. 91 D.T.C. 5506 FCTD

could not be reduced by an order under the dependant's relief legislation was not critical to the Court's determination that such interest had vested indefeasibly. The Saskatchewan Dependant's Relief Act is extraordinary in that corresponding legislation in other provinces does not contain a similar provision maintaining that a widow's portion is irreducible. thus, if irreducibility were the test for indefeasibly, then roll-overs under the Income Tax Act would only be available to widows in Saskatchewan. similarly, because provincial dependant relief legislation does not grant an irreducible share to children, no roll-overs could ever operate in favour of children.

If, however, the dependant relief legislation is deemed to have the same effect as a condition subsequent, the Plaintiff submits that the children are entitled to the roll-over with respect to the property which they actually received and which was not affected by the Order. **Because only successful application under the Family Relief Act is operative to divest the beneficiaries of their interests under the original will, the Order does not affect the remaining portion of the property left to the Children.** Therefore, the roll-over applies to the Property not affected by the Order as it was always vested in the children and remains so even after the Order. the Plaintiff suggests that if, as in Hillis, the widow was not vested with the incremental property until the actual date of the Order, it must follow that the children were not divested of their interest therein until the same date.

The Defendant submits that even if the Property had vested in the beneficiaries immediately upon the death of the Taxpayer, it was not capable of "vesting indefeasibly" until the application was settled and an Order was issued under the Alberta family Relief Act within the time limits set out in s. 70(9). Although the children acquired rights to the residue under the terms of the will, the particulars of those rights were not ascertained until after the Court order was made. The Family Relief Act allows a dependant to make an application within six months of the grant of probate of a will and provides that, upon notice of the application to the executor, the distribution of the estate shall not proceed otherwise than in accordance with the Act. By virtue of s. 5, the Court has power to divest title to property left to a beneficiary under a will. Therefore, the Defendant submits that, in Alberta, property can only vest indefeasibly in a beneficiary either upon the expiry of the six month period where no application has been made or upon Court order. Until then, the children do not have a specific or certain interest in the Property."

The indefeasible vesting of the property interest can only arise due to the terms of the documents creating it as goes the argument but in the case of buy-sell agreements this is clearly not the case since the interest of the beneficiary in the shares is not limited anywhere in the will: previously effected and quite separate aspects have been created that may not be disclosed of anywhere in the will. As stated, unless an actual order is made to divest the offsprings' interest their entitlement to the property is indefeasible on the moment of death as created under the testamentary disposition however, in the author's opinion, this must be qualified in that excessive debt may require the property's disposition for proceeds in which case the interest surely isn't vested indefeasibly, regardless of the purported rights expressed in the will, until provision for the debt is made and the executor assents to the disposition. As the argument went, a Relief Act court order can redirect the course of ownership of the estate property however until such an order is made, independent of the terms of the will, the interest remains indefeasibly vested. Obviously this follows the taxpayer's contention that effectively if all legislation is to be taken into consideration in evaluating the interest's indefeasibility few would be established and "the narrow" meaning of "indefeasible vesting", the interest resulting from the specific terms of the particular disposition, is to be followed. The Trial Court held this appropriate concluding:

"A vested interest is liable to be defeated or "defeasible" if it is subject to a condition subsequent or determinable limitation. **There is ample authority for the proposition that the condition or limitation must be contained in the grant.** For instance, in *Oosterhoff & Rayner, Anger & Honsberger on Real Property* (2nd Ed.) (Canada Law Book, 1985), p. 125 it is stated that "[a] condition subsequent is created by the addition of a condition to a grant which may cut the estate short at the instance of the grantor." It thus appears that to be vested "indefeasibly" an interest must not be subject to a condition subsequent or a determinable limitation set out in the grant.

Here, the interest in the Property is unquestionably vested: there is no condition precedent to be fulfilled before the gift can take effect; the children; the persons entitled to it, are ascertained; and, they are ready to take possession forthwith, there being no prior interest in existence. The children's' vested interest is

also not defeasible as it is not subject to a condition subsequent contained in the will. Clearly the Taxpayer has not otherwise restricted the children's' right to retain, deal with, or sell the Property, as they have done in this instance. The interest is then "vested indefeasibly" in accordance with the ascribed meanings of the terms. This is consistent with the decision of Clement, D.J. in Hillis, that upon the death of the intestate, the provisions of the Intestate Succession Act become operative and effect an indefeasible vesting in the beneficiary of the interest provided therein.

Here, the children's' property interest under the Will, as amended by the Order, had vested indefeasibly in accordance with s. 70(9). An application under dependant relief legislation, of course, may result in a transfer of the interest away from the children. Nevertheless, if as held by Clement, D.J. and Pratte, J. in Hillis, additional property received pursuant to an order under dependent relief legislation, does not vest until the actual date of the order, it follows here that the children are not divested of their interest therein until that date as well. Thus, the interest given to the children under the Will that is not affected by the Order must certainly be found to have been vested indefeasibly in the children."

There are a couple of weaknesses in the above comments one of which is that there appears to be no recognition of Finance's intention when they extended the vesting period from 15 to 36 months and from 6 to 15 months prior to that and in Hillis it was noted that the Revenue authorities did recognize that the provincial legislation relating to the devolution of property was to govern the applicability of Sec. 70(6). The fact that Sec. 70(6) was amended after the Hillis appeal to extend the vesting date to 36 months would seem to suggest that the Department was concerned with the tardiness of orders granted under dependent/family relief legislation and that the provincial laws should govern the effect of Sec. 70(6). It is questionable whether a court would find indefeasible vesting in an instance where the testator directed that **his residue** be transferred to his offspring etc. when massive *inter vivos* tax liabilities would prevent the executor from assenting to the disposition and instead disposing of property to extinguish them.

While "common" definitions of the term "indefeasible vesting" are to be adhered to in applying the provision in its context such would **include** not just the classic definitions dealing with real property, but also normal meanings derived from popular usage and it's doubted whether anyone familiar with estate practice or otherwise would be satisfied that a property interest is indefeasibly vested when statutory law could operate to specifically divest it as an objective from its preconceived recipient. In the author's opinion vesting indefeasibly plainly doesn't occur until the time limits for making applications under all of the relevant legislation that could redirect the beneficial entitlements has passed. This is regardless of whether applications are in fact made and this is still a very functional definition of the term within the context of Sec. 70(6) (or the other roll-overs). If the "narrow" definition were adhered to very few interests would not be indefeasibly vested within the context of the provision and when fairly common court orders redirect the ownership to alternate recipients the application of Sec. 70(6) would be obtained "illegitimately". Essentially everything could be given to the spouse followed with immediate application under the dependant's relief statutes and the entire estate would gain Sec. 70(6) treatment even though a substantially reduced amount of it would remain for the spouse after the appropriate order. By extending the vesting date in Sec. 70(6) so that the family law/dependant relief legislation can be fully applied the provision's availability to the **appropriate** circumstances is more ensured. It is suspected that this was one of the underlying reasons for the extension, (and the possibility of the extension in the time in which proof of vesting can be provided for that matter). The Trial Court's evaluation lacks the concern for policy as well as intention of the Department was indicated in the wording of Sec. 70(6), (as well as certain other provisions in the Act and their relation to Sec. 70(6)).

Subject: Meaning of "Vested Indefeasibly"

IT-449R Date: September 25, 1987

This bulletin replaces and cancels IT-449 dated June 13, 1980. Current revisions are designated by vertical lines.

Summary

This bulletin deals with the meaning of the expression "vested indefeasibly" used in provisions of the Act which deal with the rollover of certain properties from one taxpayer to another. The bulletin also includes comments

concerning requirements that must be met before the provisions referred to above can apply. Examples are given describing some circumstances in which the issue of whether property has vested indefeasibly is relevant.

1. The Act does not define the term "vested indefeasibly". Accordingly, the meaning of this term must be construed within the context of the provisions where it is used. In all the provisions indicated above "vested indefeasibly" refers to the unassailable right to ownership of a particular property that, in consequence of death of the owner, has been transferred or distributed either to a spouse, a spouse trust or a child of the deceased. In the Department's view a property vested indefeasibly in a spouse or child of the deceased when such a person obtains a right to absolute ownership of that property in such a manner that such right cannot be defeated by any future event, even though that person may not be entitled to the immediate enjoyment of all the benefits arising from that right. Where property is held in trust for the benefit of one or more persons it is the Department's view that such property normally vests indefeasibly in the trust and not in a beneficiary thereof. However, where the Department is satisfied that a property is held in trust solely to carry out the terms of a will under which the ultimate and absolute ownership of that property is bequeathed to a particular individual and the trust arrangement is such that the individual's ownership rights cannot be defeated by any future event and no other person has any right whatsoever to an immediate or future benefit from that property or that trust, the property will be considered to vested indefeasibly in that individual.

2. Property is considered to vested indefeasibly in the person to whom it is bequeathed when that person has an enforceable right or claim to the ownership thereof. This will be so even though the formal legal conveyance and registration of ownership of the property has not been completed. **Accordingly, the ownership of property described in a specific bequest in a will will vest in the beneficiary immediately after the death of the testator. The ownership of property emanating out of a non-specific bequest will vest in the beneficiary when such property has been identified and the beneficiary has a binding right to receive it.**

Note: In the following paragraphs, references to subsections 70(9.4), (9.5) and descriptions of requirements thereunder are applicable only with respect to transfer and dispositions made before 1988. Subsections 70(9.4) and (9.5) were repealed with respect to transfer and dispositions made after 1987 as a consequence of the introduction of the lifetime capital gains deduction.

3. The rollover provisions in subsections 70(5.2), (6), (9) and (9.2) of the Act and ITAR 26(18) (as well as 70(9.4) of the Act with respect to transfers and dispositions occurring before 1988) will apply

(a) with respect to deaths occurring after 1984 if, within the period of 36 months after the death of a taxpayer it can be shown that property owned by the taxpayer immediately before the taxpayer's death has, on or after the taxpayer's death and as a consequence thereof (see 4 below), been transferred or distributed and has become vested indefeasibly in the transferee or distributee described in the relevant subsection. (If the Minister considers it reasonable in the circumstances, a period longer than 36 months may be allowed if requested in writing by the deceased's legal representative before the end of the 36 month period following the date of the taxpayer's death), and

(b) with respect to deaths occurring before 1985 if the property can, within 15 months after the death of the taxpayer or such longer period as is reasonable, be established to have become vested indefeasibly within 15 month period in the transferee or distributee described in the relevant subsection. However, with respect to a death occurring after 1981 and before 1985, the longer period for vesting, as described in (a) above, was available with respect to the deceased's property provided that the deceased's legal representative and each person to whom an interest in the property was transferred or distributed as a consequence of the death of the deceased had jointly elected on or before January 27, 1986 to have such longer period apply. The period of time allowed for vesting (including any approved extension tot hat period) as described in this paragraph is referred to hereafter as "the relevant vesting period".

4. Subsection 248(8) applies to transfers, distributions and acquisitions occurring after 1981. This subsection provides that a transfer, distribution or acquisition of property shall be deemed to have occurred as a consequence of the death of a taxpayer where such transfer, distribution or acquisition was made

(a) pursuant to the terms of a will or other testamentary instrument of the taxpayer or of the application of provincial statutory provisions governing intestate succession (in this bulletin referred to as "intestate

succession provisions") to the estate, or
(b) as a consequence of a disclaimer, release or surrender by a person who was a beneficiary under a will or other testamentary instrument of the taxpayer or under intestate succession provisions.

Subsection 248(8) also provides that where a beneficiary under a will or other testamentary instrument of a taxpayer or on the intestacy of a taxpayer, release or surrenders any property that was property of the taxpayer immediately before the taxpayer's death, such release or surrender shall not be considered to be a disposition of that property by the beneficiary provided that such release or surrender is made within the relevant vesting period.

5. The rollover provisions in subsections 70(9.1), 70(9.3)(as well as 70(9.5) with respect to transfers and dispositions of property that occur before 1988) apply only where

- (a) property has been transferred by a taxpayer to a spouse trust described in subsection 70(6) or 73(1),
- (b) the taxpayer's child is a capital beneficiary of the spouse trust and resident in Canada immediately before the death of the spouse, and
- (c) the property has, upon and as a consequence of the death (see 4 above) of the spouse, been transferred or distributed to and become vested indefeasibly in a child of the taxpayer. (This vesting requirements contrasts with the longer period of time permitted for the vesting of property under subsections 70(5.2), (6), (9) and (9.2) of the Act and ITAR 26(18).)

6. Where a taxpayer dies with or without a will and the taxpayer's assets are allocated by the legal representatives among the beneficiaries within the relevant vesting period in accordance either with discretions in the will or with intestate succession provisions, there is no requirement that property be left specifically to a particular beneficiary either under the will or by operation of the intestate succession provisions for those subsections to apply. The fact that the legal representatives exercised discretion in allocating assets among beneficiaries does not diminish the fact that the beneficiaries obtained the assets as a consequence of the deceased's death.

7. Where ownership of the deceased's property passes to a person pursuant to a court order given under a statute such as a dependents' relief Act or family law Act, it is the Department's position that ownership of such property for purposes of subsection 70(6), (9), (9.2) and (9.4) of the Act and ITAR 26(18) will be considered to vested indefeasibly in that person within the relevant vesting period provided that the court order is actually given within that period. Generally where an application has been made to a court under a dependents' relief Act or a family law Act and within the aforementioned period of 36 months an application is made to the Minister for an extension of time the fact that the application to the court is pending would mean that a delay in the vesting of the property until the judgment of the court is received would be regarded as reasonable in the circumstances.

8. The following examples describe some circumstances in which the issue of whether property has vested indefeasibly is relevant:

- (a) A man who wishes to ensure that the absolute ownership of his farm land will ultimately pass to his child after his widow has had the use of the property during her lifetime, could achieve this result by the terms of his will as follows:
 - (i) he could direct his executors to convey the land to his widow as life tenant and to his child as remainderman. This would not involve the use of a trust.
 - (ii) he could direct his executors to hold the land in a spouse trust for the use and enjoyment of his widow during her lifetime and, on her death to convey the land to his child.

Since (i) above does not involve a trust the provisions of paragraph 70(6)(b) do not apply. It is the department's position that the farm land vested indefeasibly in the child in the death of the father. This same result would occur if it is a condition that the widow's interest in the land terminate on her remarriage.

Since the trust described in (ii) above is a spouse trust, if the entire interest in the land becomes indefeasibly vested in the trustees of the spouse trust within the relevant vesting period, the cost of the land to the trustees will be its adjusted cost base to the taxpayer. Upon the death of the widow if the land is transferred or distributed to the child and becomes vested indefeasibly in the child as a consequence of the widow's death and if the child was resident in Canada immediately before the widow's death, subsection 70(9.1) provides that there will be a rollover of the land from the trustees to the child at the

adjusted cost base of the land to the trust.

- (b) Under the terms of his will, a man directs that his farm land be held in a spouse trust for his widow during her lifetime and, on her death, that it be transferred to those of his children who survive his widow.

Since the trust is a spouse trust, the trustees of the trust will acquire the land at its adjusted cost base to the deceased. If on the widow's death and as a consequence thereof the land becomes indefeasibly vested in those of the taxpayer's children who are then alive, the land will be rolled out of the trust to the children at its adjusted cost base to the trust pursuant to subsection 70(9.1).

- (c) Pursuant to the terms of a taxpayer's will, farm land is directed to be held in a trust for the benefit of the taxpayer's child, to be distributed to the child when the child reaches a specified age and, if the child should die before that age, to be distributed to the child's estate.

The Department considers that the property vested indefeasibly in the child at the time of the taxpayer's death. Whether the child on attaining the age of majority could demand the conveyance of the land even though the specified age had not been attained, will depend upon provincial law. If the taxpayer's will had provided that the land would be distributed to other persons, for example the taxpayer's grandchildren, if the child should die before attaining the specified age, the land would not vest indefeasibly in the child until the child attained the specified age.

- (d) A taxpayer by her will directs that certain shares owned by her immediately before her death are to be distributed to a beneficiary. The shares, however, are subject to a buy-sell agreement.

Where the terms of the buy-sell agreement provide that it is compulsory for the executor of the taxpayer's estate to sell and the other party to buy the shares, the shares will not be considered to vested indefeasibly in the beneficiary. Where, however, the terms of the buy-sell agreement merely give the other party an option to acquire the taxpayer's shares which may or may not be exercised and the taxpayer's executors transfer the shares to the beneficiary before the option is exercised, the shares will be considered to vested indefeasibly in the beneficiary at the time of the transfer. These same comments will apply where the beneficiary is a trust created by the taxpayer's will and the executors are also trustees of the trust.

If the taxpayer in her will directs her executors to sell shares before setting her estate, the shares will not be considered to vested indefeasibly in any beneficiary.

- (e) A taxpayer in her will directs that her farm land is to be transferred to her child but that before that happens a mortgage or charge is to be put upon the land in order to provide funds to satisfy bequests to other beneficiaries.

Notwithstanding the fact that title to the land is encumbered by the mortgage or charge, the land will be considered to vested indefeasibly in the child.

Dependent's Relief Acts

In *Bain's Estate v. M.N.R.*⁵⁹³ wherein a testator's residuary estate was tainted and thus not eligible for Sec. 7(1)(b) treatment under the old Estate Tax Act, (substantially similar to Sec. 70(6) of the ITA), the will had initially provided that the widow was to be paid all of the estate's income arising before her death, **or time of remarriage**, whichever came first thus clearly the estate was tainted under the Sec. 7(1)(b) conditions however the widow was successful, through an application under the B.C. Testator's Family Maintenance Act, in obtaining the court order providing that the will should not be read with the remarriage clause, thus cleansing the tainted trust. The Tax Review Board found, upon the question of whether the amended estate would qualify for Sec. 7(1)(b) treatment:

"It seems also that the provisions of the B.C. Testator's Family Maintenance Act (which in substance part of which became the present Wills Variation Act) gave the Court the right to change or alter the will for the benefit of the widow of the deceased, and that the court did do so in this case... To me it would make no sense to read the provision of the Provincial Statute if one did not read them in the light of their application to the will as of the date of death, **and that the Order and the Will should be read as one, in which case the result has to be an altered testamentary document and one which would meet the**

593. 75 D.T.C. 135 (TRB)

requirements of Section 7(1)(b) of the Estate Tax Act..."

It is only due to the fact that a court order obtained under an appropriate provincial dependent support/relief statute can be construed as altering the very terms of a will that it may be accepted as a means of setting up a spousal trust, (or as in the above case, cleansing one). The order was made nunc pro tunc. Presently most Testator's Family Maintenance Acts (Manitoba: Sec. 12, N.B.: Sec. 11, N.S.: Sec. 10) provide that when an order is made under the Act the will will be deemed, for purposes of "succession duties" to have been executed with the variations in it for full effect from the time of death.⁵⁹⁴

In *Tassie Estate v. M.N.R.*⁵⁹⁵ the taxpayer left by her will the estate for **the use** of her widower but he in effect wasn't provided with an income interest and thus was not entitled **to receive** anything from the estate except the use of its property (a dwelling and incidentals). The widower required funds and petitioned the courts under the B.C. Testator's Family Maintenance Act whereby he was awarded an order calling for a \$2,500 capital payment to him and a right to receive the net income of the estate until his death, (as well the will was altered to instill in the executor's a discretionary power of encroachment exercisable in respect of the widower). The order was made nunc pro tunc, (read to take effect at the date of death), and when the executor's attempted to have the favorable Sec. 7(1)(b) of the Estate Tax Act applied the Minister refused contending that the amended will created an estate that wasn't of the nature created by the taxpayer's will. The Tax Review Board found that the court order was to be read into the will thus the character of the amended will was to be regarded as that created by the original will, thus qualifying for Sec. 7(1)(b) treatment. If this were to occur again would the Minister not have a basis for assessing the widower as being entitled to enforce a distribution of income of the trust in those years in which the court order covered, so as to cause him to become liable for the income tax on the trust's income via Sec. 104(24)-(13)(a), regardless of whether it was paid to him or not? Since the court order operated **retroactively** it would cause him to be recognized as an absolute and immediately interested income beneficiary in those years thus exposing him to a tax liability. A retroactive dependent support/relief court order shouldn't qualify an estate/trust at the same time that it exposes the spouse to possible retroactive income inclusions. Following the reasoning in *Hillis* concerning the retroactivity of court orders, in the author's opinion, the beneficiary may not have to recognize a Sec. 104(13) income inclusion in a tax year during which he had no right to sue for the income's distribution. Will this change if the court offers retroactive income disbursements to the beneficiary? Not necessarily.⁵⁹⁶

"How trust created – 248(9.1)"

For the purposes of this Act, a trust shall be considered to be created by a taxpayer's will if the trust is created

(a) under the terms of the taxpayer's will; or

(b) by an order of a court in relation to the taxpayer's estate made under any law of a province that provides for the relief or support of dependants.

There isn't any need to have a trust created as a spousal trust "under the taxpayer's will" retain that characteristic indefinitely and it is entirely possible to have the trust varied so as to have offspring, new spouses, added as beneficiaries without endangering the previous application of Sec. 70(6). These variations however will not preclude the trust from being treated as a spousal trust in respect of two major subsequent events; the reoccurring deemed dispositions under Sec. 104(4), (5) and the Sec. 107(4) capital distribution provision, and of course they would cause implicit dispositions of various capital or income rights to be

⁵⁹⁴ See *Re: Bishop*, 1952 V.L.R. 543, *Union Fidelity Trustee Co. of Australia Ltd. v. Montgomery*, 1976 1 N.S.W.L.R. 134, & *McLeod v. Johns*, 1981 1 N.S.W.L.R. 347, for instances where order did not vary terms of will but the benefit of the beneficiary was derived from the order.

⁵⁹⁵ 73 D.T.C. 180 (TRB)

⁵⁹⁶ See *Tindal* in *Retroactive Income Entitlements* for an instance when decretal order did not produce retroactive tax liability when made nunc pro tunc. See also *C.I.R. v. Earl of Haddington*, 8 T.C. 711, and *Ford v. Nauts*, 1928 1 U.S.T.C. 272.

recognized by the former beneficiaries even if income to be accumulated following the spouse beneficiary's death is then to be payable currently following her death.

If the testator's will grants a power of appointment over any of the residuary estate tainted spousal trust to the executor will he be able to exercise the power and create splinter settlements some of which will be purely spousal in character, and have Sec. 70(6) apply to the transfer? If a **"general"** unrestricted power of appointment is exercised so as to create a sub-trust then that sub-trust draws its creation from the exercise of the power, not from the terms of the initial settlement that instilled such a power in the exerciser and thus it is not to be "read back" into the original settlement and the trust cannot be a spousal trust created under the will. If the power of appointment is restricted, (special), so as to allow the exerciser to create spousal trusts with its use, then any spousal trust that results from its use will be read back into it, and considered as arising from, **the original settlement**.⁵⁹⁷ The fact that the special power of appointment arises from a tainted spousal trust and causes the sub-trust to be read back into that trust does not preclude the trust from arising as a consequence of the death **and** pursuant to the terms of the taxpayer's will when the tainted spousal trust is irrevocably terminated following the exercise. Obviously this can prove to be a major trust planning tool in that it allows the executor or trustee to decide whether **extra** spousal trusts should be set up, (and in many but not all instances "the more, the merrier"), or whether there will be a spousal trust at all arising out of an otherwise disqualified residuary estate. Understandably one would want to ensure the special power is based on the requirement that its exercise can only result in the creation of a trust with spousal characteristics for if it isn't so meticulously targeted there may be grounds to debate that the spousal character is a result of the exercisor's discretion, not the testator's secondary intention. Also, since the spousal sub-trust will be read back into the initial tainted trust there may be cause to provide that the sub-trust cannot ever rely in the initial trust's existence or provisions so as to cause it to be precluded from being merely another part of that tainted settlement.⁵⁹⁸

Family Law Act/Matrimonial Property Act Applications.

"Matrimonial regimes – Sec. 248(22)"

Sec. 248 (22) Where at any time property could, as a consequence of the dissolution of a matrimonial regime between 2 spouses or common-law partners, be the subject of a partition, for the purposes of this Act

(a) where that property was owned by one of the spouses or common-law partners immediately before it became subject to that regime and had not subsequently been disposed of before that time, it shall be deemed to be owned at that time by that spouse or common-law partner and not by the other spouse or common-law partner; and

(b) in any other case, the property shall be deemed to be owned by the spouse or common-law partner who has the administration of that property at that time and not by the other spouse or common-law partner.

"Dissolution of a matrimonial regime – Sec. 248(23)"

(23) Where, immediately after the dissolution of a matrimonial regime (other than a dissolution

⁵⁹⁷ See the chapter on Variation of Trusts and commentary on powers of appointment, advancement, encroachment. See *Blausten v. I.R.C.*, 1972 1 All. E.R. 41 (C.A.) where a special power of appointment exercisable to create a sub-trust for the exclusive benefit of certain beneficiaries under the initial settlement allowed the trust setting to be cleansed of a power in the initial settlement, via the resettlement thereof, that would have caused income attribution. The power also would satisfy the Sec. 248(8)(a) requirements.

⁵⁹⁸ The Department has fostered a continual opinion that a spousal trust will gain from a Sec. 70(6) roll where: "the will directs the establishment and terms of a trust for a spouse and provides the executors with guidelines for identifying the properties which fall to the trust", where the trusts are created "but leaves the executor the discretion to select which assets are to be transferred to the trust to satisfy the specified total value of the assets or portion of the estate to be so transferred", or where the will creates the spousal trust "but leaves total discretion to the executor to select both the total value of and properties to be transferred to the trust". (T.I. 5-8832 of the F.I.D. in Nov. 1989). The same was provided in Feb. 1984 by the Non-Corporate Rulings Division.

occurring as a consequence of death), the owner of a property that was subject to that regime is not the person, or the estate of the person, who is deemed by subsection 248(22) to have been the owner of the property immediately before the dissolution, the person shall be deemed for the purposes of this Act to have transferred the property to the person's spouse or common-law partner immediately before the dissolution.

"Transfers after death – Sec. 248(23.1)"

(23.1) Where, as a consequence of the laws of a province relating to spouses' or common-law partners'(sic) interests in respect of property as a result of marriage or common-law partnership, property is, after the death of a taxpayer,

(a) transferred or distributed to a person who was the taxpayer's spouse or common-law partner at the time of the death, or acquired by that person, the property shall be deemed to have been so transferred, distributed or acquired, as the case may be, as a consequence of the death; or

(b) transferred or distributed to the taxpayer's estate, or acquired by the taxpayer's estate, the property shall be deemed to have been so transferred, distributed or acquired, as the case may be, immediately before the time that is immediately before the death.

Subsections 248(22)-(23.1) attends to situations where the spouse chooses to take property directly under a matrimonial property regime that recognizes his property rights and thus allows the property to benefit from a Sec. 70(6) roll-through. It does not, however, go the distance in creating a trust recognizable as created by the deceased, if the court so directs in the case of the creation of a trust in respect of the spouse.

If the spouse makes an election under the particular provincial Family Law or Matrimonial Property Act to take an "equalization payment" from the estate instead of any gifts to her a tax planned succession may be "blown to smithereens" **unless** such an election is properly planned for and attended to in contingency clauses. The result of such an election usually consists of the cash payment by the estate instantly, or spread out over many periods, to the spouse while in Ontario the amount of the payment is equal to 1/2 of the excess of the testator's increase in net worth since the time of marriage to the time of death over the same increase in respect of the spouse adjusted for debts owed by both parties. If the present fair market value of the gifts given to the spouse under the will exceed such the election shouldn't be made while if it is the estate may be faced with a serious liquidity problem and may have to dispose of property to satisfy the spouse's claim. One way of avoiding such a problem is to enter into a marriage contract which provides that the **contemplated** claims can be satisfied with the net fair market value of the estate property **chosen by the executor** so that the Sec. 70(6) roll-over will apply to it.⁵⁹⁹ (The Court can have very wide powers in choosing which property to vest in the spouse pursuant to an election though such **may** be restricted with marriage contracts.) The contract may also guarantee testamentary gifts equal to a certain value or in the most ideal case preclude the election from being made or certain property of the testator from being valued for purposes of the FLA. If this can't be done and the election route is sure to be taken the will could still create a spousal trust expressly out of property not used to satisfy the claim thus allowing Sec. 248(8) to recognize their passage to be as a consequence of the death whereunder property rolled to it could be incorporated with the trust taking back preferred shares and the non-spousal beneficiaries taking back dividend paying shares for nominal consideration.⁶⁰⁰ The spouse

599. See *Swire v. Swire*, 10 R.F.L. (3d) 399.

600 Additional spousal gifts in addition to the equalization election can be held valid in the face of an election as provided in Sec. 6(7) of the FLA though the income interest would be marginal and there is a danger a disgruntled spouse would disclaim it before the trust can be constituted to gain Sec. 70(6) roll-over treatment. In T.I. 5-910290 provided in Apr. 1991 by the F.I.D. it was provided that two spousal trusts may be created under a will and ancillary spousal F.L.A. application. It was provided:

"It is possible in our view for a spouse trust created under a will to co-exist with a spouse trust created by a court order under the FLA, but only in limited circumstances as explained in the following comments. Subsection 6(7) of the FLA

would be entitled to the trust's income, which could be nil in most instances, while the tax free roll-over would apply and the beneficiaries could participate in the income generated.⁶⁰¹ All of the testator's property could be rolled this way for that matter.⁶⁰²

An equalization claim is not a creditor claim and continues to be a beneficiary claim, an obligation to pay, thus the assets of the estate could be distributed to the beneficiaries with the consent of the spouse on condition that the recipients pay the spouse a certain amount in settlement.⁶⁰³ In such a case the beneficiaries may recognize a capital loss on the distribution of the property under Sec. 107(2)(c) where the tax cost of the interest satisfied with the distribution was bumped up tax free, (such as in the case of the beneficiary becoming resident while the estate is non-resident). The tax cost of the property received via Sec. 107(2) will not be affected by the payment of the obligation⁶⁰⁴, while its cost amount will be bumped to its FMV.⁶⁰⁵

Another way to reduce the problem of liquidity is to give the executors the power to mortgage the property of the estate and then use the funds to satisfy the claim. If the cost amount of the interest has been bumped a subsequent assumption of the mortgage along with the receipt of the property may precipitate a capital loss to the beneficiary. In the extreme case the will could actually provide that upon the desire to elect that an annuity be set up out of the estate property, financed through the spousal trust, so that the present value of the future payments would exceed that of the present value of the equalization payment. This would eliminate such a desire.⁶⁰⁶ This may again seriously reduce the trust's liquidity but such could be structured via the spousal trust's incorporation of its Sec. 70(6) rolled assets for cumulative preferred shares so as to allow the beneficiaries to benefit to an extent greater than if she had chosen the equalization payment. The life expectancy of the elector is a consideration in valuing her life interest but not if upon her death a supplemental capital payment is made to her estate to increase the amount she ultimately realizes. In such an instance at least the testator could recognize a Sec. 70(6) roll.

If the spouse elects for the equalization payment she'll receive the property in the capacity of a beneficiary but with Sec. 248(23.1), she'll receive it as a consequence of the death, and not only as a consequence of the election.⁶⁰⁷

provides that where a surviving spouse elects to receive the entitlement under section 5 of the FLA, the gifts made to the spouse in the deceased taxpayer's will are revoked and the will shall be interpreted as if the surviving spouse had died first, unless the will expressly provides that the gifts are in addition to the entitlement under the FLA. It is therefore our view that a spouse trust created under a will can co-exist with a spouse trust created by a court order under the FLA only where the will provides that gifts to the surviving spouse thereunder are in addition to the spouse's entitlement under the FLA. The fact that the trustees might differ, or that the property of one trust might be located in a country different from that in which the property of the other trust is located, is in our view immaterial in and of itself." The same was provided in T.I. 901526 in March 1991 by the same Division. It was not asked in either case whether these two trusts would also be consolidated as one by virtue of Sec. 104(2) though it is arguable that they cannot be: there is a statutory allowance for the creation of the trust under the FLA as being created by the will of the taxpayer and when one asks what would happen if Sec. 70(6.1) didn't exist, and thus its need as recognized by the Department, the answer to consolidation is self-evident. Subsection 70(6.1) is targeted exclusively for purposes of Sec. 70(6) and 104(4) and nothing else: certainly not Sec. 104(2), and thus the two trusts are not created by the same individual.

601 Subsection 105(1) would not apply to the excessive dividends received since as per para. (a) therein the benefit is otherwise being included in computing the beneficiaries' incomes.

602 A substantial incentive for the spouse not to make the election can be an *inter vivos* trust previously created receiving life insurance proceeds realized on the death. Under it the spouse could have a contingent interest, to be vested if the election isn't made, whereby she receives the entire insurance proceeds or if she does make the election she gets no part of it and there's a gift over to the offspring. The *inter vivos* trust could be financed with cash contributions from the taxpayer, and could even receive *inter vivos* options to purchase critical assets with the insurance proceeds thus precluding the spouse from receiving them via an election.

603 Subparagraph 9(1)(b) of the FLA provides for this.

604 See *Passant v. Jackson*, 1985 S.T.C. 133.

605 The non-resident beneficiary should become resident prior to the spouse's M.P.A./F.L.A. application so as to achieve the maximum bump and this time period lasts only approx. 6 months after death. The equalization debt is deemed nunc pro tunc though such doesn't totally affect the value of the interest until the order is made.

606 In T.I. 5-7677 of Apr. 1989 the F.I.D. correctly provided that when an effort was made via executor, beneficiary and spousal agreement to have a will altered to increase the spouse's entitlement so as to avoid a FLA application the additional property would not gain Sec. 70(6) treatment (and the beneficiaries could be recognized to have realized a Sec. 107(1) disposition of their capital interests), however, if the will specifically provides for such without the consent of the beneficiaries Sec. 70(6) should apply to everything realized by the trust (or spousal trust).

607 Subsection 6(7) of the Ontario FLA provides that when the election is made the gifts made under the will will be revoked and the will will be read as if the elector predeceased the testator, while as per Sec. 6(11) the entitlement has virtual paramount status over other beneficial claims. It could be argued that the Sec. 70(6.1) trust created via prescribed

Severing Ownership Interests on the Roll-over.

Do all of the interests in a particular property have to be transferred or distributed to the spouse or spousal trust in order for Sec. 70(6) to apply to the capital element therein? Can the remainder interest in an income producing property be property subject to the Sec. 70(6) roll while the life interest of the property isn't transferred to the spousal party but can benefit from the Sec. 70(3) roll through or suffer from the Sec. 70(2) inclusion?⁶⁰⁸

orders made under legislation providing relief/support for dependents would include FLA trusts since the FLA does concern dependents as well as spouses on death while various other provinces' legislation are specifically targeted at providing support including support to the spouse as a dependant. Part III of the FLA concerns dependant support which qualifies the entire Act as dependant support legislation (though could it be argued that the Sec. 70(6.1)(b) reference to "law" be construed as to mean only parts of Acts)? This aspect was specifically addressed in T.I. 5-1744 provided in Oct. 1986 by the Small Business and General Division when it was held:

"It is our view that, in the absence of a reference to a specific provision of "a law of a province" in subsection 70(6.1) of the Act, the ordinary meaning of the word "law" is the law as a whole. Furthermore, paragraph 33(8)(d) of Part III (Support Obligations) of the FLA states "An order for the support of a spouse should relieve financial hardship, if this has not been done by orders under Parts I (Family Property) and II (Matrimonial Property)". It thus appears that the legislators of the FLA view Part I as providing relief in addition to equalizing net family property."

Various (but not all) provincial Dependant's Relief/Family Relief Acts provide expressly that the effects of an order awarded will be read into the will to adjust it *nunc pro tunc* for the purposes of succession duties and it could be argued that "succession duties" could include capital gains taxation arising on death since at the time the relevant Act was introduced Canada did not have testamentary capital gains taxation but succession duties. The effect of the order *nunc pro tunc* will cause the Sec. 248(8)(a) targeting to be complete, however some dependant's relief legislation do not make statutory *nunc pro tunc* orders in which case if a direct payment to the spouse is awarded the testator will not gain Sec. 70(6) treatment in respect of it.

CRA has taken a remarkably lenient position with respect to the results of a FLA order where property is transferred to the spouse directly. In the recent T.I. 901526 rendered in March 1991 by the F.I.D. it was stated as follows:

"The Department has taken the position that the revocation of any gifts in a will in consequence of the FLA election will constitute a disclaimer for purposes of section 248(8)(b) of the Act such that subsection 70(6)(a) of the Act will apply to any particular properties transferred to the surviving spouse in satisfaction of the election. The Department is prepared to apply this interpretation where the property is transferred in satisfaction of the elected FLA entitlement, and the transfer is made under court order. The Department is not prepared to allow this treatment to any transfers in excess of the elected amount or those that are not made in consequence of an application to the court."

This opinion was also provided in T.I. 5-902013 of Oct. 1990 provided by the F.I.D. provided vesting occurred within the 36 month period. It was also provided in T.I. 5-7677 in Apr. 1989 by the F.I.D.:

"However, if the widow elects to receive property under sections 5 and 6 of the Family Law Act, the property transferred to her would be in consequence of the death of X and would be eligible for the roll-over under Sec. 70(6) of the Act. It is our view that an election to receive under the Family Law Act is an act by which the widow refuses to accept the estate conveyed to her by will and constitutes a disclaimer under the will. Paragraph 248(8)(b) of the Act states that a transfer of property as a consequence of a disclaimer, release or surrender by a person who was a beneficiary under the will or other testamentary instrument or on the intestacy of a taxpayer shall be considered to be a transfer as a consequence of the death of the taxpayer."

while in Oct. 1986, (in T.I. 5-1710), the Small Business and General Section provided the same. (In T.I. 5-1500 provided in July 1986, the F.I.D. provided that property received pursuant to an order made under the Saskatchewan Matrimonial Property Act will qualify for Sec. 70(6) treatment if received by the widow but only if the action wasn't part of litigation (divorce, separation) between the parties.)

It is questionable how viable these opinions are in the face of the substance of Sec. 248(8). An election to take additional property operates to cause the will to be read as if without the original bequest to the spouse, but this doesn't necessarily constitute a disclaimer by the spouse unless the "disclaimer" inferred by the Department in Sec. 248(8)(b) is broader in definition than that in common law. A disclaimer refers to the specific and expressed avoidance of a gift exclusively phrased and the effect of section 6 of the FLA cannot fit within this definition. (See the discussion of disclaimers in the subsequent chapters. If this constitutes a "disclaimer" for Revenue then a lot of other acts that normally are not should also be so treated.) A release or surrender is also the expressed and exclusive act of forgoing future benefits from a right under a trust after benefits have been realized which often is directed to inure to the benefit of others by the releaser. The deemed alteration in the will under a FLA application also doesn't have these characteristics. The argument of an effective disclaimer via application can be countered with even more formidably with the fact that the FLA provides that the gifts may continue to the spouse if the FLA elimination of them is expressly to be disregarded: how can a "disclaimer", via the FLA application, as contended by the Department, be so complete as to allow the exact same gift to be provided in exactly the same way? Again in T.I. 901526 of March 1991 rendered by the F.I.D. it was held that the spouse who makes a FLA application for not even being named as any sort of beneficiary under the will will still acquire by virtue of Sec. 248(8) as if she was. Regardless it's reassuring to know that the Department is more than enthusiastic to provide favourable "administrative" interpretations when it seems complacent to have its statutes adjusted to attend to this very common phenomenon.

608. It could also be held on *inter vivos* trust, causing a disposition to the settlor: a full income inclusion, whereby income could be payable to the settlor until his death with gift over of the income right to the ultimate beneficiary to be determined by his will, or it could continue to be held in trust and the income distributions to the beneficiary via the will

There is a lack of Canadian tax jurisprudence on this issue, however it can easily be seen how it can operate to seriously reduce tax consequences and offer flexibility in the face of the spousal trust requirements.⁶⁰⁹ Perhaps it is for this reason that the Department has expressed in the answer to Question 55 of the 1990 Roundtable Discussions that it considers the Sec. 70(5)-(6) provisions to apply to all of the interests in the property and not to parts of the property that can be abstracted from the whole ownership. How would the courts interpret the context of the subsections on this issue? If the remainder interest goes to the spousal trust with the life interest going to the offspring the offspring isn't an income beneficiary under the trust since there isn't a trust relationship between the parties with respect to the property. Neither derives title from the other. The life tenant will acquire the right by virtue of the Sec. 70(3) roll-over without tax consequences to the testator if it is transferred within the statutory time period and such can be made conditional on payments to other parties previously discussed.⁶¹⁰ Ascertaining the value of a remainder interest may be important if Sec. 70(6.2)-(7)⁶¹¹ treatment is elected for in respect of it but the amount attributable to the life interest does not represent deductible cost for Sec. 69(1.1)(b) purposes. The fact that the testator doesn't own the remainder or life interest as distinct properties prior to death would seem to preclude Sec. 70(5)-(6) & 70(2)-(3) from applying to them when they are the subject of a testamentary fission.⁶¹²

Buy-Sell Agreements.

A question of indefeasible vesting arose in *Parkes Estate v. M.N.R.*⁶¹³ where the deceased taxpayer and

could be made conditional on the payment of a sum to the estate, or any other person, thus gaining the Sec. 69(1.1)(b) bump up in the cost of the right. This compares well with steps that would have to be taken to get a non-spousal beneficiary in on the trust's income potential after it has been constituted. The spouse would have to recognize a taxable disposition of her income interest and although the beneficiary would be able to recognize a cost thereof the entire process would be revenue neutral. If the Sec. 69(1.1)(b) bump can be attained tax free, as is possible, there will be a tax benefit to be realized. There are one hundred and one variations of these procedures. Successive dispositions could absorb unused personal tax credits, losses, etc., of the testator while depending on the spouse's predicted incidence of taxation after death it could prove advantageous to simply endure an *inter vivos* tax exposure on the initial disposition without countervailing deductions.

609 See *Western Aust. Trustee, Exor., & Agency Co. Ltd. v. Commr. of S.D.*, 32 A.L.R. 639.

610 If the taxpayer would have disposed of the right *inter vivos* proceeds would have been recognizable as income hence Sec. 70(2) applies to it however does this cause Sec. 70(2) to apply to the right to the income of a capital property inherent in its whole ownership when there isn't an ownership fission and the entire property attains a deferred Sec. 70(6) roll? Could it be argued that Sec. 70(2) cannot apply to the life estate created by the death since prior to the fission the right was inherent in the capital property which as per that subsection is exempt? The life estate is not a separate property prior to that time, and thus can it be transferred anytime after the death? Upon the fission in ownership upon death if the remainder interest is to gain Sec. 70(6) roll-over treatment the life interest must be subject to a Sec. 70(2) inclusion since both provisions suffer from the same problem in diction; not attending to the granting of legal life and remainder estates to different parties carved out of the original whole property. Note that the taxpayer does not own the interests as a particular type of property prior to the death. If the courts find that remainder interests gain Sec. 70(6) treatment one would expect substantial alteration in the manner in which the Minister assesses Sec. 70(5) dispositions of income producing property. Notwithstanding this CRA (Financial Industries Division) provided on Nov. 15, 1989, in a technical interpretation that Sec. 70(6) would be allowed to apply to an instance where the spouse would receive the legal life interest in the property while the children would realize the remainder on her death. The two types of rights were considered separate property. In the author's opinion there is a need to have an *inter vivos* fission of ownership interests in order to gain separate treatments, and this could produce substantial tax consequences (unless the severance occurred immediately after the property's acquisition). The property in specie is not that which would otherwise be disposed of under Sec. 70(5) and this is the target of Sec. 70(6). See *West. Aust. Trustee, Exor., and Agency Co. v. Commr. of S.D.*, 80 A.T.C. 4567 for provision allowing for favorable creation of life estates. See also "The Capital Gains Provisions and Life Estates", *Taxn. in Aust.*, Apr. 1990, 674, D.K. Raphael for some issues.

611 Note that the property listed under Sec. 70(7)(b) need not technically be that owned by the testator as a property prior to his death.

612 In Nov. 1989 T.I. 5-8706 rendered by the F.I.D. provided that if the remainder interest in testamentary property vested in non-spousal beneficiaries with the spouse receiving the life interest indefeasibly the Sec. 70(6) roll-over would be allowed however if such is acceptable why not in the vice versa? It was recognized however that the remainder and life interests were separate property. In T.I. 5-9747 rendered in July 1990 by the Bilingual Services and Resource Industries it was provided that when a testator in the province of Quebec creates a usufructuary under his will where his spouse was entitled to the income from property until her death there will be a Sec. 70(6) roll-over in respect of the usufructuary right where its a.c.b. will equal that of the whole property that the value of the usufructuary right is to the fair market value of the whole property while Sec. 70(5) will apply to the balance of the ownership rights that do not pass to the spouse. Capital gains will be computed on the rights transferred to the non-spousal parties based on the fair market value of those rights only.

613. 86 D.T.C. 1214 (TCC)

his brother each owned 50% of the capital stock of a corporation and before the death had entered into a buy-sell agreement whereby "upon the death of a shareholder each surviving shareholder shall purchase, and the executor or administrator ... of the deceased shareholder shall sell the shares of the company owned by the deceased shareholder immediately prior to his death, for the price and upon the terms and conditions herein stipulated...". To complicate matters, the spouse of the deceased, acting as executrix, transferred the shares of her husband's estate to her in her personal capacity and following that she entered into a buy-sell agreement with the brother whereafter upon the disposition she recognized the proceeds as a disposition on her behalf, and not on the behalf of the deceased's estate. The Minister, "cutting her off at the pass", took the position that the shares had never become vested indefeasibly in her in the first place thus Sec. 70(6) did not apply to the testator and thus the application of Sec. 70(5) could not be avoided. Goetz, T.C.J., held that:

"Unfortunately, the widow's right to have the title to the shares vest in her indefeasibly was precluded by the 1973 agreement which made it **compulsory** for her to sell the shares and compulsory for the deceased's brother to buy them. The 1973 agreement was effective up to the signing of the 1977 agreement hence the title to the shares did not vest indefeasibly with her..."⁶¹⁴

The nature of a buy-sell agreement operative upon death was the issue in *Van Son Estate v. M.N.R.*⁶¹⁵ where the testator had entered into an agreement with another shareholder whereby should he die the shareholder would be required to purchase his shares in the corporation **however** the agreement did not compel the deceased to purchase the other shareholder's shares if he predeceased him and the agreement **did not specify that the estate of the deceased was obliged to sell the shares to the shareholder**. When the Minister denied the application of Sec. 70(6) to the shares, when the spouse was entitled to the shares as sole remainderman under the estate, the Federal Court-Trial Division paid special attention to the fact that neither party had attempted to enforce the agreement. Finding the shares to have vested indefeasibly in the spouse the Court held with respect to the nature of the agreement that it was more of a consensual arrangement rather than a mutual irrevocable obligation in respect of both parties compelling them to sell and/or acquire each others' shares. The key was obviously the lack of the obligation of the estate to sell the shares upon enforcement of the agreement.⁶¹⁶ It's obvious that not to interfere with the issue of indefeasibly vesting that buy-sells collapse or are executable only within the 36 month period, otherwise they cover the period and taint the crystallizing of vesting.

It is possible to structure a shareholding buy-out **and** obtain the Sec. 70(6) roll if certain obligations and directions are arranged. One such method is to simply give a guarantee to the other shareholders that their shares will be purchased by the taxpayer's estate at a certain price **if** the taxpayer's shares are not offered for sale to them at a predetermined price by the estate within a certain period of time after death. The executors are not obliged to sell the shares but if they don't they have to purchase the other's, which may be financed with life insurance proceeds received directly, through the corporation, or by mortgaging property of the trust.⁶¹⁷

614 In T.I. 5-0116 provided Jan. 1986 by the Bilingual Services and Resource Industries Division it was held that if the beneficiary or the spousal trust is compelled to sell the shares as per the terms of the will indefeasible vesting will not occur. This was also opined in April 1981 by the Specialty Corporations Rulings Division.

615 90 D.T.C. 6183

616 In May 1981 the Non-Corporate Rulings Directorate held with respect to a hypothetical situation that when executors/spousal trust was not compelled to sell the shares even though another shareholder had the right to buy them their indefeasible vesting in the recipient would not be prevented.

617 In April 1981 the Specialty Corporation Rulings Directorate was confused in acceptable arrangements when it provided: "The Department will accept buy-sell agreements that include two options. One option gives the deceased's spouse the right to require the surviving shareholder to purchase her shares and a second option gives the surviving shareholders the right to require the spouse to sell her shares. Under such an agreement the shares will be considered to vest indefeasibly in the spouse provided the executor transfers the shares to the spouse before either of the options is exercised. It would seem to us that such an agreement would satisfy both the requirements of the deceased's spouse and the surviving shareholders." In June 1980 in an opinion of the Non-Corporate Rulings Division it was held that where the options of the above character are not exercised indefeasible vesting will not be prevented. The same was expressed in T.I. 5-9813 provided in May 1990 by the Bilingual Services and Resource Industries Division. The key apparently was that the exercise is discretionary while some agreements require a compulsory buy-out.

In a Technical interpretation provided in March 1981 by the Non-Corporate Rulings Division it was provided that where a corporation has the option of redeeming its own shares which the deceased owned at the time of his death the shares will vest indefeasibly vest with his spouse. What a buy-sell agreement can't do directly can apparently be accomplished indirectly through the proper structuring of the corporation's share structure and contingency clauses embedded therein.

If the will requires the spousal recipient to enter into a put **and a call** agreement with the other major shareholders so as to receive the shares, whereby if such doesn't occur there will be a gift over to another party, in entering into the arrangement the vesting of the legal title will be made defeasible, **as per the terms of the will.**⁶¹⁸ **If the shares are transferred to the spousal trust and vested indefeasibly therein the Sec. 70(6) roll-over is available to the deceased while if the spouse is required to enter into a buy-sell agreement in order to receive the shares from the trust the application of Sec. 70(6) will not be jeopardized. The spouse will not receive the shares via Sec. 70(6). If she doesn't enter into the agreement the spousal trust can operate to provide a future gift over of the shares to a non-spousal party and will thus be taxed on any accrued gain, (and will buy the outstanding shares). Indefeasibly vesting operates as an issue only with regards to how the trust receives the shares, not what it does with them afterwards per it's directions. If the buy-sell agreement is required to be operative at the moment the spouse receives the shares from the spousal trust**⁶¹⁹ there will be a Sec. 70(6) tax free roll while the spouse will realize the proceeds. If the spouse doesn't pursuant to the specific will terms, (concerning the ultimate transfer price etc.), the trust could be allowed to transfer the shares directly out of its hands, for proceeds that may not equal the shares' FMV, to the shareholders though such couldn't exist in the form of a testamentary option or obligation of the trustee. Such could take the form of a right of first refusal offered to the other shareholders *inter vivos* by the testator or made by the trustees under express authorization. If this isn't advisable the spousal trust deed could provide that the trustees are to abstain from the voting of the shares until a non-spousal beneficiary enters into a buy-sell agreement with the other shareholders whereby the shares will then become distributable to that person upon the death of the spouse. The other shareholders would thus obtain immediate control of the corporation while the shares are held in the trust pending the death.

The shares may themselves not be the subject of the buy-sell agreement; instead the interest in them could be if the trust deed specifies that certain interests will be contingent rights to receive the shares **if** the buy-sell agreement is entered into by the specified beneficiaries. Since the shares cannot be distributed prior to the death of the spouse the external shareholders would have to wait for such an event to receive them or arrange to indemnify the trust for any tax consequences if an early roll-out is to be made following a variation. If the trust deed specifies that the trustees are not to vote the shares after the follow through on the agreement by a beneficiary the purchasing shareholders will be able to convert the shares indirectly via the exercise of control.⁶²⁰ If the result of the non-spousal beneficiary entering into the agreement is his requirement to purchase the shares of the other shareholders at a certain price a promissory note could be given as consideration while immediately upon the receipt of the shares a reorganization could occur, between the spousal trust and himself, so as to stream higher dividend yields out to him so as to pay off the note and interest, while control of the corporation could be retained or obtained by the trust via the reorg. and low paying preferred shares could be required to be taken back, (as per the trust deed).⁶²¹ If a non-spousal trust is created

618 *Greenwood Estate v. The Queen*, 90 D.T.C. 6690 FCTD, illustrates the importance of not compelling the executors to transfer the shares at any price pursuant to an *inter vivos* agreement or testamentary direction. In this case an *inter vivos* agreement was entered into between the testator's offspring and the testator compelling the offspring to purchase the testator's shares from his estate while the agreement could not be ignored by the executors.

"I have little doubt that this agreement prevents there being n indefeasible vesting of the shares.

Indefeasible vesting requires that the person in whom the property is vested have the rights to determine whether or not the property will be retained by him or disposed of to another. There is no such discretion or control in the trustees with respect to the shares in question. Mr. Greenwood's representatives, the executors under the will, were compelled on his death, by operation of paragraphs 1 and 9(e) of the purchase and sale agreement... to sell the shares to the sons."

The Sec. 70(6) roll-over wasn't available when the executors had to honor the agreement.

619 and not the general estate

620 Understandably the selling price of the shares or contingent interest relating to them should be settled, and possibly be even delivered, before any reorganization occurs. On a conversion the trust's shares could become low dividend paying and the corporation's earnings could be streamed out to the purchasers so as to finance their acquisition. The trust's share's f.m.v. ,may also be materially reduced and since the reorganization may cause tax consequences in some instances to the trust the acquiring shareholder could be compelled to indemnify the trust for such: if a particular status dependent on a contribution to trust is to be maintained it would prove more beneficial to prevent the trust from voting the shares to the detriment of the ultimately acquiring shareholders while differing classes of discretionary dividend paying shares may prove instrumental in streaming the corporate earnings away from the trust: obviously considerable planning in the characteristics of the instrument and their interaction with the relationships of the parties to be expected is required.

621 These concerns could be extensively covered in the will.

out of the estate and it has sufficient cash the promissory note route need not be pursued if the beneficiary receives a substantial capital distribution with which to finance the purchase, (possibly generated by insurance proceeds), whereby the reorg. entered into with the spousal trust would operate in the opposite direction with respect to the beneficiaries involved.

A variation of this approach could also consist of the spouse having to enter into a buy-sell agreement in order for the shares to be rolled to the spousal trust in the first place; and if she didn't the testator would recognize a Sec. 70(5) disposition and alternate instructions could operate to create a buy-sell agreement by the non-spousal trust with the other shareholders, whereby the spouse could be completely kept out of participating. If she agreed the shares would vest indefeasibly in the spousal trust and it could then transfer them to her immediately whereby the agreement would be executed one way or the other, while if she was required to purchase then cash could be distributed out to her, as per the deed, on condition that she execute a reorganization with the trust as above.

If the spouse realizes the shares from the spousal trust Sec. 107(2) will not bump their cost and she will recognize them to have an ACB equal to that of the testator. If the interest based specifically on the shares is given to an offspring the interest cannot be enforceable prior to the spouse's death in order for the trust to be spousal while if she purchases the interest from the offspring Sec. 107(1)(a)-108(1)(d) will reduce tax consequences otherwise recognizable by him, especially if a power of appointment over excessive insurance trust funds, contingent on the spouse's death, serves to inflate the cost amounts of the capital interests without actually creating any. If she purchases the interest it will have an ACB that reflects the share's fair market value, especially since, pursuant to the will, the interest becomes immediately enforceable if acquired only by the spouse. In such an instance the Sec. 107(2)(b) cost bump is available on the shares' roll out to the spouse⁶²² and she can then enter into the put-call/buy-sell agreement with the shareholders which is required pursuant to the terms of the trust allowing specie distribution. A great deal of structuring (obviously) can inflate the cost of the shares for the spouse so as to reduce tax consequences following a buy-sell subsequent to a Sec. 70(6) roll to a trust. It could prove more efficient to bequeath an interest in the shares to a non-resident trust, have the spousal trust become non-resident, then have the beneficiary trust become resident obtaining the Sec. 128.1(1) bump in the cost of its 'non' taxable Canadian property subsequent to which the interest is disposed of to the spouse allowing a Sec. 107(2)(b) bump on the roll out of the shares and avoiding a Sec. 107(4) disposition whereafter the buy-sell agreement is entered into pursuant to the will terms. Alternately the spouse could 'visit the islands', (cease to be resident), for a two year and one day period and return once the trust has become non-resident, obtaining the Sec. 128.1(1) bump in the cost of her interest in the trust's shares subsequent to which a Sec. 107(2)(b) bump will be available. If the spousal trust is composed exclusively of taxable Canadian property a Sec. 128.1(1) deemed disposition will not cause excessive tax consequences while multiple spousal trusts could be created under the will without fear of the application of Sec. 104(2) if properly structured. When a \$50,000-\$150,000 etc. tax liability will otherwise be incurable the above steps are worth the extra draftsmanship. The spouse doesn't have to inherit the testator's cost of the property.

If the trust deed specifies that **in any manner** the other shareholders can acquire the shares from the trust or a recipient beneficiary as a result of the buy-sell agreement the benefit realized on the purchase **may** be fully included in their income under Sec. 105(1) since clearly such is being derived from the trust deed. If as a consequence of the trust deed the beneficiary or the trust has to purchase the outstanding shares at a bargain price a benefit under Sec. 105(1) will be recognizable as well, (unless the party isn't resident). With respect to these types of buy-sell agreement approaches the other shareholders would have to be parties to a contract will or other obligation to act so as to enter into the agreement with whomever wishes to be the testamentary party otherwise executing an eventual sale of the shares could be a long and laborious process while the trust's terms as expressed above would become completely irrelevant.

Of concern in a testamentary buy-sell arrangement is Sec. 111(4)-(5) which precludes the corporation from deducting booked net capital losses, non-capital losses and farm losses in a period subsequent to a change in control of the corporation or from carrying those losses back against pre-change in control periods of income. Also, where the ACB of non-depreciable capital property exceeds the property's fair market value at the time

⁶²² The bump didn't produce tax consequences to the seller with the integrated use of the power of appointment.

of the change in control the ACB will be reduced to the fair market value. Subparagraphs 256(7)(a)(ii)-(iii) provide an exception to the rules whereby a change in control will not be recognizable when the shares are acquired by the executor, administrator, or trustee of the taxpayer's estate who acquired them by virtue of the death of any other taxpayer or where the person acquired the shares by virtue of a distribution from an estate of a taxpayer arising on his death if the recipient was related to the deceased, presumably at the time of death.⁶²³ One alternative to avoid problems in loss deductibility if the shares are to be bequeathed to an unrelated party is to have the trust estate hold them until the losses have been absorbed and if this is to be done the buy-sell agreement the shareholders enter into should reflect it via the restriction of the distribution of the earnings exempt from tax via the loss application to the estate, or through a price adjustment clause. The initial exception can be satisfied even when the testator does not legally own the shares but they are held by an *inter vivos* trust over which he has a power of appointment or income interest in. If the trust's terms are such that upon his death the shares are to be distributed to his estate then they have been acquired by virtue of his death allowing them to avoid the Sec. 70(5) deemed disposition and to benefit from the Sec. 107(2) roll out while allowing for the avoidance of a deemed change in control. Alternatively the shares need not be conveyed to the estate of the person who died but instead can be conveyed to someone else's estate **as long as it is an estate apparently**. It would appear that the shares can be contracted to be held in the estate and that their manner of acquisition need not be purely as a consequence of a testamentary disposition.

Paragraph 5 of I.T. 302R2 provides the Department's opinion that a change in control will not result when there is a change in the party filling the office of trustee but not where there is a change in the beneficial interest in the estate. In the author's opinion, regardless of the change in beneficial interests in other estate property there will only be a change in control of the corporation if there is a change in the beneficial interest holder, as per Sec. 251(5)(b), but not where there is a disturbance of associated corporation status due to Sec. 256(1.2)(f), due to the alteration in the FMV of the beneficiaries' beneficial interests. If a variation in the estate is so substantial as to cause the recognition of its termination and a resettlement there may be a change in control.

In a spousal trust based buy-sell arrangement as previously described the control of the corporation⁶²⁴ can be transferred to the spouse, after which the agreement can be entered into, without a change in control. Once she disposes of them however there will be a change in control but there is a three year period during which the losses can be absorbed prior to indefeasible vesting in the spouse. If the expected rate at which losses may be absorbed is dismal the will may allow the executors to consent to a reorganization-subincorporation by the corporation during the period so as to create income to absorb the losses, (whereafter the corporation may become merely a holding corporation). Subsection 251(5)(b) should preclude the spousal beneficiary from satisfying the spousal trust distribution condition (enter into a buy-sell/put-call agreement) until the last possible moment since on entering into the agreement control will change, regardless of the time at which the agreement is actually executed. Of course the condition could be satisfied within an extended period of time and in fact the will could preclude any agreement initiated by the spouse prior to the absorption of losses from being effective at satisfying the condition precedent on the roll out thus avoiding a Sec. 251(5) change in control.

Perhaps when one examines the complexities of the possible arrangements it would be preferable to have the will provide the authority to the executors to consent to a subincorporation initiated by the other shareholders to absorb any losses via the Sec. 85(1) creation of income. The benefit of the cost bumps would inure to the other shareholders in the end.

Income Tax Interpretation Bulletin

Buy-sell agreements

IT-140R3

DATE: APRIL 14, 1989

SUBJECT: INCOME TAX ACT

⁶²³ If the beneficiary receives them as a purchaser a 'distribution' will not occur.

⁶²⁴ assuming it corresponds to the shares flowing through Sec. 70(6)-107(2)

Buy-sell agreements

REFERENCE: Subsection 70(5) (also subsection 164(6) and paragraph 69(1)(b))

Application

This bulletin replaces and cancels Interpretation Bulletin IT-140R2 dated December 29, 1980. Current revisions are designated by vertical lines.

Summary

Taxpayers who own similar interests in a business or property often make such a similar interest subject to a buy-sell agreement. Although the form and content of buy-sell agreements may vary, they almost always provide for either the compulsory or optional sale of capital property by one person and either the compulsory or optional acquisition by another of the capital property owned by the former. The price may be certain, or may be determined as outlined in the agreement. This bulletin discusses buy-sell agreements that are in effect at the time of death of a person.

Discussion and Interpretation

1. The rules in subsection 70(5) apply to property that is subject to a buy-sell agreement, unless the property can be considered to vest indefeasibly in another person pursuant to subsection 70(6), 70(9), 70(9.2) or 70(9.6) or paragraph 70(5.2)(d) or (f). Whether the property vests indefeasibly in another person depends on the terms of the buy-sell agreement and the terms of the will (see the current issue of IT-449R).

2. When determining the proceeds deemed to have been received by the deceased pursuant to subsection 70(5), the fair market value of the property subject to the buy-sell agreement must be determined at the time immediately before death. The Department's view is that, where the deceased and the surviving party to the buy-sell agreement (survivor) did not deal at arm's length, it is a question of fact whether the fair market value for the purpose of subsection 70(5) will be determined with reference to the buy-sell agreement.

3. Where the deceased and a survivor did not deal at arm's length at the time the agreement was made, the Department's view is that paragraph 69(1)(b) applies when the estate sells the property to the survivor pursuant to the agreement and that it is a question of fact whether fair market value under paragraph 69(1)(b) will be determined with reference to the buy-sell agreement.

4. In fulfilling the obligation to sell the property to a survivor, the estate may realize a capital loss on non-depreciable capital property or may be permitted to deduct a terminal loss on depreciable property. Subsection 164(6) provides some relief where, within the first taxation year of the estate, the legal representatives of the deceased dispose of capital property of the estate and incur a net capital loss, or dispose of all the depreciable property of a prescribed class and incur a terminal loss. The legal representative may elect in accordance with the conditions prescribed in section 1000 of the Regulations to treat all or part of such losses as if they were incurred in the year of death rather than in the first taxation year OF THE ESTATE. NO PART OF SUCH LOSSES MAY BE DEDUCTED FOR A TAXATION year preceding the year in which the taxpayer died. (In the case of deaths occurring after 1984, an amended return for the year of death must be filed on behalf of the deceased to give effect to the application of such losses.) Any resulting refund would be paid or credited to the estate.

The Need to "Transfer or Distribute".

The ultimate transfer or distribution of the legal title to the property disposed of by the taxpayer pursuant to his testament is completely independent of the indefeasible vesting of the equitable interest in it however is it also a necessity? The distribution or transfer must be received in the capacity of a beneficiary only and not as a purchaser as per the reasoning in *Coleman Trust v. M.N.R.*⁶²⁵ where a "sale or transfer" of the property for its Valuation Day value by the estate as prescribed by the will was found to be ineligible for Sec. 70(9) treatment⁶²⁶. Taylor, T.C.J. held, in the case, (which could easily be in respect of the application of Sec. 70(6)), that:

"It seems quite clear that she intended the farm to go to Mr. Frances O'Rourke, but only after he had made

625. 87 D.T.C. 664

626 See notes on the apparent inapplicability of testamentary options in notes below for sales and buys here as well.

available to the estate sufficient funds (\$60,000) to carry out her wishes with regard to the other beneficiaries. I am not convinced that anything other than a **sale** to Mr. Frances O'Rourke (beneficiary) would have fulfilled the terms of the will, and it is difficult for me to conceive of a process whereby Mr. Frances O'Rourke could obtain the farm without payment of some kind to the beneficiaries (**which would be very similar to a sale**). As I see it Mr. Frances O'Rourke may have had an option under the will - but the option would have been to not pay the \$60,000 and as a consequence thereof not own the farm."⁶²⁷

In *Boger Estate v. M.N.R.*⁶²⁸ a taxpayer left his estate to his wife and children, (the estate consisted of farm property, land and machinery), and the executrix attempted to file for Sec. 70(6) treatment for property transferred to her and for Sec. 70(9) treatment for farm property **bequeathed to the children as a residue in specie**. The equitable interests of the children in the subject property were vested indefeasibly in the property but at issue was whether the legal title to the property had been transferred or distributed to them.⁶²⁹ There had been a dispute amongst the executors and executrices concerning how the estate was to be settled which was eventually decided in court. The subject property had been sold by the executrix and the proceeds had been distributed to the appropriate beneficiaries, and on those grounds the Minister contended that Sec. 70(9) did not apply. Rip T.C.J., summed up the executor's argument as:

"Appellant's counsel argued that the words "transferred or distributed" in subsection 70(9) are not to be given their technical meaning, in particular they are not to be given the technical meaning of conveyance in the sense of documentation filed in a Land Titles office. In her view of the words the lands were "transferred and distributed" at the time the beneficiaries received equitable ownership of the properties and this occurred by operation of the will. As soon as the beneficiaries could call on the executrix for the properties, they are conveyed the property she said."

As to what form "a transfer and distribution" of property in specie must take he further held:

"It is not necessary, in my view, that formal conveyancing always takes place for there to be a transfer or a distribution of property as contemplated by subsection 70(9). What is necessary, however is that when the legal representative of the deceased has the power to act, she does so to divest herself of her rights and obligations in the property as legal representative of the deceased and the rights and obligation devolved to the beneficiaries of the deceased. Mrs. Boger acknowledged no transfer or distribution to the children could have taken place prior to August 4, 1981 without the Court's direction or consent because of the pending litigation between the executrix and the deceased's widow. **Subsection 70(9) requires something more than a transfer of mere equitable ownership in the property.** Otherwise the words "transferred or distributed" would be meaningless since equitable ownership of property is transferred on death to a beneficiary. The words "transferred and distributed" are used in the subsection to distinguish between a transfer and vesting. "Vested indefeasibly" in subsection 70(9) refers **to absolute transfer of equitable interest; something more than this obviously is required for there to have been a transfer or distribution of the property. The transfer and the distribution of the property to, and the vesting of the property in, a beneficiary are mutually exclusive.**"

Quoting from *Hrycej Estate v. M.N.R.* earlier where an option was exercised to purchase property from an estate in respect of which a Sec. 70(6) election was attempted, Rip, T.C.J. pointed out the comment:

⁶²⁷ See also *Tory Estate v. M.N.R.*, 76 D.T.C. 6312, for similar interpretation of "transfer or distribute" as well as *Penner v. M.N.R.*, 84 D.T.C. 1444. Exercised *inter vivos* options obviously don't produce the required effect. Whether or not testamentary options to acquire produce the required status of the recipient is questionable even in the face of *Coleman* and *Penner*. In I.T. 349R2, para. 6, the Department is of the opinion that a sale called for by the will is a transfer or distribution as a consequence of the death via Sec. 248(8) though it would appear that such an option doesn't recognize that the beneficiary's status in respect of the property's receipt is just as important as per *Tory Estate v. M.N.R.* supra.. In the case of a sale the taxpayer doesn't receive as a beneficiary and thus the property isn't transferred or distributed to him within the context of the subsection.

⁶²⁸ 89 D.T.C. 15 (TCC)

⁶²⁹ The subsection 70(9) provision offers tax free testamentary disposition treatment of farm property if bequeathed directly to children of the testator and not held in a testamentary trust for them however this case could be held to validly illustrate the estate-testamentary trust relationship under the Sec. 70(6)(b) provision.

"That Mrs. Hrycej received the cash proceeds of the sale of the farm equipment as part of the residue does not, in my view, alter the fact that the farm equipment was never transferred or distributed to her and that the farm equipment was not vested in her."

Continuing he found that the executrix had not transferred the legal title to the property:

"The executrix had one year from the termination of the litigation with the deceased's wife to the sale of the land in August 1982 to affect a transfer and distribution of the land to the beneficiary; there was no convincing reason why the land could not have been transferred or distributed once the litigation was over. Thus, in the case at bar, the fact that the property was sold directly by the executrix, **in her capacity as executrix**, would seem to preclude the appellant from taking advantage of subsection 70(9)."⁶³⁰

It should be noted that Sec. 70(6) requires that the transfer/distribution be to **a trust** and not **an estate** which owns the property from the date of death. Lying outside of subdivision K the two terms cannot be equated with each other, especially when one considers that Parliament has gone to great lengths, as per the Sec. 70(7)-(8) mechanics, to recognize the distinctiveness of estates and trusts that arise out of them hence **Boger** could illustrate problems encounterable when an estate, while being administered, must dispose of property to satisfy creditors. (The author is at slight disagreement with Rip T.C.J. with respect to the quotation cited. Equitable **ownership** is not transferred on death to a beneficiary though equitable interest in the estate will be. Whole ownership resides with the personal representative/executor until the residue has been ascertained and it is only at that time that equitable ownership with respect to specific property may arise.⁶³¹ There is a difference between specific and residual bequests.)

In the case of the applicability of these principles to the testamentary spousal trust situation it would appear that if the estate of the deceased, while in the midst of being administered to the point of residue ascertainment, disposed of property subsection 70(6) could not be applied to that property even though some of the proceeds may have subsequently ended up in the spousal trust and/or being subject to the Sec. 70(7)-(8) mechanics.⁶³² If this was not the case then the effect of the Sec. 70(7)-(8) mechanics could be seriously negated in that the estate could dispose of the property and satisfy the "non-qualifying debt" before it was to be assumed by the residuary trust. Once the property, however, has gone through the administration process and has become indefeasibly vested in the spousal trust, (while also possibly being the subject of a Sec. 70(7) listing), its disposition by the trust will not cause the Sec. 70(6) provision to be inapplicable to it. Indefeasible vesting has occurred.

In *C.I.R. v. Clydesdale Bank and Another*⁶³³ assets were held by the executors of an estate which were to be divided amongst several beneficiaries after the residue had been ascertained (or liquidated) while the executors were also empowered "to allow any beneficiary to take over any of said assets at valuation." Part of the estate consisted of some land that the testator was negotiating to sell at the time of death and the executors continued to negotiate the sale however under a different pretence than being just executors of the estate. If the beneficiaries would have sold it there would have been aggregately less taxation. They decided that they would **treat** the land as being "allocated" to the beneficiaries and thus in common law, upon ascertainment of residue and allocation, a bare trust would arise however the will implicitly provided that there could be no allocation and no beneficial **ownership** of any property prior to the ascertainment of the residue. There was no provision for the creation of a trust in respect of the residue and upon its ascertainment and necessarily

630 Is this opinion similar to that provided in *Lewis Estate. v. M.N.R.* cited earlier, by Kempo T.C.J.?

631 *Pagels v. MacDonald*, 54 C.L.R. 519, *Solomon v. Attenborough*, 1913 A.C. 76. See also recognition of this in *C.L. Leonhardt Estate v. M.N.R.*, 1990 1 C.T.C. 2198, at 2202, quoting *Hanbury and Mandsley's Modern Equity*, 11th Ed. pg. 163-165:

"A legatee or devise does not, on the testator's death, become equitable owner of any part of the estate. The executor takes full title to the testator's property, not merely a bare legal estate... A devisee or legatee may be said to become the equitable owner of specific property once property has been allocated by the executor for the purpose. In the case of a residuary gift or a claim on intestacy, the allocation cannot occur until the residuary accounts are prepared..."

632 See *Re: Campbell*, 1968 V.R. 46.

633 58 T.C. 120 (CS)

realization had to be distributed and not held under a bare trust.⁶³⁴ When the property was sold the executors contended, upon assessment by the Commissioner as a disposition in their hands qua executor, that the property was beneficially **owned** by the beneficiaries and that they had decided to treat **as being allocated** the title thereto however as per the will such an allocation was void.⁶³⁵ Perhaps even more damning was the fact that they had not informed the beneficiaries of this process and the beneficiaries had remained essentially ignorant of it. As per Lord Cameron:

" The respondents did not profess to 'allocate' or appropriate the land but merely to '**treat** the land as being allocated and beneficially owned', the plain implication being that it was in fact and in law neither so allocated nor beneficially owned but was being treated as if it had been for purposes of fiscal advantage.

.... **The Respondents were acting solely in discharge of their duty as executors. They could not at their own hands constitute themselves as agents for principals who had never instructed or authorized the action said to be taken in pursuance of that agency.** Indeed, it was only by letters dated 4 December 1978, that the Respondents informed the residuary beneficiaries of what they had done and sought letters "instructing and authorizing" the respondents "to sign all documents necessary to complete the sale on the beneficiaries behalf." Each beneficiary obediently complied with this request.

...
At the time the 'allocation' so called was made, the residue had not been ascertained and therefore in strictness there was no residue fund in the true sense from which allocation could be made, an 'allocation' which, be it observed, was clearly intended to bring s. 28 of the 1976 Act, into play with the necessary effect of depriving the Respondents of any control over the disposal of the subjects put or held in trust-the **exclusive**-control being ipso facto placed in the hands of the defined beneficiaries themselves and removed from that of the Respondents.⁶³⁶ But further, it is no doubt that the Respondents were given certain powers as trustees. Powers, however, are given to trustees to be exercised for trust purposes as these may be ascertained from the testator's disposition for the discharge of their duties in carrying out his instructions. There was here, in this will, no duty which required or as a consequence permitted, the Respondents to set up or cause to be set up a trust in respect of any particular asset of the estate in favour of any particular beneficiary."

The Court found that the respondents had disposed of the land **in the capacity of executors** and not agents however this case illustrates a very interesting aspect that may be relevantly pursued in respect of the application of Sec. 70(6).⁶³⁷ As per the comments in *Boger Estate* (supra) of Rip T.C.J.: "It is not necessary, in my view, that formal conveyancing always takes place for there to be a transfer or a distribution of property as contemplated by subsection 70(9). What is necessary, however, is that when the legal representative of the deceased has the power to act, she does so to divest herself of her rights and obligations devolve to the beneficiaries of the deceased... Thus in the case at bar, the fact that the property was sold directly by the executrix, **in her capacity as executrix**, would seem to preclude the appellant from taking advantage of subsection 70(9)." The critical issue is that highlighted. If the executor had carried through the administration to a point where legal title was subject to the rights of the beneficiary, and beneficial **ownership** had arose to the beneficiary, and the beneficiary had directed that the property be disposed of and the proceeds transferred to the beneficiary then the executrix would have been acting as an agent with respect to the sale of the property and Sec. 70(9) would have been applicable since the executrix would have performed so as to divest herself of the right to the property and it would have devolved to the beneficiary but the legal title was retained at the direction of the beneficiary.⁶³⁸

634 The executors could distribute in specie but that was left to their discretion.

635 The executors were also not given the power to create splinter trusts with appropriations.

636 See *Williams on Wills*, Vol. 1 15th Ed., pg. 182, for the effect of an appropriation of property out of estate property: a trust arises and it may be bare. See also *Re: Wedgewood*, 1921 1 Ch. 601.

637 or any other tax free testamentary roll over requiring that property be "transferred or distributed" to the recipient. See also *Cochrane's Exors. v. I.R.C.*, 1974 S.T.C. 335., 49 T.C. 299.

638 See also *Public Trustee v. Kidd*, 1931 N.Z.L.R. 1, *Re: Donohue*, 1933 N.Z.L.R. 477, *Attenborough v. Solomon*,

In *Dushinsky Estate v. M.N.R.*⁶³⁹ a herd of cattle, being rights or things, was bequeathed to a spouse in specie but the spouse found that she would not be capable of attending to them properly and asked the executor to dispose of them. The Minister reassessed the testator in respect of Sec. 70(2) when the executor disposed of the property and the executor contended that he was merely acting as **an agent** for the widow and that there had been a roll-over. When heard in the Tax Court he did not suggest that he had made any conscious decision to transfer legal title of the cattle to the widow and it was found that the proceeds hadn't even been transferred to the widow but had instead been deposited in the estate account. **In fact he expressed that following legal advice he could not disburse proceeds until probate was granted which was complicated with the widow's application under the Family Relief Act of Alberta for a larger chunk of the estate.** Bonner T.C.J. didn't spend much time analyzing the facts since it was obvious that the administration of the estate had not been completed and that in particular the widow's rights to the cattle in specie had not crystallized. At issue, accordingly, was the assent of the executor to the bequest of the cattle and whether it had occurred prior to the time at which the cattle were sold. The executor could only act as agent for a person who had beneficial ownership and Bonner T.C.J. referred to two maxims in Halsbury's Laws of England⁶⁴⁰,

"The bequest of a legacy, whether general or specific, transfers only an inchoate property to the legatee: the executor's assent is necessary to render it complete and perfect."

"An assent to the vesting of personal estate or of an equitable interest in real estate may be express or implied; it need not be in writing, nor need it be given in any particular form. Informal expressions, if sufficiently clear to indicate intention, may amount to an assent. The assent may also be implied from the executor's conduct."

He further quoted from *Attenborough v. Solomon*⁶⁴¹ at pg. 82, concerning the disposition/transfer of property as per a will and with respect to the executor's control thereof:

"He (executor) takes that, I say, by virtue of his office. The will becomes operative so far as its dispositions of personalty are concerned **only** if and when the executor assents to those dispositions."

From the conduct of the executor it was found that he had not assented to the bequest and thus on the sale of the cattle he could not act as agent for the widow and thus the Sec. 70(2) provision had to apply to the testator since there had been no roll-over of the rights or things.⁶⁴² The same principles would apply in respect of Sec. 70(6). Does this contradict the opinion of Rip. T.C.J. in *Boger Estate* where he held that transfer and distribution and indefeasible vesting are mutually exclusive? In *Dushinsky Estate* it seems the roll-over would have been available if the executor had assented to the bequest but had not got around to transferring legal ownership.⁶⁴³

Boger Estate v. The Queen as described previously was appealed to the Federal Court Trial Division⁶⁴⁴ with some startling results with respect to the issue of transfer and the submissions of the parties as stated by Jerome A.C.J. were as follows:

"The Plaintiff submits that, by virtue of the Will, which speaks from the moment before death, a

1913 A.C. 76, Re: Donkin, 1966 Qd. R. 96, Re: McPhail, 1971 V.R. 534, for the use of the terms "distribute" - "distribution" meaning completion of administration and assent to dispositions without legal conveyance.

639 90 D.T.C. 1391

640 4th Ed. Vol. 17, para. 1345 & 1347

641 [1913] A.C. 76

642 See *Easterbrook v. Young*, 13 A.L.R. 351, for the effect of assent and indicative behavior as well as Halsbury's Laws of England, 4th Ed. Vol. 17 para. 1355-56. See Re: Campbell, 1968 V.R. 46, for the withholding of assent and disposition so as to extinguish estate liabilities precluding favorable roll over treatment. The property didn't "pass" to the beneficiary without the assent and there was no roll over.

643 This seemed to be the basis of an opinion of the Non-Corporate Rulings Division provided in T.I. A0554 of Nov. 1984 when in respect of an incorporation of real estate out of an estate at the direction of the widow when it held: "... we are of the opinion that it is not necessary for the title to the above shares and real estate to be registered in the name of the widow in order for the property to be 'transferred or distributed' for the purposes of subsection 70(6) of the Act and that the title may be transferred directly from the deceased individual to his widow's holding company without affecting the availability (of) the provisions contained in that subsection."

In I.T. 282R para. 1 the Department opines however that a transfer is recognizable when the executor/trustee relinquishes control over the property to the beneficiary and not when the beneficiary acquires a right to it.

644 91 D.T.C. 5506

vested beneficial interest in the remaining farm land and depreciable property (the "Property") was effectively "transferred or distributed" to the children. The children's rights in the Property were determined immediately upon the Taxpayer's death and no further action was required to give them full ownership. She submits that the ordinary meanings of "transfer" and "distribute" are very broad and do not require a conveyance of legal title or physical possession. As well, no such requirement is found in s. 70(9) which provides for a transfer "on or at the instance of a taxpayer's death and as a consequence thereof" and the Plaintiff notes that the term "property", as broadly defined in s. 248(1) must include property recognized under Equity. **An executor under a will, therefore, need not take the superadded mechanical step or action to "transfer" the Property to the children.** The Plaintiff submits that the fact that she held legal title to the Property as trustee, in accordance with s. 3 of the Devolution of Real Property Act, R.S.A. 1980 c. D-34, when it was sold to a third party does not, in this instance, affect the fact that the Property had been transferred to the children as a consequence of the Taxpayer's death. **Once the debts of the Estate had been paid, the children were entitled to call for the property at any time and at that point, the Plaintiff became an agent for the children. The Property was sold by the Plaintiff to a third party on the instruction of and with the concurrence of the beneficial owners. In accordance with usual estate practice in Alberta, there was no actual conveyance of the legal title before it was transferred to the third party purchaser.** Finally, the Plaintiff submits that the spouse's application under the Family Relief Act does not prevent the property from being "transferred or distributed" to the children immediately upon the Taxpayer's death for the purposes of the s. 70(9) roll-over **although the possibility of such an application may prevent a personal representative from conveying the property.**

The Defendant submits that because the Property was never conveyed to the Taxpayer's children and because the Property was sold by the Executor to a third party, it was not "transferred or distributed" to the children in accordance with s. 70(9). The Defendant submits that the definitions and judicial consideration of the terms "transferred or distributed" connote a legal conveyancing. Reference is made to *Willis Estate v. M.N.R.*, 68 D.T.C. 204 (T.A.B.) at 210 where it was held that a court order directing an executor to transfer all property of a deceased does not, in itself, transfer the property. the order only empowers the executor to act **and it is only when he actually gives effect to the direction that the transfer occurs.** Relying on Mr. Justice Rip's decision in *Hrycej v. M.N.R.*, [1984] C.T.C. 2115, 84 D.T.C. 1090 [sic, 1089](T.C.C.) the Defendant further submits that the fact that the property was sold by the Executor to a third party supports the position that it had never been transferred to the children. The Defendant notes as well that the Taxpayer did not leave specific pieces of land or equipment to his children. Rather, the Will provides that they are to receive the "residue" of the estate in equal shares. The Defendant suggests, therefore, that what was to be distributed to the children presumably was funds and not property subject to s. 70(9)."

In the author's, opinion, while there are severe weaknesses in the Defendant's submissions those of the Plaintiff are certainly not free of doubt especially with respect to the apparently exceedingly broad connotation of the term "transfer". If the term "transfer" can be referenced to the event in which the incidents and burdens of beneficial ownership are divested from one owner and vested in another a "transfer" to the beneficiary via a will, as inferred from the Plaintiff's submission itself, doesn't occur until the executor has assented to the disposition and until that time the beneficiary merely has the right to have the estate administered. Even in the case of specific devises such is still the ordering of steps by which property is transferred to a beneficiary: there must be an assent to the disposition by the executor. Until that time the offspring were not entitled to call for the legal ownership of the property and could not deal with its beneficial ownership which was retained fully by the executors to administer the estate: beneficial ownership would only pass on the assenting to the disposition by the will, not the death itself which made dispositions contingent upon it subject to debt extinguishment. Notwithstanding this the Trial Court held:

"Here, the Taxpayer's Will appointed the Plaintiff executrix and trustee and left all his property to the Plaintiff in trust for his wife and children. Therefore, upon his death the legal title to his property vested in the trustee to assist her to manage and administer the estate and the equitable or beneficial title vested in the beneficiaries. The Taxpayer had in this way divested himself of ownership in his property. In this instance, the creation of a valid will passing the Taxpayer's property to his spouse and children is a sufficient "transfer" for purposes of s. 70(9). The fact that the "residue" of the estate was left to the children does not, in my opinion, change the character of the property entitled to the roll-over. Surely Parliament did not intend that a specific bequest of each item of farm land and depreciable property be made before a "farm roll-over" could occur, the object of s. 70(9) being to provide a measure of tax relief when transferring these assets from one generation to another.

The Defendant, and the Tax Court below in *Boger v. M.N.R.*, 89 D.T.C. 15 at 20, rely on *Hrycej* to support the position that, because the property was sold directly by the executrix in her capacity as executrix, "there was no transfer or distribution of the land to the children of the deceased". In *Hrycej*, the deceased taxpayer's will gave his daughter an option to purchase certain farm equipment which, if not exercised within a specified period, would fall into the residue of the estate left to his widow. the daughter exercised the option and the widow received the cash proceeds of sale. the estate claimed a s. 70(6) roll-over on the basis that the widow had been vested with the equipment upon the death of the taxpayer, however, *Rip T.C.J.*, held that, because the farm equipment was subject to the option it was not vested in the widow. Although *Rip T.C.J.* stated that "the farm equipment was never transferred or distributed to the wife", I note that a specific finding on the transferred or distributed issue was not in fact made as the parties admitted that the farm equipment "remained in the possession of the executors and was not transferred or distributed to Mrs. Hrycej."

Finally, [at p. 5368] *Clement, D.J.* in *Hillis* also appears to have recognized that a formal conveyance may not be necessary:

"In effect the spouse must be able to establish that in law in the circumstances of the case the property vested indefeasibly in her within the prescribed 15 months. In the whole of the context it is clear that it is not necessary that actual conveyance of the property to her shall have been completed within that time: if she makes the required proof, then in law the conveyancing must follow as a matter of course and of right. What must inevitably occur is to be taken as having occurred. this interpretation affords an intelligible reconciliation of the phrase with the preceding phrase which speaks of property that has on or after the death been transferred or distributed: it gives some recognition to the difficulties and complexities attendant in some cases on the due administration and distribution of estate and which may have to be resolved, particularly when the construction and operation of a will is contested, before distribution can be made."

I find that the sale of the farm land to a third party by the trustee, was upon the direction and consent of the children and that she was not acting on behalf of the Taxpayer at that time but on behalf of the children as beneficial owners of the land. I note that, following the Order, title to the Home Quarter was transferred to the spouse on January 8, 1982. Presumably, title to the remaining farm lands could have been transferred as well to the beneficiaries when they were sold in August, 1982 and I accept the Plaintiff's explanation that title was not transferred to the children in accordance with "usual estate practice in Alberta". I therefore accept that "transfer or distribute" includes the passing of property under a Will and I am satisfied that the property was "transferred" to the Taxpayer's children in the sense required by s. 70(9)."

This situation should be compared to *C.L. Leonhardt Estate v. M.N.R.*⁶⁴⁵ where the Sec. 70(9.1) roll out of farm property from a spousal trust was attempted to be used. The property was to be divided amongst the kids after the spouse's death and when such occurred there was passage of a substantial period of time before the

645. 1990 1 C.T.C. 2198, (TCC)

property was sold and the proceeds directly paid to the appropriate beneficiaries. The Minister contended that there hadn't been a transfer within the context of Sec. 70(9.1) since there wasn't a legal title conveyance while Judge Bonner provided:

"Nothing in the agreed statement of facts suggests that debts of Julius Leonhardt remained to be paid at the time of the death of Agnes Leonhardt or that there was anything else to be done by the executor save to convey legal title to the children. It is of course clear that legal title remained in the executor's hands at all times prior to the sale of the farm in 1984. On the other hand, **the agreement for sale named the executor as vendor but provided for the division of the purchase price among the beneficiaries of the estate of Julius Leonhardt.** As I see it the appellants have failed to establish the factual basis for the assertion that the only property which passed on the death of Agnes Leonhardt was a right to require due administration of the estate.

Counsel for the appellants turned next to the statutory requirement that on the death of the spouse the property be transferred or distributed to and become vested indefeasibly in the children. He referred to authorities including *Executors of the Estate of David Fasken v. M.N.R.*² and *J.S.D. Tory Estate v. M.N.R.*,³ as to the meaning of the word 'transfer' and he submitted that a change in ownership and conveyance is required. Nothing in the cases referred to is authority for the proposition that subsection 70(9.1) will operate to effect a roll-over only if, on the death of the spouse, there is a prompt conveyance to the children of the legal title of the property. I find no basis in the language of the subsection for such a construction. If it were so read, a capricious and illogical limitation on its operation would be imposed."⁶⁴⁶

The property transferred to the spouse/spousal trust may or may not be identical to the property owned by the testator at the time of death. The Department has held privately that where a legal life interest is given to the spouse with remainders to the offspring in the same property the Sec. 70(6) provision will apply to the entirety of the property. In a Technical Interpretation provided in June 1984 however the Non-Corporate Rulings Division provided that where a corporation was to suffer a dissolution upon the death of the taxpayer even though his shares were otherwise transferred to a spousal trust the Sec. 70(6) provision would not apply to them. If the corporation is wound-up as a consequence of death the shares can't vest indefeasibly in the spousal trust but if the dissolution is to be effected by the trustees upon the receipt of the shares indefeasible vesting for purposes of Sec. 70(6) will occur. What happens subsequently due to the directions in the trust deed doesn't reflect upon the conditions attached to the delivery of the property to the trustees. In T.I. A-5846 of Oct. 1981 rendered by the same Division it was held (correctly) that a shareholders' agreement that required an exchange of common shares by the estate for preferred shares via section 86 after which the special shares would be distributed to the spouse would prevent indefeasible vesting. In another T.I. provided in March 1981 it was held by the same Division that a redemption option of a corporation which could be exercised to redeem shares of a testator passing to his spouse **did not** prevent the indefeasible vesting of the ownership of the shares in the spouse, even though such clearly wasn't the case.⁶⁴⁷ The discretionary exercise of this option apparently allows the provisions to apply though if the redeeming was mandatory such would not occur.

The Use of Testamentary Options and those Dangerous Words "Buy" and "Sell".

It would appear that property transferred to a spouse directly may need to be transferred other than under the pretence of the exercise of a testamentary option to acquire estate property since upon the exercise of the option a sale would occur. These cases pivot on the instances where the testator has used the coinage "**buy**" and "**sell**" estate property to transfer it to her beneficiaries. This was the opinion of the Tax Court in *Penner v. M.N.R.*⁶⁴⁸ where the applicability of Sec. 70(9) to farm property transfers was restricted when the property

⁶⁴⁶ See also *Lewis Estate v. M.N.R.*, 89 D.T.C. 291 (TCC), where possession also was recognized to be unnecessary providing:

"If vesting indefeasibly in possession as well as in interest was intended by Parliament it could have easily expressed that intent in clear and unambiguous words."

⁶⁴⁷ This provides an interesting alternative to the straight buy-sell which would prevent indefeasible vesting: if the share structure is such that classes of shares can be redeemed in certain situations to cause the same as a buy-sell Sec. 70(6) could be accessed.

⁶⁴⁸ 84 D.T.C. 1444

was acquired by way of an option and not a direct bequest, charged or otherwise.⁶⁴⁹ In respect of Sec. 70(6) if the spouse had been given an option to acquire property from a spousal trust to which the property of the deceased had been conveyed there would be no tax consequences in respect of Sec. 70(6).⁶⁵⁰

The validity of the dicta in Penner, and the case law it was based upon, is definitely subject to criticism when one reviews *Perpetual Exors. and Trustees Assc. of Aust. Ltd. v. Commr. of Probate Duties*⁶⁵¹ and *O'Neill v. O'Connell*⁶⁵² both cases of the Australian courts that have not gained attention in the U.K. or Canada that consist of an exhaustive evaluation of a multitude of U.K./Aust./N.Z. cases from various courts concerning testamentary options concluding with persuasive dicta to the effect that property is received in the capacity of a beneficiary when the option is exercised. Both cases deal **specifically** with the issue of statutory exemptions/roll-overs of the character in Sec. 70(6).

In *O'Neill v. O'Connell* a testator left land and directed that it be converted though his offspring was to be allowed the chance to "purchase" it (similar to the diction in *Coleman Trust v. M.N.R.*) from the executors for a price expressed in the will. The option was exercised and such a "purchase" purportedly directly contravened a certain provision of the National Security Regulations restricting purchases. In that Act there were specific provisions that exempted the restrictions on transfers "the purpose of which is to vest any property, or any interest in property, in any person **beneficially entitled thereto or by virtue of any will or intestacy**". Counsel for the beneficiary contended that the exercise was to satisfy a condition attached to a gift and that no contract had been entered into to purchase; the executors were bound by the terms of the will to convey and the land devolved to the beneficiary by the machinery of a testamentary gift. Speaking of the executors' and beneficiary's duties and rights Starke J. held:

"By the exercise of his option O'Neill became entitled, upon payment of the sum mentioned by the testator, to call for a transfer of the land and to an equitable interest therein (*London and South Western Railway Co. v. Gomm*.⁶⁵³). And it would be the duty of the personal representative of the testator to make this transfer in a due administration of the testator's estate, e.g., after payment of his debts, funeral and testamentary expenses. **This duty arises not from any agreement or contract made by the personal representative of the testator, but from the disposition of the testator coupled with the exercise by Daniel O'Neill of the option given to him. No action would lie against the personal representative at law for the breach of any contract with the person to whom the option was given; the remedy for any refusal to carry out the disposition in the testator's codicil would be founded upon equitable principles.**

...
A testator does not enter into transactions with anyone⁶⁵⁴, he makes dispositions of his property which in the case of devises of land often operated of their own force and still do in some cases: Cf. *Robertson v. Deputy Federal Commissioner of Land Tax*⁶⁵⁵. O'Neill

⁶⁴⁹ The will in Penner offered the taxpayer the right "to purchase my farm land for the sum of 100\$ an acre.." and in the author's opinion the fact that the term "purchase" was used could be argued to imply that the taxpayer could have the title abstracted and not subject to the estate debt hence receive as purchaser albeit not subject to any contract: if the terms "receive my farm land upon the payment of 100\$ an acre" were to have been employed it could more easily be interpreted to mean the taxpayer to receive a bequest subject to a condition precedent subject to abatement.

⁶⁵⁰ As previously stated the Department considers as per I.T. 349R2, para. 6, that a sale called for by the will will be recognized as a consequence of the death of the taxpayer if it satisfies the description of the transaction under Sec. 248(8) though it's important to recognize that this opinion was expressed in the frame of transfers as a consequence of death, not as to how the property is received. Obviously when the beneficiary has the ability to abstract the title of the property and obtain it without effect of estate debt it does not acquire as a beneficiary and thus does not acquire as a beneficiary within the context of the roll-over subsections. A very similar opinion was expressed in *Coleman Trust v. M.N.R.*, 87 D.T.C. 664 previously discussed.

⁶⁵¹ 1981 V.R. 91

⁶⁵² 1946 72 C.L.R. 101

⁶⁵³ 1882 20 Ch. D. 562

⁶⁵⁴ This is in direct opposition with Lord Denning M.R. in *Re: Harmsworth* where he held: "I am disposed myself to think there is a contract here. Sir Leicester made an offer through his executors to his wife, just as much as if he had directed them to make it: and she accepted it when she accepted the conditional bequest. Even if there is no contract, however, I think there was a purchase..."

⁶⁵⁵ 1941 65 C.L.R. 338 at 347

purchased nothing, he took no option, he acquired nothing by any transaction with the testator or with his personal representatives. **The terms of the testamentary disposition and the exercise by O'Neill of his option gave him whatever interest he has in the land."**

Dixon J. gave more detailed analysis holding:

"The manner in which the option in the present case is expressed makes it plain that it was intended to confer upon the appellant an immediate right, if he should so elect, to become the owner of the land at the fixed price of 6,500\$. Such a provision imparts to the donee of the option a beneficial right in reference to or an interest in the land. Substantially the same result might have been produced by a devise of the land conditional upon the devisee paying the sum named. A not very different result might have been produced by a direction to the executors or trustees to propose a contract of sale to the intended donee of the option upon the terms and conditions stated in the will or to be settled in some manner indicated by the will.

But in form the disposition now in question stands between a conditional devise and a direction to propose a contract. It gives an immediate, though innominate, beneficial interest, one of the many miscellaneous rights and interests which under the wide power of testamentary disposition allowed by English law a testator may create.

...

The donee of the option, by electing to take the property at the price fixed or upon the terms **indicated by the will**, incurs an equitable duty to preform the condition **upon which, under the provisions of the will, he becomes entitled to the property**: Cf. Attorney-General v. Wax Chandlers' Co. 1873 L.R. 6 H.L. 1 at 19; Messenger v. Andrews 1828 4 Russ. 478/38 E.R. 885. **The obligation is independent of contract.**

The exercise of a testamentary option by the donee makes absolute his right to the property, except in so far as the will makes payment of the price or the performance of any other obligation laid upon him an essential condition. His position becomes, of course, very similar to that of a purchaser. Indeed, questions have been raised as to how far, in connection with what may be called verification of title, rules implied upon an open contract of sale are applicable as between him and the executors or trustees of the will. **But though it has been said that there "must be taken to be" the elements of contract, the relation does not rest upon contract. The executors' obligation arises from the terms of the will, not from any contractual promises made by them in exchange for promises made by the donee of the option. Of such promises there are none on either side.**⁶⁵⁶ If a will, upon its proper interpretation, confers upon the donee of an option a right, upon exercising his option, to call upon the executors to give him a contract for the better evidencing or definition of his rights, a possible case where there are long terms of purchase, the execution of the contract may place the donee of the option on the actual footing of a contractual purchaser in all respects. **But until the contract is entered into the rights of the executors and the beneficiary exercising the option do not arise ex contractu but depend upon the provisions of the will and the doctrines of equity operating upon the will.** Considering the matter apart from the effect of the National Security (Economic Organization) Regulations, it appears to me that on the death of the testator the appellant became entitled to the option as an interest in or beneficial right in relation to the land. By his notices exercising the option he became entitled to the land subject to paying the purchase money and upon payment to call for a transfer."

Judge Williams pursued an exhaustive analysis of the case law pertaining to the ranking, nature and foundation of the optionee's rights in relation to those of other beneficiaries providing:

⁶⁵⁶ In re: Malpass, 1985 1 Ch. 42 at 49, citing Talbot v. Talbot, 1968 Ch. 1, Sir Robert Megarry V.C. held that in the case of a "direct gift of an option, the nature of the option sounds in the field of contract where it is present in terms of an offer and acceptance" and citing Harman L.J. in Talbot:

"...the principles of contract seem to me to apply to it, because the person given a property under a testamentary option obtains it by exercising the option and entering into a contract in that behalf with the executors."

He also held that where the option is framed in terms of an offer and acceptance its contractual nature seems to be a fortiori.

"The Chief Justice considered that an option given by a will to purchase property does not in itself and independently of its exercise give an equitable interest in that property, whether or not the right of the optionee can properly be described as itself being property; and that it is only if the option is exercised, and if in the proper course of administration the executors are in a position to make and do make a contract of sale to the optionee, that the optionee will then under the contract obtain an equitable interest in the property in respect of which the option is given. But with respect, I am unable to agree with this view. **The authorities establish in my opinion that an option to purchase land whether created by an instrument *inter vivos* or by a will creates an immediate equitable interest in the land.**⁶⁵⁷ **A donee of an option to purchase land given by a will is a beneficiary of that beneficial interest.**⁶⁵⁸ **The executors have as against him the same overriding common law or statutory power as they have against a devisee to sell the land to pay the funeral and testamentary expenses, death duties and debts of the deceased.** But the donee of the option is still entitled to exercise the option, and upon such exercise and performance of its conditions to follow the proceeds of sale in the hands of the executors.⁶⁵⁹ As Lord Romilly said in *Ex parte Hardy*⁶⁶⁰ referring to a compulsory purchase of land subject to such an option: "The option will remain, whether the fund continues, as it is, in stock, or is invested in land." This is because the option creates an equitable interest in the land at the date of death. **The donee, therefore, upon exercising the option in accordance with the conditions contained in the will, acquires against the executors, irrespective of whether a contract is entered into or not, all the rights intended to be thereby conferred upon him, and if a contract is entered into, it cannot override, but will be subject to these conditions.**⁶⁶¹ In this case, in the Court below, the option was described by Sir W. Page Wood, as he then was, as a trust to convey the property to the optionee provided he complied with conditions of the option, and in *Radnor (Earl of) v. Shafto*⁶⁶² Lord Eldon pointed out that the remedy of the optionee would be to bring suit to administer the trust. Thus, an option has been described by Lord St. Leonards in his book on Vendors and Purchasers, in a passage cited with approval in *In re: Davison and Torrens*⁶⁶³, as in substance a devise of the estate itself if the favoured objects elects to take it and in *Williams on Vendor and Purchaser*, 4th Ed. (1936) at p. 571, note(m), it is stated that "in order that an option to purchase land may be well exercised, the terms of the ... devise, which created the option, must in all respects be strictly pursued": Cf. also Seton's *Judgments and Orders*, 7th ed. (1912) vol. 2 at pp. 1487, 1488."

and concluded essentially that the optionee acquires a beneficial interest in the land and that this overrides the executors' power of sale until its exercised or forfeited. He also held that a contract need not be entered into to fulfil the terms of the devise.⁶⁶⁴

In *Perp. Exors. and Trustees v. Commr. of Probate Duties*, a partnership interest was the subject of an option to purchase given by the will and probate duty would not be applicable to it if it "passed" to persons related by blood or marriage to the deceased. The option was exercised and the executors contended that probate duty wasn't payable on the devise. On appeal to the Supreme Court of Victoria Booking J. held:

"It has been said that a testamentary option to purchase property is not a devise or bequest of property (*Sharp v. The Union Trustee Co. of Aust. Ltd.* 1944 69 C.L.R. 539 at 557 per Williams J.). On the other hand, a testamentary option to purchase land has been described as in the

⁶⁵⁷ *Oppenheimer v. Minister of Transport*, 1942 1 K.B. 242, *In Re; Cant's Estate*, 1859 4 DeG. & J. 503/45 E.R. 196, *In Re; Kelly*, 1889 W.N. (Eng.) 3, *In Re: Armstrong's Will Trusts*, 1943 Ch. 400, *Commr. of Taxes v. Camphin*, 1937 57 C.L.R. 127, *Trustees Exors. & Agency Co. Ltd. v. F.C.T.*, 1944 69 C.L.R. 270, at 285. *inter vivos* options do create such interests as per the Supreme Court of Canada as well: *Davidson v. Norstrant*, 61 S.C.R. 493.

⁶⁵⁸ *Re: Busby*, 1930 30 S.R.(N.S.W.) 399

⁶⁵⁹ *In Re: Armstrong's Will Trusts*, *supra.*

⁶⁶⁰ 1861 30 Beav. 206 at p.208/54 E.R. 867 at 868.

⁶⁶¹ *Brooke v. Garrod*, 1857 3 K. & J. 608/ 44 E.R. 911.

⁶⁶² 1805 11 Ves. 448 at 454/ 32 E.R. 1160 at 1162.

⁶⁶³ 1866 17 Ir. Ch. 7 at 10

⁶⁶⁴ Could it be inferred from the reasoning that if the taxpayer's right to acquire the land cannot be abated in the case of excessive testamentary debt he does not stand in the capacity of a beneficiary?

nature of a conditional gift and as an executory devise (Oliver v. Oliver 1958 99 C.L.R. 20 at p. 26, per McTiernan, J.) and the grant of an option to take specific property, including real estate, in satisfaction of a share of residue has been held to be equivalent to a specific devise of the equitable fee in that real estate: *Re Jolly* 1901 17 T.L.R. 244; doubted in *Re Lander decd.*, *Lander v. Lander*, 1951 Ch. 546 at p. 552. Eve J. appears to have been of opinion that one who acquired land by reason of a testamentary option could properly be described as taking under the will: *Re Cockerill*, 1929 2 Ch. 131 at p. 134.

In England the opinion has been expressed that upon the exercise of a testamentary option to purchase a contract of sale comes into existence: *In re Eve*, 1956 Ch. 479, at p.482; *Re Harmsworth*; *Barclays Bank v. I.R.C.*, 1967 Ch. 826, at pp. 832, 851, 855,⁶⁶⁵; *Talbot v. Talbot*, 1968 Ch. 1, at p. 10,⁶⁶⁶; compare *Pritchard* (1974) 38 *Conveyancer and Property Lawyer* 8, at pp.18-9. In Australia this view has been rejected, it having been authoritatively laid down that **the exercise of such an option does not itself give rise to any contract, the rights of the executors and the beneficiary exercising the option arising not from contract but from the provisions of the will and the operation of the doctrines of equity upon those provisions: *O'Neill v. O'Connell*, 1946 72 C.L.R. 101.**

...

In *Re Wilson*, *supra*, there was a gift by will of the whole estate to trustees upon trust for sale and a codicil directing them "to allow" the testator's son "the option of purchasing" certain freeholds at a stated price. At (1908 1 Ch. 839) p.843 Warrington, J. had this to say of the codicil: "Reading that power in connection with the trust for sale and conversion which is given to the trustees, the trustees, having that power to sell to anyone they please, are bound in the first place to offer this property to the son. If he desires to have it and if he exercises his option, in my opinion he elects to become a purchaser and must be taken to have made an offer to the trustees which they are bound to accept and must be taken to have accepted. If they do not expressly accept it, it will be taken by intendment of the law that they have done so as if it was their duty to do so. Thus it will be inferred from the facts that there is a contract by the trustees to sell and by the son to purchase the houses."

Whatever the position may be where the testator in terms directs his trustees to propose a contract of sale to a specified person, a situation envisaged by Dixon, J. in *O'Neill v. O'Connell* 1946 72 C.L.R. 101 at pp. 119-20 and one concerning which **I express no opinion**, I am not prepared on the authority of the observations of Warrington J. set out above, to hold that in the present case a contract of sale arose upon the exercise of the option. **It may be possible to distinguish *Re Wilson, supra*, as an example of a direction to the trustees to propose a contract for sale. In my opinion the judgments of the Full High Court in *O'Neill v. O'Connell, supra*, make it impossible to regard the observations of Warrington J. as correctly stating the effect of the exercise of the option with which I am concerned, to the extent to which**

⁶⁶⁵ In *Re: Harmsworth* concerned what could be described as a textbook illustration of a conditional bequest and in that case the Court of Appeal held that there had been "a purchase" of a reversionary interest in an *inter vivos* trust fund settled by the devisee as a condition to receive the bequest. In the Chancery Buckley J. held that a purchase and sale need not be founded on a contract and that the fact that one party or the other is obliged to sell to the other does not negative the mutual intention of the parties to execute the type of transfer, and giving the case of a testamentary option as an illustration of the executors' obligations to make the sale held that in such a case there would be a mutuality of intention. Harman L.J. in the Appeal Court held that an option exercised forms a contract between the executors and the beneficiary. The conditional bequest was found to have placed the beneficiary and the executors in the purchaser-seller relationship.

⁶⁶⁶ Valuation of the property for purchase consideration was at issue and Harman J. held:
"Principally they say (and I think that really this is the pith and marrow of their plea) that this is a contract too vague to be entertained or specifically enforced by the court. I say "contract" because a testamentary option is something which **potentially can become a contract** on its exercise at any time by the person holding the option, and so the principles of contract seem to me to apply to it, because the person given a property under a testamentary option obtains it by exercising the option and entering into a contract in that behalf with the executors. That was decided, if there is need for authority, by this court the other day in *Re: Harmsworth*..."

Russell L.J. found the option to be a benefit/right conferred by the will the duties of the executor to take what steps are necessary to confer that benefit. See also *In re: Price*, 1950 Ch. 242, for quasi purchaser status.

those observations suggest that a contract of sale arises upon the exercise of the option."

He further held that, pursuant to *O'Neill v. O'Connell*, the donee of a testamentary option takes on the death an immediate equitable interest in the property⁶⁶⁷, that the obligation to be performed by the devisee is not contractual but equitable and the terms of the will govern the passage of title⁶⁶⁸, and that the executors' obligations arise from "the operation of the doctrines of equity upon the provisions of the will" and that "the exercise of the option does not give rise to any contract between the executors and the donee, though they may in fact in a particular case subsequently enter into a contract."

Concerning whether such a transfer was within the context of "pass" in the exempting provision⁶⁶⁹ he concluded:

"In my opinion, where there is a disposition by will, property may "pass" within the meaning of para.

(b) whether the disposition is by way of unconditional gift, or by way of gift subject to a condition requiring the donee to incur some detriment, (be it a detriment of a value that is less than or equals or exceeds the value of the property given), or by way of option to purchase. **I see no difference, for the present purposes, between the grant to the brother of an option to purchase at the probate valuation and a gift to the brother upon condition that he pay to the executors, or to the residuary beneficiary, a specified sum (small or large) or the amount of the probate valuation of the property given.**

In the result I have concluded that upon the exercise of the option to purchase by the giving of the notice dated 25 March 1974 the interest in the partnership which formed part of the estate of the deceased passed to the brother within the meaning of s. 24(7)(b), since by giving that notice the brother determined his election to take the property in question **under the will upon the terms laid down in the will.**"

In *Penner* the Tax Court based its conclusion on the precedents of two English cases; *In re: Wilson*⁶⁷⁰ & *In re: Eve*⁶⁷¹ and did not examine case law other than these two cases. In the author's opinion pursuant to the jurisprudence above **directly on the point** the right the beneficiary acquires under the will without reference to the actions of the executors and not based on their actions taken is acquired as a testamentary gift and upon its exercise the terms of the will and not the terms of any contract would compel the trustees/executors to convey the property. There may not even be a contract entered into with the executor and by the terms of the testamentary disposition the option was acquired, not through negotiation with the testator or his executor while the executor's obligations arise under the will, not due to a contractual *inter vivos* arrangement.⁶⁷²

The treatment of testamentary options is very inequitable given the administrative liberal interpretations afforded FLA results and when one considers that in many instances, (such as Sec. 69(1.1)(b)), the Act recognizes that the beneficiary may have to make payments to obtain the bequest. Is there such a difference between a condition precedent requiring payment and a testamentary option requiring payment **fiscally speaking** that allows favourable treatment in respect of the former and not in respect of the latter? In the author's opinion the taxpayer in *Penner* folded too easily; especially given the case law available, and the Tax Court does not in this instance provide authoritative jurisprudence.

667 citing *Cox v. Archer*, 110 C.L.R. 1

668 failing the creation of an ancillary contract for such, as cited in *O'Neill v. O'Connell*, in the author's opinion

669 which could be equally relevant in respect of Sec. 70(6) and Sec. 70(3)

670 1908 1 Ch. 839

671 1956 Ch. 479

672 There has been no authoritative Canadian jurisprudence (that the author knows of) as to which country's law will be followed: *Penner* decided in the Tax Court is not authority in the author's opinion. *Esders v. New Zealand Guardian Trust Co*, 1 N.Z.L.R. 723 HC, illustrates various ranks of property/equitable interests where a testamentary option was arrested mid-exercise and some beneficiaries placed caveats on the underlying property, though is not reflective of the issue as to the true nature of the interest to act in the hands of the beneficiary.

On or after his death and as a consequence thereof and its implications.

In order for the Sec. 70(6) provision to apply to testamentary dispositions the subject property must have been owned by the deceased (in his personal capacity) and it must have "on or after his death and as a consequence thereof" been transferred to the spousal trust.⁶⁷³ The above phrase occurs in the Sec. 108(1)(i),(ii) and (iii) definition of testamentary trust whereby such contributions by any taxpayer will not taint an otherwise testamentary trust⁶⁷⁴. Whether or not a particular transfer is a testamentary disposition, ("as a consequence thereof"), was the issue in *National Trust Company and Robertshaw v. Robertshaw et al.*⁶⁷⁵ where a testator had previously contributed sums to an R.R.S.P. the designated beneficiary of which was his spouse whom he later divorced.⁶⁷⁶ While approaching death the testator transferred funds to the particular R.R.S.P. the terms of which made the divorced spouse the principal beneficiary upon his death. On his death, as per his will the standard opening phrase consisted of:

"I...hereby revoke all former **testamentary dispositions** made by me and declare this to be my
---- last will.",

while at the same time providing that his offspring were to be the beneficiaries of the particular R.R.S.P.. The former spouse contended that this would be impossible since the set-up of the R.R.S.P. was an *inter vivos* gift and that the opening phrase of the will could not operate to revoke it. Boyd L.J.S.C. of the B.C. Supreme Court attempted to resolve the main issue: whether the set up of the R.R.S.P. was a testamentary disposition thus revocable by will, and quoted from *Cock v. Cooke*⁶⁷⁷ concerning the description of a testamentary disposition:

"...whatever may be the form of a duly executed instrument, if the person executing it intends that it shall not take effect until after his death, **and it is dependent upon his death for its vigour and effect**, it is testamentary."

The plaintiffs maintained that the R.R.S.P. designation was a testamentary disposition since its revocation could have been operative until death, did not affect the property in the R.R.S.P. until the death, and conferred no right or interest upon the former spouse until the death, however the Judge thought otherwise:

"Notwithstanding the plaintiffs' counsel's able submission, I am not convinced that the designation in question amounts to a testamentary disposition. In my opinion, although the designation was revocable until death, and although there was no provision in the agreement requiring that the consent of the beneficiary be obtained before revocation, it does not necessarily follow that the designation was entirely dependent upon death to be effective. Rather, in my opinion, an immediate interest, albeit a contingent future interest, may well have been conferred upon the annuitant's wife by way of an *inter vivos* trust, when the plan was established."

Quoting from *Corlet v. Isle of Man Bank*⁶⁷⁸ concerning the validity of a non-testamentary disposition in the form of an *inter vivos* trust the comment of Ford, A.J. was noted:

"The fallacy in the argument based upon the "oft quoted words" of Sir J.P. Wilde in *Cock v. Cooke*, (1866) L.R. 1 P. & D. 241, lies in a misunderstanding of what the words "vigour and effect" are applicable to. They are clearly applicable not to the result to be obtained by, or to the performance of, the terms of the instrument, **but to the instrument itself**. The question is whether the instrument has vigour to effect, and does effect, or is "consummate" to create a trust *praesenti*, though to be performed after the death of donor it is not dependent upon his death for its vigour

673. In *Penner v. M.N.R.*, 84 D.T.C. 1444, the Tax Court interpreted the term "consequence" as having the meaning provided by Black's Law Dictionary: "Consequence: The result following in natural sequence from an event which is adapted to produce, or to aid in producing, such result: - the correlative of "cause"."

674 while incidentally it should be noted that the spousal trust described under Sec. 70(6) need not be "testamentary" in the technical sense of the word but could receive contributions *inter vivos* from other taxpayers though thus suffering highest arbitrarily set tax rates as per Sec. 122(1)

675 [1986] 5 W.W.R. 695 (BCSC)

676 The R.R.S.P. administered by a trust company had been held judicially in the past to be an *inter vivos* trust created for the benefit of its designated beneficiaries. See also *McFadden v. Public Trustee for Vic.*, 1981 1 N.S.W.L.R. 15, Commr. of Prob. Duties v. Mitchell, 105 C.L.R. 126, Re: Reynolds, 1931 V.L.R. 254, Shannon v. Shannon et al., 1985 50 O.R. 456, though *Ralna Ltd. et al. v. Can. Life Assurance Co.*, 1985 51 O.R. 781. Such arrangements presently pass an interest while a will or potential trust under a will will not.

677 (1866) L.R. 1 P. & D. 241

678 [1937], 2 W.W.R. 209

and effect."

In Robertshaw the arrangement was found not to constitute a testamentary disposition though the case itself provides an excellent illustration of some of the concepts underlying the phrase "on or after and as a consequence of death".⁶⁷⁹

The spousal trust must also be created as per the terms of the taxpayer's will. In *Re: White*⁶⁸⁰ the High Court of Justice had to decide whether a disposition of property was testamentary or *inter vivos* in nature and Judge Oyen referred to *Carson et al. v. Wilson et al.*⁶⁸¹ and *Govenors & Guardian of Foundling Hospital v. Crane*⁶⁸² as well as *Habergham v. Vincent*⁶⁸³ quoting from the latter:

"But those cases have established, that an instrument, in any form, whether a deed poll, or indenture, if the obvious purpose is not to take place till after the death of the person making it, shall operate as a will. The cases for that are both at law and in equity; and in one of them --- there were express words of immediate grant and a consideration to support it as a grant; but, as upon the whole intention, that it should have a future operation after death, it was considered as a will."⁶⁸⁴

The ability to revoke the instrument is critical and if a contract is binding then it can't be testamentary: *Palmer v. Bank of N.S.W.*,⁶⁸⁵

In order for the property to gain subsection 70(6) treatment on the other hand it must have been owned by the deceased as per the phrase "where any property of a taxpayer...", however, one should also recognize that no such qualification exists with respect to the type of property that can be listed in the process of untainting a tainted spousal trust under the Sec. 70(7)(b) mechanics by virtue of the fact that the phrase describing the potential property to be listed concerns "one or more specified properties...that have, on or after the taxpayer's death and as a consequence thereof, been transferred or distributed to the trust." Listing property which was conveyed under a testamentary exercise of a power of appointment will thus reduce the testator's tax consequences otherwise recognizable without causing additional ones to be recognized. The Sec. 70(6) phrase recognizes that such a transfer or distribution must occur on or after the taxpayer's death but the provision itself is silent as to how much time after the death the treatment will be allowed to a transfer occurring subsequently. As per the jurisprudence it must be capable of being established that vesting of the property in the trust has occurred within the statutory 36 month period. Specific bequests vest indefeasibly upon death while non specific bequests vest when the rights thereto of the beneficiaries have been established. By the fact that the phrase "on or **after** and as a consequence of death" reads as it does both types of bequests qualify.

Subparagraph 70(5)(c), the opening preamble of Sec. 70(5.1), 70(5.2)(d) & (f), 70(6) etc. all provide treatment to property that is transferred or distributed as a consequence of death and although buy-sell agreements, testamentary options (of a certain character), etc. may all cause a taxpayer to acquire a testator's property the ultimate transfer of legal title of the property will not be within the context "transfer or distribute" in the subsections since such relates to recipients receiving exclusively in the capacity of a beneficiary. There is a major difference however between purchasing property from an estate and purchasing the beneficiary's rights under that estate to receive that property and it would appear that if a spouse purchases offspring's rights under an unadministered estate property ultimately realized will gain Sec. 70(6) treatment since the property is being transferred or distributed as a consequence of death to a person who is receiving it in the

⁶⁷⁹ See also *Re: Estate of Isles*, 1947 47 S.R. (N.S.W.) 33.

⁶⁸⁰ 1987 59 O.R. (2d) 488

⁶⁸¹ 1961 O.R. 113

⁶⁸² [1911] 2 K.B. 367

⁶⁸³ (1793) 2 Ves. 204

⁶⁸⁴ See *Re: Shepperd*, 1893 5 Q.L.J. 116, *Re: Reid*, 1893 5 Q.L.J. 120, *Re: Northcliffe*, 1925 Ch. 651, *Re: Dawson*, 1890 24 S.A.L.R. 92, *Re: Greenwood*, 1918 Q.S.R. 58, & *Beyer v. Beyer*, 1960 V.R. 126, and *In Re: Estate of Slavinsky*, 1988 53 S.A.S.R. 221. The University of Saskatchewan has on display a red tractor fender that was ascribed with a key by a farmer who had lost an appendage in the field: great example of a holographic will.

⁶⁸⁵ 7 A.L.R. 671

capacity of a beneficiary. If this is the case, as the author thinks it is, then the interaction of Sec. 107(2), (1) and 70(6) in respect of the taxation of capital gains, breaks down and the spouse should not pay more than the tax cost of the property expected to be received in respect of the interest since Sec. 107(2) being inapplicable will not allow a bump up in the cost thereof however CRA may attack such transactions with Sec. 69(1) since rarely will the tax cost of the estate property equal its FMV however litigation over application of various Dependant/Family Relief/Maintenance Acts may adjust the FMV of the interest and the applications need not be followed up. Subsection 70(6.2) may be used to elect for Sec. 70(5) treatment for the testator in respect of certain property in order to allow Sec. 107(2) to operate but a multitude of factors need to be considered.

Subsection 248(8) broadens considerably, for purposes of the Act, the meaning of "as a consequence of the taxpayer's death". Paragraph (a) therein provides that any transfer, distribution or acquisition of property under, or as a consequence of the terms of the will or other **testamentary** document or as a consequence of intestacy law will be considered such as a consequence of the death of the taxpayer. This obviously allows conditions to be stacked in respect of any bequest without the bequest's receipt being considered as a consequence of the satisfaction of the condition and not due to the death. Transfers in specie made pursuant to intestacy court orders will also gain such treatment but if specific property is transferred as a result of a settlement of an order based claim for a certain value, and not for certain property, it may not satisfy the conditions expressed in para. (a) since it isn't being transferred pursuant to the law since the order was for value, not for certain property. As previously commented upon at the beginning of this chapter, transfers, distributions or acquisitions as a consequence of a disclaimer, release or surrender by a person who was a beneficiary under the will, or other testamentary document or on the intestacy of the taxpayer will be considered as a consequence of the death if the relevant actions satisfy the descriptions in Sec. 248(9), while as per para. (c) the latter two will not cause the beneficiary to recognize a disposition. If the testator has contracted *inter vivos* with the spouse to roll certain property to the spousal trust, possibly to avoid an equalization election, that property may not gain Sec. 70(6) treatment since it is being rolled by the executors pursuant to an *inter vivos* obligation.⁶⁸⁶

The Department has been lenient in at least one instance in the application of Sec., 70(6) to transfers pursuant to variations in the testator's will such as in *Re: Ridall's Estate*⁶⁸⁷. In that case the testator left his farm property on trust the income of which was to be payable to his widow until her death or age 65 whichever the earlier with remainder interests vested contingently in his offspring. If an offspring did not survive until the widow attained the age of 65 or died there would be a gift over of the share to the offspring's offspring or to his siblings if he/she didn't leave offspring. The trust was not technically a spousal trust due to the life of the income interest and the taxpayers agreed to wind it up. A Variation of Trust Act application was made to delete the gift over provision whereby the offspring would wind the trust up whereby the widow would receive legal title of the property and when the Court of Queen's Bench recognized that such transactions, **endorsed with an advance tax ruling received from the Minister**, would reduce the estate's tax bill by approx. \$250,000 and that arrangements had been made between the parties to convey the property subsequently to the offspring the deletion was executed.⁶⁸⁸ Subsection 70(6) was then applicable to the *Saunders v. Vautier* common law wind-up of the trust⁶⁸⁹ whereafter the property passed to the spouse but in the author's opinion the ITA provisions do not provide for such in that the property passed to the widow as a consequence of the wind-up, not as a consequence of the death. Subsection 248(8) does not provide that as a consequence of the wind-up of a trust created by the death of the taxpayer by the beneficiaries thereunder, property realized by the beneficiaries will be as a consequence of the death, though if they disclaim or release their interests so that the trust completely fails any subsequent realizations by the spouse or spousal trust will gain Sec. 70(6)

⁶⁸⁶ See *Schaefer v. Schuhman*, 1972-3 A.L.R. 501, and *Robertson v. Ramsay*, 1891 24 S.A.L.R. 112.

⁶⁸⁷ 24 Sask. R. 16

⁶⁸⁸ Compare this to the deletion attempted in *Re: Assie Estate*, 24 E.T.R. 278.

⁶⁸⁹ which was restricted prior to the statutory variation due to the lack of the ability of the minor grandchildren or non-existence children to consent

treatment⁶⁹⁰.

Spousal Entitlement.

In order to be a qualifying recipient trust created under a testator's will the testator's spouse must be entitled **to receive** all of the income of the trust **arising** before her death and no one except the spouse **may**, before her death, receive or obtain the use of any of the income or capital of the trust.⁶⁹¹ Subsection 108(3) provides that "income" in the Sec. 70(6)(d)(i), but not the 70(6)(b)(ii), provision as well as that in Sec. 73(1), means income of the trust computed **without** reference to the Act, thus trust law income, but it shall not include dividends that have been included that are not included in computing taxable income by reason of section 83 that are qualifying or capital dividends, or are those described under Sec. 131(1) as certain capital gains dividends from mutual fund corporations. The provision thus requires the spouse to be entitled to received all of the trust law income computed as per the terms of the trust agreement/will or as per the previous accounting practices of the deceased/settlor, or as the court provides.⁶⁹²

"Income of a trust in certain provisions – Sec. 108(3)"

(3) For the purposes of the definition "income interest" in subsection (1), the income of a trust is its income computed without reference to the provisions of this Act and, for the purposes of the definition "pre-1972 spousal trust" in subsection (1) and paragraphs 70(6)(b) and (6.1)(b), 73(1.01)(c) and 104(4)(a), the income of a trust is its income computed without reference to the provisions of this Act, minus any dividends included in that income

(a) that are amounts not included by reason of section 83 in computing the income of the trust for the purposes of the other provisions of this Act;

(b) that are described in subsection 131(1); or

(c) to which subsection 131(1) applies by reason of subsection 130(2).

No Need for A Sec. 104(13) Inclusion.

The first main characteristic of a spousal trust is that the "spouse is entitled to receive all of the income of the trust that arises before" her death and on this wording, given that "income" in the context is trust law income the spouse would appear not to have to be entitled to receive the trust law income "arising" on an annual basis⁶⁹³. If trust law income is to be accumulated by the trust and distributed to her every third calendar year

690 if the disclaimer/release is made within the 36 months after the death

691. These are also the identified characteristics required of an *inter vivos* spousal trust.

692 Subsection 108(4) adds some flexibility in that it precludes a person from being regarded as receiving or obtaining the use of income or capital of an otherwise qualifying spousal trust described under Sec. 70(6)(b), 73(1)(c), or 104(4) by reason only of the payment or **provision for the payment of**, estate, legacy, succession or inheritance **duty** payable as a consequence of the taxpayer's death, in respect of any or the trust property, in respect of any interest in the trust, or any income or profits tax payable by the trust in respect of any of its income. Thus it is possible to charge the trust with the payment of inheritance or succession taxes paid with respect to the interest in, or the property received by, the trust **but** not with the payment of **income taxes** relating to such property or persons when the property or interest is received by them. The spouse must still, however, continue to be entitled to all of the trusts's income. In general the provision offers an attractive method of relieving an estate that's being administered from disposing of property to satisfy such claims in order that they will not be chargeable against a resulting spousal trust. The scope of Sec. 108(4) limited to Sec. 70(6)(b)(i) also creates the requirement that non-spousal beneficiaries be disallowed from receiving either tax law income or capital from the trust prior to the spouse's death.

Sec. 108(4)

(4) Trust not disqualified reason only of payment of certain duties and taxes. For greater certainty, for the purposes of subparagraphs 70(6)(b)(ii), 73(1)(c)(ii) and 104(4)(a)(iv), where a trust has been created by a taxpayer whether by his will or otherwise, a person, other than the taxpayer's spouse, shall be deemed not to have received or otherwise obtained or to be entitled to receive or otherwise obtain the use of any of the income or capital of the trust, by reason only of the payment, or provision for payment, as the case may be, by the trust of

(a) any estate, legacy, succession or inheritance duty payable, in consequence of the taxpayer's death, in respect of any property of, or interest in, the trust; or

(b) any income or profits tax payable by the trust in respect of any income of the trust.

693 See *Trustees of The Mrs P L Travers Will Trust v Revenue & Customs* [2013] UKFTT 436 (TC) for an interesting instance of where income was determined/directed to be capital by the settlor and consequently the trustees that caused substantial tax consequences. The case is replete with other case for consideration.

with the balance before her death will she be considered to be "entitled to receive all of the income of the trust that arises before" her death? The ambiguity arising in interpreting the provision results from the fact that the Department has not applied diction similar to that used to transfer tax liabilities on the income as that described in Sec. 104(24) and (13)(a) but instead made the income to which the spouse must be entitled to **trust law income as described in Sec. 108(3)**, thus it is entirely possible for her to be entitled to receive all of the income of the trust arising after a particular length of time but not be in the position to enforce a distribution thereof before that period of time which is the basis of the Sec. 104(13) income inclusion.⁶⁹⁴

Trust law income may not be in realizable form to allow it to be distributable to the spouse in a given period and trust law income was specifically recognized as the basis if her entitlement in accompany with the term "arises": since Part I income was statutorily exempted from Sec. 70(6) targeting how can it be for Sec. 104(13) inclusion? The Sec. 70(6)(b)(i) provision requires that she be entitled to receive all of the trust law income that arises before her death **but** by the very fact that the basis of the entitlement is trust law income and not Division B income it would appear that **she may receive this "income" in any form including what would be considered tax capital in that some of the trust law income could be treated under tax law as capital**. The provision **does not** state that she must receive the trust income, in her hands, **as income**, but she may receive it in her hands as capital after it has been accumulated by the trust, and thus turned into capital.⁶⁹⁵ This could prove very favorable given the effective tax rates of the trust when it is testamentary and the spouse when she's recognizing substantial income. If the draughtsman of the provision wanted the spouse to be captured under Sec. 104(13) in respect of the trust's tax income on a yearly basis then why didn't the provision's diction conform with that used in the Sec. 104(13) inclusion provision or that in the Sec. 104(24) "amount payable" definition?⁶⁹⁶

694. This certainly isn't the opinion of the Reorganizations and Non-Resident Division when in T.I. 911730 it provided that only the spouse must be the party who decides if she receives income in the year. In the author's opinion the trustees could have full discretionary power to determine the extent of income distributable to her given any concern for the on-going cash requirements of the trust without the spousal trust being disqualified. Cash income could be distributed immediately while book income would be distributed when the trustee feels that he has distributable proceeds on hand subsequently.

695 If it were otherwise that the spouse be entitled to enforce the distribution of trust law income, every trust that due to accounting methods computes a book income that in trust law is undistributable would be prevented from being a spousal trust. This can arise in many situations where book revenue is recognized without the realization of distributable proceeds and is commonly encountered when the trust carries on business activities.

696 Simply put, the Sec. 104(24) provision recognizes income payable and thus includable in income under Sec. 104(13) if the beneficiary was entitled **in the year** to enforce payment thereof while all Sec. 70(6)(b)(i) requires is that she be entitled to receive all of the trust law income arising before her death (...in any form). In the author's opinion this doesn't require her to recognize virtually all of the trust's Division B income under Sec. 104(13) on an annual basis since there may be periods where she doesn't have the entitlement to enforce a payment thereof in the period but may be in such a position every two years but then have the right to enforce a distribution of all of the trust's income that arose during the two years. The Non-Corporate Rulings Division in June 1983 provided in T.I. A-8234 a clause that could operate to allow trustees to withhold trust income and restrict a spouse's **current** entitlement to it should she become bankrupt would disallow Sec. 70(6) from applying to the trust even though the accumulated income could be payable to her estate upon her death. The fact that the income could be applied for her benefit indirectly by the trustees was also held irrelevant. In March 1980 the Division held concerning the instance where a trustee could withhold income from the spouse "There is, of course, no reason why income cannot be accumulated in the trust but if the trust is to be a spouse trust, a **current** entitlement to it cannot be withheld from the spouse." In Sept. 1981 the Non-Corporate Rulings Division provided to the Audit Programs Division that the fact that a spouse is entitled to only receive after tax income from the trust disallows the trust from being a spousal trust since "A spousal trust is never subject to tax on its income because all of the income is payable to the spouse each year." In Jan. 1983 the same Division held that "It is our opinion that as a consequence of the combined effects of subsections 70(6), 108(3), 104(24), 104(13) and 104(6) of the Act, the spouse is taxable upon the income (in the trust sense) of a qualifying spousal trust and, may or may not be taxable upon the remainder of the income (computed under the I.T.A.)." Clearly the author of this opinion inferred that the legislators of Sec. 70(6) wished that the spouse was to recognize all of the income as income instead of being able to receive all of the benefits of the trust property, to the exclusion of everyone else, before her death. In the author's opinion, the opinion is wrong. In a Technical interpretation provided in June 1984 by the Non-Corporate Rulings Division it was provided: "Depending upon the terms of the trust deed the income of the trust computed under the Act, to the extent that it exceeds the trust's income computed under trust rules, may be (a) paid or payable to the spouse in the year and taxed in her hands, (b) included in her income under a preferred beneficiary election, or, taxed in the hands of the trust." This opinion the author agrees with.

If the courts succeed in addressing the issue and decide that the provision is to be read as requiring the spouse to recognize all of the tax income net of taxable capital gains and other capital nature income inclusions the spouse's income inclusions may still be limited due to the fact that the trust law income is in not payable to her because it is not in distributable form or due to accounting loss carry-forwards which consequently reduce the shadow tax law income also recognizable. If the trust deed allows the trustee to measure the income but distribute it to the spouse in the subsequent period when

Powers of Encroachment and Effects on Income.

A testator cannot write in a power of encroachment in favour of anyone with recouping powers without the trust losing its spousal nature. If the powers of the trustee allow him to encroach on capital for the spousal beneficiary he cannot be allowed to accumulate subsequent income to boost back up the expended capital; the spouse would not be entitled to receive all of the trust income that arises before her death on the other hand.

If, on the other hand, the trust deed allowed the trustee to expend capital sums to acquire her **divisible** income rights to subsequent year's income Sec. 106(3) would allow a tax free roll-out of cash and the spousal nature of the trust would be retained, while the spouse would not recognize a Sec. 106(2) or 104(13) inclusion. The same result would occur if the trust deed specifies that the spouse is entitled only to the net income after the application of losses until her death the Sec. 70(6)(b)(i) provision shouldn't be offended since the spouse is receiving all of the income of the trust arising before her death. The income to which the spouse must be entitled should be, as per the phrasing, that which accrued over the period prior to her death and not that prior to the application of trust law deductible accounting losses sustained within that period of time.⁶⁹⁷

Remarriage Clauses.

A remarriage clause could jeopardize the indefeasible nature of the spouse's entitlement to income under the trust until her death, whereby if the income interest terminates upon remarriage the Sec. 70(6) roll-over will not be available.⁶⁹⁸ If upon a remarriage the trustees have the ability to convert the income producing assets of the trust into capital appreciating ones, possibly through incorporation, then some control exists over the spouse's income interest that will still allow the Sec. 70(6) provision to be available. This is also the case with spendthrift trusts where the spouse loses her income interest due to her bankruptcy or insolvency.

Spousal Trust Income and Entitlements to Receive or Enforce a Distribution.

Both subsections 73(1) and 70(6) require that, in order for the roll-over to be available, the spouse under the spousal trust must be "entitled to receive all of the income of the trust that arises before" her death while subsection 108(3) provides that for purposes of these provisions (and Sec. 104(4)) the "income" of a trust is to be computed without reference to the ITA and where they have been included in the trust law income amount qualifying and capital dividends described in section 83 are to be deducted as well certain capital gains dividends described in Sec. 131(1).

One should immediately recognize that trust law income will rarely be equivalent with or computed similarly to tax law income as that described in section 3 for at least two broad reasons; the first being that the latter is particularly arbitrarily determined with instances where expenses may not be deductible even though they have been incurred to produce revenue and income may not be recognizable due to political good-will etc, while the trust law income may be computed as per the settlor's/testator's expressed or implied intentions, he being in the situation to determine so since it is he who is making the gift of legal title thereto. As per the provisions in Sec. 73(1) or 70(6) the spouse must also be entitled to **receive** all of the trust law income that

considerable cash may exist the same would result.

Alternatively there is the issue of how broad a discretion a testator/settlor can give to the trustee in determining what is a trust law income receipt for purposes of the trust. There are certain limitations here however it depends on accurately the settlor defines the accounting for the trust and to which beneficiaries the increases in wealth are to inure.

697. See *Re: Winter v. Irving*, 84 C.L.R. 532. Trust law income can be computed in so many ways that it deserves to be commented on in a separate chapter following this one.

In a Technical interpretation provided in Jan. 1983 by the Non-Corporate Rulings Division a guaranteed minimum income entitlements was addressed. A trust was to recognize income and pay the tax on it and that tax and trustees fees were to be deducted from the income to be added to the corpus of the trust. Five percent of the value of the capital of the trust was to be paid annually to the spouse, as valued at year end, while a special account was to absorb certain excesses: if the net income of the trust was in excess of the tax paid and trustee fees and the amount actually paid to the spouse it would be debited to the account, while in years of shortfall it would be deducted and paid. Any balance in the account would be payable to the remaindermen upon the spouse's death. It was held by the Division that the trust would not be spousal and that it could be if all the trust law income would be instead taxable in the spouse's hands.

698. The same occurs if the income interest becomes unenforceable because of the spouses bankruptcy, as per the trust terms, but the income is to be accumulated and passed to her estate upon her death.

arises before her death, and although in the absence of judicial opinion expressing otherwise it was previously commented that she may receive the income after it had been capitalized in a subsequent period, she still must be entitled to **receive all** of the trust law income that arises however that trust law income may not be payable to her because of the existing capital beneficiary-trust-income beneficiary equity standing and the fact that the trustee must, under common trust law, retain some income from the income beneficiary to boost the capital beneficiary's ultimate receivable amount which may have decreased for the benefit of the income beneficiary.

The major differences between trust law income and tax law income are described in a following chapter however here it is important to recognize how trust law income may be adjusted with explicit language in the trust deed so as to allow the spouse to receive less and less trust law income which will also allow her to recognize less and less tax law income payable and includable under Sec. 104(13)(a)-(c), thus allowing the trust to recognize more and more of the tax law income that is recognizable by the group.⁶⁹⁹

The income of a trust for purposes of trust law is to be computed as per the terms of the trust deed and its here that a "properly" drafted spousal trust deed can be highly beneficial. If the testator/settlor states explicitly that certain deductions are to be made from revenue being realized, (that gross income/revenue be recognized on a particular basis being anywhere from absolute accrual to absolute cash), then the courts will defend such an expression even if it operates to severely reduce the amount of net revenue that is subject to an income beneficiary's immediately and enforceable entitlement in a particular year; it is the settlor/testator who is making the gift of income/capital to which he formerly held legal title thus it is only he who can decide in what form the gifts should be computed and receivable. The key to this indication process is that the directions must be clear enough so as to allow whoever is validly involved, including trustee, capital and income beneficiaries, and possibly the courts, to have enough evidence to establish the steps that the trustee must take in determining the amount that represents the spouse's entitlement amount. If the testator/settlor uses particularly ambiguous terms such as "net income" or "income", "revenue" etc. depending upon the type of activity carried on by the trust the trustees may encounter serious interpretation limitations attempting to determine what type of expenses, if any, can be charged against this revenue (so as to maintain an even-hand between the capital and income beneficiaries in such a way that the expenses do not reduce one's ultimate benefits to be realized so as to benefit the others). In instances where this ambiguity and interpretation difficulty has been encountered the courts may be applied to for advice whereby they will usually evaluate the intentions of the testator from the speech he used to make the gift which includes the evaluation of factors such as the nature of the activity producing the revenue, what type of expenses are being encountered and to what property/activity they relate, and what, if any, was the manner in which the testator accounted for these expenses previously if he previously carried on the business as a proprietorship. It will be upon evaluating these factors, plus determining the nature of the capital beneficiaries' entitlements as a mutually exclusive variable and whether or not they have unjustly realized a decrease or increase in the value of their entitlements for the benefit or at the expense of an income beneficiary, that treatment of any particular expense/charge will be ascertained as equitable.⁷⁰⁰ In *inter vivos* trust situations the settlor may be asked directly rather than go through the courts. If the testator gives the executor/trustee the power to determine the nature of a receipt/expense in his own discretion the source of the payment or its reason will have to be evaluated in that the discretion is not absolute and is subject to the situation. This was the case in *Terrill Estate v. M.N.R.*⁷⁰¹ when such a power was contended by the Minister to have tainted a spousal trust since it could regulate the income recognizable by the spouse. T.C.J. Tremblay was not convinced and provided:

"...the decision to regard an amount as income or capital is not a purely arbitrarily decision made at the whim of the executors. This is a purely objective question based on the general principles of accounting."

"When it is a question of determining whether an amount received is in the nature of capital or income

699 This discussion is also relevant with respect to the determination of "amounts payable" to an income beneficiary given that the income beneficiary's income interest defined under Sec. 108(1)(e), is based, as per Sec. 108(3), on trust law income.

700 See *McBride v. Hudson*, 107 C.L.R. 604

701 87 D.T.C. 504, see also *Re Wynn* (dec'd); *Public Trustee v Newborough* [1952] 1 Ch 271, *Wendt v Orr* [2004] WASC 28, *Orr v Wendt* [2005] WASC 199. For further cases where the court could be approached to over-rule an executor's/trustee's determination.

the source must be considered. If the source is interest or rent collected, this is obviously income. If the source, on the other hand, is the proceeds from the sale of a house, it is just as obvious that this is capital. There is no way, in my view, that the executors can regard the proceeds of the sale of the house as income and distribute them to a beneficiary as income. There is no way either that the executors can decide that rents or interest are capital and not distribute them to a beneficiary."

The court found that the power could not disturb the spouse's right to income.⁷⁰² In *Miller v. I.R.C.*⁷⁰³ the court had to decide whether a widow's interest in the income of an estate was in possession when the executors/trustees could exercise a power to withhold income to cover depreciation on estate assets and other incidental expenses. The power was found to be merely administrative and not dispositive on a review of the will read as a whole and thus didn't interfere with the widow's rights to the income plus it was also held that the power was enforceable in respect of gross income and not net income to which the spouse was entitled. It could also not be used to accumulate income out of her reach and the expression in its creation did not operate to counter the absolute gift of the net income.

If no particular income recognition method is described in the trust deed (and the settlor's intentions are not ascertainable *inter vivos*) then the courts will endorse some sort of accounting method applicable to the activity being carried on which may be either an investment or business activity while the accounting treatment afforded the revenue being realized may be based on some sort of accrual system if the activity is a business carried on by the trust. In the instance where a business is carried on and an accrual revenue recognition is employed regardless of the level of expenses chargeable against it there may be instances where the net **book** income of the trust that is subject to a beneficiary's entitlement isn't distributable simply due to the lack of funds that have been got in. This phenomenon was of concern in *Taylor v. Clark*⁷⁰⁴ an often quoted case, wherein it was found that until income was actually received by the trust in distributable proceeds the trust deed operated only to calculate an amount of income to which the life tenant becomes entitled while it is only at the time that this income is received and distributable that it can be considered **payable** to the life tenant. Although the deferral of receipt will not jeopardize the spousal trust characteristics described in Sec. 70(6) or 73(1) in that the spouse will still receive the income when it is realized the major advantage in the accrual system comes in the form that Sec. 104(24)⁷⁰⁵ provides that the amount of income paid or in respect of which the beneficiary was entitled in the year to enforce **payment** thereof will be the amount included in the beneficiary's income under Sec. 104(13), thus if an amount of income measured has been credited to the beneficiary's income account, until its substance has been got in, since he can't enforce a payment thereof in the year, he will not have to recognize its Division B equivalent under Sec. 104(13). In order for the beneficiary not to be able to enforce a distribution the trust deed must preclude him from enforcing a conversion of property such as A.R., inventory, etc. by the trustee to obtain proceeds which he could then distribute. If the beneficiary isn't capable of enforcing a distribution of income until a later period then its Division B equivalent will be taxed in the hands of the trust and distributed as capital subsequently, the income beneficiary having then obtained a capital interest in the interim. If a preferred beneficiary election can be made in respect of the income beneficiary then the income recognition can be transferred to the beneficiary even though the income isn't payable however Sec. 104(15) and its accompanying Regs. may impose some parameters. If the beneficiary can act to enforce a distribution of the income item in specie against the wishes of the trustees then Sec. 106(3) will cause the disposition by the trust of that account receivable, inventory, etc., for proceeds equal to

⁷⁰² This is also the case in *Re: Bronson*, 14 D.L.R. (2d) 51, *Re: Wynn*, [1952] 1 Ch. 271, and *Re: Fenwick*, *Fenwick v. Stewart*, [1936] 2 All E.R. 1096. In T.I. 5-902411 from the F.I.D. dated Oct. 1990 it was held with respect to a discretionary power that allows the trustee to distinguish between income and capital:

"It is our view that such discretionary powers cannot change the nature of an amount of income or deductible expense into a capital receipt or expenditure or vice versa. As stated in para. 10 of I.T. 305R3 if the trust is a qualifying trust its income is determined for trust purposes under Sec. 108(3) of the Act to exclude amounts that are income for income tax purposes. (e.g., taxable capital gains). As such, the wording of the specific clause referred to above would have to be very specific, as the Department would not accept that the trustee would have the power to rule that income (eg interest) could be capital."

⁷⁰³ 1987 S.T.C. 108

⁷⁰⁴ 66 E.R. 990

⁷⁰⁵ the basis of the Sec. 104(13) inclusion

its fair market value⁷⁰⁶ and the beneficiary will recognize a Sec. 104(13) income inclusion and not one under Sec. 106(2) if his interest isn't reduced in any way.

Accrual income recognition suffers from the characteristic that book income may exceed cash on hand which may be distributable to the beneficiaries thus although the income amount will be credited to the particular beneficiary's income account until it is actually received it will not be payable to him as income. This obviously affects the beneficiary's ability to enforce a payment of it, as per the Sec. 104(24) basis of the Sec. 104(13) income inclusion, in that the beneficiary may not, in a period, be entitled to enforce a payment of it. In *Federal Commissioner of Taxation v. Totledge*⁷⁰⁷ concerning an effectively equivalent charging provision under the Australian Income Tax Assessment Act 1936, Bowen C.J. and Deane Fitzgerald J.J. held in their judgment as to whether a beneficiary had a right to receive income, "presently entitled", when the income had gone to pay the creditors:

"The preferable construction of section 97(1) is to treat the requirement of present entitlement to a share of the income of the trust estate as not being concerned with distinctions between gross income as deprived and "surplus income"...but as referring to a **present vested right to demand and receive payment of the whole or part of what has been received by the trustee as income and, retaining that character in his hands, is legally available to be distributed to those entitled to it as beneficiaries...**"

See also *Taylor v. F.C.T.*⁷⁰⁸ where it was provided:

"...I think that 'presently entitled' refers to an interest **in possession** in an amount of income that is legally **ready** for distribution so that the beneficiary would have a right to obtain payment of it..."

The Australian Income Tax Assessment Act targets a beneficiary's "**share**" of a trust's assessable income independent of what is real or artificial and includes it in his income. Taylor J. described the difference very accurately in *F.C.T. v. Belford*⁷⁰⁹ with:

"The ascertainment of the total assessable income of the trust estate for any year is, of course, not concerned with payments by way of distribution to beneficiaries and the total assessable income of the trust estate will, in any particular case, be precisely the same whether the whole or some part only, or none of the estate income has, during the relevant year, been distributed to beneficiaries presently entitled to shares thereof. Yet in some cases, s. 97 requires that the appropriate share of the total assessable income of the trust estate shall be included in the assessable income of each beneficiary, and this is so whether any beneficiary has actually received the whole or some part, or none of the income. To my mind this is a clear indication that the Act intends, in such cases, that there shall be included in a beneficiary's assessable income, not the amount of his actual receipts of the estate income, but a proportion of the total assessable income of the trust which, for obvious reasons, may be a quite different amount."⁷¹⁰

If the trust deed expressly provides that the only amounts distributable to a life tenant are to be cash or cash equivalents then the basis of application of Sec. 104(13) can clearly be derived from the amount of cash the trust has on hand at year end or that has been distributed during the year, after the trustee has extinguished operating debt, etc. with the amounts that he may, if allowed, feel is sufficient. If the trust deed provides for it, the trustee may even have a discretionary power as to determine which income beneficiary may be more affected than others due to the provision for debt however, if the debt itself relates to a business expansion then some of the liability should be indemnified out of the capital beneficiaries' entitlements as well, since an expansion clearly is to their ultimate benefit as well.

If the trustee is not to carry on a business to realize it but instead is to liquidate immediately the debt that remains after partial extinguishment with the business's proceeds should be indemnified from any property on

⁷⁰⁶ which may essentially cause few tax consequences to the trust

⁷⁰⁷ (1982) 12 A.T.R. 830

⁷⁰⁸ 119 C.L.R. 444

⁷⁰⁹ 10 A.T.D. 105

⁷¹⁰ See also *Davis & Anor. v. F.C.T.*, 89 A.T.C. 4377, 9 C.T.B.R. (N.S.) Case # 76, Case C36, 71 A.T.C. 156, & Case R32, 84 A.T.C. 298, for more proportional assessment. The concepts are fully discussed in: "Trusts and I.T. Concepts of Income.", L.G. Priddle, 1978 8 A.T.R., 91, "The Taxation of Trusts.", R.F. Edwards, 1981 15 Taxn. in Aust. 398, "Pitfalls in the Future Operation Of Trusts in Tax Planning.", T.W. Magney, (1978) 12 Taxn. in Aust. 650, "Contemporary Issues of Concern.", Munn, 1983 Taxn. in Aust. 362, "Developments in Taxation of Trusts.", G.L. Davis, July 1979 Taxn. in Aust. 3.

hand, however the courts may cause such an extinguishment to be executed even handedly⁷¹¹ between capital and income beneficiaries to the extent that they will benefit ultimately, but only if the trust deed is silent as to the possibility of certain gifts being protected from such encumbrances.

If a business is carried on by the trustees as per the terms of the trust, (in order to realize it or otherwise), trading debts may be incurred and accounting losses may occur which will have considerable effect on the trust law income realizable by the beneficiary in any particular year.⁷¹² In respect of the former, *Vacuum Oil Company Ltd. v. Wiltshire*⁷¹³ describes many different ways in which a trustee/executor may become personally liable for debts incurred in carrying on the business of a trust as per its terms however he is also entitled to indemnity in respect of the debts out of certain assets of the estate/trust.

Latham C.J. held:

"An executor is entitled (apart from any express authority given by the will) as against both beneficiaries and estate creditors to carry on the business of his testator for the purpose of realization, but only for that purpose (*Collinson v. Lister*, [(1855) 52 E.R. 639]). In respect of debts incurred by him in so carrying on the business he is personally liable to the trading creditors-the debts are his debts, and not the debts of his testator (*Labouchere v. Tupper* (2); *Ex parte Garland* (3)). But as against beneficiaries and both classes of creditors he is entitled to indemnity in respect of those debts out of the assets of the estate (*Dowse v. Gorton* (1891 A.C. 190))."

"If an executor is authorized by the will to carry on the business not merely for the purpose of realization, then it is still the case that debts incurred by him are his debts for which he is liable to the new creditors. The authority given to the testator is part of the disposition of his estate and binds beneficiaries under his will. Thus, as against the beneficiaries in such a case the executor is entitled to an indemnity against the new debts out of the assets of the estate which the testator authorized to be used for the purpose of carrying on the business and out of any assets acquired in the course of carrying on (*ex parte Garland*, [(1804) 32 E.R. 786])."

In *Octavo Investments Pty. Ltd. v. Knight*⁷¹⁴ *Wilson, J.J.* held:

"It is common ground that a trustee who in discharge of his trust enters into business transactions is personally liable for any debts that are incurred in the course of those transactions: *Vacuum Oil Co. Pty. Ltd. v. Wiltshire*, (1945) 72 C.L.R. 319. However he is entitled to be indemnified against those liabilities from the trust assets held by him and for the purpose of enforcing the indemnity the trustee possesses a charge on right of lien over those assets: *Vacuum Oil Co. Pty. Ltd v. Wiltshire supra*. **The charge is not capable of differential application to certain only of such assets. It applies to the whole range of trust assets in the trustee's possession except for those assets, if any, which are under the terms of the trust deed the trustee is not authorized to use for the purposes of carrying on the business: *Dowse v. Gorton*, (1891) A.C. 190."**

The debt must have been incurred in **carrying on** the business and not incurred to expand the business. If the trust does not provide any particular manner in which the trustee is restricted from being indemnified operating loans assisting the carrying out of business can be recouped from the revenue of the business since the loan was expressly incurred to produce revenue, thus the exercise of the discretion of the trustee (which may possibly be restricted by the trust terms) may cause the revenue to be applied to the loan thus extinguishing the liability hence the beneficiary will not be able to enforce a distribution of the income. As *Wilson J.J.* held in *Octavo*:

"In such a case there are two classes of persons having a beneficial interest in the trust assets: first cestuis que trustent, those for whose benefit the business was carried on; and secondly, the trustee in respect of his right to be indemnified out of the trust assets against personal liabilities incurred in the performance of the trust. The latter interest will be preferred to the former, so that the cestuis que trustent are not entitled to call for a distribution of trust assets which are subject to a charge in favour of the trustee

⁷¹¹ See *Lottman et al. v. Stanford et al.*, [1980] 1 S.C.R. 1065, where the Supreme Court had to consider an action in respect of a disenfranchised income beneficiary.

⁷¹² See *Massey v. Commr.*, 1929 R. & McG. 237.

⁷¹³ 72 C.L.R. 319 at pg. 325

⁷¹⁴ (1979), 54 A.L.J.R. 87

until the charge has been satisfied: *Vacuum Oil Co. Pty. Ltd. v. Wiltshire Supra.*" If the trustee had the discretionary ability to determine what portion of the revenue would be used in any particular period to extinguish any particular revenue debt then that discretionary power could be used extremely effectively to determine the amount of net income, regardless of how computed, the beneficiaries would be entitled to, thus causing adjustment to their Sec. 104(13)(a) or (c) recognizable income. Such a recoupment power, however, would jeopardize the Sec. 70(6)(b)(i) requirement that the spouse be entitled to all of the income that arises before her death. If the trust was a personal trust, and the income beneficiary also had a "blanket" capital interest therein which was not acquired for consideration payable the trustees could distribute the proceeds of the debt, as capital to him, whereby neither Sec. 105(1) nor 53(2)(h) would apply thus allowing for a tax-free distribution. Upon the extinguishment of the debt with the income the trust would recognize the Part I tax liabilities in respect of it, and the beneficiary would not receive any income, (although he had previously received it all in the past).⁷¹⁵ If the revenue debt is required to be assumed by a capital beneficiary as a condition of receiving the personal trust's inventory in satisfaction of his capital interest then it may cause a capital loss to be recognizable by him under Sec. 107(2)(c) if the debt assumed is in excess of the tax cost of the property to the trust (possibly bumped up by excess interest ACB as per Sec. 107(2)), **and if** the taxpayer has been able to inflate the ACB of his interest through a sale or purchase or change in residency **after** he has received the tax-free distribution of debt proceeds through reliance on the Sec. 107(1), 108(1)(d) mechanics. Given that the particular beneficiary may have already received the debt proceeds tax-free, the above arrangement takes on a particularly offensive nature.

Depreciation and business loss carry forwards are discussed in a following chapter whereby it was commented that if certain conditions exist; (ie, the carrying on of a business and the actual decline in value of the depreciable property due to wear-and-tear etc), then a depreciation charge on income⁷¹⁶ would reduce the amount of trust law income payable ultimately, while it was also held that losses sustained in a previous period of the business, (that effectively reduced capital), could be applied against subsequent period's income so as to recoup that capital drain, thus reducing the trust law income payable as well. Both of these income charges could be limited in a particular year as per the terms of the trust deed however if the trustee is given unfettered discretionary powers fine tuning of trust law income payable, (as well as resulting Division B tax law income payable), could proceed. This is also the case with respect to the exercise of powers of encroachment where capital is distributed early and recouped from the recipient income beneficiary's subsequent entitlements. For purposes of subsection 70(6) and 73(1) the income to which a spouse must be entitled is to be computed without reference to the Act and although the trust deed may provide for several deductions chargeable against the revenue stream so as to derived "net income", in tax law not all of them may be deductible. In *English Estate v. M.N.R.*⁷¹⁷ the Income Tax Appeal Board allowed an executor of an estate to deduct from the estate's Division B income current repair expenses only when they were directly incurred to produce taxable income, and not capital expenses that would produce benefits over more than one period and were of a permanent improvement.

In order for the first spousal trust condition to be satisfied the spouse must be entitled to receive all of the income of the trust that **arises** before her death however how much significance one has to pay to the term **"arises"** in this case is questionable. If the term should be taken to mean **realized** income, which in one form or another, means revenue net of expenses, then until the revenue is realized there can be no income however if it is taken to mean **"accrues"** then the revenue may be recognized before it is realized, as in the case where timber is growing, penned tuna or cattle are breeding, et cetera, or some other accretion activity is taking place, while on the other hand in the absence of a contrary expression in the trust deed, a certain degree of **accretions** may usually be taken to benefit the capital rather than the income beneficiaries.⁷¹⁸

In *McBride v. Hudson and another*⁷¹⁹ the High Court of Australia had to decide the scope of a life tenant's

⁷¹⁵ If a distribution of the borrowed capital takes place such as above interest costs would not be a deductible Part I expense.

⁷¹⁶ failing the expression, implied or otherwise, of a contrary in the trust deed

⁷¹⁷ 56 D.T.C. 18

⁷¹⁸ See *Hassell v. Perp. Exors., Trustees, & Agency Co*, 86 C.L.R. 513, and *Hughes v. Fripp*, 30 C.L.R. 508, where partnership income becomes capital at will.

⁷¹⁹ [1961-62] 107 C.L.R. 604

rights with respect to the "income" of a pastoral business carried on by the executors. The particular provision in the will read:

"10, I direct that the net profits derived from the carrying on of my pastoral business during the lifetime of my wife shall be divided between my wife and my said son in equal shares and I declare that in ascertaining net profit available for division under this paragraph the salary or remuneration and expenses paid to my said son for managing my pastoral business shall first be deducted."

There had been an increase in the number of sheep of the estate since its inception and the estate of the life tenant contended that part of the natural increase was to inure to her, since the flock was considerably smaller at that time and had grown since by retaining the sheep rather than selling them. Taylor, J. held:

"Essentially question 1(c) is concerned with the rights of the parties in the circumstances as they were found to exist upon and immediately after the death of the testator's widow. Literally the question which is asked requires whether, upon the death of the widow, the estate of the testator was entitled to the whole of the sheep, some 4,346, the depastured on the property, or whether, on the contrary, it was entitled to only 1,850 of them."⁷²⁰

...

The contention that the interest of the estate was limited to 1,850 only of the sheep rested upon the circumstances already related, it being said that the sheep in excess of this number represented accrued profits of the business, and, in effect, that they belonged to the life tenants. But it is not possible to entertain the suggestion that the plaintiff and his mother at any time acquired any interest in the natural increase which was retained in order to build up the flock. Their interest was in the profits of the business, from time to time, and these, of course, could be ascertained only by taking into account the relative business operations. However, it may do less than justice to the plaintiff's argument to deal with the question in this way for, in spite of the form of the question, what was primarily asserted was, in effect, that upon the ultimate realization of the business assets, including the sheep in question, after the widow's death, the proceeds of the sale of the sheep in excess of 1,850 should be credited to the widow's estate and the plaintiff in equal shares. The ground upon which this contention was based was that, as was said in *McIntyre v. McIntyre*, (1914) 15, S.R. (N.S.W.) 45, and in *Re Porter*; *Porter v. Porter*, (1930) 31. S.R. (N.S.W.) 115, trustees carrying on a pastoral business are not justified in building up the number of livestock on the property at the expense of the life tenants. **But the statements to this effect were concerned with defining the duties of trustees and not with defining or identifying the distributable profits of any such business. No doubt it is not for the trustees to build up the flock at the expense of the life tenants for the benefit of the remaindermen but it does not follow that whenever the number of sheep carried on a grazing property managed by trustees is increased by the retention of all or some part of the natural increase it can be asserted that the flock is being built up at the expense of the life tenants.** Primarily the profits from a business such as that with which we are concerned is **earned by the sale of wool** and in the discharge of their duties to both life tenants and remaindermen it is of importance that the property shall be stocked to its full carrying capacity from time to time. **In contrast with the return from the sale of wool the profits on the sale of surplus sheep are a matter of minor importance. Essentially it is a matter for the trustees to determine how the business should be carried on to the best advantage. In particular, it is for them to determine whether livestock shall be sold in the ordinary course of business and, in the present case, it is worthy of note that the trustees were authorized "in the carrying on of the said business to exercise all powers reasonably necessary or incidental thereto as fully and effectually as" the testator could, himself, exercise them "if alive and attending to the matter in question and in person."**

The Court unanimously found that the life tenant's rights did not extend to the natural increase in the flock. This case did not deal with the rights of the life tenant to property built up through the reinvestment of earnings rather than through distribution in that the increase in the income producing property, (the sheep), was not the primary business activity but the production of wool was. The accretion in number inured to the benefit of the

⁷²⁰ The number existing at the time of the initial testator's death.

capital beneficiaries in the same way that it would have had the income producing property been a building or land. The accounting for the natural increase in the flock was not included in computing the profit from the wool production business.⁷²¹

If an accrual revenue recognition method is used the life tenant's estate will be entitled to receive the income that has been credited to the deceased's income account before he died that is subsequently realized however if the year's accounting adjustments have not been made before the life tenant dies it would seem reasonable to apportion the period's income and credit to his account such amount that arose while he was alive, **unless** the trust deeds specifically requires that income be computed at year end and accredited to beneficiaries who are alive at that specific time. In the absence of such an expression the apportionment should proceed. In the U.K. the jurisprudence in respect of businesses entitled to be carried on is that only income ascertained at the end of the trust's fiscal year is subject to the entitlement of a life tenant at that time and if the entitlement is extinguished mid-term for whatever reason the entire period's income inures to the benefit of the other respectively entitled beneficiaries.⁷²² In Australia/New Zealand and Scotland the "broken period's" income is payable to the life tenant regardless of when within the period the right ceases to be enforceable⁷²³. Of course the terms of the will/deed may expressly provide another basis of measuring an entitlement in such a situation.

In *Tait Estate v. M.N.R.*⁷²⁴ the Tax Court Judge considered the income rights of the life tenant (who had died mid-term) under a spousal trust with respect to grain that had grown but had yet to be harvested:

"In each estate the trustee prepares on the death of a life tenant a statement of **"net paid and accrued income"** representing what has been paid and what was owing at the date of death. In this case, the grain is no different from the bond coupon. The trust must follow the equitable maxim of "treat as done that which ought to have been done". In no way can an asset on hand which is normally considered as income become a capital asset of a spousal trust nor can it remain as an income asset and not be the property of the life tenant...If the estate had farmed the property the grain unconverted to cash represented income from the capital asset of the farm and so belonged to the life tenant on a net paid and accrued basis."

Tait Estate is a rare case, and a recent one, which provided that income of a trust, for purposes of ascertaining beneficiaries' entitlements, is to be computed with the accrual method however if the trust deed specifies otherwise, or if the method of accounting for the activity formerly by the testator was not such, accrual accounting will not automatically apply. Implicit is the endorsement of the entitlement to the income of the stub period.

Structuring out Income Potential.

Through incorporation by a spousal trust of its income producing assets it's possible to structure out the income potential to non-spousal parties and thus circumvent the spousal characteristic of the non-spousal restrictions in income participation prior to her death: non-spousal beneficiaries and the trust can jointly contribute cash and income producing property respectively to a common corporation using Sec. 85(1) for common shares with differing dividend payment terms. The trust deed may specify what degree of control must be maintained by the trust however the structuring of the voting hierarchy amongst the shareholders as provided in the corporate charter may allow the trust to remain in control without rights to considerable levels of dividends. Preferred shares with fixed dividend rates may be subscribed for by the trust however of paramount concern is insuring that the non-spousal (or for that matter spousal) subscribers do not realize a benefit from the trust by virtue of their subscription for shares with a greater fair market value than the resources

721 See also *Thornley v. Boyd*, 36 C.L.R. 526, *Kelly v. Perp. Trustee*, 109 C.L.R. 258, *Re: Bowman*, 1955 S.A.S.R. 98, *Hassell v. Perp. Trustee & Agency Co.*, 86 C.L.R. 513, *Re: Archer*, 1961 Tas. S.R. 1, *Re: Buckley*, 1941 G.L.R. 640, and latterly, *Re: Richards*, 1974 2 N.Z.L.R. 60, *Union Trustee Co. of Aust. Ltd. v. Bartlan*, 1948 A.C. 495, and *Re: Hemi Matenga*, 1942 G.L.R. 72, for endorsement of *McBride* principle. See *Watson v. F.C.T.*, 42 A.L.R. 573, & *Re: Porter*, 1930 31 S.R. (N.S.W.) 115, for accretions of capital as compared to accumulations on income in unincorporated activities.

722 In *Re: Cox's Trusts*, 1878 9 Ch. D. 159, In *Re: Robbins*, 1941 Ch. 434, *Browne v. Collins*, L.R. 12 Eq. 586, *Lambert v. Lambert*, 22 W.R. 359. The opposite occurs in respect of investment income: *Re: Winterstoke's Will Trusts*, 1937 4 All E.R. 63.

723 In *re: Havill*, 1953 N.Z.L.R. 443, *Re: Richards*, 1974 2 N.Z.L.R. 60, *Marshall v. I.R.C.*, 1960 N.Z.L.R. 972 (CA), *Andrew's Estate v. Hallett*, 1926 S.C. 1087.

724 89 D.T.C. 309

they are contributing to the corporation. Such resources include both cash/non-cash property as well as directorship responsibilities and management functions to be attended to and if the aggregate of such is greatly lesser in value than the shares obtained determined by their expected dividend streams and residual value a Sec. 105(1) benefit could be arguably realized. A trust may confer a benefit on share subscribers when it goes from a majority shareholder controlling the board to a minority player through successive share subscriptions by the outside beneficiaries however the benefit is realized only if the fair market value of the shares isn't offered for them. This conferring of a benefit may be recognized as a disposition to which Sec. 69(1) applies where an economic interest is passed for no consideration as was the case in *Ovis Brooks v. M.N.R.*⁷²⁵ or *M.N.R. v. Dufresne*⁷²⁶ whereby Sec. 69(1) will apply to the trust and Sec. 105(1) is not prevented from applying to its acquisition by the beneficiary.

To avoid the recognition of a benefit the beneficiaries must provide value of a magnitude for their shares that accurately reflects their fair market value and this consideration could include the above, (director responsibilities, top management functions, know-how, etc.), while another route would be to provide less for shares with less dividend participation though allow the beneficiaries to become employees and to receive a salary providing top management expertise. The latter would allow the same streaming off of income to the non-spousal parties though allowing them to recognize a different source of income.

Essentially the same may be obtained through the creation of a partnership whether general or limited whereby income producing property is managed actively by non-trust partners and earnings are only partially streamed off to the trust. Income sharing could depend on the relative amounts of the capital account balances and the trust could use excessive drawings to reduce its entitlement though of course the trust deed would have to be structured to allow such be legally flexible in the face of the requirement to deal without partiality with the interests of the trust's beneficiaries. The trust could become merely a limited partner and all parties could contribute to the partnership using Sec. 97(2) if all are resident in Canada while excessive drawings will not produce tax consequences to the limited partner trust. Since cash is being systematically withdrawn the trust could distribute it out to non-spousal beneficiaries without tax consequences under Sec. 107(4).

If incorporation is the option then the trust deed should expressly allow the trustees to vote themselves as directors and have the fiduciary duty of reducing taxable dividend distributions to the trust. Alternatively, the trust deed could compel the trustees to transfer the income producing property to another trust, created via a power etc., the terms of which are to accumulate income and distribute capital thus reducing the spousal trust's income which is payable to the spouse.⁷²⁷ The corporation's share structure and the nature of the head trust's beneficiaries could allow for "outside" parties to participate via the purchase of shares/receipt of income interests so as to directly benefit from the head trust or corporation and these characteristics should be expressly provided for in the spousal trust's contingency clauses so as to preclude actions against trustee purported partiality. In the author's opinion the fact that the trust deed **compels** the trustees to incorporate the assets does not jeopardize the Sec. 70(6) requirement of indefeasible vesting since the former concerns only how the trust is to operate after it has been fully constituted and received clear title and the latter concerns only how it is constituted and whether it receives clear title.⁷²⁸ Indefeasible vesting isn't undermined by a functioning of the trust deed as such; though it may be as a consequence of the administration of the estate that creates the trust.⁷²⁹ Likewise no non-spousal parties obtain the use of any of the trust's capital while the

⁷²⁵ 91 D.T.C. 639

⁷²⁶ 67 D.T.C. 5105, as well as *Boardman et al. v. The Queen*, 85 D.T.C. 5628, *Perrault v. The Queen*, 76 D.T.C. 6021, *Levine v. M.N.R.*, 73 D.T.C. 5182

⁷²⁷ Subsection 75(2) should be reviewed in order to ensure it can't apply to this arrangement.

⁷²⁸ A power to appoint to new trusts will however taint the spousal character of the trust though it is possible to vary it in after the roll-over has been accepted.

⁷²⁹ The Non-Corporate Rulings Division was not of this opinion in April 1985 when in a technical interpretation it provided:

"Since the executor's transfer of the common shares to the holding company will be discretionary and not obligatory, it is our opinion that the proposed arrangement will not prevent the shares vesting indefeasibly in the spousal trust. Whether or not the trust is, in fact, a spousal trust within paragraph 70(6)(b) of the Income Tax Act is not so clear. Subparagraph 70(6)(b)(ii) of the Act denies anyone but the spouse the "...use of any of the income or capital of the trust" during the spouse's lifetime and while your proposal may not conflict with this requirement we have too little information to form an opinion upon the matter. That is, before expressing an opinion we would wish to review the terms of the will establishing the spousal trust and the

extent that the excessive dividends are recognized by the non-spousal beneficiaries Sec. 105(1) will not apply to them due to para. (a) therein.⁷³⁰

Access to Capital.

The second requirement that must be satisfied in order for the trust to qualify is that no person other than the spouse **could, may, possibly**, be in a position, before her death, to receive or obtain the use of any of the income or capital of the trust. One can infer, **perhaps** correctly in the author's opinion, that the party cannot receive the capital **in the capacity of a beneficiary** only however how correct this opinion is depends on what intention the legislators had when they introduced Sec. 108(4). If the intention of the settlor was that the spouse should be entitled to income and that no one else should **benefit** from the trust capital then it would appear that the provision applies to those instances where the trustees are to incorporate or resettle on a head trust. The provision on the other hand **does not specify benefits; only "obtain the use of"** the capital and with this in mind it would appear possible to have incorporation/resettlement potential drafted into the trust deed since the corporation/trust is not obtaining the use of the capital as a beneficiary. It would be ludicrous to be of the opinion that the trust must keep all of its funds in a proverbial 'old sock' so as to preclude a bank from obtaining their use. Legitimate investments are obviously excluded from consideration, while so too are legitimate loans.⁷³¹ In such an instance property is not being distributed to either creditor or beneficiary whereby it is irretrievably gone but instead it is simply being altered in form.⁷³² There is no element of bounty in the arrangement.⁷³³ In the author's opinion the incorporation of the trust's property so as to give the beneficiaries extremely beneficial income participation through share structuring does not cause the Sec. 70(6)(b)(ii) provision to be offended since the beneficiaries are merely **benefitting** from the property; they are

conditions which attach to each class of shares the spousal trust of the holding company. Also we would expect to be informed as to the nature of the property underlying the common shares which are to be transferred to the holding company. Whether or not someone other than the spouse has obtained the use of any of the capital of the spousal trust during her lifetime may depend upon more than the identity of the legal owner of the common shares; accordingly we propose to express an opinion only after we have examined all of the circumstances in each particular fact situation."

730 Since the f.m.v. of the shares may be excessive when compared to that consideration given to receive them the beneficiary may realize a benefit from the arrangement **only if he disposes of the shares** and not until then. If they are mortgaged it would appear that Sec. 105(1) can apply. An alternative to an upstream hive-off would be to have the spouses enter into domestic contracts restricting post-mortem remarriage.

731. In T.I. 5-1718 of the F.I.D. provided in Aug. 1986 the Department had to address the concern of whether a power given to the spousal trustees to lend money out of the testamentary estate to any beneficiary caused the spousal trust to be tainted and whether the fact that commercial rates of interest were to be applied made any difference. It held:

"In our opinion, if the will specifically grants a power to the trustees to make loans to any beneficiary, the spousal trust would be tainted. We have considered the reasoning that if a loan is made to a beneficiary on the same commercial terms as would be offered by an arm's length commercial enterprise then that loan should not taint the spousal trust. However, in our opinion, the problem with such reasoning is in determining what constitutes "reasonable commercial terms" (e.g. security required, degree of credit limits, etc.) in the context of the non-arm's length situation which exists between a trust and its beneficiaries. If reasonable commercial terms could be defined in this context, then we submit that it would not be necessary for the beneficiary to borrow from the trust in the first place, since he could then satisfy the requirements of a commercial arm's length institution with respect to obtaining a loan. Therefore, if a loan was to be made from the trust to a beneficiary (other than the spouse) it would not, in our opinion, be at "reasonable commercial terms".

We also have considered the reasoning that, if one was to interpret subparagraph 70(6)(b)(ii) of the Act literally and, given that "person" as defined by subsection 248(1) of the Act would include a financial institution, it could be said that if the will granted the trustees the power to make any loan, including loans to a bank, then the spousal trust would be tainted. However, it is our opinion that the intent of the Act was not to so restrict the investment opportunities of a spousal trust and to interpret the legislation in this manner would be unreasonable. However, for the reasons stated above, it is our view that if a will grants the trustees of a spousal trust the power to make loans to beneficiaries of the trust (other than the spouse) or to persons related to them, then the existence of this power would taint a spousal trust."

In T.I. 5-902601 of Nov. 1990 rendered by the Business and General Division of the Rulings Directorate it was held that fees paid to trustees out of capital will not contravene the Sec. 73(1), (equivalent to 70(6)(b)(ii)) provision while fees that are deductible in computing the trust's tax income will not affect the Sec. 73(1) (or 70(6)(b)(i)) requirement.

732 See Brown and Secretary, Department of Family and Community Services [2004] AATA 48 (22 January 2004).

733 If there is an element of bounty in the arrangement allowed by the trust terms (interest free loans to related parties etc.) the legitimacy of the use of the capital may be so tarnished as to cause it to be recognized to be a use of the trust property qua beneficiary.

not **receiving** or themselves **obtaining its use** though they are obtaining the benefits of its use. The Department's position as expressed in previous pages seems to be contradictory to this. Subsection 105(1) definitely isn't precluded from applying in such a situation, however, if the dividends received on the shares are included in income that subsection can't apply to them by virtue of para. (a) therein.

In *Jenkins v. I.R.C.*⁷³⁴ the U.K. Court of Appeal had to ascertain whether a trust's income was payable to the settlor of the trust "in any circumstance whatsoever". The trust was for the exclusive benefit of his offspring while the settlor loaned the trust so funds which were to be repaid with its income. Section 38 of the Finance Act, being very broadly targeted, caught the payment of income, but Lord Greene M.R. provided a comment very applicable in respect of Sec. 73(1)-70(6) non-spousal beneficiary entitlements:

"I put to counsel for the respondents in the course of his argument another case. I said: Suppose a settlement contained a power to the trustees to purchase a dwelling house under the result the trustees entered into a contract to buy a dwelling house from the settlor himself. I asked counsel for the respondent whether in the year in which that position arose it would be time to say that **the terms of the settlement** provided for the payment to the settlor of the purchase price of that house. He, very fairly, said, and I think he was bound on his argument to say, that that would be the case. It seems to me that the language cannot, on any of the consideration, lead to any such result. **It would not be the terms of the settlement which provided for payment to the settlor; it would be the circumstances that the trustees, in pursuance of their powers, had happened to enter into a particular legal relationship which involved the payment of money and the person with whom they happened to enter into it was the settlor....**"

This dicta is, in the author's opinion, extremely relevant in respect of Sec. 75(2) as well and illustrates the issue of where the Sec. 70(6), though perhaps not 105(1), rules are not offended merely because a non-arm's-length party obtains property on perhaps favorable terms⁷³⁵.

The question of who could benefit from a spousal trust was at issue in *Peardon Estate v. M.N.R.*⁷³⁶ wherein by the terms of the taxpayer's will a trust was created whereunder the trustees had the absolute discretion of making income or capital payments to the spouse **for her maintenance** however the will did not explicitly state how any excess income that wasn't distributed was to be handled. The Minister contended that the arrangement was not "spousal" in that the payments of income and capital were left to the absolute discretion of the executors. Brule T.C.J., of the Tax Court provided that:

"The provision that income and capital be paid to the spouse in the executors' absolute discretion presents another problem. Certainly there is no concern over capital because what is not used for her maintenance will pass on her death. However the treatment of income must be looked at carefully. As mentioned above, counsel for the Appellant offered that the meaning of "entitled" in subparagraph 70(6)(b)(i) means a "claim or right", and I find no objection to this.⁷³⁷ However, the will does not say that the spouse is "entitled" to the income or capital, only that the executors "may use any part of my estate". **It does not say "all of the income"**. If the executors exercise their discretion and the wife is properly maintained the Courts presumably will not overrule their discretion as to quantum and the spouse would not be in a position to require the executors to pay her all the income if such was more than required for her proper maintenance. This principle is to be found in the case of *Re; Sayers et al.* and *Philip*, a decision of the Saskatchewan Court of Appeal found in 38 D.L.R. (3rd) 602,...In the event that the income of the trust was more than adequate for the spouses maintenance, I ask **"What would happen to the excess?"** There is no provision for **accumulation** and in the absence of such a requirement it could well be that there would be an intestacy as to the surplus. **If such were the case, perhaps the spouse would not be entitled to receive all the surplus. If not, then some other party or parties might benefit. If the testator wished his widow to receive all the income, he should have said so.**"

⁷³⁴ 1944 2 All E.R. 491

⁷³⁵ See also *Ellis and Others v. C.I.R.*, 31 T.C. 178 (CA), as to the ability to use, and *McCrone v. C.I.R.*, 44 T.C. 142.

⁷³⁶ 86 D.T.C. 1045 (TCC)

⁷³⁷ Remember this when reviewing powers of appointment and the interests that arise **upon** their exercise.

Thus the fact that the testator instilled an unrestricted discretionary power in the trustees caused the spouse to never be in the position to be entitled to receive all of the income, **accumulated or otherwise**.⁷³⁸ If the testator would have required the trustees to distribute the accumulated excess of trust law income over income applied for maintenance, every five years etc. and upon her death then in the author's opinion, even though over the short term she would not be entitled to receive due to the effect of the power, she would have been ultimately entitled to receive all of the income arising before her death.⁷³⁹

In a Technical Interpretation provided in March 1980 by the Non-Corporate Rulings Division it was held that a trust that can be wound up prior to the death of the spouse will not be a spousal trust unless the property can be distributed exclusively to the spouse. Subsection 107(4) will also be prevented from applying to such a trust on the distribution since it will not be spousal. If the trust can be dissolved with the property going exclusively to the spouse **but** she is compelled as per its terms to mortgage it and settle a trust for the immediate benefit of the offspring Sec. 70(6) and 107(2) should apply to the flow of ownership to the spouse after the death and tax consequences will not be created for any party except the spouse upon the property's disposition of course. The mortgage proceeds could also be gifted directly to the offspring or whoever else the testator directs as expressed in his will: the fact that the spouse is prevented from benefiting exhaustively as any ordinary beneficiary under the trust does not prevent the trust from being spousal. The terms of the distribution require the conferment of a benefit on the secondary offspring but the beneficiary can enforce his rights only against the spouse while since the spouse is required to mortgage the property, or any property she owns, the offspring does not have any right to receive or otherwise obtain the use of any income or capital **of the trust, only of the spouse**, and where the spouse must mortgage property **not** received from the trust, the offspring certainly can't be said to benefit in any way from the trust capital. Needless to say Sec. 105(1) may be arguably applicable in this case since the offspring is in fact realizing a benefit in respect of a trust but whether this type of benefit can be captured by Sec. 105(1) is questionable. If agreements are entered into by the spouse and offspring quite independant of the trust deed, so as to ensure that proceeds are ultimately realized by the offspring CRA can't tax what they are not aware of.

Constructive Receipt.

It is important to note that subparagraph 70(6)(b)(i) requires that she only be **entitled** to receive all of the income arising before her death, but in fact she need not in fact receive it, however **she** must be entitled **to receive** it, **and not simply have it applied for her benefit**. Paragraph 12 of I.T. 305R3 provides the Department's opinion with regard to the latter aspect being that the Department will consider that the spouse is entitled to receive all of the income even when it is to be applied indirectly for the spouse's sole benefit, however the author wonders which hat they pulled this opinion out of given that the statute provision, which is the **only** relevant authority, recognizes that she must be entitled to **receive** the income herself. If the draughtsman of the provision wanted indirect beneficial application to be treated would he not have had the Sec. 70(6)(b)(i) provision read "his spouse is entitled to, or to receive, the income..." given that this is the manner that constructive though indirectly beneficial rights are recognized under the definition of "income interest" or "capital interest" in Sec. 108(1)(e) & (c) respectively? Once the Department has finished "playing with the keys to a Pandora's box" would they be able to describe just what kind of indirect constructive distributions can be considered "used solely for the benefit of the spouse", eg; do rental payments to a retirement home at which the spouse resides receive the same treatment as payments to the spouse's offspring to maintain her at their residence(?), how about payments to them, as a function of a discretionary power, in satisfaction of their desire to have the spouse committed to an asylum which is of clear benefit to her. ...The opinion should be changed, or at least properly qualified.⁷⁴⁰

Also, **and perhaps more importantly**, if income is applied for her benefit Sec. 105(1) may be applicable,

738 See *Davies v. Perp. Trustees*, 52 C.L.R. 604.

739 This was precisely what Brule was getting at when he questioned the destination of accumulated income. In this case a son was renting trust property for close to fair market value consideration and was found not to be deriving a benefit from the trust within the Sec. 70(6) context.

740. In June 1983 in T.I. A-8234 the Non-Corporate Rulings Division held essentially that indirect application of income, in a spouse beneficiary bankruptcy situation, though for her benefit did not qualify a spousal trust when the income could not be paid to her as per the trust deed.

(unless she's non-resident), so as to cause a full income inclusion rather than Sec. 104(13)-(6). In such an instance double taxation of the income applied would result. If the trust deed specifies that property is to be maintained with income of the trust the type of income should be specified to mean only that which isn't trust law income in that if not the spouse obviously won't have a right to all of the trust's income. If the trust deed specifies that property is to be maintained with income from the trust the type of income should be specified to mean only that that isn't trust law income in that if not the spouse obviously won't be entitled to receive all of the trust's income.

The Spouse as Trustee.

In *Bouck v. M.N.R.*⁷⁴¹ a testator provided in his will that the net revenue from the estate was to be paid to an income account, to which his spouse had access and that "the monies to the credit of the said account shall be under the sole control of my wife **to be used** by her to maintain a home for herself **and** my children, for the maintenance of my wife **and** my children, for the proper education of my children **and otherwise** for the benefit of my wife **and** my children **as my wife in her sole discretion may from time to time determine.**"

The widow, in one of the subsequent years, apportioned, for reporting purposes, the amount of income drained from the "income account" between the offspring (2) and herself however the Minister contended that it was all hers in that it came under her "sole control" while the Supreme Court of Canada held:

"Where, as in the case at bar, income is placed under the control of a wife and mother for the benefit of herself and children, **she being under obligation so to apply it, it would appear to be a contradiction in terms to say that her interest is absolute**, and yet that, while her discretion will not be interfered with so long as it is being exercised **bona fide**, the court will interfere where she is not acting properly in the application of the income, or where the creditors intervene for the purpose of seizing it. ...I think equally, in the present case, that the wife, being **obligated** to apply the income needed for the benefit **not only of herself but also for the children**, although her discretion is absolute, as was that in the case just sighted, has an interest limited to **that which she appropriates for herself**, and the children become entitled to the remainder in the proportions she from time to time determines."

Although the spouse in this case did act under an obligation she did not act as a trustee of the income made available to her while it should be recognized just from the manner in which the Kellock, J., described the spouse's obligation that the court could jump in if the discretionary power is not exercised and maintenance isn't given to the children whereby they would uphold the offspring's' rights to be maintained, at some level of comfort, thus clearly the offspring had a right to the use of the trust income. The "give away" in effect that caused the children to have rights to the income was that the spouse was to use the proceeds in the income account for **explicitly her and their benefit**, and especially for their education. She could not in fact empty the income account and go for a cruise around the world or, even more restricted, purchase investment property, since the funds were to be used primarily to **maintain** the home and the family, and provide education. In such a case Sec. 70(6) could not apply since parties other than the spouse could receive the income of the trust **as beneficiaries**.

In *Tetreault Estate v. M.N.R.*⁷⁴² the spouse received a bequest of the whole of the testator's estate however the will declared that she was to undertake the instruction, education and care of the offspring of the marriage. The wife contended that the estate had indefeasibly invested in her while the Tax Review Board (Lucien Cardin Q.C.) held that the property had not vested indefeasibly in her in that she was to fulfill the condition of the bequest being the instruction, education, etc., before she could be considered to have received the estate indefeasibly. In *Clouston v. M.N.R.*⁷⁴³ the spouse was to receive as a bequest the sum of \$9,600 per year from the estate but that the child, D.G. Clouston, was to be provided for in respect of pursuing education by a charge on the yearly sum. The will explicitly stated that:

"The foregoing provisions for my wife, **however, to be charged with the support, maintenance**

741. 52 D.T.C. 1090 (SCC)

742 73 D.T.C. 61 (TRB)

743 74 D.T.C. 1176 (TRB)

and education of my daughter, Diana Gertrude, in such manner as shall in the opinion of my executors and trustees be commensurate with her station in life... I direct that the annual income to be paid to my wife be supplemented by such amounts as may be **required to enable my daughter, D.G., to pursue her education...**"

Roland St. Onge Q.C. of the Tax Review Board found quite correctly that:

"I am certain that in the case of failure on the mother to maintain her child, the latter would have a right of action against the mother **and the estate** to obtain the necessary funds from the estate to provide for her education... Consequently this case is subject to a charge which allows a person other than the spouse to obtain, before the death of the spouse, any of the income from the settlement."

Thus due to the fact that the spouse could be regarded as a conduit through which the daughter had a choice in action **against the estate**, the trust was tainted in that the child could lay claim as a beneficiary, and have it administered favourably. Where there isn't a connection between the providing of support to the child and the exclusive entitlement of the spouse to receive all of the income of the trust it cannot be considered tainted on the above grounds.⁷⁴⁴ Where the **trust deed/will** does not attach an obligation/condition to the spouse's undivided interest then the trust/will can be read as being spousal for purposes of the ITA even though the spouse and offspring could have been parties to a domestic contract drawn up between the two, one to provide maintenance, education, etc. for the other, prior to the death/writing of the will/trust deed. If the trust deed/will doesn't make any reference to the domestic contract (ie; spouse's interest conditional upon its performance), regardless of whether the domestic contract makes any reference to the possible estate the estate can only be held to be spousal if the testator dictates that all of the income shall solely be paid to the spouse to see as she sees fit, and in arranging the circumstance this way the testator, with a bit of planning, can insure that the obvious result occurs. On the basis described in *Mr. Lucky v. M.N.R.* the arrangement will be de hors the trust arrangement and not caught by it. (In effect, the arrangement works on the principle that the offspring has a right against the spouse only, and not the trust.) If a spouse's interest in the income of the spousal trust is to be contingent upon her extinguishing an initial equitable charge then such a contingency should terminate within 36 months after the death so as to allow the spousal trust roll-over to apply. If the equitable charge is not fulfilled the trustees could be compelled to incorporate income producing property held, maintain the shares in the spousal trust, and thus control the amount of income that the trust receives and thus spouse is entitled to, and still allow the Sec. 70(6) roll-over to apply. If the equitable charge is fulfilled within the 36 months then incorporation will be restricted and the spouse's income rights will be resultantly increased in scope. (The offspring could be granted options to acquire the shares.) In either case in order to allow Sec. 70(6) to apply she must be entitled to receive the income from the trust that was realized in the contingency period.

One can structure testamentary or *inter vivos* trust income interests so as to create sub-trusts with respect to the application of the income of the head trust and still allow a spouse or settlor to control the income in the capacity of a trustee. The *Countess of Bective v. F.C.T.*⁷⁴⁵ illustrates four different situations and approaches taken by the courts of Australia in respect of income interests in head trusts primarily granted to spouses etc. though subject to the requirement that the income beneficiary use the income to maintain offspring. Dixon J. cited four different approaches in this case practically identical to *Bouck v. M.N.R.* where:

- "(1) The expression of purpose may be taken as but a statement of the donor's motive or of his expectation. If so, the first person takes the gift absolutely and incurs no legal or equitable obligation to fulfill the purpose.
- (2) The purpose may be so stated as to amount to a condition upon and subject to which the first person takes the gift beneficially. By accepting it the donee incurs an equitable duty to perform the condition which is annexed to the gift.
- (3) The first person may take the gift beneficially, but the statement of the purpose, particularly if it involves the payment of money, may operate as an equitable charge thereon in favour of the

⁷⁴⁴ See *Green & Anor. v. Commr. of S.D.(NSW)*, 85 A.T.C. 4229 (SCNSW), for some issues of interests in estates retained upon conveyance.

⁷⁴⁵ 1932 47 C.L.R. 417 (HCA)

other or others. Bequests and devises to parents for maintenance and benefit of their children are from their very nature peculiarly susceptible of this interpretation.

- (4) The direction to pay the first person may be regarded as conferring no beneficial interest upon him, and, whether he receives it strictly in the character of a trustee or in some other character such as guardian, the expression of the purpose may amount to a statement of objects to which he is bound to apply the fund."

The case goes on into depth in analyzing the approaches and how they arise however the judge provided generally:

"But an obligation to apply moneys in the maintenance of children or others does not involve the liability which arises from an ordinary trust. It is a general rule that guardians of infants, committees of the person of lunatics, and others who are entrusted with funds to be expended in the maintenance and support of persons under their care are not liable to account as trustees. They need not vouch the items of their expenditure, and, if they fulfill the obligation of maintenance in a manner commensurate with the income available to them for the purpose, an account will not be taken. Often the person to be maintained is a member of a family enjoying the advantages of a common establishment; always the end in view is to supply the daily wants of an individual, to provide for his comfort, edification and amusement, and to promote his happiness. It would defeat the very purpose for which the fund is provided, if its administration were to be hampered by the necessity of identifying, distinguishing, apportioning and recording every item of expenditure and vindicating its propriety. Although these considerations furnish an independent foundation for the general rule, yet, after all, it is a doctrine regulating the application of moneys payable under an instrument, whether a will, a settlement or an order of a Court of equity, and the operation of the doctrine must depend upon the provisions contained in the instrument, both express and implied. **But the effect of the instrument will often be governed by the circumstances to which it was intended to apply, and, in particular, by a consideration of the nature of the actual abode, the condition of the household and the state of the family of the infant or other person to be maintained. Courts of equity have not disguised the fact that the general rule gives to a parent or guardian dispensing the fund an opportunity of gaining incidental benefits, but the nature and extent of the advantages permitted must depend peculiarly upon the intention ascribed to the instrument.**"⁷⁴⁶

Without going into in detail it is thus possible to have a secondary bequest be subject to a trust where the intermediary person acts as trustee providing the terms of the bequest are drawn up showing the intention of such. In *Bective* the court provided that the settlor's intention can be ascertained by measuring the extent of the intermediary's right to the use of the receipt, how the ultimate recipient is described, and if and how the intermediary's involvement terminates upon the occurrence of certain events and whether he has alternate interests. Obviously one would not want this to occur if the Sec. 70(6) roll-through provision is wished to be accessed since it doesn't apply to spousal recipients receiving in the capacity of a trustee.^{747, 748}

A testator can ensure that his offspring and spouse are provided for if he transfers all of his property to a spousal trust upon death if he has directed the trustees to incorporate the property if the spouse does not agree to vary the trust to accelerate the offspring's' interests. A disposal by her of her income interest will not produce major tax consequences if the directions call for capitalization of earnings rather than distribution to the trust.

⁷⁴⁶ See *Mclsaac v. Beaton*, 1906 37 S.C.R. 143, and *Shearer v. Hogg*, 46 S.C.R. 492, for related jurisprudence on the extent of personal gifts taken in spousal testamentary situations. Maintenance payments made to spouses *inter vivos* in respect of providing support for children do not create a trust nor does the offspring gain equitable interests: *Stevens v. Tirard*, 1939 4 All E.R. 186.

⁷⁴⁷ See also *Re: Crepeau*, 23 Sask. R. 170, for an example where a trust was recognized to exist in a situation similar to *Tetreault Estate* as well as *Howey v. Commr.*, 44 C.L.R. 289, & *Manning v. F.C.T.*, 40 C.L.R. 506. In *Case Q3*, 83 A.T.C. 7, the Aust. Bd. of Review held that a mother receiving a pension "in respect of" her children did not receive as trustee for them on account of the scheme of the pension legislation and use of the diction therein.

⁷⁴⁸ See also "Noik v. Noik Estate: A Case Note - Trust, Conditional Gift, Charge and Personal Obligation", *Donovan Waters, Q. C.*, *Estates, Trusts and Pensions*, Vol. 28, Pg. 88 for additional notes on another Cdn. case.

Indirect Receipt of Capital.

The second major spousal trust condition described under para. 70(6)(b)(ii) or 73(1)(c)(ii) is that no person except the spouse may before her death "receive or otherwise **obtain the use of** any of the income or capital **of the trust...**" however the provision does not preclude other individuals from benefitting from the trust income or capital without receiving or obtaining the use **of it**. If a remainderman has a capital interest that is enforceable against the specific amount of capital, that will exist, after the death of the spouse would he be using or receiving the trust capital or income if he were to receive a loan "collateralized" on the interest or sold the interest outright, or would he be receiving the benefit from the holding of the legal title to the equitable title to the capital? The key to the fact that, in the author's opinion, a taxpayer isn't receiving or otherwise obtaining the use of trust income or capital when he sells or mortgages his capital interest is that he has not **indirectly** obtained the use of any income or capital of the trust nor does the provision speak of receiving benefits from the income or capital's **substitute** property⁷⁴⁹. If the provision read, "...received or obtained the use of any of the trust income or capital, directly or indirectly, by means of a trust or by any other means whatsoever..." as the scope or the attribution provisions is termed then the ability to sell or mortgage the interest could not be seen as satisfying the conditions. If the provision read "...received or obtained the use of, indirectly or directly, any of the trustees income or capital, or any substitute property therefore..." then the ability to sell or mortgage the capital interest would definitely taint the trust at its creation. Thus, presently, the taxpayer can mortgage his interest and receive a benefit which he would not be able to otherwise receive from the trust (unless it was varied). To think otherwise would be to contend that Parliament wished testators to impose alienation restraints on the interests in spousal trusts created under their wills; a ridiculous idea.

The provision also does not specify how the other taxpayer can obtain the use of the capital of the trust although in the author's opinion interest free loans could constitute a benefit within the context. Does this require the initial trust deed to expressly preclude the extending of interest free loans to the non-spousal beneficiaries, even though none are initially contemplated? The benefit from the use of the capital and obtaining its use directly should not be confused. If the trust is to insure the life of one of its beneficiaries the beneficiary has not obtained the use of the trust's capital though his spouse will have realized a benefit if she is to be the proceeds recipient. Interest free loans to a beneficiary's holding corporation **may eventually** constitute a benefit for purposes of Sec. 105(1) but the beneficiary hasn't obtained the use of the trust's capital. **The provision targets the receipt of the use of the trust capital or income, not benefits from its use.** In *Peardon v. M.N.R.*⁷⁵⁰ an offspring was allowed the use of trust property, a dwelling, that was made available to him as a consequence of his renting accompanying land. The Tax Court didn't find this to offend the Sec. 70(6)(b)(ii) requirements but in that same case the trustees could allow certain other specified parties to use trust property gratuitously and on those grounds the provision was violated; other parties **could** obtain the use of the trust property.

Powers of Encroachment/Advancement/Appointment in Respect of Access to Capital.

A testator would want to ensure that the ability of the executors/trustees to use a power of appointment, advancement, maintenance, or encroachment instilled in them to redirect the benefits of a spousal trust away from the spouse during her life is limited following *Terrill Estate v. M.N.R.*⁷⁵¹ whereunder the deceased provided that the trustees could exercise powers of encroachment so as to pay capital to the present income beneficiary, while he also provided that the trustees were to pay the net annual income derived from the trust to the spouse until her death, while until that time the son and all the other beneficiaries would not be entitled to revenue from the estate. The Minister denied the application of Sec. 70(6)(b) to the arrangement on the

749 See the House of Lords decision in *Ingram* [2000] 1 AC 293. Lord Hoffman at page 304 said:

".... 'property' in section 102 is not something which has physical existence like a house but a specific interest in that property, a legal construct, **which can coexist with other interests in the same physical object. Section 102 does not therefore prevent people from deriving benefit from the object in which they have given away an interest. It applies only when they derive the benefit from that interest.**"

750. 86 D.T.C. 1045

751. 87 D.T.C. 504 (TCC)

grounds that the will stated that the trustees and executors "shall **always** have the right to draw and encroach upon the capital of my estate for the benefit of my wife and son" and with that counsel contended that if the executors **always** have the right to **encroach** on capital for the benefit of the son, then they could do so when the spouse-mother was alive. Tremblay T.C.J. of the Tax Court of Canada held:

"However, it is while the executors are paying income to the wife, the son, or someone else, ("while they are paying revenues to..."), (as per the trust deed), that the encroachment on the capital can take place but "for the benefit of" the beneficiary, the wife or the son. Knowing that Terrill, Jr. cannot be a beneficiary (income) until after his mother died (clause b), it seems obvious to me that the testator's intention was to follow the logical order established by clauses 6a and 6b as argued by counsel for the appellant." "The word "always" must be interpreted as meaning at any time, for the benefit of a beneficiary, **during the period in which he is entitled to the income.**"

Powers of encroachment operate only in respect of an income beneficiary who is entitled, **at the time** to income while a power of advancement may be exercised with respect to future or contingent capital beneficiaries whose entitlements have not become immediately enforceable, however the Sec. 70(6)(b)(ii) provision explicitly precludes trusts whereunder anyone other than the spouse **may** receive or obtain the use of any of the capital or income hence if the above case was based on a power of advancement or appointment the executors would have surely failed in their argument.⁷⁵² It's of paramount importance when drafting the testamentary spousal trust terms to place restrictions on any powers of appointment, advancement or maintenance by prohibiting their exercise before the death of the spouse. This applies regardless of if power holder is the spouse herself or not.⁷⁵³

Poor Drafting.

Simple failures to draft a concise and accurate will/trust deed can cause serious problems as well. In Johnson Estate v. M.N.R.⁷⁵⁴ the testator set up a trust fund whereby \$600 was to be paid to the spouse per month from the income of the fund and if the trust revenue was insufficient for these purposes the trustees could draw on capital. Unfortunately the testator also expressed that in setting up **the same fund** upon which the spouse's income was to be earned "there shall be added thereto a sufficient sum to provide for education at university or school of post secondary education for" his sons and that "pending the utilization of such monies same shall be invested and reinvested and the income shall be added to the capital of the said Fund," being a **singular trust**. J.B. Goetz of the Tax Review Board found that:

"Trust Fund #1 for E.M. Johnson (the spouse) was subject, unfortunately, to other persons, namely N. Johnson and J. Johnson(sons), to make claims against the fund **during** E.M. Johnson's lifetime and during the life of Fund #1. The trust then, is subject to the encumbrance which allows others other than the spouse to obtain, before the death of the spouse, a portion of the capital or income from the Fund."

In Matson Estate v. M.N.R.⁷⁵⁵ the entitlement of the spouse to all of the income of a **singular** testamentary trust wherein **two** indefeasible life interests existed, (one for the payment to the widow of a fixed amount of income and the remaining amount of income after the testator's former initial spouse received a monthly payment of \$50.00 from the trust and another equivalent amount from the estate), was at issue. The Minister successfully convinced A.J. Frost of the Tax Appeal Board that the widow spouse was not entitled to receive all of the income of the singular trust in that payments were to be made from it to the former spouse (\$50.00) and thus the trust did not qualify for Sec. 7(1)(b) treatment under the E.T.A.. If the testator had set up two trusts, one for each of the income beneficiaries there would not have been a taint of the spousal one, and in this respect one should proceed cautiously when laying out beneficiary trust relationships in a testamentary document.

In Machacek Estate v. M.N.R.⁷⁵⁶ a testator provided that his estate was to be held on trust for his wife and

⁷⁵² Though see Re: Henderson's Trusts, 1969 3 All E.R. 769 (CA).

⁷⁵³ See also A.N. Gilbert v. M.N.R., 83 D.T.C. 645.

⁷⁵⁴ 82 D.T.C. 1381 (TRB)

⁷⁵⁵ 71 D.T.C. 504 (TAB)

⁷⁵⁶ 76 D.T.C. 1023 (TRB)

offspring whereby the spouse was to receive all of its income while he also gave the trustees the discretionary power to advance/encroach on capital **or income** for the maintenance education and benefit of the offspring. He also gave the trustees the power to determine the nature of any particular receipt, (as being either income or capital), and when the trustees attempted to secure the application of Sec. 7(1)(b) of the old E.T.A., (substantially similar, in respect of spousal trusts, to Sec. 70(6) of the ITA), the Minister understandably refused it on the grounds that the spouse's interest in the trust was not absolute and indefeasible. The Tax Review Board found, agreeing with Judge Flanigan in *Kamichik Estate v. M.N.R.*⁷⁵⁷ that:

"An encroachment clause for the benefit of children must impose more than a moral obligation to do what a natural parent would do for his children. I fully agree with Judge Flanigan that clauses of this nature do not detract from an otherwise indefeasible settlement under paragraph 7(1)(b) of the Act. In the case at bar, the words used - "for the advancement, maintenance, education or benefit of any infant." - are little more than a suggestion to look after the children in a natural way, and cannot be considered to deprive the widow of a tax benefit simply because they happened to be used in the will."

In the author's opinion, as an example of determining whether the estate had vested indefeasibly in the trust or spouse, this conclusion is wrong, and if as an example of determining whether anyone can obtain or use any capital of the trust prior to the spouse's death the conclusion is even more so wrong. Clearly, **as a question of fact**, the children **could** receive trust property, (capital or income), before the spouse's death, **as beneficiaries**, regardless of the reason. Clearly both vesting of interest was defeasible and potential benefits to beneficiaries prior to the widow's death were not limited to being received exclusively by her. If "push came to shove", and the children were not properly maintained or provided for, "in a natural way", they could have their rights to such upheld in court.⁷⁵⁸ In the above case, if as a question of form, the testator had not had in mind the support of offspring why did he not simply bequeath the funds to the parties instead of tagging on "the suggestion" of what would "naturally" follow. The trustees were given special powers to exercise in the case that the spouse did not act properly in respect of the offspring but this doesn't necessarily imply that the offspring did not have recourse even if the power was not exercised. If the power wasn't exercised, and it was obvious that the offspring were not being properly maintained or educated the courts could be used to order that the power be exercised for its intended purpose.⁷⁵⁹

In *The Queen v. Hewitt Estate*⁷⁶⁰ the trustees of a testamentary spousal trust were given the discretionary power of deciding whether to utilize income earned to sustain the trust's business operations and to pay the balance over to the widow. Essentially they could decide what the business's needed in terms of reinvested earnings while the surplus was to be paid to the spouse. The trustees applied for Sec. 7(1)(b) treatment under the E.T.A. and the Minister denied its applicability. No business activities were carried on by the trust since the testator had disposed of all of his business interests prior to death hence the discretionary power allowed to the trustees to reinvest earnings was of no effect and unexercisable. The wife was entitled, in fact, to all of the earnings.

Timing of Vesting.

In order for subsection 70(6) to apply to particular property it must be shown within a period ending 36 months after the death or longer if written application to the Minister in that period has been accepted to allow an extension, that the property has become vested indefeasibly in the spouse or the trust as the case may be and the 36 month plus period **usually** gives the executors plenty of time to wind-up the estate and have any

⁷⁵⁷ 73 D.T.C. 177

⁷⁵⁸ if the encroachment power was in the nature of a trust power

⁷⁵⁹ This was of issue in *Singer v. Singer*, (1915), 33 O.L.R. 602, Re: Blow, 1977 18 O.R. 516. See also *Schipper v. Guaranty Trust*, 1989 69 O.R. 386 (CA), where a spousal power was ordered exercised and it was held:

"We recognize that the court will generally refuse to interfere with the "uncontrolled" discretion of a trustee, where the trustee is acting bona fide. However, in our opinion, the court is entitled to interfere where the trustee is attempting to exercise its discretion to achieve a purpose not intended under the terms of the trust."

Even if the trustees could not be compelled to exercise the power of encroachment they **could** voluntarily before the death of the spouse. See "Control of Trustee Discretions", Parry, *The Conveyancer*, 1989 pg. 244 for more detail.

⁷⁶⁰ 78 D.T.C. 6123

spin-off trusts properly constituted. It must be shown to the Minister, if need be, through the appropriate documentation or legal implications that the property has vested indefeasibly within that 36 month period regardless of whether the actual conveyancing of legal title has occurred.⁷⁶¹ The timing of the vesting is critical in that the executors don't have to show proof **immediately** upon obtaining it that the indefeasible vesting has occurred, which allows them time to adjust the inheritance to take better advantage of the favorable ITA testamentary provisions while on the other hand they must be **able to do so** within the 36 months or extended period. The Minister will extend the vesting period to an amount that considers "reasonable" if properly informed in advance.

The timing of the indefeasible vesting was of critical issue in *Hillis Estate v. The Queen*⁷⁶² where two and one-half years after the date of death the totality of the estate finally became vested indefeasibly in the widow but only after the then statutorily recognized 15 month time limit had lapsed and the sons of the testator had disclaimed their interest therein and the spouse had obtained a vesting order under the Saskatchewan Dependents' Relief Act. W. Hillis died on February 21st, 1977. On June 15th 1979 one son disclaimed his interest in the estate and on July 4th of the same year the other son did the same. On Nov. 29th, 1979 the spouse applied under the province's Dependents' Relief Act for an order granting the entire estate to her and on Dec. 14th, 1979 she received that order. Since Mr. Hillis had died intestate the two previous disclaimers by the son resulted in their share remaining subject to the Intestate Succession Act whereafter application under the province's Dependant's Relief Act was made to vest the balance of the estate in the spouse. The order resulting under the D.R.A. deemed the balance to have been vested in the spouse from the time immediately after death thus allowing the condition in Sec. 70(6) to be satisfied, even though the arrangements were finally concluded **29 months after the death**. Smith, D.J. of the Federal Court-Trial Division had few problems in finding the "appropriate conclusion" however he did consider one aspect of the case as such:

"The only ground of explanation for the delay in this case is that for a long time no lawyer was engaged to look after the legal steps of administering the estate. All such matters were left in the hands of an accountant who it seems did practically nothing.

...
In my view the foregoing explanation for the long delay which occurred in this case cannot be considered to be reasonable justification for that delay... The administrators probably were not aware of, or at least not well informed about the terms of Sec. 70(6) of the Income Tax Act particularly the conditions laid down in the last four lines thereof, but if so, ignorance of the law is not an excuse for the long delay that occurred... From the evidence I can see no reason why the estate could not easily have been fully administered and wound up within six or seven months following the death of the deceased. The administrators were entitled to wait for a reasonable period of time to permit the accountant, on whom they relied, to get on with the administration, but to allow matters to drag on for well over two years without any progress being shown, requires, in my opinion, much better grounds of justification than have been expressed here."

The application of Sec. 70(6) was not available to the executors through the Trial Division hence they took the issue to the Appeal Division⁷⁶³ where three justices provided varying opinions on the matter.

Clement D.J. provided with respect to the ability of the taxpayer to establish vesting:

"In this context, the verb "can" takes the meaning of "be able to". In effect the spouse must be able to establish that **in law** in the circumstances of the case the property vested indefeasibly in her within the prescribed 15 months. **In the whole of the context it is clear that it is not necessary that actual conveyance of the property to her shall have been completed within that time; if she makes the required proof, then in law the conveyancing must follow as a matter of course and of right.** This interpretation affords an intelligible reconciliation of the phrase with

761. The extension to the time period is in respect of the providing of proof that vesting has occurred within the 36 months and apparently in respect of actual vesting the 36 month period cannot be extended. (Memo from Non-Corporate Rulings Division to Audit Programming Division Nov. 1981)

762 82 D.T.C. 6249 (FCTD)

763 83 D.T.C. 5365

the preceding phrase which speaks of property that has on or after the death been transferred or distributed: it gives some recognition to the difficulties and complexities attendant in some cases on the due administration and distribution of estate and which may have to be resolved, particularly when the construction and operation of the will is contested, before distribution can be made. Then when necessary, the provision for the enlargement at the time may be invoked. If the circumstances warrant it, the required proof may be made within a reasonable time after the lapse of the prescribed 15 months whether or not conveyancing has been completed."

Following this he made a somewhat obvious comment concerning the retroactive application of the Intestate Succession Act (of Saskatchewan):

"In my opinion the provisions (of the Succession Act) came into operation upon the death of the intestate and effect an indefeasible vesting in the beneficiary of the interest (in the estate) provided to which the administration must give effect albeit subject to dealings with the vested interest by the beneficiary. In this view, the vesting of the interest is not dependent upon an order of the court granting administration of the intestate's estate; it takes place by force of imperative statutory provision operating at the moment of death of the intestate."

As per the Dependant's Relief Act he provided:

"It does not have force until an application for relief is made by or on behalf of a dependent, and then only for the purposes of the statute which **cannot** include federal income tax. And by S. 14(1) it is not until an order is made that the fictional will, modified as to the court may seem proper in the circumstances having regard to the purposes and directive of the statute, is to have effect. Then the deemed will is deemed to have effect from the date of death of the intestate. These provisions are stated to be for all purposes but obviously that can mean only for all provincial purposes..."

"Beyond this it may be observed that there was no certainty within the 15 month period that any part of the estate, beyond that already vested in her by the Intestate Succession Act, would be the subject of a relief order nor what terms the court might impose. During that period the sons had not disclaimed and the disclaimers do not appear to have been brought to the attention of the court making the relief order..."

"There is no justification or need to assign to these disclaimers a retrospective operation, they took effect in reality upon their execution which was posterior to the prescribed 15 month period. The effect, in my view, was an accretion to the interest of the spouse of whatever net estate might then be left, but at a time when the spouses right to relief from tax had crystallized under the provisions of the Intestate Succession Act."⁷⁶⁴

As a conclusion he provided that part of the property of the estate did vest indefeasibly in the spouse, being the part which vested indefeasibly in her only as a result of the operation of the Intestate Succession Act. As a closing comment the reasonableness of the time taken for the proper effects of the relevant Acts to be felt were analyzed:

"The purpose of Sec. 70(6) is to give a measure of tax relief to the surviving spouse of a family unit. This is laudable. One can well understand the reasons and motive that moved Parliament to its enactment. They set the spouse apart from the commercial aspects of the tax. **What is enacted is a remission of tax burdens arising on the death of a taxpayer that would otherwise fall upon a surviving spouse. She (or he) is to be helped. The enlargement of time jurisdiction should be given a generous operation so that this purpose is not lightly defeated; it should not be construed stringently and unsympathetically to the purpose. The result of the enlargement is no more to enable the spouse to obtain the same tax relief which was available to her in the beginning. Nothing new, nothing offensive to the intent of Parliament. The time limit for establishing the case for relief is no doubt a departmental concern in bringing it to finality, but Parliament has recognized that there are cases in**

⁷⁶⁴ This was also the basis of an opinion (5-0051) provided in Jan. 1981 by the Non-Corporate Rulings Division to the Audit Programs Division Technical Applications Section. Indefeasible vesting can't occur until the disclaimers are made.

which 15 months (or 36) is inadequate."

Although the vesting period has been extended to 36 months since this case was heard the opinion of Clement D.J. could still hold.

Pratte J. came to a completely different conclusion based on the mere technicalities of the case being his basis of analysis concentrated practically exclusively on whether the evidence could be provided by the spouse within the period that could prove that indefeasible vesting had occurred.

"I will assume for the sake of discussion, that the order and the disclaimers had the effect of vesting indefeasibly the properties here in question in Mrs. Hillis; I will also assume that, underlying the law of Saskatchewan, the disclaimers as well as the order may under the Dependant's Relief Act had a retroactive effect to the date of Mr. Hillis' death. On the basis of these two assumptions, when did the estate become indefeasibly vested in Mrs. Hillis? In my view, when the disclaimers were executed and when the order was pronounced since the effects of the disclaimers and the court order, **in spite of their retroactivity**, did not exist as long as the disclaimers were not executed and the court order was not pronounced. **It is only when the disclaimers were executed and the Court order was pronounced that Mrs. Hillis became entitled to the whole of her husband's estate with retroactive effect to the date of his death.** If therefore, the disclaimers and the Court order had, as contended by the Appellants, the effect of vesting the estate in Mrs. Hillis, **that effect did not take place within the 15 months after the death of Mr. Hillis.**"⁷⁶⁵

Concerning the estate rights of the spouse and their necessary character he held:

"...it is necessary to bear in mind that subsection 70(6) applies when some particular properties of the kind described in the subsection have been transferred to a widow as a consequence of her husband's death, if those properties become vested indefeasible in the widow within the 15 months of the death of the husband. In order for subsection 70(6) to apply, therefore, the widow must, within the 15 months, have become vested indefeasibly with the properties that were later transferred to her; it is not sufficient for the wife to have acquired, within the time prescribed, rights in the estate of her husband...**From the mere fact, therefore, that Mrs. Hillis, on the death of her husband, acquired rights under the Intestate Succession Act, it cannot be inferred that she, thereby, became vested indefeasibly with the properties that were later transferred to her.**"

Pratte J. would have dismissed the appeal therefore entirely on those grounds.

Herald J., provided:

"I agree with appellant's counsel that the wording of subsection 70(6) of the Income Tax Act contemplates the disposition of property other than by will, as well as by will, since it deals with the transfer or distribution of property after the death of a taxpayer, and "...as a consequence thereof...". This wording in my view makes it clear that Parliament contemplated that the law of the provinces in respect of the disposition of property on or after death, being matters relating to property and civil rights, would apply so as to control the application of subsection 70(6) in accordance with the law of the particular province concerned."

He then went on to provide that since this aspect was implicit in the provision and since the antedating effect of the Court order under Dependant's Relief Act was such as to cause the property to be deemed vested indefeasibly the day after death in the spouse, then for purposes of Sec. 70(6) it would hold. In a particularly valid comment he held:

"If the indefeasible vesting required for the application of the subsection 70(6) exemption is to be effective only from the date of an order made under the Dependant's Relief Act...or the parallel legislation in effect in most of the other provinces, then a widow in the position of this widow, for whose maintenance reasonable provision has not been made, either because of intestacy or because of inadequate provision in the taxpayer's will will stand in jeopardy of losing the benefit

⁷⁶⁵ See Off. Rec. in Bank. v. Schultz & Ors., 170 C.L.R. 307 HCA, for a discussion of retroactivity of court orders made under widow maintenance provisions.

of an exempting provision which Parliament, in my view, clearly intended to provide to persons in her circumstances."⁷⁶⁶

In respect of the reasonableness of the time period after the death in which the widow took to ascertain her rights he provided:

"The evidence clearly discloses that the widow first saw a lawyer in the fall of 1979 and only then became aware of her rights under the Dependant's Relief Act as a result of which the application under the Act was commenced on November 29th, 1979. In my view of this fact and the fact that prior to 1979, the administration of the estate was handled by an accountant, rather than by a solicitor, and that long delays occurred through his unsatisfactory handling of these matters, I think the conclusion reached by the Trial Judge *supra* was not reasonably opened to him on the evidence, particularly when the totality of that evidence is viewed from the perspective of the reasonableness of the delay."

Herald, J., thus would have allowed the entirety of the estate to qualify for the Sec. 70(6) exemption on the grounds that it had "vested indefeasibly" in the spouse on death. The Court however, taking the moderate approach, which was significantly influenced by the fact that the disclaimers of the sons were executed after the vesting period, allowed only the one third portion of the estate to be considered vested indefeasibly in her within the 15 month period, that part which was so regardless of the disclaimers and court order. It must be recognized that the Dependant's Relief Act court order could almost be considered as a sham transaction in this case since the sons had already disclaimed their interest allowing the whole of the estate to fall to the spouse regardless. Its only effect was to have such vesting be considered under provincial law to have occurred within the 15 month period. If the sons had disclaimed **within** the 15 month period the case wouldn't have had to go to the lengths it did simply due to the fact that the indefeasible vesting would have occurred within the prescribed time.⁷⁶⁷

Under numerous provincial Intestate Succession Acts rights to various amounts **of the value of an estate** that is intestate vest in the spouse or offspring from the time of death (**but not particular property**) while orders made pursuant to a Dependant's Relief Act/Testator's Family Maintenance Act may allow vesting of property to be recognized as from the time of death while in the case of Estate Administration Acts property vests in the personal representatives as trustees for persons by law beneficially entitled thereto however in the latter case beneficially interested parties need not have rights to the estate property in specie. Instead the testator may have bequeathed the residue of his estate, and allowed the executor a power of sale so as to generate funds to satisfy debt. In the case of the Intestate Succession Acts one should refer to Pratte J.'s comment in *Hillis v. M.N.R.*, concerning vesting of property in specie:

"Under the Intestate Succession Act, Mrs. Hillis became entitled, on the death of her husband, to a sum of \$10,000 and to one third of the **residue** of his estate. However, all the property of the deceased devolved and was vested in his personal representative. As Mrs. Hillis's rights under the Intestate Succession Act were merely rights to a sum of money and to a share of the **residue**, she had no specific interest in any of the property comprising in the estate **until that residue had been ascertained** in the due course of administration. From the mere fact, therefore, that Mrs. Hillis, on the death of her husband, acquired rights under the Intestate Succession Act, it cannot be inferred that she, thereby, became vested indefeasibly with the properties that were later transferred to her."

In instances where the provincial Intestate Succession Acts, Dependant's Relief Acts, Testator's Family Maintenance Acts, are not relevant, and the Estate Administration Acts and Trustees Acts are, it would appear that vesting of property of the residue is put off until after the residue has been ascertained as per the reasoning in *ex. parte Barnardo's Homes National Incorporated Association*⁷⁶⁸ and vesting of interest **in specie** does not

⁷⁶⁶ This comment is particularly relevant in the author's opinion and its substance may have led to the extension of the vesting period to 36 months after death.

⁷⁶⁷ In a Technical Interpretation rendered in July 1984 the Non-Corporate Rulings Directorate provided that when an application is made under a Dependant's Relief Act within the 15 month (36 mth. now) period but the vesting isn't awarded until after that time the roll-over isn't available.

⁷⁶⁸ 7 T.C. 646

arise until that time as well. Pratte J.'s comments are thus equally relevant to residuary gifts. Until the residue is ascertained (or ascertainable) there would appear to be grounds to contend that title to any particular property has not been indefeasibly vested in the beneficiary **in law** since in law the personal representative could liquidate the property to cover estate debt.

A lot of arguments in *Hillis Estate v. The Queen* would also be relevant where a special power of appointment is exercised by any person to vest indefeasibly in the spouse estate property that was otherwise not so vested, outside of the vesting period. The results of a special power exercise would stand as being derived as per the terms of the will since the effects of the special power are to be "read into" the will however if such an exercise takes place **after** the 36 month vesting period it could quite easily be argued, as per the reasoning of Pratte J. in *Hillis Estate*, that the vesting could not be shown to have occurred within the 36 month period.⁷⁶⁹ It is also essential that powers capable of divesting the estate property from the spouse/spousal estate be shown to have lost applicability prior to the end of the 36 month period.

A more recent case involving the issue of indefeasible vesting is *May Estate v. M.N.R.*⁷⁷⁰ where a testator left a holographic will and the widow contested the validity thereof and commenced an action, under the Saskatchewan Matrimonial Property Act to have the farm assets declared to be matrimonial property to which she would be entitled under Sec. 35(e) of the M.P.A.. On the same day and just previous to the trial between the executors and herself an agreement was reached whereby the executors were given certain rights in respect of three parcels of land, which were the three properties the Minister refused to apply the Sec. 70(6) roll-over to. The agreement was conditional upon the widow being vested with all of the property as per the court order, which had not yet been delivered, in that it opened with:

"And whereas it is a condition of obtaining the consents of Gerald May, Keith May, and Joyce Bowerman to the said settlement that they be granted certain rights with respect to certain lands, which said lands **shall be ordered to vest in the Grantor as part of this said settlement;**"

The other executors were given a first right of refusal upon the purchase of the land in question if the appellant received a bona fide purchase offer, and should such a right not be granted the agreement vested an irrevocable and binding option in the executors allowing them to purchase the land. Should the appellant still own the land at death she would be required to bequeath it to the executors⁷⁷¹. During the time of the agreement the executors, as per the agreement, were deemed to have an interest in the land and they did register and maintain a caveat against them. The Court handed down the order under the M.P.A., retroactively applicable to the **same day of the agreement** after 9 months, whereby all of the land⁷⁷² were vested in the appellant. The agreement was made on April 9th/86 the trial was held April 9th/86, and the order **was issued** Dec. 11th/86 and since the agreement provided for the vesting of title to the land in the appellant the Minister contended that she did not receive title by virtue of the order but by virtue of the agreement she entered into. Kempo, T.C.J., provided in conclusion:

"The conclusion at law is that the orders pronounced 9 April 1986 were effective as at the day and time of pronouncement and not at the later time when they were "issued" through the auspices of the Deputy Register on 11 Dec. 1986. These orders are unconditional and unreserved, and are not expressed to be on or by the consent of the parties. The fact that **conditional** consents had been exchanged between the parties prior to the orders being pronounced does not transpose, without more, otherwise unconditional orders into something else. The orders stand at face value until they have been effectively set aside in an action or proceeding directed to that special end. Accordingly, the subject property in fact and in law became the property of Phyllis May on 9 April 1986 and it was in that capacity that the Agreement, Exhibit A-5 supra, was actually made. Not only was this as a result of the effective date of the orders, it also accords with the fact that the parties themselves viewed her as the "grantor" of the rights given in the

⁷⁶⁹ There is consistent jurisprudence that though the result of the exercise of special power of appointment is to be read back to test the vesting period of the gift the result of the exercise isn't to be relate back to the time of the creation of the power only the time of its exercise.

⁷⁷⁰ 89 D.T.C. 534 (TCC)

⁷⁷¹ all of whom were the next of kin

⁷⁷² as well as buildings situated thereon and machinery/grain etc.

Agreement in her personal capacity and not as representative of the estate. In my opinion the Respondent has not made out his case that Phyllis May received the subject property by virtue of the Agreement rather than by virtue of the orders."

The Minister's counsel further submitted that since the agreement entered into between the parties served, to a certain extent, to limit the rights of the appellant given to her under the orders then the agreement could defeat the interest of the appellant directly and that her rights to the property would not be indefeasible. Kempo T.C.J., provided with respect to this, (quite appropriately):

"The granting of the right of first refusal which may be converted into an option to purchase on breach of the former does not, in my opinion, amount to a divestiture of Phyllis May's interest in the land per se. **Unfettered legal and beneficial ownership permits such deals to be made, the consideration here being the resolution of various legal battles.**"

The essence of the agreement obviously convinced the executors to be lenient in their presentation when the order was asked for and thus rather than fall into protracted litigation the parties allowed for the benefit to be recognized by the testator and at the same time gain rights to the property. If they would have gotten into a bind the vesting period would have lapsed and the testator wouldn't have obtained the roll-over treatment.

While indefeasible vesting of property in a spousal trust created by the testator's will, (or intestate/dependant's relief court order), must occur within 36 months of the death the income producing property can generate income for non-spousal beneficiaries prior to such vesting without jeopardizing the rollover. Up to **almost** 3 years worth of income can be accumulated while the estate undergoes administration and be distributed upon complete administration to non-spousal parties while understandably vesting of the property in the spousal trust must be deferred as per the terms of the will in order for this to occur.⁷⁷³

The Roll-Over.

Paragraph 70(6)(c) provides that where the discussed conditions in Sec. 70(6) exist subsection 70(5)(a) to (d) **but not (e)** is not applicable to the property of the taxpayer and as per para (d) the taxpayer will be deemed to have disposed of the property immediately before his death for proceeds equal to its adjusted cost base at that time if it was a non-depreciable capital property or where the property was depreciable property of a prescribed class, the proportion of the undepreciated capital cost of the class immediately before his death from which the property came that the fair market value of the property is of the fair market value of all of the property of the class, at that time. Depreciable capital property not of a prescribed class (Part XVII of Regulations) will be deemed disposed of for its FMV. Since he is deemed to have disposed of his property **immediately before** his death, and since the taxpayer's terminal tax year ends **at** the date of death⁷⁷⁴ he will not be able to deduct C.C.A. in respect of the property. The spouse or spousal estate will be able to recognize a cost of the property equal to the proceeds recognized by the deceased being the initial cost, and adjusted cost of the property. As per para. (e) of Sec. 70(6), para. (e) of Sec. 70(5) is to be adapted to instances where the resulting capital cost to the spouse/spousal trust of depreciable capital property is **less** than its capital cost to the deceased. In such a case, for purposes **only** of the C.C.A./terminal loss provisions in sections 13 and 20, (and the accompanying Regs.), but not the section 39 or 40 capital gains provisions the excess shall be considered deducted by the recipient of the property as C.C.A. previously and the capital cost to the recipient of the property shall be deemed equal to that of the testator, thus exposing the recipient to recapture of C.C.A. taken by the deceased, when the property is disposed of to a third party.

With the reform of 1990 subparagraph (d.1) was added to Sec. 70(6), applicable in respect of transfers and distributions after Jan. 15, 1987, whereby there will be integrated roll-through of the tax cost of a partnership interest held by the testator other than an interest described in Sec. 100(3). That subsection refers to partnership interests acquired by virtue of the death of an individual where the taxpayer isn't a partner and doesn't become a partner by virtue of the acquisition of that particular interest however this doesn't apply where the interest was, immediately before the individual's death, a residual interest described in section 98.1. Thus the Sec. 70(6)(d.1) provision applies to residual partnership interests and interests acquired by the

⁷⁷³ See para. 9 of I.T. 305R3.

⁷⁷⁴ as per *Katz Estate v. The Queen*, 76 D.T.C. 6377

spouse/spousal trust that allow it to become a partner by virtue of the particular acquisition or where the recipient was already a partner. As per subpara. 70(6)(d.1)(i) the testator will be deemed not to have disposed of the interest, except for purposes of Sec. 98(5)(g), and will thus not suffer from a taxable disposition while as per subpara. (ii) the recipient will be deemed to have acquired the interest at a cost equal to that recognized by the testator while under subpara. (iii) in computing the ACB of the interest the Sec. 53(1)-(2) adjustments incurred by the testator will be added or deducted in computing the ACB of the interest in the recipient's hands. Negative partnership interest ACBs can thus pass through to the spousal recipient without tax consequences to the testator.

If the interest is a residual partnership interest described in section 98.1 and the spousal recipient isn't a partner and doesn't become a partner by virtue of the acquisition the interest will pass through Sec. 70(6)(d) so as to possibly allow negative interest ACBs to be recognized as capital gains if the spousal party is the recipient while Sec. 100(3)(b) will then apply to cause the negative ACB to be retained by the recipient while section 98.2 will cause the same.

Under paragraph 70(5.2)(d) and (f) tax-free dispositions are available to a deceased when Canadian resource or foreign resource property or land inventory used in the business carried on by the deceased are rolled to a spouse or spousal trust under the conditions described in Sec. 70(6) whereby the recipient will be able to recognize a cost of the property equal to the deemed proceeds of the deceased which will equal the cost of the property to him, (for all intents and purposes). In respect of the resource property the legal representative may elect an amount of proceeds deemed to be recognized, up to the fair market value of the property, thus allowing the deceased to take advantage of the deductions available in respect of such properties when disposed of. Where land inventory is transferred it need not retain its income/inventorial characteristic to the trust⁷⁷⁵ and thus when it realizes the property the disposition will be on account of capital, thus reducing the effective taxation on the property's initial use.⁷⁷⁶ When the trust disposes of it a capital gain may result which could be negated at the trust level with a Sec. 104(21) designation which could be absorbed by the spouse's capital gains deduction balance.

Once the land inventory becomes a capital property of the trust the trust capital beneficiaries may receive it directly under Sec. 107(4) in satisfaction of their interest which would cause the trust to recognize substantial capital gains. If the capital beneficiary can inflate the ACB of the interest through circular disposition-acquisition, which can be performed tax-free under Sec. 107(1) through the variation of the trust's debt, use of powers etc., the trust's capital gain on the deemed disposition of the property under Sec. 107(4)(f) will not be lessened with a capital loss recognized by the beneficiary when he sells the property though this isn't the case if the spouse acquires the interest, realizes the Sec. 107(2) bump, liquidates the property and satisfies the note given to the other beneficiary on the acquisition of his interest.

Structured Payments to the Estate/Trust by the Beneficiaries.

There isn't one provision in the Act that precludes the spouse or spousal trust from being required to give consideration to the general estate in respect of the property transferred to it and in such a manner the benefits from the testator may be finely tuned so as to be spread over several parties without the disposition, (attracting tax results), of any property so as to obtain the capital to do so. Once property is severed from the estate to satisfy the terms of the will the asset amount of the estate is severely reduced however if the spouse or spousal trust provides consideration to the estate the distributable amount is boosted back up. By the mere fact that Finance has recognized an estate and the spousal trust arising out of it via all the mechanics in Sec. 70(7)-(8) it is impossible for CRA to legitimately argue that the two are the same.

Subparagraph 248(8)(a) effectively provides that where there is a transfer, distribution, or acquisition of property of a taxpayer as a consequence of the terms of his will it will be considered as a consequence of his death for purposes of the Act however this doesn't necessitate the recipient to act only in the capacity of a beneficiary but instead he can act instead exclusively in the capacity of a purchaser. The provision allows the

⁷⁷⁵ which may be structured so as to preclude it from carrying on the business of the taxpayer

⁷⁷⁶ The change in use rules do not apply here.

beneficiary to make a payment of an amount to the estate to receive the bequest without upsetting the transfer's nature as being as a consequence of the death and not as a consequence of the payment. The testator can thus require that certain payments be made to the general estate or the trusts arising out of it as a condition of the receipt of the property however in the spousal circumstance it's important that such payments not constitute a selling price/consideration for a **sale** for if the transaction assumes such an appearance the Sec. 70(6) roll-over will not apply to the property's receipt.⁷⁷⁷ The spousal trust or the spouse can make payments to the estate to receive the property, while so too can the non-spousal beneficiaries. Unfortunately, the very actions taken by the spousal parties to ensure that the Sec. 70(6) roll-over applies upon the payment also automatically precludes the recipient estate/trust from being of the testamentary nature since in avoiding the status of purchaser the spousal party can only be regarded as making "a contribution" to the recipient; that isn't on or as a consequence of **the spousal party's** death. If the spouse makes the payment directly to the other beneficiary(ies) Sec. 105(1) may apply if the recipient is resident so as to cause a full income inclusion of the amount⁷⁷⁸ while the cost of the property to the acquirer will not reflect this taxation. If the payment is made to a non-spousal "flushing" trust set up under the will the same may occur, but if the general estate is to be wound up quickly, (or it isn't to recognize income on its own account), the loss of the testamentary status may not be of paramount importance. The only way the payment may avoid taxation is if the recipient is non-resident, (the will may set up a non-resident trust just for such purposes).

The amount that is to be required to transfer any particular asset to any particular beneficiary has its repercussions. If FMV consideration is paid the recipient trust/estate will retain its testamentary status while the Sec. 70(6) roll-over will not apply if the payer is spousal since such would constitute a sale. Financing the payment can taken many forms; the spouse may assign her income interest under the spousal trust for a lump sum and the amount will be paid off with the income realized while it is not possible to have the spousal trust set up under the will so as to pay its income to the recipient as consideration since as per the will the spouse will not be entitled to all of the trust's income. The property recipient could actually sell the property upon its receipt and extinguish any note payable given as consideration, while retaining any balance, or he could even mortgage it in which case the interest may be deductible. If this isn't possible then it can be possible for the testator to ensure the same effect occurs by mortgaging his property selectively or having the executors mortgage it and ensuring that certain beneficiaries can only receive the property if they assume the mortgage whereby the proceeds can be bequeathed to other parties.⁷⁷⁹ Subsections 70(7)-(8) may solve any problems perhaps with very little tax consequences that may occur with respect to the assignment of this debt to the spousal trust. Understandably cash or property with accrued tax benefits should be used to make such payments. Alternatively the will may provide that as a condition of the bequest to the spouse she must mortgage the property and create a trust of the cash proceeds for non-spousal beneficiaries. If she doesn't agree the property can, as per the terms of the will, fall back to be held in a spousal trust with gift over to the non-spousal beneficiaries or incorporation thereafter. Indefeasible vesting would have to be proven to have occurred within the 36 month period in either case.

One particularly interesting arrangement to benefit from the Sec. 70(6) roll-over to the maximum would be to have the will provide that as much cash and property with minimal accrued tax liabilities as possible be held in a non-spousal trust with non-spousal beneficiaries while those with the highest accrued tax liabilities are to be held in a spousal trust. If both trusts' terms are that the income producing properties are to be incorporated, via Sec. 85(1), into a common corporation with the spousal trust taking back non-cumulative preferred shares and the non-spousal trust taking back excessive dividend producing common shares then the income potential of the assets rolled to the spousal trust has been shifted out of the trust and the non-spousal beneficiaries can immediately participate. The spouse will continue to be sole immediate income beneficiary under the spousal trust, but realize and recognize less income, while she may also be an income/capital beneficiary under the non-spousal trust. Corporate control could reside with either trust party, (and specific directions should be given

⁷⁷⁷ Per Penner and the other Cdn cases involving testamentary options, until better reasoned foreign jurisprudence recognized.

⁷⁷⁸ even if the recipient has a contingent interest in the trust/estate if the spouse doesn't accept the terms; the **trust** isn't making the payment

⁷⁷⁹ See *Passant v. Jackson* for possible problems in substance being recognized instead of form.

as to how that control is to be exercised and to what ends), while mortgage produced cash could actually be distributed to the spousal and non-spousal beneficiaries so as to allow them to acquire the shares directly and **on condition** that they do so. This latter aspect could facilitate more precise income sprinkling, especially when the trustees holding control of the voting shares have specific direction to do so.

Subsection 70(6.2) Fair Market Value Deemed Disposition Elections.

“Election – Sec. 70(6.2)”

(6.2) Subsection 70(6) or 70(6.1) does not apply to any property of a deceased taxpayer in respect of which the taxpayer’s legal representative elects, in the taxpayer’s return of income under this Part (other than a return of income filed under subsection 70(2) or 104(23), paragraph 128(2)(e) or subsection 150(4)) for the year in which the taxpayer died, to have subsection 70(5) or 70(5.4), as the case may be, apply.

Under subsection 70(6.2) the legal representative may elect in the deceased's terminal return of income to have Sec. 70(5) instead of Sec. 70(6) apply to the particular transfers or distributions of property to the spouse/spousal trust thus causing accrued tax benefits to be recognizable by the deceased.⁷⁸⁰ Subsection 54(i)(iii) provides, for purposes of the computation of capital gains or losses in subdivision C, that any loss created under section 70 cannot be treated as a non-deductible superficial loss hence Sec. 70(6.2) provides a means by which a deceased's terminal income can be manipulated and by recognizing both capital gains and negating them with capital losses initial costs of non-depreciable capital property to its recipient may be adjusted so as to be of ultimate benefit. The deceased's capital gains exemption under section 110.6 may also be drained through such elections, on a property by property basis, so as to benefit the property recipient while subsection 111(2) allows allowable capital losses to be applied against other income recognized adjusted for the amount of capital gains exemption taken in the year. If Sec. 70(5) is to be elected for the benefiting beneficiary should be expressed as well as how he is to benefit.⁷⁸¹ It is not possible to have a part of the property undergo a Sec. 70(5) transfer and the other part undergo a Sec. 70(6) roll: the provisions cannot be interpreted to apply to partial as well as whole interests in the property. The use of Sec. 70(6.2) may be warranted when the spouse has purchased offspring's or other parties' interests whereby if Sec. 70(6) is precluded from applying the spouse will get the benefit of the Sec. 107(2) bump-up in the cost of the property realized. Numerous factors must be considered in such an instance.⁷⁸²

Finally the subsection 70(6) terms are well set out and may be quite easily satisfied with proper drafting, however they still apply where **non-income producing property** is transferred to the possible recipient. If the property is capital property both appreciating and depreciating in value, and it doesn't produce any revenue, then neither the trust nor the spouse must recognize a tax expense in the interim until that property is disposed of. Since the spouse's income rights need only be enforceable against trust law income as per Sec. 108(3) and 70(6)(b)(i) a capital gain on the disposition of the property realized by the trust will not be recognizable by her but instead will be taxed in the hands of the trust. The trust may also be able to obtain the spousal trust capital gains deduction available under Sec. 110.6(12) in the year the spouse dies, which, to a limited extent, may reduce the tax consequences of such an actual disposition. Understandably to avoid taxable dispositions by both parties, (trust and capital beneficiary), the capital should not be distributable until the spouse dies (so

⁷⁸⁰ There is no election in respect of eligible capital property or resource property since they are attended to by Sec. 70(5.2) (and thus to cause a f.m.v. disposition of that property in an instance where it is to be held by a spousal trust assent to its transfer must be without the 36 month period).

⁷⁸¹ The executor may wish this as a means of direction though it is questionable whether a beneficiary could base a claim of trustee negligence in not attending to the even hand rule where the beneficiary doesn't benefit from the election since the legal representative would be acting qua executor and not qua trustee in respect of the election.

⁷⁸² A Sec. 70(6.2) election ignorantly made by accountant and taxpayer may be appealed against successfully as was the case in *Musslewhite Estate v. M.N.R.*, 85 D.T.C. 608, where "the blind yanked around the dumb" by making a Sec. 70(6.2) election without having a clue as to its effect.

as to avoid the application of Sec. 107(4)). In effect such an arrangement could operate only as a deferral method, under which the tax consequence ultimately realized by all parties may increase or decrease depending on what the value of the property does.⁷⁸³ If the spousal trust is set up with the spouse having the right to draw on the capital of the trust, and to have that right satisfied with either direct property distributions or distribution of proceeds received on the mortgaging of the property then an interesting situation may arise with respect to capital interest transfers and ultimate distribution. If the spouse is entitled to draw on 50% of the initial fair market value of capital for a period of five years, after which the interest expires she may decide to purchase the other capital interest issued to an offspring which becomes enforceable upon the death of the spouse or if she purchases it in the interim, after the five year period and termination of the interest originally issued to her. If, after the purchase of the offspring's interest, the trust property is mortgaged to produce funds to distribute to the spouse in respect of her **original** interest the funds can be received by her, in respect of her initial interest, tax free as per the Sec. 105(1)-53(2)(h) mechanics. Since she has paid for the acquired interest with cash, and the mortgage proceeds cannot be considered in satisfaction of the second acquired interest, upon an ultimate terminating distribution the spouse, if she assumes the mortgages as a condition of the property distribution in respect of the second capital interest, she will be in a position to recognize potential capital losses, as per the Sec. 107(2)(b) & (c), and the 107(1)(b) mechanics, when the debt assumed is large in relation to the legitimate ACB of her second interest and its Sec. 108(1)(d)(i) cost amount.⁷⁸⁴ This transaction would obviously be an abuse of form and the substance of the arrangement may attract recharacterization under section 245 if the section can apply to it.

Income Tax Interpretation Bulletin

Testamentary Spouse Trusts

IT-305R4

DATE: October 30, 1996

SUBJECT: INCOME TAX ACT

Testamentary Spouse Trusts

REFERENCE: Subsections 70(6), (6.1), (7) and (8) (also subsections 12(10.2), 70(5), (5.4) and (6.2), 108(3) and (4), 248(3), (8), (9), (9.1) and (9.2) and 252(3) and (4) and paragraph 5 of Article XXIXB of the *Canada-United States Income Tax Convention* (1980))

Notice -- Bulletins do not have the force of law

This document is also available for download in PDF format.

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Explanation of Changes

⁷⁸³ If the trust property doesn't produce excessive income her income interest has a reduced value and this could facilitate less tax costly variations that shift income rights to other beneficiaries.

⁷⁸⁴ See *In re: Ralli's Settlements*, 1966 A.C. 483 (PC), for case of two successive interests enforceable mutually exclusively held by one beneficiary.

Application

This bulletin replaces and cancels Interpretation Bulletin IT-305R3, *Establishment of Testamentary Spouse Trust*, dated June 29, 1987. It also incorporates relevant comments from Interpretation Bulletin IT-207R, *"Tainted" Spouse Trusts*, dated March 26, 1979 and cancels that bulletin.

Summary

The purpose of subsection 70(6) is to allow a deferral of the tax consequences that would otherwise arise from the deemed dispositions of capital property occurring as a result of a taxpayer's death, if the property is transferred or distributed to the taxpayer's spouse or to a testamentary trust established in favour of the spouse and the other requirements of that provision are met.

This bulletin discusses the conditions which must be met for a trust to qualify as a spouse trust described in subsection 70(6) and the situations under which such a trust becomes "tainted." It also discusses the tax implications of a tainted spouse trust and how, if at all, a tainted spouse trust can be "untainted." Finally, the bulletin discusses a similar deferral, under subsection 70(6.1), of what would otherwise be the tax consequences of the deemed payments out of a NISA Fund No. 2 occurring as a result of death.

Discussion and Interpretation

General

¶ 1. Taxable capital gains, allowable capital losses, recaptures of capital cost allowance and terminal losses which would otherwise arise as a result of a taxpayer's death, by virtue of the deemed disposition of capital property under subsection 70(5), are generally deferred if, as a consequence of the taxpayer's death (see ¶s 9 to 12 below), the property is transferred or distributed to the taxpayer's spouse or to a trust established in favour of the taxpayer's spouse as described in subsection 70(6) (a "spouse trust").

¶ 2. When subsection 70(6) applies, the spouse or spouse trust which acquires a capital property as a consequence of the taxpayer's death generally assumes the taxpayer's tax cost of the property. This amount is also the deceased's proceeds of disposition of the property. The deceased taxpayer's legal representative may, however, elect under subsection 70(6.2) to have subsection 70(5), rather than subsection 70(6), apply to any capital property of the taxpayer. In these circumstances, the proceeds of disposition of the property to the deceased and its cost to the spouse or spouse trust are each equal to the fair market value of the property immediately before death. An election made under subsection 70(6.2) must be made in the deceased's regular income tax return for the year of death.

¶ 3. When a partnership interest of a deceased taxpayer is transferred or distributed to the taxpayer's spouse or to a spouse trust, as described in subsection 70(6), and the taxpayer's adjusted cost base of the interest was negative immediately before death, subsection 70(6) may not result in a complete tax-deferred transfer or distribution. For more information, see the current version of IT-278, *Death of a Partner or of a Retired Partner*.

¶ 4. By virtue of subsection 252(3), a taxpayer's spouse includes, for purposes of subsection 70(6), an individual of the opposite sex who is party to a voidable or void marriage with the taxpayer. Furthermore, subsection 252(4) extends the meaning of spouse, for purposes of the Act, to include what is generally referred to as a "common-law spouse."

Establishment of Testamentary Spouse Trust

¶ 5. A spouse trust, as described in subsection 70(6), is created by a taxpayer's will (see ¶s 11 and 12 below) and must entitle the spouse to receive all the income of the trust arising before the spouse's death. Furthermore, no one but the spouse may receive or otherwise obtain the use of any of the trust's income or capital before the spouse's death (see also ¶s 13 to 16 below). For subsection 70(6) to apply, the capital property transferred or distributed to the spouse or spouse trust must vest indefeasibly in the spouse or spouse trust within 36 months of the taxpayer's death or, upon written application to the Minister within that period, within such longer period as the Minister considers reasonable in the circumstances. In addition, by virtue of subsection 248(9.2), the property must vest indefeasibly in the spouse or spouse trust before the

spouse's death. For information on the term "vest indefeasibly," see the current version of IT-449, *Meaning of "Vested Indefeasibly."*

¶ 6. For a testamentary trust to qualify as a spouse trust under subsection 70(6), the deceased must have been resident in Canada immediately before death and the trust created by the deceased's will must be resident in Canada immediately after the time the property vested indefeasibly in the trust.

¶ 7. An executor may have the discretion as to which properties are to be transferred to the spouse trust with the will specifying only the total value of the property or portion of the estate to be so transferred. The will may also provide for the establishment of more than one trust (for example, a spouse trust and a family trust) and specify the total value of property to be transferred to each trust while leaving to the executor's discretion the selection of specific property to be transferred to each trust. In other instances, the will may direct the establishment and terms of a spouse trust but leave total discretion to the executor to select both the total value of and property to be transferred to the trust. In the absence of any express directions in the will, the executor is governed by the law of the relevant jurisdiction in allocating the property of the estate to the various beneficiaries and trusts. These kinds of arrangements do not disqualify a trust otherwise qualifying as a spouse trust.

¶ 8. Once a trust qualifies as a spouse trust under the terms of subsection 70(6), it remains a spouse trust and is subject to the provisions affecting such trusts (for example, paragraph 104(4)(a)) even if its terms are varied by agreement, legal action or breach of trust. However, these events may cause other provisions of the Act to apply, such as paragraph 104(6)(b) and subsections 106(2) and 107(4).

Transfer or Distribution as a Consequence of Death and Trust Created by Will

¶ 9. By virtue of subsection 248(8), a property is considered to have been transferred or distributed to, and acquired by, a spouse or spouse trust as a consequence of a taxpayer's death when the transfer, distribution or acquisition was:

- (a) under, or as a consequence of, the terms of the will or other testamentary instrument of the taxpayer,
- (b) as a consequence of the law governing the intestacy of the taxpayer, or
- (c) as a consequence of a disclaimer, release or surrender (see ¶ 10 below) by a beneficiary under the will or other testamentary instrument or on the intestacy of the taxpayer.

¶ 10. Subsection 248(9) describes "disclaimer" and "release or surrender" for the purposes of subsection 248(8). A disclaimer involves an outright refusal to accept a gift, share or interest under a will, with no stipulation as to how the taxpayer's legal representatives should distribute the disclaimed property. A disclaimer of property in favour of another person is not a true disclaimer but an assignment. However, when such a disclaimer or assignment would achieve the same effect as a simple disclaimer without any assignment, a disclaimer is considered to have been made for the purposes of subsection 70(6). In Quebec a disclaimer includes a renunciation of a succession made under the laws of that province that is not made in favour of any person. For subsection 70(6) to apply, a disclaimer must be made within 36 months of the taxpayer's death or, upon written application to the Minister within that period, within such longer period as the Minister considers reasonable in the circumstances.

A release or surrender made under the laws of a province (other than the Province of Quebec) must not be in favour of a particular person. For the Province of Quebec, a release or surrender means an *inter vivos* gift of an interest in, or right to property of, a succession made to the person who would have benefited had the donor renounced the succession but not in favour of anyone. A release or surrender, whether made within the Province of Quebec or otherwise, must be made within the same time as a disclaimer is made, as described above.

¶ 11. In relation to the Province of Quebec, subsection 248(3) deems

- (a) a usufruct,
- (b) a right of use or habitation, or
- (c) a substitution,

to be a trust. The trust is deemed to be created by will where (a), (b) or (c) was established by will. The property subject to (a), (b) or (c) is deemed to have been transferred to and held by a trust. Furthermore, the transfer is deemed to have occurred on, and as a consequence of, the death of the testator when (a),

(b) or (c) arises on the death of that person. For more information on subsection 248(3), see the current version of IT-437, *Ownership of Property (Principal Residence)*.

¶ 12. Whether or not a trust was created by a taxpayer's will, subsection 248(9.1) recognizes that a qualifying spouse trust may be established by a court order, in relation to the taxpayer's estate, made under any law of a province that provides for the relief or support of dependants. A similar result may not be achieved by a variation made by agreement among the beneficiaries, even under variation of trusts legislation since such a trust is not created as a consequence of death within the meaning of subsection 248(8).

Requirements regarding the Income and Capital of a Spouse Trust

¶ 13. As indicated in ¶ 5 above, to qualify as a spouse trust, the spouse must be entitled to receive all the income of the trust arising before the spouse's death and no one but the spouse may receive or otherwise obtain the use of any of the income or capital of the trust before the spouse's death. For this purpose, subsection 108(3) provides that the income of the trust is its income calculated under trust rules (rather than in accordance with the Act) less any dividends included therein:

(a) that are not included in computing the trust's income, for other purposes of the Act, by reason of section 83,

(b) that are described in subsection 131(1), or

(c) to which subsection 131(1) applies by reason of subsection 130(2).

Consequently, a trust will not be precluded from qualifying as a spouse trust because of the fact that, under the terms of the trust, such dividends are not paid or payable to the spouse. Also, amounts such as taxable capital gains (that are not in the nature of income under trust rules) which were neither paid nor payable to the spouse under the terms of the trust, nor included in the spouse's income under a preferred beneficiary election, are necessarily taxed in the trust, since during the spouse's lifetime no one but the spouse may receive anything out of a qualifying spouse trust or make a preferred beneficiary election in connection with the trust's income.

¶ 14. Under subsection 108(4), a trust is not prevented from qualifying as a spouse trust solely because it is charged with the payment of

(a) any income or profits tax on any of its income computed in accordance with the Act, or

(b) any estate, legacy, succession or inheritance duty payable in consequence of the testator's death on any property of the trust or any income or capital interest in it.

¶ 15. In interpreting the requirement that the spouse must be entitled to receive all of the income of the trust that arises before the spouse's death, the doctrine of constructive receipt is applied. Consequently, the payment according to the will of, or the provision in the will for the payment of, any income of the trust to a person other than the spouse, on the condition that it be used solely for the benefit of the spouse, does not disqualify an otherwise qualifying spouse trust.

¶ 16. In interpreting the requirement that no person except the spouse may, before the spouse's death, receive or otherwise obtain the use of any of the income or capital of the trust, the renting of real estate at market value or the lending of money on commercial terms (including market rates of interest, appropriate securities and a reasonable repayment schedule), does not generally mean that the person renting the real estate or borrowing the money has received or has the use of that property as the term is used in this requirement.

"Tainted" Spouse Trust

¶ 17. A trust created by a taxpayer's will in favour of a spouse that does not meet the qualifications of a spouse trust set out in subsection 70(6) is commonly referred to as a "tainted" spouse trust. One cause of a spouse trust being tainted is a direction in the will to pay out of the trust various debts, obligations or death duties, other than those to which subsection 108(4) applies (see ¶ 14 above).

¶ 18. Subsection 70(7) provides a method for untainting some types of tainted spouse trusts, thus permitting the rollover provided by subsection 70(6). This is possible when the debts, obligations and death duties referred to in ¶ 17 above are "testamentary debts" and the trust otherwise qualifies as a spouse trust. The term "testamentary debt," which is defined in paragraph 70(8)(c), means:

- (a) any debt of the taxpayer, or any other obligation of the taxpayer to pay an amount, that was outstanding immediately before his or her death, and
- (b) any amount payable by the estate in consequence of the taxpayer's death, other than any amount payable to any person as a beneficiary of the estate, including income or profits tax payable by or for the taxpayer for the taxation year in which he or she died and for any previous taxation year, and any estate, legacy, succession or inheritance duty payable in consequence of the taxpayer's death.

Testamentary debts also include funeral and testamentary expenses and compensation to representatives for carrying out those duties which are normally exercised by an executor or administrator, that is, up to the point the estate properties are transferred or distributed to the beneficiaries or to the trustee of the tainted spouse trust or any other trust arising on death.

¶ 19. A trust for the benefit of a spouse is tainted in a manner that cannot be remedied by the method provided in subsection 70(7) if certain types of obligations are to be met out of its property before the death of the spouse. Examples of such obligations include:

- (a) a contingent liability to make good any deficiency that may arise in another trust created under the same will,
- (b) a liability for the payment of trustee fees applicable to other trusts under the will,
- (c) an obligation to pay a bequest to another beneficiary out of the property of the estate that is held by the spouse trust, and
- (d) a remarriage clause which, if the spouse remarries, would result in someone other than the spouse being entitled to income or capital of the trust before the spouse's death.

The trust is not tainted in this manner, however, if the debt or obligation to be met is:

- (e) a testamentary debt (see ¶ 18 above),
- (f) a debt or obligation to the spouse,
- (g) a debt or obligation incurred for the benefit of the spouse, or
- (h) an obligation to pay fees to the trustee for the administration of the spouse trust.

¶ 20. In general terms, the method provided in subsection 70(7) to untaint a tainted spouse trust that is capable of being untainted is to total all testamentary debts of the trust and deduct:

- (a) any estate, legacy, succession or inheritance duty payable, in consequence of the taxpayer's death, for any property of the trust, or for any interest in the trust (note that these amounts do not taint a spouse trust as explained in ¶ 14 above), and
- (b) any debt secured by a mortgage on property owned by the taxpayer immediately before his or her death.

The remaining debts are referred to in paragraph 70(8)(b) as non-qualifying debts. In the deceased taxpayer's regular income tax return for the year of death (that is, not a return filed under subsection 70(2), 104(23) or 150(4), or paragraph 128(2)(e)), the taxpayer's legal representative must elect to have the trust treated as a spouse trust and list one or more properties of the trust (other than a net income stabilization account) having a total fair market value immediately after the taxpayer's death at least equal to the total of the non-qualifying debts. The list may include money and if it alone is sufficient to cover the non-qualifying debts, no other properties need be listed. The trust is then deemed to be a spouse trust and capital properties listed against the non-qualifying debts are deemed to have been disposed of, by virtue of subsection 70(5), at fair market value immediately before the taxpayer's death. As a result, any gains, income or losses arising from such deemed dispositions are included in computing the deceased's income. The other capital properties transferred to the spouse trust qualify for the rollover provided in subsection 70(6). The following example illustrates how a tainted spouse trust may be untainted:

Testamentary debts

Income tax owing by the deceased	\$ 10,000
Business debt of the deceased	25,000
Mortgage on apartment	80,000

building		
Mortgage on land	10,000	
Testamentary and funeral expenses	1,000	\$ 126,000

To determine non-qualifying debts, deduct:

Mortgage on apartment building	\$ 80,000	
Mortgage on land	10,000	90,000
	-----	-----

Non-qualifying debts		\$ 36,000
		=====

The executor then lists properties of the tainted spouse trust having a total fair market value immediately after death at least equal to these non-qualifying debts. For this purpose, paragraph 70(8)(a) defines the fair market value of a property as the amount, if any, by which its fair market value otherwise determined exceeds the amount of any debt secured by a mortgage on the property.

Listed property:

Shares -- Fair market value		\$ 9,000
Land -- Fair market value	\$ 41,000	
Less: Mortgage on the land	10,000	

Net fair market value of the land		31,000

Net fair market value of listed property		\$ 40,000
		=====

Capital gain or loss:

Shares -- Fair market value	\$ 9,000	
Adjusted cost base to the deceased	6,000	

Capital gain		\$ 3,000
		=====
Land -- Fair market value	\$ 41,000	
Adjusted cost base to the deceased	30,000	

Capital gain		\$ 11,000
		=====

The deemed disposition rules in subsection 70(5) apply to the capital properties so listed and, in this example, the total capital gain before any reduction under subparagraph 70(7)(b)(iii) (see ¶ 21 below) is \$14,000 (\$3,000 + \$11,000).

¶ 21. When the fair market value of all the properties listed exceeds the total non-qualifying debts (this excess is referred to as the "listed value excess") and the taxpayer's legal representative designates **one** capital property so listed (other than money and depreciable property) in the taxpayer's return, the capital gain or loss on that property (from the deemed disposition under subsection 70(5)) will be reduced as a result of the formula in subparagraph 70(7)(b)(iii). Under subparagraph 70(7)(b)(iii), the capital gain or loss on the property is:

Capital gain or		Fair market value of the one property			
		minus			
		the listed value excess			
Loss	×	-----			

otherwise determined		Fair market value of the one property immediately after death			

¶ 22. The following examples illustrate the application of the rule in subparagraph 70(7)(b)(iii).

Example 1:

The listed value excess in the example in ¶ 20 above is \$4,000 (\$40,000 - \$36,000). In that example, assume that the legal representative has designated the shares that have been listed. Pursuant to subparagraph 70(7)(b)(iii), the capital gain on the shares is calculated as follows:

$$\begin{array}{rcl}
 & (\$9,000 & - \\
 & \$4,000) & \\
 \$3,000 \times \frac{\quad}{\$9,000} & = & \$1,667
 \end{array}$$

Therefore, the total capital gain to be included in the deceased's income is \$12,667 (\$1,667 + \$11,000). The adjusted cost base of the two properties to the spouse trust is: land \$41,000 (by virtue of paragraph 70(5)(b)) and shares \$7,667 (\$6,000 + \$1,667, by virtue of clause 70(7)(b)(iv)(A)).

Example 2:

Same as example 1 above; however, assume that the adjusted cost base of the shares is \$16,000 and that, consequently, the shares otherwise result in a capital loss of \$7,000 (\$9,000 - \$16,000). The capital loss calculated in accordance with subparagraph 70(7)(b)(iii) is:

$$\begin{array}{rcl}
 & (\$9,000 & - \\
 & \$4,000) & \\
 \$7,000 \times \frac{\quad}{\$9,000} & = & \$3,889
 \end{array}$$

Therefore, the net capital gain from the land and shares is \$7,111 (\$11,000 - \$3,889). The adjusted cost base of the two properties to the spouse trust is: land \$41,000 (by virtue of paragraph 70(5)(b)) and shares \$12,111 (\$16,000 - \$3,889, by virtue of clause 70(7)(b)(iv)(B)).

¶ 23. Where non-qualifying debts include income tax payable by the deceased's representative for the income tax return for the year of death, the amount payable is calculated after giving effect to the provisions of paragraph 70(7)(b). It is therefore necessary to consider the effect that the listing of a particular property will have on the amount of tax payable. The adjustment of a capital gain or loss on a designated property pursuant to subparagraph 70(7)(b)(iii) may also have a significant effect in some circumstances. When the amount of the tax liability is a critical factor in the selection of properties to be listed (or the property to be designated), more than one notional tax calculation may be necessary.

¶ 24. The legal representative is not obliged to dispose of the listed properties of the trust to obtain the funds to pay the non-qualifying debts. They may be paid from any available source of funds.

¶ 25. The legal representative is responsible for calculating the non-qualifying debts and the fair market value of listed properties as accurately as possible from the facts available. When these calculations are subsequently determined to be incorrect, despite the reasonable efforts of the legal representative, and the value of the listed properties is actually less than the total of the non-qualifying debts, we will permit additional properties to be listed at that later time in order that the provisions of subsection 70(6) may still apply to the properties of the trust that are not listed.

¶ 26. It is arguable that a trust in favour of a spouse created under a taxpayer's will out of the residue of his or her estate is tainted by the distributions and payments necessary to establish the trust corpus. Under this interpretation, it is necessary to follow the procedures set out in subsection 70(7) when it is intended that the trust qualify as a spouse trust under subsection 70(6). Another view is that subsection 70(6) applies to such of the original properties of the estate as are retained to form a part of the trust corpus without the necessity of following the procedures described in subsection 70(7). Either interpretation is acceptable with the result that a trustee has the following options available when an otherwise qualifying spouse trust is created out of the residue of an estate:

(a) The trustee may choose to have the provisions of subsection 70(5) apply to all of the capital properties of the estate.

(b) By following the procedures described in subsection 70(7), the rules in subsection 70(6) will apply to those capital properties of the spouse trust that are not listed and the rules in subsection 70(5) will apply to listed properties of the estate, subject to adjustment for any "listed value excess" (see ¶ 21 above).

(c) The trustee may choose to have subsection 70(5) apply to all of the capital properties of the estate that are distributed or otherwise disposed of before the corpus of the spouse trust is established and have subsection 70(6) apply to such of the original capital properties of the estate as are retained as the property of the trust. The fact that, prior to the indefeasible vesting of the properties in the trust, income derived from these properties is used by the estate to pay specific bequests or testamentary debts does not preclude the trust from qualifying as a spouse trust.

The right to elect under subsection 70(6.2) (referred to in ¶ 2 above) is unaffected by the adoption of either option (b) or option (c).

¶ 27. Although the treatment for tax purposes applicable to the acquisition of listed properties by a trust differs from that applicable to the acquisition of the balance of the trust properties, listed properties are, nevertheless, properties of a spouse trust and subject to the special rules relating to spouse trusts found elsewhere in the Act (for example, the deemed disposition of such properties under paragraph 104(4)(a) upon the death of the spouse).

¶ 28. Whenever a tainted spouse trust capable of being untainted by subsection 70(7) is created, regardless of the simultaneous creation under the will of other trusts to which subsection 70(7) is irrelevant, the legal representative has up to 18 months from the date of death to file the deceased's final income tax return. This is the case whether or not such a trust is successfully untainted under paragraph 70(7)(b). This extended time for filing also applies to special returns that may be filed pursuant to subsection 150(4) and paragraph 104(23)(d). Although the due date for making an election under subsection 70(2), for rights or things of the deceased at the time of death, is indirectly extended if the extended filing date referred to above delays the mailing of a notice of assessment for the year of death, the basic rule (the later of one year after death and 90 days after the mailing of any notice of assessment for the year of death) remains unchanged. If death occurs on or before April 30 in a taxation year, the deceased's legal representative has up to 6 months from the date of death to file the deceased's income tax return for **the immediately preceding taxation year**. Otherwise, there are no extensions in the filing requirements for income tax returns of taxation years prior to the year of death.

Note: Bill C-36 contains a number of income tax measures announced in the February 27, 1995 budget. Among other things, the Bill will amend paragraphs 150(1)(b) and (d), applicable to the 1995 and later taxation years. As a result of these amendments, the due date for filing a deceased person's income tax return may be extended if the deceased person, or the deceased person's spouse, carried on a business

in the year of death (except where the expenditures of the business are primarily the cost or capital cost of "tax shelters"). In such circumstances, the due date for filing the return is:

- *on or before June 15 of the year following the year of death if the individual died during the period January 1 to December 15; and*
- *within six months after the date of death if the individual dies during the period December 16 to December 31 or during the period January 1 to June 14 of the following year (that is, before the individual's filing due date for the previous year had the individual not died).*

¶ 29. Although the income tax return for the year of death may be filed within 18 months of death whenever a trust is untainted by an election provided for in subsection 70(7) so as to qualify as a spouse trust, interest at the prescribed rate will be assessed on any unpaid balance from the later of six months after death and April 30 of the year following death.

Transfer or Distribution of Net Income Stabilisation Account (NISA) to Spouse Trust

¶ 30. The income which would otherwise arise as a result of a taxpayer's death, by virtue of the deemed payment out of the taxpayer's NISA Fund No. 2 under subsection 70(5.4), is deferred if, on or after the death and as a consequence thereof, the taxpayer's NISA is transferred or distributed to his or her spouse or to a trust established in favour of his or her spouse and the requirements of subsection 70(6.1) are met. The requirements applicable to a spouse trust in subsection 70(6.1) are the same as those applicable to a spouse trust in subsection 70(6), with the exception that subsection 70(6.1) does not contain any residency requirements such as those described in ¶ 6 above.

¶ 31. The deceased taxpayer's legal representative may, however, elect under subsection 70(6.2) to have subsection 70(5.4), rather than subsection 70(6.1), apply to the deceased's NISA Fund No. 2. If subsection 70(5.4) applies, all amounts in the deceased's NISA Fund No. 2 will be deemed to have been paid out to the deceased immediately before death and such amounts will generally be required, under subsection 12(10.2), to be included in computing the deceased's income for the year of death. The election under subsection 70(6.2) must be made in the regular income tax return for the year of death.

¶ 32. When a trust, which would otherwise qualify as a spouse trust under subsection 70(6.1), is tainted as a result of the payment (or provision for payment) of a testamentary debt (see ¶s 17 to 19 above), subsection 70(7) may be used to untaint the trust (as explained in ¶s 20 to 29 above), thus permitting the rollover provided in subsection 70(6.1). It should be noted, however, that, as indicated in ¶ 20 above, when untainting the trust, a NISA cannot be a listed property.

Canada-United States Income Tax Convention (1980)

¶ 33. For subsection 70(6) to apply on the transfer or distribution of property to a taxpayer's spouse, the taxpayer and the taxpayer's spouse must be resident in Canada immediately before the taxpayer's death and if the property is to be transferred or distributed to a spouse trust created by the taxpayer's will, the taxpayer must be resident in Canada immediately before death and the trust must be resident in Canada immediately after the time the property vests in the trust. Pursuant to paragraph 5 of Article XXIXB of the *Canada-United States Income Tax Convention* (1980), where an individual was a resident of the United States immediately before the individual's death, for the purposes of subsection 70(6), both the individual and the individual's spouse are deemed to have been resident in Canada immediately before the individual's death and, if certain conditions described in that paragraph are met, a trust for that spouse will also be treated as being resident in Canada.

Explanation of Changes

Introduction

The purpose of the *Explanation of Changes* is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised departmental interpretations.

Overview

We revised the bulletin to incorporate relevant comments from Interpretation Bulletin IT-207R, "*Tainted*" Spouse Trusts, dated March 26, 1979 and to cancel that bulletin. The revised bulletin also reflects amendments to the *Income Tax Act* by S.C. 1988, c.55 (formerly Bill C-139); S.C. 1991, c.49 (formerly Bill C-18); S.C. 1994, c.7 Schedule VIII (S.C. 1993, c.24 - formerly Bill C-92); and S.C. 1994, c. 21 (formerly Bill C-27). A note has been added following ¶ 28 to describe a proposed amendment to paragraphs 150(1)(b) and (d) contained in Bill C-36 (the February 27, 1995 Federal Budget). Except as described in the Note following ¶ 28, the comments in the bulletin are not affected by proposed legislation that was released before August 30, 1996.

Legislative and other changes

The title of the bulletin has been revised since, as indicated above, the bulletin has been broadened to include comments from IT-207R.

Throughout the bulletin we have made minor changes for clarification or readability purposes.

¶ 3 has been added to clarify that, in certain circumstances, subsection 70(6) will not result in a complete tax-deferred transfer to a spouse or spouse trust.

¶ 4 has been added to reflect the Bill C-92 amendment to subsection 252(3). As a result of this amendment, the extended meaning of spouse contained in subsection 252(3) also applies for purposes of subsection 70(6). ¶ 4 also reflects the Bill C-92 amendment which added the extended meaning of spouse contained in subsection 252(4).

¶ 5 replaces the second part of ¶ 1 of IT-305R3 and the first sentence of ¶ 1 of IT-207R. The information that applied to years which are now statute-barred has been deleted. Furthermore, the paragraph refers to subsection 248(9.2) which clarifies certain requirements that have to be met for property to become vested indefeasibly.

¶ 7 (¶ 8 of IT-305R3) addresses the situation in which a will directs the establishment and terms of a spouse trust but leaves total discretion to the executor to select both the total value of and property to be transferred to the trust.

¶ 8 contains the same information as ¶ 7 of IT-305R3, except that a reference to paragraph 104(6)(b) has been added to the last sentence. This reference has become relevant as a result of amendments to paragraph 104(6)(b) in Bill C-92.

¶ 11 has been added to reflect subsection 248(3). As a result of this provision, property subject to certain types of legal relationships in the Province of Quebec (a civil law jurisdiction) may be eligible for the rollover to a spouse trust provided in subsection 70(6).

¶ 12 (¶ 5 of IT-305R3) reflects subsection 248(9.1) added by Bill C-92. This provision explains the circumstances under which a trust shall be considered to be created by a taxpayer's will for purposes of the Act. This provision replaced a similar rule that was found in subsection 70(6.1) which applied for purposes of subsection 70(6) and paragraph 104(4)(a).

¶ 13 (¶ 10 of IT-305R3) reflects the Bill C-139 amendments to subsection 108(3) relating to the description of the types of dividends referred to in that provision.

¶ 16 has been added to clarify the implications, to a spouse trust, of the renting of real estate or the lending of money, in light of the requirement (in subsection 70(6)) that no person except the spouse may, before the spouse's death, receive or otherwise obtain the use of any of the income or capital of the trust.

¶s 17 and 18 contain the same information as ¶s 3 and 4, respectively, of IT-207R.

¶ 19 is ¶ 5 of IT-207R, except that a new example of when a spouse trust cannot be "untainted" has been added.

¶ 20 replaces ¶ 6 of IT-207R and reflects relevant Bill C-92 amendments to subsections 70(5) and (7). Subsection 70(5) was amended to provide that the deemed disposition of a taxpayer's depreciable property, under that provision, would be for proceeds equal to the fair market value of the property immediately before the taxpayer's death. Prior to this amendment to subsection 70(5), depreciable property was essentially deemed to have been disposed of immediately before death for proceeds equal to midpoint between the undepreciated capital cost and the fair market value of the property immediately before death. Amendments to subsection 70(7) ensure that the election referred to in that provision is made in the regular income tax return for the year of death. The amendments provide that a net income stabilization account could not be

listed for purposes of untainting a spouse trust and they delete the references to "specified" properties from subsection 70(7).

The example in ¶ 20 is essentially the same as in ¶ 6 of IT-207R, except that death duties have been removed from the example for simplification purposes since such duties are not common.

¶s 21 and 22 are a rewording and reorganization of ¶s 7 and 8 of IT-207R. The reference to "specified" capital property, in ¶ 7, has been deleted as a result of amendments to subsection 70(7) (see discussion in ¶ 20 above).

¶s 23 and 24 contain the same information as ¶s 9 and 10, respectively, of IT-207R.

¶ 25 replaces ¶ 11 of IT-207R and reflects the deletion by Bill C-92 of the references to "specified" properties from subsection 70(7).

¶ 26 contains the same information as ¶ 12 of IT-207R and ¶ 9 of IT-305R3.

¶ 27 contains the same information as ¶ 15 of IT-207R.

¶ 28 replaces ¶ 13 of IT-207R. The paragraph reflects the Bill C-18 amendment to paragraph 150(1)(b) for the filing deadline for a deceased's income tax returns for taxation years prior to the year of death. A Note has been added following the paragraph to reflect a proposed amendment to paragraphs 150(1)(b) and (d).

¶ 29 contains the same information as ¶ 14 of IT-207R.

¶s 30 and 31 reflect the addition of subsections 12(10.2), 70(5.4) and 70(6.1) and the amendment of subsection 70(6.2) by Bill C-92. The paragraphs briefly discuss the tax consequences for a deceased taxpayer, where amounts were held for or on behalf of the taxpayer in his or her NISA Fund No. 2 at the time of death. In particular, the paragraphs discuss subsection 70(6.1) which provides for a deferral of these tax consequences, where the taxpayer's NISA is transferred or distributed to the taxpayer's spouse or to a trust established in favour of the spouse and the other requirements of that provision are met.

¶ 32 reflects the reference to subsection 70(6.1) in subsection 70(7) which was amended by Bill C-92. As a result, subsection 70(7) may be used to "untaint" certain types of "tainted" spouse trusts in order to permit the rollover provided by subsection 70(6.1).

¶ 33 has been added to discuss paragraph 5 of Article XXIXB of the *Canada-United States Income Tax Convention* (1980).

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Director, Business and Publications Division

Income Tax Rulings and Interpretations Directorate

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Tainted Spousal Trusts

The testamentary spousal trust roll-over provision in Sec. 70(6) is available when, amongst other factors, the spouse is entitled to receive **all** of the income of the trust that arises before her death and no one except her can receive or obtain the use of any of its income or capital before her death and it is these two criteria that are so often violated, either unknowingly or unavoidably when constituting spousal trusts. Habitually the death of a taxpayer will result in the realization of a whole species of expenses that were not foreseeable and while the estate might be capable of extinguishing the smaller ones out of incidental pools of funds the larger debts of the testator may not be extinguishable in the same manner but instead may be required to be secured by property of the estate which may find its way into a spousal trust or may be transferred directly to an estate beneficiary. In the latter case the substantial debt may have been incurred by the taxpayer and secured upon specific property prior to his death hence quite possibly the repayment of it will have to be negotiated with the creditor when the taxpayer dies, thus enabling the beneficiary, the estate, or the trust to obtain similar benefits and burdens of repayment as were realized previously by the deceased. If the debt is secured upon property bequeathed to a beneficiary then that person will be required, habitually, by the terms of the will to assume that debt as a condition of the bequest while obviously any trusts arising out of the estate upon the ascertainment of the amount of its residue may serve as such recipients. The fact that an estate debt has yet to be extinguished does not preclude the ascertainment of a residue⁷⁸⁵ and hence a trust in respect of it if all that is to be done is the extinguishment of that debt. The crystallization of the beneficiary's equitable title has occurred. If the extinguishment of the debt out of the residue is not provided for, and the will allows the executors to maintain the liability then the residue will still be recognized as a trust and it will thus be charged until the liability is extinguished.⁷⁸⁶

The "Taint".

If the will of the deceased provides that certain terminal expenses which are larger debt are to be assumed and extinguished by a spousal trust either immediately or possibly "collateralized" with property that is rolled into the spousal trust, the spousal trust will be "tainted" in that some party other than the spouse will be able to receive or obtain the use of income or capital of the trust before her death. The Sec. 70(6)(b) criterion concerning the spousal entitlements operates not just with regards to the trust/beneficiary relationship that exists but also the creditor/debtor relationship that might exist when the trust is created.

The subsection 70(6)(b) and 73()(c) descriptions of spousal trusts refer to trusts created that have the spousal characteristics however they do not indicate that the trust must retain those characteristics after the settlor finishes dealing with the trust. If the will of a taxpayer immediately creates a trust having the spousal character out of some of the estate property will the trust remain spousal if after two years, upon the operation of a contingency clause or exercise of certain powers of assignment, a debt is assumed by the trust? The Sec. 70(6)(b) spousal trust cannot allow any person other than the spouse to receive capital/income before the spouses death but does it have to be structured so as to preclude it from ever being in that situation where, as per the operation of the trust as an arrangement itself, a non-spousal party can obtain capital/income? In the author's opinion not necessarily. If the trust purchases property it will not lose its spousal character. If the spouse however varies the nature of the trust herself, after it has been fully constituted as spousal, so as to allow it to assume debt that she herself would have to assume under the will, the Sec. 70(6)(b) conditions should be satisfied in that the trust was **formerly** constituted, thus the debt could be assumed without consequence. Subsections 70(7)-(8) apply only when the debt is to be assumed when the trust is constituted.⁷⁸⁷ If property which is subject to a mortgage or lien is transferred to a testamentary spousal trust it cannot be

⁷⁸⁵ See the chapter "Trusts Arising out of Estates".

⁷⁸⁶ This is the case with wills that do not express the creation of a residuary trust but under which the spouse is to take everything. If an estate is sustaining ongoing problems in administration and it is doubted that an appropriation can occur or a residue can be established within the 36 month vesting period in Sec. 70(6) an extension can be obtained if applied for within that 36 month period. the late vesting doesn't affect the application of Sec. 70(7)-(8).

⁷⁸⁷. See the substance of "testamentary debt" and the opening preamble of Sec. 70(7).

recognized as indefeasibly vested in the spouse or trust due to the fact that ownership thereof depends, to a further extent, on the repayment of the interest and debt, and if such repayment doesn't occur then the legal title may be divested. Where debt that does not constitute a lien on property transferred to the spousal trust is required to be assumed it still constitutes the ability of a non-spousal party to receive capital/income prior to her death **but only** where the debt's extinguishment is to occur prior to her death.⁷⁸⁸ If a creditor/debtor relationship evolves **after** the spousal trust has been fully constituted⁷⁸⁹ then the Sec. 70(6) tax free roll over will not be affected however if it exists at the time the T.S.T. is being created the trust will be tainted.^{790 791} If the trust deed allows, but doesn't compel the trustees to immediately mortgage property subject to the trust and pay/distribute the proceeds the Sec. 70(6) provision should still be available.⁷⁹²

The Exception.

A testamentary spousal trust will be "tainted" where certain terminal expenses or legal obligations to pay are sustained by it as a consequence of the operation of the will however subsection 108(4) provides an exception which allows the sustaining of certain expenses by a trust to have no effect. Under Sec. 70(6)(b) or 73(1)(c), where a spousal trust has been created by will or otherwise, any recipient will be deemed not to have received or obtained the benefit of income or capital of the trust provided the payment thereof was a payment of an estate, legacy, succession or inheritance **duty payable as a consequence** of the taxpayer's death, in respect of any property **of**, or interest **in, that particular trust** or any income or profits tax payable by the particular trust in respect of any income of **that particular** trust. Section 108(4) isn't widely targeted in that it relates solely to incidental current payables that were sustained directly in relation to the particular trust that is to pay them. Any estate, legacy, succession duty cannot be charged without effect to **any** particular trust but instead only those expenses that arose in respect of property that is of, or interests related to, that trust will be exempt. Provision for the payment of taxes or duty cannot thus be so easily redirected to a trust which has nothing to do with the particular tax or duty. Subsection 108(4) concerns only duties and taxes, not the subject of the duty or tax itself. The mere fact that Parliament enacted Sec. 108(4) to exempt certain non-beneficiary related obligations clearly indicates that all other non-beneficiary related obligations arising from creditor-borrower relationships **at the time the trust is constituted** or subsequently will affect the availability of Sec. 70(6).⁷⁹³

788 If a substantial debt is assumed and as per the terms of the loan contract the lender cannot call for the extinguishment thereof prior to the spouse's death it would appear that, as will be seen, it doesn't disqualify the spousal trust nor attracts the possible need of the application of Sec. 70(7)-(8).

789 possibly through mortgage of trust property so as to secure cash. This is the opinion of the author. The contrary opinion of the Financial Industries Division as stated in T.I. 5-4053 of December 1987 is that where the trust property is used as security **as required by the will** the spousal trust will be tainted and if the property is transferred encumbered as security to the trust the same results. There's a difference between an encumbered vesting of property in a spousal trust and a vesting with instructions, arbitrary or discretionary, that the property be encumbered and the context of Sec. 70(6) looks only at the transfer to the trust and not what happens after. Whether or not a non-spousal party receives or obtains the use of the trust capital before her death is another matter however but it would seem that where property is to be used as security the borrower has received its use.

790 This is fully provided in the substance of the definition of "testamentary debt" in Sec. 70(8) and it is the sustaining of testamentary debt that activates Sec. 70(7).

791 See Brown and Secretary, Department of Family and Community Services [2004] AATA 48 (22 January 2004) for an instance where beneficiaries tried to have it both ways.

792 What can't be achieved directly, have the trust become liable for the debt, can be indirectly, by having the trust raise the funds through mortgage, advance them to the spouse who is obliged to assume the debt if her capital interest is to vest, and have her satisfy the mortgage with the advanced funds of the same approx. amount.

793. As it was confirmed in T.I. 5-9105 of Dec. 1989 provided by the F.I.D. the exception does not apply in respect of the Sec. 70(6)(b)(i) requirement that the spouse be entitled to receive all of the (essentially) trust's trust law income arising before her death. Consequently if the trust's tax liability is to be satisfied with trust law income, regardless of whether it also tax law income, the trust will be tainted. though capital dividends and taxable capital gains may not constitute trust law income, and thus can be used to satisfy the liability, this technicality can causes considerable problems when the trust isn't realizing those types of trust law capital. In the above T.I. it was asked whether a Sec. 104(13.1)-(13.2) designation had an effect on the spousal trust status if as a consequence the trust was to pay the resulting income tax and it was held that payment of taxes out of capital gains would not taint the trust. In T.I. 5-902601 of Nov. 1990 rendered by the Business and General Division of Rulings it was opined that the payment of a tax liability created by a Sec. 104(13.1) designation out of trust income would not taint a spousal trust. Subsection 108(4) specifically provides for this.

“Trust not disqualified – Sec. 104(4)”

(4) For the purposes of the definition "pre-1972 spousal trust" in subsection (1), subparagraphs 70(6)(b)(ii) and (6.1)(b)(ii) and paragraphs 73(1.01)(c) and 104(4)(a), where a trust was created by a taxpayer whether by the taxpayer's will or otherwise, no person is deemed to have received or otherwise obtained or to be entitled to receive or otherwise obtain the use of any income or capital of the trust solely because of the payment, or provision for payment, as the case may be, by the trust of

- (a) any estate, legacy, succession or inheritance duty payable, in consequence of the death of the taxpayer, or a spouse or common-law partner of the taxpayer who is a beneficiary under the trust, in respect of any property of, or interest in, the trust; or**
- (b) any income or profits tax payable by the trust in respect of any income of the trust.**

Unfortunately the payables described in Sec. 108(4) are only incidental expenses that arise as a direct result of the death of the taxpayer or from the realization of income by the trust and thus have virtually nothing to do with the debt that the testator owed at the time of his death to third parties that is to be charged upon property held by the trust or to be extinguished by the trust in any manner. When this debt is to be paid by a spousal trust then as previously commented, the trust will be "tainted" whereby the Sec. 70(6) provision would not apply to **any** property transferred to it,...were it not for subsection 70(7).

Subsection 70(7) provides a method by which a "tainted" spousal trust can be untainted and allow the testator to benefit from the Sec. 70(6) rules in certain instances. A trust will be tainted in such a manner that it can be untainted where it would, but for the payment of or provision for particular "testamentary debts" in respect of the particular deceased taxpayer, be a spousal trust described under Sec. 70(6), thus all of the conditions under Sec. 70(6) must be otherwise satisfied in order for the provision to apply. The entire subsection 70(7) applies **only where the type of obligation to pay imposed upon the trust falls under the definition of "testamentary debt" and where it doesn't then the trust will be "tainted" in a manner that will not benefit from the Sec. 70(7) provision** and thus the testator will not benefit from the Sec. 70(6)(b) provision in respect of property transferred to it. This will occur when the trust can pay capital to non-spousal beneficiaries prior to the spouse's death, the payment of trustee fees of other trusts, or the pledging of the spousal trust's property for the benefit of non-spousal parties (possibly since a guarantee-surety does not constitute an actual debt obligation).

“Special rules applicable in respect of trust for benefit of spouse – Sec. 70(7)”

(7) Where a trust created by a taxpayer's will would, but for the payment of, or provision for payment of, any particular testamentary debts in respect of the taxpayer, be a trust to which subsection 70(6) or 70(6.1) applies,

(a) for the purpose of determining the day on or before which a return (in this subsection referred to as the “taxpayer's return”) of the taxpayer's income for the taxation year in which the taxpayer died is required to be filed by the taxpayer's legal representatives, subsection 150(1) shall be read without reference to paragraph 150(1)(b) and as if paragraph 150(1)(d) read as follows:

“150(1)(d) in the case of any other person, by the person's legal representative within 18 months after the person's death; or,” and

(b) where the taxpayer's legal representative so elects in the taxpayer's return (other than a return of income filed under subsection 70(2) or 104(23), paragraph 128(2)(e) or subsection 150(4)) and lists therein one or more properties (other than a net income stabilization account) that were, on or after the taxpayer's death and as a consequence thereof, transferred or distributed to the trust, the total fair market value of which properties immediately after the taxpayer's death was not less than the total of the non-qualifying debts in respect of the taxpayer,

(i) subsection 70(6) does not apply in respect of the properties so listed, and

(ii) notwithstanding the payment of, or provision for payment of, any such particular testamentary debts, the trust shall be deemed to be a trust described in subsection 70(6),

except that, where the fair market value, immediately after the taxpayer's death, of all of the properties so listed exceeds the total of the non-qualifying debts in respect of the taxpayer (the amount of which excess is referred to in this subsection as the "listed value excess") and the taxpayer's legal representative designates in the taxpayer's return one property so listed (other than money) that is capital property other than depreciable property,

(iii) the amount of the taxpayer's capital gain or capital loss, as the case may be, from the disposition of that property deemed by subsection 70(5) to have been made by the taxpayer is that proportion of that capital gain or capital loss otherwise determined that

(A) the amount, if any, by which the fair market value of that property immediately after the taxpayer's death exceeds the listed value excess,

is of

(B) the fair market value of that property immediately after the taxpayer's death, and

(iv) the cost to the trust of that property is

(A) where the taxpayer has a capital gain from the disposition of that property deemed by subsection 70(5) to have been made by the taxpayer, the total of

(I) its adjusted cost base to the taxpayer immediately before the taxpayer's death, and

(II) the amount determined under subparagraph 70(7)(b)(iii) to be the taxpayer's capital gain from the disposition of that property, or

(B) where the taxpayer has a capital loss from the disposition of that property deemed by subsection 70(5) to have been made by the taxpayer, the amount by which

(I) its adjusted cost base to the taxpayer immediately before the taxpayer's death

exceeds

(II) the amount determined under subparagraph 70(7)(b)(iii) to be the taxpayer's capital loss from the disposition of that property.

"Meaning of certain expressions in s. (7) – Sec. 70(8)"

(8) In subsection 70(7),

(a) the "fair market value" " at any time of any property subject to a mortgage or hypothec is the amount, if any, by which the fair market value at that time of the property otherwise determined exceeds the amount outstanding at that time of the debt secured by the mortgage or hypothec, as the case may be;

(b) "non-qualifying debt" in respect of a taxpayer who has died and by whose will any trust has been created that would, but for the payment of, or provision for payment of, any particular testamentary debts in respect of the taxpayer, be a trust described in subsection 70(6), means any such particular testamentary debt in respect of the taxpayer other than

(i) any estate, legacy, succession or inheritance duty payable, in consequence of the taxpayer's death, in respect of any property of, or interest in, the trust, or

(ii) any debt secured by a mortgage or hypothec on property owned by the taxpayer immediately before the taxpayer's death; and

(c) "testamentary debt" , in respect of a taxpayer who has died, means

(i) any debt owing by the taxpayer, or any other obligation of the taxpayer to pay an amount, that was outstanding immediately before the taxpayer's death, and

(ii) any amount payable (other than any amount payable to any person as a beneficiary of the taxpayer's estate) by the taxpayer's estate in consequence of the taxpayer's death,

including any income or profits tax payable by or in respect of the taxpayer for the taxation year in which the taxpayer died or for any previous taxation year, and any estate, legacy, succession or inheritance duty payable in consequence of the taxpayer's death.

Testamentary Debt.

"Testamentary debt" is defined in Sec. 70(8)(c) to be a debt in respect of the particular taxpayer who had died which was a debt owing by that particular taxpayer⁷⁹⁴ that was outstanding immediately before his death **or any amount payable by his estate as a consequence of his death**⁷⁹⁵.

In order to qualify as testamentary debt the obligation must have been held primarily against the testator in his personal capacity prior to his death and it would seem that guarantees given by the testator on account of another person's debt will not constitute testamentary debt if such a guarantee is provided by the trust as a condition of its deed. It also includes any income or profits tax payable by or in respect of the particular taxpayer for any year and any estate legacy, succession or inheritance duty payable in consequence of his death.

If the debt is to be "testamentary" it must either have been outstanding immediately before his death or it must have arose and is payable by his estate as a consequence of the testator's death and it should be recognized that the debt outstanding at the time of his death may be owed to a person who may also become a beneficiary of the estate in which case this particular beneficiary could have a dual status under the estate as being both a creditor and a beneficiary.⁷⁹⁶ Where this creditor's entitlement is charged to the estate it would constitute an amount payable by the estate in consequence of the death of the taxpayer that is other than to a person as a beneficiary of the estate. As will be seen this dual status is critical in perfecting a particular debt transaction.

An interesting interpretational problem exists in respect of the definition of testamentary debt in that it includes amounts payable by the taxpayer's **estate** as a consequence of his death and not by the spousal testamentary trust that arises out of the property of that estate. If the debt is to be paid by a trust the property of which was severed from the general estate, as per the will via an appropriation/appointment, will it qualify as "amount payable...by his estate in consequence of his death"? Subsection 108(1) provides a definition of "testamentary trust" that applies **only** for purposes of subdivision k of the ITA which includes both the estate and resulting testamentary trust while "estate" defined through Sec. 248(1) to the definition in Sec. 104(1) is

⁷⁹⁴. or any obligation to pay any amount

⁷⁹⁵ that was not an amount payable to a person **as a beneficiary** of his estate

⁷⁹⁶ The party has the ability to take under the lower title of a testamentary donee: Doe d. Smyth v. Smyth, 1826 6 B. & C. 112.

ineffective in that the latter provision operates only as to assign the tax liability to the executor. Thus it would seem, that since "estate" and "trust" are two different legal arrangements, and the Act does, through Sec. 248(1), assign different definitions to them, amounts payable directly by the trust and **not** by the estate from which it arose will not satisfy the definition of "testamentary debt" solely on those grounds but instead would have to do so by the two other major characteristics.⁷⁹⁷

Under para. 4, I.T. 207R. the Department is of the opinion that any amount payable by the estate as a consequence of death such as funeral, testamentary expenses, compensation to representatives for carrying out duties which are normally exercised by an executor or administrator up to the point at which the property is transferred to the **beneficiaries**, or to the trustee of the tainted spousal trust **or any other trust arising on death** will qualify as "testamentary".⁷⁹⁸ Although the latter testamentary expenses may be unrelated to the trust or property that is being transferred to it they will still qualify as "testamentary debt" while they will cause some tax consequences as will be described.

It's important to recognize that any amount payable by the taxpayer's estate that was not owed by the testator immediately before his death or was not of the incidental taxes or duties also described, or, that was **not payable as a consequence of his death** will not qualify as a "testamentary debt". The linkage between the sustaining of the debt by the estate **as a consequence of the death** must be explicit hence where a debt was **voluntarily** sustained by the estate so as to provide more funds to the immediate estate capital beneficiaries, it will not qualify as testamentary debt.⁷⁹⁹

If this debt is assigned to the spousal testamentary trust, or to property that is being transferred to it then the trust will be tainted in such a manner that it cannot be untainted if the will does not specify that it must be incurred. If the will provides that the executors are to sustain the debt and either mortgage the property of the estate or not, distribute the cash proceeds to beneficiaries directly and transfer the encumbered property to a spousal trust then the amount will become payable by his estate as a consequence of his death since the vigour and effect of how it was sustained and possibly on the mortgage agreement, springs from the testator's death, not the voluntary actions of the executors.⁸⁰⁰

It is better to make sure that there is liquidity possibility in an estate by compelling the executor to raise debt like this, and give his discretion to assign it via mortgage: if it's compelled it satisfies the "testamentary debt" definition, though remains a "non-qualifying debt" which causes tax consequences, but by also allowing him to mortgage estate property to secure it exempts it from being "non-qualifying debt" against which property must be listed to cause FMV dispositions. This is a case of "*wiggling between*" the definitions since the definition of both "testamentary debt" is lacking in when it can be sustained, thus latent debt gets tucked in – only that it be as a consequence of the testator's death, and, the definition of "non-qualifying debt" is also lacking since it doesn't state that the debt in question has to be outstanding immediately before death – the paragraph (b)(ii) targets property owned immediately before death, not debt outstanding.

Non-qualifying Debt.

Subsection 70(7) applies where the testamentary spousal trust would have been so but for the provision for or payment of testamentary debts however the testamentary debts that will actually cause the tax consequences are those that are "non-qualifying debt" which are defined in Sec. 70(8)(b).

"Non-qualifying debt" means any testamentary debt in respect of the deceased that is **not** either an estate, legacy, succession, or inheritance duty payable in consequence of the taxpayer's death, in respect of any property of, or interest in, the **trust**, (and not in the estate), **or** any debt that was **secured by a mortgage or hypothec on property owned by the taxpayer immediately before his death**. The obvious exception should be noted in respect of this definition being that where a debt is owed to a person by the testator and it is secured by a mortgage on property owned by the testator before his death then the debt will not cause tax

⁷⁹⁷ This is further evidenced by the fact that para. 4(b) of I.T. 207R in the appendix, as follows, states that fees payable to executors only up to the point of transfer of property to the trust will qualify as testamentary debt.

⁷⁹⁸ The Department's opinion, and more importantly, the diction used in Sec. 70(7)-(8), clearly indicates that a trust is not to be equated with the estate out of which it arose and one need only examine the definition in Sec. 70(8)(c)(ii) and the use of the terms "trust" and "estate" to ascertain this.

⁷⁹⁹ There was an exercise of a discretion not the fulfillment of a direction having as its vigour and effect the death.

⁸⁰⁰ This is endorsed by the substance of Sec. 248(8)(a).

consequences when it's assumed by the testamentary spousal trust.

Interestingly the property upon which the mortgage is secured **need not** be transferred to the spousal trust in order for the debt to be excluded from being "non-qualifying" for under the opening preamble of the definition the scope thereof is to provisions for a payment of particular testamentary debt by the trust, **not just such debt that relates to property which was transferred to the trust**. This is particularly beneficial in that it allows for the assigning of debt to a spousal testamentary trust, without the transfer of property, without the sustaining of a tax consequence.

The mortgage also need not be outstanding and owing by the deceased before his death it would appear; all it has to be, in order to be excluded from being a non-qualifying debt, is secured by property owned by the taxpayer before his death, and payable by the estate as a consequence of his death. *A debt secured as a mortgage on one property before the taxpayer's death may be altered after his death to be mortgaged upon trust property.* The mortgagor may be any type of person but the critical aspect about the assignment/assumption of the debt⁸⁰¹ by the trust is that it will not cause tax consequences, since the Sec. 70(7)-(8) mechanics will not be activated in respect of it, while if a capital beneficiary under the personal trust is to assume it as a condition of a distribution in satisfaction of his capital interest, he may be able to recognize a capital loss, as per Sec. 107(2)(c) and 107(1)(b), depending on the ACB of his capital interest and the ACB of the property, to the trust, received.⁸⁰²

Structuring around the Definitions.

The substance of "non-qualifying" and "testamentary debt" should not be overlooked in possible application to allow tax effective "smooth" testamentary transfers.

Estate debt (notes payable), providing funds to the testator's estate which is secured via a mortgage upon any property owned by him prior to his death will not attract tax consequences when it is assigned to the trust. The funds which are realized by the sustaining of this debt can then be bequeathed to particular immediate estate capital beneficiaries who may also become ultimate capital beneficiaries of the resulting spousal trust. In this regard the taxpayer has been able to increase the amount of **non-taxable** immediate bequests made through Sec. 70(5) in that transfers of cash will never cause tax consequences under that subsection to either party. Where the creditor isn't an ultimate capital beneficiary of the spousal trust, in his role as creditor, he will be able to receive capital from the trust before the spouse dies, with varying tax consequences to the trust, thereby avoiding the possible taxation of that capital held in trust when the spouse does die, however when the trust transfers property in satisfaction of the debt it will recognize a disposition of that property for proceeds equal to its FMV. The recognition of any accrued gain may thus only be (substantially) deferred. The main advantage of the creditor is actually the ability to receive funds from the trust prior to the death of the spouse, which may be paid out gradually.

Mortgages assumed by the trust appear not to be of the character of relationship that would cause Sec. 70(6) to be inapplicable and they can be satisfied through the sale of any trust property rewarding proceeds however planning for the negating of the recognition of any gain recognizable on such a disposition is another matter.

If the debt directly relates to income producing property then the interest thereupon will be deductible by the trust, thus reducing its Division B income, however it should be noticed that the Sec. 70(7)-(8) mechanism refers primarily to debt/obligations to pay, existing prior to death or shortly following, and not those realized in respect of such debt, such as interest, after the death, hence by charging the trust with the payment of **the interest on the debt** the trust **may** be tainted in such a way that it cannot be untainted.⁸⁰³

If the debt is transferred out to the initial estate beneficiary, who realized the funds from that debt, as on

801. that isn't non-qualifying debt

802. Would it be a GAARable transaction to have the spouse transfer her capital interest to her off-spring prior to the debt being assigned thus allowing it to have a high relative FMV and cost amount thus reducing tax consequences, and then have the executor assign the debt to the trust so as to deflate the scenario and create capital loss for the off-spring on eventual wind-up?

803. (If the trust deed provides that distributable income is to be arrived at after discretionary debt sinking fund deductions then some control over the amount of income recognized by the spouse under Sec. 104(13) will be obtained.

condition of a capital distribution from a personal trust as described in Sec. 107(2)(c) then it may be extinguished without consequence or hardship **but**, as per the mechanics of Sec. 107(1)(b), 108(1)(d) and 107(2)(c), the beneficiary may be able to recognize a **capital loss**, effectively, if he has been able to inflate the ACB of the capital interest without tax cost to any party, (such as when he becomes resident).⁸⁰⁴

The Sec. 70(7)-(8) provisions operate in an ongoing fashion, until the estate has transferred to the spousal trust the property upon which the provisions operate (and it is entirely possible for more than one spousal trust to be constituted out of a general estate), however, in the interim the will may give the legal representative the power to assign to any severed trust or retain against the residuary estate the debt charge, and this is especially so if the legal rep. is also given the power to decide which property is to be held under which terms.

Upon a reading of the will a **capital beneficiary** (with a deferred interest only realizable upon her death in order to satisfy the Sec. 70(6) spousal trust mechanics proper) under a severed spousal trust, which has not been saddled with a debt, may wish to dispose of his capital interest to the spouse, and until the debt of the estate has been assigned to that trust the capital interest's cost amount, as per Sec. 108(1)(d)(ii) for purposes of the disposition provision in Sec. 107(1), may be inflated, effectively allowing the beneficiary to realize more tax free benefits in the form of the proceeds. When the trust is subsequently assigned a debt charge, the spouse capital interest holder, with the capital interest having an inflated real ACB as per Sec. 107(1.1), may be in a position to realize a substantial capital loss when the trust is wound up, as per the mechanics of Sec. 107(2)(c) and 107(1)(b). The subsection 107(2) provision will apply to a spousal trust roll out to the spouse but not to where the property is being transferred to the trust or spouse under Sec. 70(6). This can really warp the overall cost flow through mechanics and can be effected by selling the capital interest⁸⁰⁵ to the spouse (or if time isn't an issue a non-spousal party) before the debt is assigned. The substance of the debt, in cash, could of course be distributed tax free to the spouse by the testator previously.⁸⁰⁶

Also, while there is reference to the fact that Sec. 70(6) will not apply to the property listed, statutorily, there is no requirement that the property must be capital property held by the estate or testator: the provision merely states that Sec. 70(6) will not apply to it once listed against "non-qualifying debt" and that the adjustment property which conclusively integrates the FMV tax consequences of the listing must be a capital property other than a depreciable capital property.⁸⁰⁷ The fundamental question that causes the author to think that inventorial property can be listed against non-qualifying debt is that, isn't all Sec. 70(6) property "capital property" to begin with?⁸⁰⁸ **The provision simply says that Sec. 70(6) doesn't apply to the property so**

804. These latter points are being brought up here only due to the fact that they relate to the subject matter however they may also be instrumental in rigging favorable tax consequences in respect of non spousal testamentary trusts as well.

805 or have the non-resident become resident

806 If the interest is transferred to a non-spousal party he'll have to await the death of the spouse to realize property from the trust unless property with accrued benefits/cash is distributed to him after a variation in the trust prior to the spouse's death so as to avoid Sec. 107(4) inclusions.

807 See the Aust. case of Mark Gerard Ireland as Executor of the Estate of the late Charles Stuart Gordon v Sandra Jane Retallack & Ors [2011] NSWSC 846 (12 August 2011) where courts were petitioned to perfect a testamentary gift of property not technically owned by the taxpayer.

808 In statutory interpretation there is a presumption against redundancy. The governing principle has been described in Ruth Sullivan, *Sullivan and Driedger on the Construction of Statutes*, 4th ed. (Markham: Butterworths, 2002) at 158:

It is presumed that the legislature avoids superfluous or meaningless words, that it does not pointlessly repeat itself or speak in vain. Every word in a statute is presumed to make sense and to have a specific role to play in advancing the legislative purpose.

As was opined in MNR v. TD Bank, 2004 FC 169:

"[26] Further, the wording of section 232.2(2) is clear and in my view does not permit an interpretation that disregards the literal meaning in favour of an interpretation which is considered more likely to advance the objectives of the Act, which might be possible in the case of less clear legislation.

[27] In *Canada v. Antosko*, [1994] 2 S.C.R. 312, at 326-327, the Supreme Court of Canada said:

While it is true that the courts must view discrete sections of the *Income Tax Act* in light of the other provisions of the Act and of the purpose of the legislation, and that they must analyze a given transaction in the context of economic and commercial reality, such techniques cannot alter the result where the words of the statute are clear and plain . . . [My emphasis.]

listed, and then further qualifies the operation of the mechanics by requiring that at least one property listed must be capital property to allow fine-tuning? Thus the next question is whether Sec. 70(2)-(3) rights or things can be rolled through to a spousal trust: can a spousal trust serve as a “beneficially interested” party in respect of the general estate within the scope of the Sec. 70(3) roll-through? And why not? Thus any inventory a testator had that went to her estate can be listed, in the author’s opinion.⁸⁰⁹

Another interesting arrangement is when a property is transferred to the spousal trust, and then a mortgage is granted on it by the general estate giving the spousal trust further cash, with the note transferred to another spousal trust as property that can be listed against further debt. If the will specifies that this is the route to take, are not all the steps as a consequence of death. The subsequent mortgaging of the property once inside the preliminary trust is not a step to which the section 70(7)-(8) rules apply and we have a creation of a property in the hands of the estate that can be used, with minimal tax impact. In such a case the note can be distributed out to the spouse thereunder the 2nd trust and the cash can be distributed out from the 1st and given that the Sec. 70(7)-(8) provisions do not specify that the mortgage must exist prior to the date, only the property upon which it is founded does one need excessive property holdings or that coming into the estate to off-set high testamentary debt? As Nathan Bedford Forrest could always predict – split up the sequencing of hurdles as they will come up, in your arrangements and analyze.

The overall manner in which the amount of non-qualifying debt in respect of a particular T.S.T. is determined is to subtract from testamentary debt that relates to the **trust** those amounts that represent death duties described in Sec. 108(4)(a) and mortgages/hypothecs secured by property owned by the testator immediately before the testator's death that have been charged to the trust. The amounts deducted in arriving at the non-qualifying debt amount may be charged to and payable by the trust without tax consequences.

The Listing Process.

Under subsection 70(7), in order to untaint the testamentary spousal trust of these non-qualifying obligations, the legal representative must elect in the deceased's return of income for such treatment and list "specified properties", which have on or after the death and as a consequence thereof been transferred to the trust, the fair market value of which immediately before death is not less than the aggregate amount of **non-qualifying debt** which will cause Sec. 70(6) not to apply to the "specified properties" and thus in respect of the properties so specified the tax free roll-over treatment will not be obtained. Effectively the legal representative will compute the aggregate of all non-qualifying debt that is to be assumed by the trust and will

[28] In this regard, I adopt the comment on *Antosko, supra*, by Peter Hogg, cited with approval by Major J. in *Friesen v. Canada*, [1995] 3 S.C.R. 103, at 113-114:

. . . P.W. Hogg and J.E. Magee, *Principles of Canadian Income Tax Law* (1995), Section 22.3(c) "Strict and purposive interpretation", at pp. 453-54:

It would introduce intolerable uncertainty into the *Income Tax Act* if clear language in a detailed provision of the Act were to be qualified by unexpressed exceptions derived from a court's view of the object and purpose of the provision . . . [The *Antosko* case] is simply a recognition that "object and purpose" can play only a limited role in the interpretation of a statute that is as precise and detailed as the *Income Tax Act*.

[29] Further, as P.A. Côté stated in his text *The Interpretation of Legislation in Canada*, 3d ed., at pages 624 and 625: The guideline affirming the primacy of the text is principally grounded on two arguments. First, the highly detailed style of drafting for this type of legislation naturally contributes to accentuate the importance of the text for the taxpayer and their counsellors. And, eventually for the official interpreter, the judge. Further, some fear that the tremendous possibility offered when doing away with the literal meaning of the text, in favour of a meaning deemed more apt to promote the objectives of the statute, will introduce too much uncertainty in an area of law where decisions are taken, daily, based on the letter of the provision."

809 While, in the author's opinion rights and things and inventorial property can be listed they cannot be used for the capital gains FMV disposition adjustment at the conclusion of the exercise. Why did the draughtsman choose to further qualify "the sink" property in the listing process as being "a capital property" when Sec. 70(6) can only apply to capital property to begin with? Clearly this is a situation where an extra word causes a bit too much damage since by qualifying "the sink" to opens the door to all the other types of property that may come into play.

then specify certain properties, including money, the fair market value of which exceeds the amount of non-qualifying debt, that are transferred to the trust. Where this is done, subsection 70(6) will not apply to those properties specified however the initial obvious and more permanent second obvious results are undeniable.

Eligible Property.

Where the legal representative has listed specified property which is capital property to which Sec. 70(6) would otherwise apply then a negation of the application of Sec. 70(6), (as per Sec. 70(7)(b)(i)), will result in the property being subject to deemed disposition treatment under Sec. 70(5). If the property listed is resource property or inventory of a business which is land then Sec. 70(6) would initially not have affected it in the first place. The tax free roll-over in respect of those two types of property are contained in Sec. 70(5.2), (d) and (f) hence where those types of properties are listed, the negation of the application of Sec. 70(6) will have **no effect** and the property will still enjoy the Sec. 70(5.2) tax-free roll-over treatment at the same time as untainting the trust.⁸¹⁰

Even more interesting is the fact that the property listed **need not be property owned by the testator** immediately before his death in that the Sec. 70(7)(b) provision refers exclusively to properties "that have, on or after the taxpayer's death and as a consequence thereof, been transferred or distributed to the trust" and not exclusively to properties owned by him. If the vigour and effect of a instrument causing the transfer of property to the trust, say under a power of appointment exercisable under will etc., springs from the death such property will qualify as potential property to be listed, regardless of the previous holder of their legal title however if the testator exercised the power under will the power may be subject to Sec. 70(5) with the same tax consequences as if the underlying property were in fact owned.⁸¹¹ Does this also apply to life insurance proceeds that are payable to the testator's general estate?

Alternatively a condition may be enforceable against the spousal or non-spousal beneficiaries requiring them to sell or contribute property to either the estate or trust.⁸¹² If it is sold to the estate and the taxpayer takes back a mortgage both may be transferred to the spousal trust as per the executor's allocation powers whereby the mortgage may cause tax consequences⁸¹³, the spousal trust and the estate will remain testamentary and the property can be listed.⁸¹⁴ If the property is **contributed** to the general estate gratuitously the estate will lose its testamentary character which may not be catastrophic. (The estate and trust are two distinct tax creatures obviously here – so the possible short-term loss of the general estate's testamentary status is not at all important here.) It can then be rolled to the spousal trust and listed. If the property is to be sold to the spousal trust it may **not** be "transferred or distributed"⁸¹⁵ even though it transfer will be as a consequence of the death as per Sec. 248(8)(a). It will not be "listable" but the trust will retain its testamentary nature and thus personal nature. If it is required to be contributed to the tainted spousal trust it will be transferred or distributed within the context of the subsection **but** the trust will lose its testamentary nature and if it is paid by the beneficiary to **acquire**, (though not necessarily accelerate or enhance), an interest **in the trust**, the trust will lose its personal nature resulting in extremely harsh tax consequences subsequently.

One better option would be to have the beneficiary sell or contribute the property to **the general unadministered estate** whereafter it is rolled into the T.S.T. and listed with no tax consequences. The trust remains testamentary and thus although the beneficial interest of the beneficiary becomes enforceable and is not acquired by virtue of the payment. As long as the beneficiary doesn't then acquire an interest in the estate both trust and estate will retain their personal character facilitating tax free distributions. Once the mortgaged property is loaded into the spousal trust it can be transferred to the creditor in satisfaction of the debt, without tax consequences to the trust since its cost thereto will approx. equal or be exactly equal to the cost of the

810. Subsection 70(7)(b)(i) prevents the roll-over in Sec. 70(6) from applying to the particular properties: it does not negative the spousal character of the trust which Sec. 70(5.2)(d)-(f) recognize whereby both provide completely separate roll-over treatment with respect to the trust referred to.

811 unless the power was held as a trustee. See Re: Carter, 1944 44 S.R.(N.S.W.) 285.

812 See Byrnes v. Comm. of Stamps, 11 S.R. (N.S.W.) 499.

813 though not where the mortgage is upon property previously owned by the testator

814 Under subdivision k the estate and trust are recognized as the same tax entity though **outside** of subd. k the two are recognized as distinct tax entities.

815 as per the reasoning in Tory Estate, 76 D.T.C. 6312.

property caused by its listing. If a condition precedent is the route to be taken whereby the property must be contributed to the estate so as to gain an enforceable capital interest in the trust the spousal trust's capital beneficiaries' entitlements may be adjusted to reflect the respective contribution however the estate will cease to be testamentary, not necessarily with insurmountable tax cost, but the spousal trust will remain testamentary. These factors are all relevant when the taxpayer habitually carries material amounts of unsecured personal debt that are to be assumed by the T.S.T.⁸¹⁶

A testamentary option granted by the testator's will is not property owned by the taxpayer but can be transferred and distributed to the spousal trust from the general estate so as to allow it to **purchase** property from the estate.⁸¹⁷ Property subsequently purchased **may** not gain Sec. 70(6) treatment however the option itself is a bequest to the trust and as such can be listed in the author's opinion since it is a property. The fair market value of the property immediately after the death will have to be ascertained in relation to the property in respect of which the option is exercisable though the fact that the option may be personal and incapable of alienation should not affect its FMV. If Canadian tax jurisprudence evolves to an extent where a testamentary option is held to be a bequest, a capital interest, could it be listed? Can a testamentary spousal trust have an interest in the actual estate it arises out of?⁸¹⁸ If not, why?

Debt held by the testator and transferred to the T.S.T. could be listed if it isn't forgiven by the testator under the will. It will be subject to the Sec. 70(5)-(6) provisions while if the debt is forgiven it will have a nil fair market value, nor will it be transferred even though the borrower will not recognize an income inclusion as per section 80. If the forgiving of the debt is conditional on the beneficiary performing some act etc. it will have a fair market value when transferred to the trust **but** the trust will become even more tainted **if** the debt can be forgiven prior to the death of the spouse.⁸¹⁹ If the debt is to be maintained, even upon satisfying the condition, with nominal interest payable to the trust Sec. 70(6) will not be violated and the debt can have some value for listing purposes depending on the probability of it being satisfied at the time legal ownership thereof is passed to the T.S.T.. If the debt cannot be forgiven prior to the death and it has a reduced rate of interest its FMV for Sec. 70(5) purposes may be less than its cost amount while its FMV for Sec. 104(4) purposes will be reduced⁸²⁰. Life insurance proceeds could also be listed if transferred to the trust from the recipient general estate however the general estate must be the designated recipient and not the T.S.T. itself since the transfer must be as a consequence of death; and not an *inter vivos* contract.⁸²¹

Subparagraph 70(7)(b) is the operative paragraph of the whole Sec. 70(7)-(8) mechanism and while non-depreciable capital property and money are referred to as possible listing subjects the provisions do not explicitly state that property listed must have been otherwise qualified for Sec. 70(6) treatment.⁸²² The provisions do apply for purposes of Sec. 70(6), but they are not specifically restrictively structured to apply only in respect of property that would gain from Sec. 70(6) treatment. In the author's opinion the Sec. 70(7)-(8) provisions operate so as to allow the Department to ascertain the value of the capital property that vests for the benefit of the spouse under Sec. 70(6). If the provision's purpose is to operate as such; to determine the net amount of capital property that will vest for the benefit of the spouse, or any other party, for that matter, then when one recognizes that the Sec. 70(7) provision has **not been restricted** so as to apply explicitly only in respect of capital property it should become reasonable to assume that the draughtsmen were allowing room for non-capital property to be legitimately listed. Inventorial property, resource property, etc., have value

816 See Re: Chester, 1978 19 S.A.S.R. 247, for a classic example.

817 See Abbott v. Union Trustee Co. of Aust. Ltd., 41 C.L.R. 384.

818 *inter vivos* options are clearly "listable" and could be the property which must be contributed or sold as per the above arrangements.

819 The taxpayer will receive a bequest from the trust as a beneficiary prior to her death and thus the trust will not be spousal altogether. The author admits that this is a conceptually correct observation but whether the taxpayer can "receive or otherwise obtain the use of" the trust debt when it is canceled is an interesting question. In substance the debtor would receive trust capital in the form of that which the trust expected to realize on the extinguishment of the debt.

820 See Re: McClintock, 1976 12 O.R. 742, for discretionary forgiving of debt.

821 If the spousal trust is to receive it directly it will not be transferred as a consequence of the death: see Russell v. Scott, 55 C.L.R. 440, & Williams v. F.C.T., 81 C.L.R. 359.

822 It is also possible to list property which was transferred to the T.S.T. that was the subject of the Sec. 70(6.2) alternate treatment election.

that can be applied against the non-qualifying debt without the trustees having to resort to capital property that received Sec. 70(6) treatment in order to satisfy it. In some wills this is exactly the case and in fact when one examines many wills one may find that "major ticket items", property with substantial cost that is usually capital in the tax sense, will rarely be subject to an instruction to convert to cash so as to satisfy debt when other forms of property are available.

Is it possible to list rights or things that are realizable by a spousal trust given the wording of Sec. 70(3)? That provision speaks only of recipients being "beneficiaries or beneficially interested" hence give the broadness of the wording in possible recipients is it possible that a spousal trust can serve as either within this context? As will be pointed out, a "sink" must be provided at the end of the listing process that statutorily is required to be "a capital property" and if the draughtsman felt required to add that term as the sink to cause some FMV integration, and that Sec. 70(6) only applies to capital property to begin with, **why wasn't the extra step taken to ensure that only capital property could be listed?**

It is the amount of "non-qualifying debt" that will cause the negation of the Sec. 70(6) treatment to the particular type of property hence with the definition of "non-qualifying debt" it should seem obvious that where a mortgage has been arranged prior to death, (secured upon property owned), the proceeds of which were used to extinguish the non-qualifying debt existing the tax consequences therefrom may be negated without the harsh negation of the applicability of Sec. 70(6). Even more tax effective is the specifying of such cash under Sec. 70(7)(b) so as to untaint the trust, transfer the cash to the trust, and maintain the liability for the non-qualifying debt while maintaining the applicability of Sec. 70(6) to all other property. The cash could then be distributed to the spouse as under Sec. 107(2) or possibly be used to extinguish the claim of the mortgagee/creditor⁸²³. In either case through the sustaining of a mortgage on property owned prior to his death the deceased has managed to eliminate the tax consequences of the listing process simply by having sufficient cash on hand.⁸²⁴

By choosing the mortgagor the testator can also fine-tune to whom interest will be paid ahead of the spousal party under the trust, by knitting it to income production there is a tax-free generation of cash for sprinkling to beneficiaries to be chosen, a production of a debt does not draw consequences under the Sec. 70(7)-(8) and tax deduction for interest payable, and the under-cutting of income to which the spouse must be entitled under the trust.

The legal representative will thus list property the "fair market value" of which immediately before death exceeds the amount of non-qualifying debt however Sec. 70(8)(a) provides that the "fair market value" of property subject to a mortgage or hypothec is equal to the fair market value of that property that exceeds the amount of the debt outstanding in respect of it at that time thus where the taxpayer has secured mortgages then his legal representative might find himself having to list more property. As per Sec. 70(7) it is the "fair market value" of the property immediately **after** the taxpayer's death as opposed to immediately before that is to be recognized.⁸²⁵ It must be remembered that the application of Sec. 70(5) resulting from the listing process will have as its recognized amount a deemed disposition at **actual** fair market value hence the deceased will recognize far more substantial tax consequences if the legal representative has to list mortgaged property. Where the property wasn't subject to a mortgage lien but instead the debt was simply formerly guaranteed by the deceased then it will be considered a non-qualifying debt if it is to be assumed by the trust. It should be recognized that the Sec. 70(6.2) election which can be made by the legal representative causing the specified property not to be treated under Sec. 70(6) but instead under Sec. 70(5) is a process mutually exclusive of the listing process described under Sec. 70(7) however both that election, and the listing under Sec. 70(7) will be

⁸²³ who may also be an ultimate capital beneficiary of the trust

⁸²⁴ Income tax refunds and rights thereto can be listed as well: see *Perp. Exors. (Thomson's Case) v. Commr.*, 77 C.L.R. 1.

⁸²⁵ If a taxpayer has an interest in a trust that is discretionary during his life its value immediately before his death will be very subjectively determined while if, as per the trust terms, the interest vests upon his death so that his estate or heirs receive a vested interest then the Sec. 70(5) provision will be beneficially applied. This is of interest where the taxpayer has set up a spousal *inter vivos* trust, and wishes to retain some sort of trust law capital interest and have his testamentary trust benefit from the arrangement albeit there is a danger of the effect of Sec. 75(2).

executed in the same return; the one for the taxpayer's terminal year.⁸²⁶

It is also obvious that the property specified under Sec. 70(7)(b) need not be property that will cause the recognition of capital gain or income but may also cause tax benefits, through the deemed disposition, in the form of the recognition of accrued capital losses or terminal losses or income losses. Where non-depreciable capital property is "listed" the superficial loss provision under Sec. 54(i) would not operate to deny the recognition of a capital loss on a superficially unfavourable listing however it should be kept in mind that the listing of property should be done with full integrated use of the Sec. 70(6.2) election hence when possible, through the combined use of both, tax consequences from dispositions may net each other out. The even hand rule should be carefully observed in this process in two aspects; a listing of specific property will affect the ACB of the property for purposes of its subsequent disposition by the trust which will affect the ultimate beneficiary's realized benefit while the immediate consequences due to the application of Sec. 70(5) may or may not reduce or increase the amount of capital that is transferred to the trust or direct beneficiary due to the need to satisfy the resulting tax bill. Specific directions should be prudently provided in the will to attend to these issues, (if an intentional taint is to occur), whereby particular beneficiaries' entitlements are to be affected for the benefit of others. If not, via the listing process, the beneficiaries may not be treated equally.⁸²⁷

In the author's opinion these provisions should definitely be the focus of some fine-tuning of the terminology by which the subject matter is dealt with since per what the provisions now say there is very porous description of what property can be used to off-set the loading of debt into a spousal trust while there is too much leniency in when the debt can be incurred that allows for too much, arguably, unintentional flexibility.

Excessive Listings and Arbitrary Reductions.

The unfortunate aspect about the Sec. 70(7) listing process is that it operates on a property by property basis hence where limited large property items exist their listing may cause recognition of a disposition which would cause the resulting recognition of a substantial gain or loss, except where the property is a capital property other than depreciable property, (regardless of whether or not it's of a prescribed class), that isn't money. If the estate transferred does not consist of at least one non depreciable capital property other than money then the following cost adjustments cannot be made.

Where the fair market value of all of the property listed, **regardless of its character**, exceeds the aggregate of the non-qualifying debt the excess is the "listed value excess". If the legal representative has listed a non-depreciable capital property, other than money, then the capital gain or loss recognizable under Sec. 70(5) from the deemed disposition of that property will be that proportion of the capital gain or loss otherwise determined that the fair market value thereof that exceeds the listed value excess is of the fair market value of the property itself. Apparently, where the fair market value of the capital property does not exceed the listed value excess the proration breaks down and capital gain or loss will not be adjusted. Thus it is not enough to list a non-depreciable capital property to allow for an adjustment to take place, the property so listed must in fact have a fair market value that exceeds the listed value excess, (only one property is to be listed).⁸²⁸ If the designation is made the capital loss or gain realized from the disposition of that property will be reduced to that determined by the above formula. Understandably, where the capital gain or loss is cut back by the proration then under para. (iv) the cost to the trust of that particular capital property will be its cost to the taxpayer plus or minus the capital gain/loss ultimately to be recognized as per the proration. With this in mind the designation need not always be made such as in the instance where the capital loss otherwise recognized can be fully absorbed by the deceased or oppositely in respect of a capital gain, without immediate tax consequence. Effectively whatever the deceased recognizes as capital gain or loss will have a direct effect on the cost of the property to the trust. If the deceased can afford to realize capital gains and thus absorb capital losses that are

⁸²⁶ Property which was subject to the Sec. 70(6.2) alternative treatment is not precluded from being listed under Sec. 70(7) as well.

⁸²⁷ It is questionable whether in fact the legal representative must be concerned with offending the even-hand rule in this case since listing the property he may only be acting in the capacity of an executor/administrator and thus not have to worry about impartiality. Even still it may be better to be safe than sorry: someone should obtain a judicial opinion.

⁸²⁸ "Fair market value" in this case, as per Sec. 70(8)(a) is the fair market value of the property net of the value of any mortgages/hypothec liened upon it, immediately **after** the death.

"on the books" and would otherwise be lost then either the capital property should be listed under the Sec. 70(7) process or under Sec. 70(6.2) alternative treatment since the trust will be able to recognize the property as having a higher initial cost.⁸²⁹

Filing.

In order to have the Sec. 70(7) untainting process apply the legal representative must elect for such in the deceased's return of income for the terminal year and as per para. (a) of Sec. 70(7) the day that such a return is due is 18 months after the date of death however this applies even if the trust is unsuccessfully untainted. This extended period will also allow the legal representative extra time to ascertain that the trust is properly constituted as otherwise eligible for treatment under Sec. 70(6). This extended time period also applies to the special returns described under Sec. 150(4) or 104(23)(d) however such an extended filing date may affect the Sec. 70(2) election. Although the required filing time is extended to 18 months after death interest is still calculated on unpaid balances of tax payable from the date that is the later of six months after death and April 30th of the year following death.

With regards to the ultimate extinguishment of the non-qualifying debt the trust may utilize funds from any source and not just from dispositions of the previously listed property.

In the author's opinion a spousal trust untainted by the Sec. 70(7)-(8) mechanics is a spousal trust to which the Sec. 104(4) deemed disposition rules apply **on a technical reading of the provisions**. Subparagraph 70(7)(b)(ii) provides that such a purified trust will "be **deemed** to be a trust described in subsection (6)" and thus it will be **deemed** to be a trust under which no person other than the spouse may obtain or receive the use of the trust's capital or income. The Sec. 70(7)(b)(ii) provision does not apply solely for purposes of Sec. 70(6); statutory convention is that if it were to be it would be specified, hence it applies for purposes of the whole Act and thus the fact that the trust may have been constituted with creditors "on board" does not detract from the effect of the deeming for purposes of Sec. 104(4) etc..⁸³⁰

Subject: "Tainted" Spouse Trusts.

IT-207R Date: March 26, 1979

This bulletin replaces and cancels Interpretation Bulletin IT-207 dated April 28, 1975. Current revisions are designated by vertical lines.

1. A spouse trust, as described in subsection 70(6), is created by a taxpayer's will entitling the spouse, during his or her lifetime, to receive all income of the trust and allowing no one but the spouse (prior to the spouse's death) to receive or obtain the use of any of its income or capital. A spouse trust is also considered to have been created by the taxpayer's will under subsection 70(6.1) where beneficiaries of the trust disclaim any interests that would otherwise disqualify the trust, or where the spouse trust is created by an order obtained under provincial dependents' relief legislation. Death duties payable in consequence of a taxpayer's death out of the assets of a spouse trust in respect of any property, or any interest in, that trust and any income or profits tax payable by it in respect of its income do not, by virtue of subsection 108(4), prevent the trust from qualifying under subsection 70(6).
2. Under subsection 70(6), capital property transferred to the spouse trust "rolls over" to the trust with the result that no capital gains or losses arise in respect of that property at the time of the taxpayer's death (unless an election is made under subsection 70(6.2) to have the deemed realization rules under subsection 70(5) apply to any property with respect to which the election has been made). Under the general rules contained in subsection 104(4), there is a deemed disposition of the non-depreciable capital property of the spouse trust for proceeds equal to fair market value at the time of the spouse's death. In the case of the deemed disposition of depreciable property, the proceeds are prescribed as the midpoint between undepreciated capital cost and fair market value at the time of death, pursuant to subsection 104(5).
3. A trust created by a taxpayer's will in favour of a spouse does not meet the qualifications of a spouse trust

⁸²⁹ If trusts are set up on an individual property/class of property basis obtaining the spousal characteristics in respect of any of them, given the above, may lose its importance.

⁸³⁰ See I.T. 349R2, para. 19, for the Department's recognition of this result.

set out in subsection 70(6) is colloquially referred to as a "tainted spouse trust". One cause of a spouse trust being tainted is a direction in the will to pay out of the trust various debts, obligations and death duties, other than those to which subsection 108(4) applies (see 1 above.).

4. Subsection 70(7) provides a method for untainting some types of tainted spouse trusts, thus permitting the rollover provided by subsection 70(6). This is possible when the debts, obligations and death duties referred to in 3 above are "testamentary debts" and the trust otherwise qualifies as a spouse trust described in 1 above. The term "testamentary debt", which is defined in paragraph 70(8)(c), includes:

- (a) . any debt of the taxpayer outstanding immediately before his or her death;
- (b) . any amount payable by the estate in consequence of death, including funeral and testamentary expenses and compensation to representatives for carrying out those duties which are normally exercised by an executor or administrator, i.e., up to the point the estate assets are transferred or distributed to the beneficiaries or to the trustee of the tainted spouse trust or any other trust arising on death;
- (c) . income or profits tax payable by or in respect of the taxpayer for the taxation year in which he or she died and for any previous taxation year for which it has not been paid;
- (d) . death duties payable in consequence of the taxpayer's death.

Testamentary debts do not include any amount payable to any person as beneficiary of the estate.

5. A trust for the benefit of a spouse is tainted in a manner that cannot be remedied by the method provided in subsection 70(7) if certain types of obligations are to be met out of its assets before the death of the spouse. Examples of such obligations include:

- (a) . a contingent liability to make good any deficiency that may arise in another trust created under the same will,
- (b) . a liability for the payment of trustee fees applicable to other trusts under the will, and
- (c) . an obligation to pay a bequest to another beneficiary out of the assets of the estate that are held by the spouse trust.

The trust is not tainted in this manner, however, if the debts or obligations to be met are:

- (d) . a testamentary debt (see 4 above),
- (e) . a debt or obligation to the spouse,
- (f) a debt or obligation incurred for the benefit of the spouse, or
- (g) . an obligation to pay fees to the trustee for the administration of the spouse trust.

6. In general terms, the method provided in subsection 70(7) to untaint a tainted spouse trust that is capable of being untainted (i.e., as described in 4 above) is to total all testamentary debts of the trust and deduct:

- (a) . death duties payable in respect of property bequeathed to the trust, or in respect of interests in the trust (note that these amounts do not taint a spouse trust; see 1 above), and
- (b) . debts secured by mortgage or hypothec on property owned by the deceased.

The remaining debts are referred to in paragraph 70(8)(b) as non-qualifying debts. In the return of income for the taxpayer's last taxation year, the taxpayer's legal representative must elect to have the trust treated as a spouse trust and listed one or more specified properties of the trust having a fair market value at death at least equal to the total of the non-qualifying debts. The list may include money and if it alone is sufficient to cover the non qualifying debts, no other properties need be listed. The trust is then deemed to be a spouse trust and the assets listed against the non-qualifying debts are deemed to have been disposed of at fair market value (or midpoint for depreciable property) immediately before the death of the deceased pursuant to subsection 70(5), with the result that the capital gains or losses arising therefrom are included in computing the deceased's income. The other assets transferred to the spouse trust qualify for the rollover provided in subsection 70(6). The foregoing procedure may be illustrated as follows:

Assumptions

Testamentary Debts

Income tax owing by the deceased	\$10,000
Death duties on bequest to sister	10,000
Death duties payable on spouse's interest in trust	20,000

Death duties payable on remainderman's interest in the trust	40,000
Business Debt of the deceased	15,000
Mortgage on apartment building	80,000
Mortgage on land	10,000
Testamentary and Funeral expenses	<u>1,000</u>
	\$186,000

To determine non-qualifying debts, deduct:

Death duties payable on spouse's interest in the trust	\$20,000
Death duties payable on the remainderman's interest in the trust	40,000
Mortgage on apartment building	80,000
Mortgage on land	<u>10,000</u>
	\$150,000

Non-qualifying debts	<u>\$36,000</u>

The executor then specifies any properties of the tainted spouse trust having a fair market value at least equal to these non-qualifying debts. The fair market value of any property listed must be reduced by the amount of any debt secured by a mortgage or hypothec on the property.

Listed property:

Shares - Fair market value at death	\$9,000
Land - Fair market value	\$41,000
less mortgage thereon	<u>10,000</u>
Net fair market value at death	31,000
Net fair market value of listed property	<u>\$40,000</u>

Capital gain or loss:

Shares - fair market value at death	\$9,000
adjusted cost base to deceased	5,000
Capital Gain	<u>\$4,000</u>
Land - fair market value at death	\$41,000
Adjusted cost base to deceased	30,000
Capital gain	<u>\$11,000</u>

he deemed realization rules in subsection 70(5) apply to the capital properties so listed, and in this example the capital gain is \$15,000 (\$4,000 + \$11,000).

7. The deemed capital gain of one specified capital property other than depreciable property may be reduced according to a formula if the fair market value of all the property listed exceeds the non-qualifying debts. The excess is called the "listed value excess" and in the example in 6 above is \$4,000 (\$40,000 - 36,000). To illustrate how the reduction is calculated, assume that in the example above the legal representative has designated, in the taxpayer's return, the particular property to be the shares. The capital gain on the shares and their adjusted cost base to the trust are then calculated pursuant to subparagraph 70(7)(b)(iii) and (iv) as: Capital gain as otherwise determined x (Fair market value of the shares less the listed value excess) ÷ Fair market value of the shares.

$$\$4,000 \times (9,000 - 4,000) \div 9,000 = \$2,222$$

Therefore the total capital gain is \$13,222 (\$2,222 + 11,000). The adjusted cost base of the two properties to the spouse trust is:

land \$41,000; shares \$7,222 (\$5,000 + 2,222).

8. A capital loss that arises by reason of the application of subsection 70(5) to a particular capital property (other than a depreciable property) that has been designated by the legal representative in respect of a "listed value excess" is reduced by the application of subparagraph 70(7)(b)(iii) if the transfer or distribution of the property to the trust occurs after May 25, 1976. To illustrate the application of this rule, assume in the example in 6 above that the adjusted cost base of the shares (being the designated property) was \$15,000, resulting in a capital loss of \$6,000. The capital loss calculated in accordance with subparagraph 70(7)(b)(iii) is as follows: Capital gain as otherwise determined x (Fair market value of the shares less the listed value excess) ÷ Fair market value of the shares.

$\$6,000 \times (9,000 - 4,000) \div 9,000 = \$3,333$

Therefore the net capital gain is \$7,667 (\$11,000 - 3,333). The adjusted cost base of the two properties to the spouse trust is: land \$41,000; shares \$11,667 (\$15,000 - 3,333).

9. Where non-qualifying debts include income tax payable by the deceased's representative in respect of the return for the year of death, the amount payable is computed after giving effect to the provisions of paragraph 70(7)(b). It is therefore necessary to consider the effect that the listing of a particular property will have on the amount of tax payable. The adjustment of a capital gain or loss on a designated property pursuant to subparagraph 70(7)(b)(iii) may also have a significant effect in some circumstances. When the amount of the tax liability is a critical factor in the selection of assets to be listed (or the asset to be designated), more than one notional tax calculation may be necessary.

10. The legal representative is not obliged to dispose of the listed properties of the trust to obtain the funds to pay the non-qualifying debts. They may be paid from any available source of funds.

11. The legal representative is responsible for computing the non-qualifying debts and the fair market value of specified properties as accurately as possible from the facts available. Where these computations are subsequently determined to be incorrect, despite the reasonable efforts of the legal representative, and the value of the specified properties is actually less than the total of the non-qualifying debts, it is the practice of the Department to permit additional properties to be specified at that later time in order that the provisions of subsection 70(6) may still apply to the unspecified properties of the trust.

12. It is arguable that a trust in favour of a spouse created under a taxpayer's will out of the residue of his estate is tainted by the distributions and payments necessary to establish the trust corpus. Under the interpretation, it is necessary to follow the procedures set out in subsection 70(7) when it is intended that the trust qualify as an exclusive spouse trust under paragraph 70(6)(b). Another view is that subsection 70(6) applies to such of the original assets of the estate as are retained to form a part of the trust corpus without the necessity of following the procedures described in subsection 70(7). Either interpretation is acceptable to the Department with the result that a trustee has the following options available in respect of an estate involving a residuary spouse trust that otherwise satisfies the requirements of subsection 70(6).

- (a). The trustee may choose to have subsection 70(5) provisions apply to all of the assets of the estate.
- (b). By following the procedures described in subsection 70(7), subsection 70(6) rules will apply to those assets of the residuary spouse trust that are not listed as described in 6 above and subsection 70(5) rules will apply to all other assets of the estate, subject to adjustment in respect of any "listed value excess" (see 7 above).
- (c). The trustee may choose to have subsection 70(5) apply to all of the assets of the estate that are distributed or otherwise disposed of before the corpus of the residuary spouse trust is established and have subsection 70(6) apply to such of the original assets of the estate as are retained as the property of the trust.

The right to elect under subsection 70(6.2) (referred to in 2 above) is unaffected by the adoption of either option (b) or option (c).

13. Whenever a tainted spouse trust capable of being untainted by subsection 70(7) is created, regardless of the simultaneous creation under the will of other trusts to which subsection 70(7) is irrelevant, the legal representative has up to 18 months from the date of death to file the deceased's final return of income. This is the case whether or not such a trust is successfully untainted under paragraph 70(7)(b). This extended time for filing also applies to special returns that may be available pursuant to subsection 150(4) and paragraph

104(23)(d). Although the due date for making an election under subsection 70(2) in respect of rights or things of the deceased at the time of death is indirectly extended if the extended filing date referred to above delays the mailing of a notice of assessment, the basic rule (the later of one year after death and 90 days after mailing of an assessment notice) remains unchanged. Returns that the deceased failed to file for years prior to the year of death must be filed by his or her legal representative within six months of the date of death.

14. Although the return of income for the year of death may be filed within 18 months of death, interest at the prescribed rate commences to run on any unpaid balance from the later of six months after death and April 30th of the year following death.

15. Although the treatment for tax purposes applicable to the acquisition of listed properties by a trust differs from that applicable to the acquisition of the balance of the trust properties, listed properties are, nevertheless, properties of a trust which is deemed to be a spouse trust and subject to the special rules relating to spouse trusts found elsewhere in the Act (e.g., the deemed disposition of such properties under paragraph 104(4)(a) upon the death of the spouse).

Deemed Dispositions.

There's only so long that a trust can own property without it recognizing the tax consequences due to the deemed disposition rules below.⁸³¹

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March 2001 FINANCE TECHNICAL NOTES Subsections 104(4) to (5.2) set out what is generally referred to as the "21-year deemed realization rule" for trusts. The purpose of the rule is to prevent the use of trusts to defer indefinitely the recognition for tax purposes of gains accruing on capital properties, resource properties and land inventories. These subsections generally treat such properties as having been disposed of and reacquired by trust (other than certain trusts for the benefit of a spouse or common-law partner) every 21 years at the properties' fair market value. The first deemed disposition day for post-1971 spousal or common-law partner trusts, as provided under paragraph 104(4)(a), is the day on which the spouse or common-law partner beneficiary dies. The fair market value of property that is deemed to be disposed of on a day determined under paragraph 104(4)(a) or (a.1), is determined with reference to the valuation rule for insurance policies in amended subsection 70(5.3) (see the commentary above on that provision).

Subsections 104(4) to (5.2) are amended so that the deemed realization rules do not apply to "exempt property" of a non-resident trust, as the expression is now defined in subsection 108(1). "Exempt property" is defined as property the income or gain from the disposition of which by a taxpayer is exempt from Canadian taxation for the taxpayer either because the taxpayer is not resident in Canada or because of a tax treaty. The purpose of this amendment is to prevent the deemed realization rules from being used to increase the cost of such property. The increased cost might be relevant in the event that a non-resident trust distributes such property to Canadian beneficiaries. These amendments apply to deemed disposition days that are after December 23, 1998. In the case of capital property (other than depreciable property), the amendments also apply to deemed disposition days that are after 1992, but only for the purpose of determining after December 23, 1998 the cost amount to a trust of property.

June 1992 FINANCE TECHNICAL NOTES: Subsections 104(4) to (5.2) set out what is generally referred to as the "21-year deemed realization" rule for trusts. The purpose of the rule is to prevent the use of trusts to defer indefinitely the recognition for tax purposes of gains accruing on capital properties, resource properties and land inventories. These subsections generally treat such properties as having been disposed of and reacquired by trusts every 21 years at their fair market value (or in the case of depreciable property, at the mid-point between fair market value and undepreciated capital cost). However, this rule does not apply to unit trusts and certain trusts established to provide pension and other employee benefits. In addition, the 21-year deemed realization rule is modified in the case of certain spousal trusts.

June 1992 FINANCE TECHNICAL NOTES: Under the existing rules, the first deemed realization for those spousal trusts described in paragraph 104(4)(a) occurs on the day on which the beneficiary spouse dies. A spousal trust described in this paragraph includes a testamentary trust created as a consequence of the death of a taxpayer after 1971 under which the surviving spouse was exclusively entitled to the income of the trust before his or her death and no other person was entitled before that time to the capital of the trust. It also includes a similar trust created by a taxpayer during the taxpayer's lifetime for the benefit of the taxpayer's spouse, provided the trust was created after June 17, 1971 or was a trust created on or before that date which does not qualify for graduated rates of personal tax because of subsection 122(1).

Subsection 104(4) is amended to clarify that a deemed realization of non-depreciable capital property or land inventory on a day determined thereunder occurs at the end of the day. Subsection 104(5) is amended so that a deemed realization of depreciable property likewise occurs at the end of a day determined under subsection 104(4).

Subsection 104(4) is also amended so that it does not result in the realization of gains with respect to "excluded property", as defined in new paragraph 108(1)(d.12). "Excluded property" is a share of the capital stock of a non-resident-owned investment corporation (as defined in section 133) which does not constitute taxable Canadian property. This amendment is consistent with the other taxation rules with respect to such corporations in subsections 104(10) and (11), section 133 and subsection 212(9) which allow a trust holding such shares exclusively for the benefit of non-residents to be treated as a conduit for its beneficiaries.

Paragraph 104(4)(a) is amended so that a post-1971 spousal testamentary trust referred to therein includes a trust that, immediately after any capital property, Canadian or foreign resource property or land inventory vested indefeasibly in the trust on a rollover basis as a consequence of the death of a taxpayer, was a trust under which the surviving spouse of the taxpayer was exclusively entitled to the income of the trust before his or her death and no other person was entitled before such death to the capital of the trust. This amendment recognizes that subsections 70(5.2) and (6) allow beneficiaries of a trust to make disclaimers, releases and surrenders pursuant to subsection 248(8) in order for property to be transferred on a rollover basis on death of a taxpayer for the benefit of the taxpayer's spouse. It is thus appropriate that a deemed realization occurs with respect to such a trust when the beneficiary spouse dies. This amendment is applicable with respect to deaths of beneficiary spouses occurring after December 20, 1991.

Paragraph 104(4)(a) is also amended so that it will no longer apply to "tainted" inter vivos spousal trusts created before June 18, 1971 (i.e. those trusts that have failed to meet all the conditions set out in paragraphs 122(2)(b) to (e)). Such trusts would generally fall within the new category of "pre-1972 spousal trusts", as described below.

Under the rule introduced in new paragraph 104(4)(a.1), the first deemed realization for a trust that is a pre-1972 spousal trust on January 1, 1993 occurs on the later of the day on which the beneficiary spouse dies and January 1, 1993. The expression "pre-1972 spousal trust" is discussed in the commentary on new paragraph 108(1)(f.2).

Paragraph 104(4)(b) is amended so that it causes a deemed realization with respect to a pre-1972 spousal trust only 21 years after any deemed realization under paragraph 104(4)(a.1). This is consistent with the existing rule for post-1971 spousal trusts.

Paragraph 104(4)(c) provides for further deemed realizations 21 years after any other deemed disposition day under subsection 104(4). It is amended to avoid the determination of a deemed disposition day with respect to a spousal trust that is determined under paragraph 104(4)(b).

Except as noted above, these amendments are applicable to taxation years of trusts ending after February 11, 1991.

Sept. 1985 FINANCE TECHNICAL NOTES: Subsection 104(4) treats all non-depreciable capital property, resource property and land inventory of a trust as having been disposed of for fair market value and to have been reacquired for the same value at specified times. Generally, those times are on the death of a spouse and every 21 years thereafter in the case of a spousal trust, and every 21 years in the case of other trusts. A similar rule is provided in subsection 104(5) for depreciable properties. These provisions result in the realization by the trust of any accrued capital gains or losses and of depreciation recapture at the times specified. The existing provisions do not produce the intended result on the deemed disposition and reacquisition of resource properties because of the way in which the Act pools the costs of resource properties and the proceeds of disposition of such properties. Subsection 104(4) is amended so that it no longer applies to resource properties and new rules dealing with these properties are set out in new subsection 104(5.2).

1982 FINANCE TECHNICAL NOTES: Subsection 104(4) deems all non-depreciable capital property of a trust to have been disposed of for its fair market value at certain times. Generally, those times are on the death of a spouse and every 21 years thereafter, in the case of a spousal trust, and every 21 years, in the case of other trusts. The amendment to subsection 104(4) expands the properties of a trust to which the deemed disposition rules apply after November 12, 1981 to include resource properties and land inventories of a trust.

1976 Notice of Ways and Means Motion: That paragraph 104(4)(a) of the Act be revised so that

(a) where the spouse who is a beneficiary under a trust has died after December 31, 1975 if the trust was created before January 1, 1972 and fulfils certain other conditions the trust shall not be deemed to have disposed of each of its capital properties on the spouse's death, and

(b) for greater certainty, where the spouse who is a beneficiary under a trust has died after May 25, 1976 and the trust at any time after June 18, 1971 was a trust as described in that paragraph the trust shall be deemed to have disposed of each of its capital properties on the spouse's death.

March 2001 FINANCE TECHNICAL NOTES: Paragraph 104(4)(a) is amended to Provide the first deemed disposition day in respect of an inter vivos trust created after 1999 that at any time after 1999 was a trust for the exclusive benefit of the settlor during the settlor's lifetime (i.e., an "alter ego trust", as newly defined in subsection 248(1)) or a trust for the joint benefit of the settlor and the settlor's spouse or common-law partner during their lifetimes (i.e., a "joint spousal or common-law partner trust", as newly defined in subsection 248(1)). The first deemed disposition date in these circumstances, in the event that the settlor was at least 65 years of age at the time of the settlement, is generally the day on which the senior dies (or, in the case of a trust for the joint benefit of the settlor and spouse or common-law partner, the day on which the survivor dies). However, where a trust that would otherwise be an alter ego trust so elects under subparagraph 104(4)(a)(ii.1), the first deemed disposition date of the trust will generally be the 21st anniversary of the creation of the trust, as determined under paragraph 104(4)(b). For an explanation of the age 65 restriction, see the commentary on new subsection 73(1.02).

July 2010 FINANCE TECHNICAL NOTES (Part 1 — technical): Subsection 104(4) sets out what is generally referred to as the "21-year deemed realization rule" for trusts. The purpose of subsection 104(4) is to prevent the use of trusts to defer indefinitely the recognition for tax purposes of gains accruing on capital property. Subsection 104(4) generally treats capital property of a trust (other than certain trusts for the benefit of a spouse or common-law partner) as having been disposed of and reacquired by the trust every 21 years at the property's fair market value.

Subparagraph 104(4)(a)(i.1) is amended to apply to a trust to which property is transferred in circumstances to which paragraph 70(5.2)(c) applied. It is also amended to ensure that it continues to apply to a trust to which property was transferred in circumstances to which paragraph 70(5.2)(b) or (d) applied as those paragraphs read in their application to taxation years that began before 2007. This amendment applies to trust taxation years that begin after 2006.

Dec. 1997 FINANCE TECHNICAL NOTES (technical): Subsection 104(4) contains provisions that relate to what is generally referred to as the "21-year deemed realization" rule for trusts. Subparagraph 104(4)(a)(i.1), which deals with certain spousal trusts, refers to paragraph 70(5.2)(d) or (f). Those paragraphs were amended by the Statutes of Canada 1994, chapter 21 (Bill C-27), which restructured subsection 70(5.2). This amendment to subparagraph 104(4)(a)(i.1) updates the corresponding references so that they correctly reflect that restructuring. It applies to acquisitions and dispositions that occur after 1992, the same period to which the corresponding amendment to subsection 70(5.2) applies.

Dec. 1995 FINANCE TECHNICAL NOTES: Subsections 104(4) to (5.2) set out what is generally referred to as the "21-year deemed disposition" rule for trusts. Under paragraph 104(4)(a.1), a deemed disposition for a trust that is a pre-1972 spousal trust on January 1, 1993 occurs on the later of the day on which the beneficiary spouse dies and January 1, 1993. The expression "pre-1972 spousal trust" is defined in subsection 108(1). Paragraph 104(4)(b) causes a deemed disposition with respect to a pre-1972 spousal trust 21 years after any deemed disposition under paragraph 104(4)(a) or (a.1). Paragraph 104(4)(a.1) is amended to provide that a pre-1972 testamentary spousal trust is not subject to a deemed disposition under that paragraph, unless the beneficiary spouse was alive on January 1, 1976. Amended paragraph

“Deemed disposition by trust – Sec. 104(4)”

(4) Every trust is, at the end of each of the following days, deemed to have disposed of each property of the trust (other than exempt property) that was capital property (other than excluded property or depreciable property) or land included in the inventory of a business of the trust for proceeds equal to its fair market value (determined with reference to subsection 70(5.3)) at the end of that day and to have reacquired the property immediately after that day for an amount equal to that fair market value, and for the purposes of this Act those days are

(a) where the trust

(i) is a trust that was created by the will of a taxpayer who died after 1971 and that, at the time it was created, was a trust,

(i.1) is a trust that was created by the will of a taxpayer who died after 1971 to which property was transferred in circumstances to which paragraph 70(5.2)(b) or 70(5.2)(d) or 70(6)(d) applied and that, immediately after any such property vested indefeasibly in the trust as a consequence of the death of the taxpayer, was a trust,

(ii) is a trust that was created after June 17, 1971 by a taxpayer during the taxpayer’s lifetime that, at any time after 1971, was a trust, or

(ii.1) is a trust (other than a trust the terms of which are described in clause (iv)(A) that elects in its return of income under this Part for its first taxation year that this subparagraph not apply) that was created after 1999 by a taxpayer during the taxpayer’s lifetime and that, at any time after 1999, was a trust under which

(iii) the taxpayer’s spouse or common-law partner was entitled to receive all of the income of the trust that arose before the spouse’s or common-law partner’s death and no person except the spouse or common-law partner could, before the spouse’s or common-law partner’s death, receive or otherwise obtain the use of any of the income or capital of the trust, or

(iv) in the case of a trust described in subparagraph (ii.1) created by a taxpayer who had attained 65 years of age at the time the trust was created,

(A) the taxpayer was entitled to receive all of the income of the trust that arose before the taxpayer’s death and no person except the taxpayer could, before the taxpayer’s death, receive or otherwise obtain the use of any of the income or capital of the trust,

(B) the taxpayer or the taxpayer’s spouse was, in combination with the spouse or the taxpayer, as the case may be, entitled to receive all of the income of the trust that arose before the later of the death of the taxpayer and the death of the

104(4)(a.1) also provides that a pre-1972 inter vivos spousal trust is not subject to deemed disposition under that paragraph unless the beneficiary spouse was alive on May 26, 1976. These amendments recognize that, in the event that a beneficiary spouse died after 1971 and before 1976 (or before May 26, 1976 in the case of an inter vivos trust), a pre-1972 spousal trust would have already been subject to a deemed disposition on the day the beneficiary spouse died because of the former wording of paragraph 104(4)(a). Paragraph 104(4)(b) is amended to clarify that, in these circumstances, such a trust is subject to a further deemed disposition on the day that is 21 years after the beneficiary spouse died.

spouse and no other person could, before the later of those deaths, receive or otherwise obtain the use of any of the income or capital of the trust, or

(C) the taxpayer or the taxpayer's common-law partner was, in combination with the common-law partner or the taxpayer, as the case may be, entitled to receive all of the income of the trust that arose before the later of the death of the taxpayer and the death of the common-law partner and no other person could, before the later of those deaths, receive or otherwise obtain the use of any of the income or capital of the trust,

the day on which the death or the later death, as the case may be, occurs;

(a.1) where the trust is a pre-1972 spousal trust on January 1, 1993 and the spouse or common-law partner referred to in the definition "pre-1972 spousal trust" in subsection 108(1) in respect of the trust was

(i) in the case of a trust created by the will of a taxpayer, alive on January 1, 1976, and

(ii) in the case of a trust created by a taxpayer during the taxpayer's lifetime, alive on May 26, 1976,

the day that is the later of

(iii) the day on which that spouse or common-law partner dies, and

(iv) January 1, 1993;

(a.2) where the trust makes a distribution to a beneficiary in respect of the beneficiary's capital interest in the trust, it is reasonable to conclude that the distribution was financed by a liability of the trust and one of the purposes of incurring the liability was to avoid taxes otherwise payable under this Part as a consequence of the death of any individual, the day on which the distribution is made (determined as if a day ends for the trust immediately after the time at which each distribution is made by the trust to a beneficiary in respect of the beneficiary's capital interest in the trust)⁸³²;

832 March 2001 FINANCE TECHNICAL NOTES: Paragraph 104(4)(a.2) is introduced to provide for a deemed disposition day for a trust that distributes property financed by a liability of the trust. This measure only applies, however, if one of the purposes of the transaction was to avoid taxes otherwise payable as a consequence of the death of an individual. The deemed disposition under this paragraph occurs immediately after the distribution of the property (as the determination is made as if a day had ended immediately after each distribution). This amendment applies to deemed disposition days determined after December 17, 1999.

Paragraph 104(4)(a.3) is introduced to provide for a deemed disposition day for a trust in the event that an individual, after December 17, 1999, has transferred property to the trust in circumstances to which subsection 73(1) applies, it is reasonable to conclude that the property was so transferred in anticipation that the taxpayer would subsequently cease to reside in Canada and the individual subsequently ceases to reside in Canada. This measure does not apply, however, to property transferred that is exempt under amended subparagraphs 128.1(4)(b)(i) to (iii) from a deemed disposition on the transferor's emigration. The deemed disposition under paragraph 104(4)(a.3) occurs immediately after the individual ceases to be resident in Canada. This amendment applies to deemed disposition days determined after December 17, 1999.

Paragraph 104(4)(a.4) is introduced to provide the first deemed disposition day in respect of an inter vivos trust to which property was transferred by a taxpayer who is an individual (other than a trust) in circumstances in which section 73 or subsection 107.4(3) applied. Where the transfer does not result in a change in beneficial ownership of that property and no person (other than the taxpayer) or partnership has any absolute or contingent right as a beneficiary under the trust (determined with reference to subsection 104(1.1)), the first deemed disposition date of the trust property is the day on which the taxpayer dies. This amendment applies to the 2000 and subsequent taxation years, and, where a trust elects in

(a.3) where property (other than property described in any of subparagraphs 128.1(4)(b)(i) to (iii)) has been transferred by a taxpayer after December 17, 1999 to the trust in circumstances to which subsection 73(1) applied, it is reasonable to conclude that the property was so transferred in anticipation that the taxpayer would subsequently cease to reside in Canada and the taxpayer subsequently ceases to reside in Canada, the first day after that transfer during which the taxpayer ceases to reside in Canada (determined as if a day ends for the trust immediately after each time at which the taxpayer ceases to be resident in Canada);

(a.4) where the trust is a trust to which property was transferred by a taxpayer who is an individual (other than a trust) in circumstances in which section 73 or subsection 107.4(3) applied, the transfer did not result in a change in beneficial ownership of that property and no person (other than the taxpayer) or partnership has any absolute or contingent right as a beneficiary under the trust (determined with reference to subsection (1.1)), the day on which the death of the taxpayer occurs⁸³³;

(b) the day that is 21 years after the latest of

(i) January 1, 1972,

(ii) the day on which the trust was created, and

(iii) where applicable, the day determined under paragraph (a), (a.1) or (a.4) as those paragraphs applied from time to time after 1971; and⁸³⁴

writing and files the election with the Minister of National Revenue on or before March 31, 2001 (or at a later time that is acceptable to the Minister), the amendment applies to days after December 23, 1998. For more detail on section 73, subsection 104(1.1) or section 107.4, see the commentary on those provisions.

833 Nov. 2006 FINANCE TECHNICAL NOTES (Part 1 - NRTs and FIEs): Paragraph 104(4)(a.5.) i& ,introduced to provide for a deemed disposition day for a trust that is deemed by subsection 94(3) to be resident in Canada for a taxation year for the purpose of computing the trust's income for the year. The deemed disposition day is the day (in that taxation year) on which, because a "contributor" (as defined in subsection 94(1)) to the trust either ceases to be resident in Canada or ceases to be a contributor to, the trust because of the application at any time of paragraph 94(2)(t), there is no resident contributor to the trust (or the only resident contributors to the trust are entities .each of which is an entity the maximum amount recoverable from Which under the provisions referred to in paragraph 94(3)(d) is limited to the entities' recovery limits determined under, subsection 94(8)). However, no deemed disposition will occur under paragraph 104(4)(a.5) if subsection 94(5) applies in respect of the contributor ceasing on that day to be a resident contributor of the trust. For more information on section 94, see the commentary on that section.

834 May 2001 FINANCE TECHNICAL NOTES (Commons Finance Committee): Clause 78 of Bill C-22 deals with section 104 of the Act. This section provides rules governing the tax treatment of trusts and their beneficiaries.

Subclause 78(5) of Bill C-22 would provide, in paragraph 104(4)(b), for a deemed disposition of the property of certain trusts at the end of the day that is 21 years after the latest of January 1, 1972, the day on which the trust was created and the day determined under the paragraphs referred to in subparagraph 104(4)(b)(iii).

Paragraph (a) of this motion would replace the reference to a "time" a reference to a "day" being determined under the paragraphs mentioned in subparagraph 104(4)(b)(iii).

March 2001 FINANCE TECHNICAL NOTES: Paragraph 104(4)(b) provides for a deemed disposition of the property of certain trusts at the end of the day that is the 21 years after the latest of January 1, 1972, the day on which the trust was created, and, where applicable, the day determined under paragraph 104(4)(a) or (a.1) as those paragraphs applied from time to time after 1971. Subparagraph 104(4)(b)(iii) is amended to add a reference to new paragraph 104(4)(a.4). This will ensure that the first deemed disposition day of a trust that is determined under subsection 104(4) and that is after the day determined under paragraph 104(4)(a.4) in respect of the trust generally will be the day that is 21 years after the day determined under paragraph 104(4)(a.4). This amendment applies to the 2000 and subsequent taxation years, and, where a trust elects in writing and files the election with the Minister on or before March 31, 2001 (or at any later time that is acceptable to the Minister), to days after December 23, 1998. For more detail on section 73 or subsection 104(1.1) Or 107.4(3), see the commentary on those provisions.

(c) the day that is 21 years after any day (other than a day determined under any of paragraphs (a) to (a.4)) that is, because of this subsection, a day on which the trust is deemed to have disposed of each such property.⁸³⁵

These provisions disallow the taxpayer from “getting very far” in deferring the inherent tax liabilities in the streaming of property through a trust. Paragraph (a) captures for deemed dispositions on the date of death of the underlying spouse of a spousal trust. Paragraph (a.1) provides some grandfathering of the implementation of the new measures that cause recognitions in the hands of the trust when the underlying spouse dies.

Paragraph (a.2) targets those instances where there is a financing through mortgage etc. that even though qualify as “eligible off-sets” defined in section 107 allows the capital beneficiary receiving the property from the trust to have it fiscally considered. It’s to be noted that the targeting for deemed dispositions on distributions in Sec. 104(4) refers exclusively to liabilities of the trust and even though there is a purpose test ascribed to their creation, if the eligible off-set recognized in the section 107 definition is not an actual liability of the trust incurred to reduce taxes then the provision doesn’t apply. In the author’s opinion such would include instances where the trust is varied to allow conditions precedent to attach to property to pay alternative beneficiaries.

Paragraph (a.3) targets emigrating spouses who toss their property into an *inter vivos* Sec. 73(1) spousal trust and then leave the ship. The provision disallows them to avoid immediate deemed dispositions in the hands of the trust once they “pass the customs’ questions” (“flying into Los Angleeez”) by having a tax-free rolled-to trust hold onto it for them. I wonder what would happen if, “in anticipation” the taxpayer would transfer the property to her spouse directly and then have her set up a Sec. 73(1) trust for him, doing the “hot-potato” thing. Is this what the legislators were broadly speaking of when they chose to not specifically knit the actual trust with the emigrating taxpayer using instead to target the transfer as “**in circumstances to which subsection 73(1) applied**”? Even still, even in the face of very loose “multiple trust” rules, it could be beneficial to sprinkle ownership across multiple spousal trusts each with slightly different classes of beneficiaries so that when they all suffer deemed dispositions they are all in lower tax brackets: how many different trusts can own the same house at the same time? And, if the taxpayer comes back, the trust gets hit again for every time the particular taxpayer ceases to be resident: says a lot for going through customs on the 183rd day in Toronto doesn’t it Kim. Thankfully the opening preamble of Sec. 104(4) sets up the cost of the trust property equal to that FMV from that point on so it may prove better to simply own the property out-right and go through a section 128.1 deemed disposition and perform some sorcerers tricks while non-resident and then come back with an enhanced FMV rather than get it stuck in a trust in Canada.

Paragraph (a.4) causes FMV deemed dispositions on the death of a **beneficial owner** of property that has been transferred to the trust under an *inter vivos* roll-over cited. “Beneficial ownership” carries more weight in the dealing with trust property than merely being beneficially interested in it. It denotes instances where the beneficial owner can call for it to be mortgaged/disposed of/used at his discretion without any say from the trust documents while in converse the trustee has practically no power to deal with the property and merely has legal name registered with her.

Paragraph (b) and (c) are the “head’m off at the pass” provisions that cause every trust to recognize a FMV disposition every 21 years measured from the day it was created or the above events.

835 Nov. 2006 FINANCE TECHNICAL NOTES (Part 1 - NRTs and FIEs): Paragraph 104(4)(c) is amended so that there is not a deemed disposition day for a trust 21 years after any day determined under new paragraph 104(4)(a.5). In effect, the time from which 21 years is counted under paragraph 104(4)(c) is determined without regard to days determined without regard to days determined under any of paragraphs 104(4)(a) to (a.5)

These amendments apply to trust taxation years that begin after 2006. They also apply to trust taxation years that begin after 2000, after 2001, after 2002, after 2003, after 2004 or after 2005 if the trust makes the appropriate election under the coming-into-force provision for new section 94.

March 2001 FINANCE TECHNICAL NOTES: Paragraph 104(4)(c) is amended so that there is not a deemed disposition day for a trust 21 years after, any day determined under new paragraph 104(4)(a.2), (a.3) or (a.4).

“Depreciable property – Sec. 104(5)”

(5) Every trust is, at the end of each day determined under subsection (4) in respect of the trust, deemed to have disposed of each property of the trust (other than exempt property) that was a depreciable property of a prescribed class of the trust for proceeds equal to its fair market value at the end of that day and to have reacquired the property immediately after that day at a capital cost (in this subsection referred to as the “deemed capital cost”) equal to that fair market value, except that

(a) where the amount that was the capital cost to the trust of the property immediately before the end of the day (in this paragraph referred to as the “actual capital cost”) exceeds the deemed capital cost to the trust of the property, for the purpose of sections 13 and 20 and any regulations made for the purpose of paragraph 20(1)(a) as they apply in respect of the property at any subsequent time,

(i) the capital cost to the trust of the property on its reacquisition shall be deemed to be the amount that was the actual capital cost to the trust of the property, and

(ii) the excess shall be deemed to have been allowed under paragraph 20(1)(a) to the trust in respect of the property in computing its income for taxation years that ended before the trust reacquired the property;

(b) for the purposes of this subsection, the reference to “at the end of a taxation year” in subsection 13(1) shall be read as a reference to “at the particular time a trust is deemed by subsection 104(5) to have disposed of depreciable property of a prescribed class”; and

(c) for the purpose of computing the excess, if any, referred to in subsection 13(1) at the end of the taxation year of a trust that included a day on which the trust is deemed by this subsection to have disposed of a depreciable property of a prescribed class, any amount that, on that day, was included in the trust’s income for the year under subsection 13(1) as it reads because of paragraph 104(5)(b), shall be deemed to be an amount included under section 13 in the trust’s income for a preceding taxation year.⁸³⁶

836 May 1994 FINANCE TECHNICAL NOTES: Subsection 104(5) provides rules that treat depreciable property of most trusts as having been disposed of at its fair market value every 21 years. This deemed realization is meant to prevent trusts from being used to defer indefinitely the recognition of taxable gains with respect to trust property. The first deemed realization for pre-1972 trusts occurs on January 1, 1993.

Subsection 104(5) is amended to clarify the computation of the amount (known as the “undepreciated capital cost”) that can be written-off by a trust subsequent to the deemed disposition in the event that the fair market value of depreciable property at the time of the deemed disposition is less than the original capital cost of the property. In these circumstances, this amendment ensures that the “undepreciated capital cost” of depreciable property after the reacquisition is equal to its “undepreciated capital cost” before the disposition plus any amount included in the trust’s income by virtue of the disposition.

The following example illustrates the effect of this amendment.

EXAMPLE

A pre-1972 trust owns a building having an original capital cost of \$100,000. The undepreciated capital cost of the building is \$30,000, as a consequence of the trust having earlier claimed in total \$70,000 as capital cost allowance (CCA). The fair market value of the building on January, 1, 1993 is \$80,000.

Result:

1. As a consequence of subsection 104(5), the trust includes in income “recaptured” CCA of \$50,000 (\$80,000 - \$30,000).
2. The new undepreciated capital cost is equal to \$80,000. This amount is determined as follows:

	(a)	\$100,000 (original capital cost)
+	(b)	100,000 (capital cost on reacquisition)
+	(c)	50,000 (recaptured CCA)
-	(d)	70,000 (CCA previously claimed)
-	(e)	20,000 (CCA deemed to have been previously claimed)
-	(f)	80,000 (proceeds on deemed disposition)

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“Election – Sec. 104(5.3)”

(5.3) Where a trust files an election under this subsection in prescribed form with the Minister within 6 months after the end of a taxation year of the trust that includes a day before 1999 (in this subsection referred to as the “disposition day”) that would, but for this subsection, be determined in respect of the trust under paragraph 104(4)(a.1) in the case of a trust described in that paragraph, or under paragraph 104(4)(b) in any other case, and there is an exempt beneficiary under the trust on the disposition day,

(a) for the purposes of subsections 104(4) to 104(5.2), paragraph 104(6)(b) and subsection 159(6.1), the day determined under paragraph 104(4)(a.1) or 104(4)(b), as the case may be, in respect of the trust is deemed to be the earlier of

(i) January 1, 1999, and

(ii) the first day of the trust’s first taxation year that begins after the first day after the disposition day throughout which there is no exempt beneficiary under the trust;

(b) subsection 107(2) does not apply to a distribution made by the trust during the period

(i) beginning immediately after the disposition day, and

(ii) ending at the end of the first day after the disposition day that is determined in respect of the trust under subsection 104(4) to any beneficiary (other than an individual who is an exempt beneficiary under the trust immediately before the time of the distribution);

(b.1) where the trust filed the form before March 1995, paragraph 104(5.3)(b) does not apply to distributions made by the trust after February 1995; and

(c) subsection 107.4(3) does not apply to a disposition by the trust during the period

(i) beginning immediately after the disposition day, and

(ii) ending at the end of the first day after the disposition day that is determined in respect of the trust under subsection 104(4).

(d) [Repealed, 2001, c. 17, s. 78(11)]⁸³⁷

\$80,000

3. In the absence of this change, it is arguable that the new undepreciated capital cost would have been computed without reference to items (a) and (d), above. This would clearly have been unintended.

Sept. 1985 FINANCE TECHNICAL NOTES: The amendment to subsection 104(5) is strictly technical and ensures that the specified times for the deemed disposition of depreciable properties of a particular trust are those determined in relation to the circumstances of that trust.

837 March 2001 FINANCE TECHNICAL NOTES: Subsection 104(5.3) allowed the deferral of the 21-year deemed disposition date (determined under paragraph 104(4)(a.1) or (b)) for certain family trusts. The measure has already been terminated under the existing rules, so that the deferred disposition date was no later than January 1, 1999.

Subject to paragraph 104(5.3)(d), paragraph 104(5.3)(c) ensures that the deemed disposition date cannot be deferred beyond January 1, 1999 (or an earlier date, where applicable) through a transfer of property from one trust to another that does not constitute a "disposition" because of existing paragraph (e) of the definition "disposition" in section 54.

Any trust-to-trust transfer in the period (referred to below as the "relevant period") that is after the original date of the deemed disposition and before the date of the deferred deemed disposition is considered to be a "disposition" (i.e., a taxable event) for a trust that has made an election under subsection 104(5.3). Paragraph 104(5.3)(d) provides for relief from paragraph 104(5.3)(c) where, essentially, one trust is replaced by another trust with the same terms and beneficiaries. In this case, the new trust is deemed to be the same trust as, and a continuation of, the original trust.

Paragraph 104(5.3)(c) is amended to eliminate the reference to the existing definition of "disposition" in section 54, as a consequence of the repeal of that definition and its replacement by a new definition of "disposition" in subsection 248(1).

Paragraph 104(5.3)(c) is also amended so that it only applies where there is a "disposition" of property (as now defined in subsection 248(1)). The only relevant "trust-to-trust" transfer where there is no "disposition" is one to which paragraph (f) of the new definition "disposition" applies. Where paragraph (f) of that definition applies, the transferee trust is considered under subsection 248(25.1) to be the same as and a continuation of the transferor trust.

Paragraph 104(5.3)(d) is repealed, consequential to the introduction of paragraph (f) of the new definition "disposition" and new subsection 248(25.1).

Dec. 1995 FINANCE TECHNICAL NOTES: Subsections 104(4), (5) and (5.2) set out what is generally referred to as the "21-year deemed realization" rule for trusts. These subsections generally treat trust assets as having been disposed of and reacquired by trusts at their fair market value every 21 years. Subsection 104(5.3) provides an exception to the 21-year deemed realization rule. This exception applies where a trust elects to have the rules in paragraphs 104(5.3)(a) to (d) apply. The election must be made in prescribed form and filed with Revenue Canada within 6 months after the end of the trust's taxation year which includes the day that, but for the election, would be its first deemed realization day (or its second realization day in the case of a post-1971 spousal trust to which the rules in paragraph 104(4)(a) apply). Where the trust so elects and, at the end of such day, any individual is an exempt beneficiary under the trust, the deemed realization of a trust's property would generally be postponed to the first day of the first taxation year following the death of the last surviving "exempt beneficiary". In addition, because of existing paragraph 104(5.3)(b), rollovers from a trust Under subsection 107(2) are available only to exempt beneficiaries during the period for which the 21-year deemed realization rule is postponed. An "exempt beneficiary" under a trust is defined in subsection 104(5.4).

Subsection 104(5.3) is amended so that no election is available to postpone deemed disposition days that occur after 1998.

Paragraph 104(5.3)(a) is amended to modify the tax consequences for trusts which have elected under subsection 104(5.3) to postpone the 21-year deemed realization rule. Under amended paragraph 104(5.3)(a), a trust which has so elected will generally be subject to a deemed realization of its assets at fair market value on January 1, 1999 (or, if earlier, the first day of the first taxation year following the death of the last surviving exempt beneficiary).

Paragraph 104(5.3)(b.1) is introduced so that rollovers under subsection 107(2) to all beneficiaries under a trust are available after February 1995 where the prescribed form containing the election under subsection 104(5.3) was filed before March 1995. This measure, in conjunction with new subsection 104(5.31), ensures that trusts are not penalized by having made an election under subsection 104(5.3).

New subsection 104(5.31) allows a trust to apply before 1997 to the Minister of National Revenue to revoke an election that was filed under subsection 104(5.3) before July 1995. Where the Minister grants permission to revoke an election under subsection 104(5.3), paragraph 104(5.31)(a) provides that it is to be treated as if it were never made.

New paragraph 104(5.31)(b) provides that a trust is not liable to any penalty under the Act to the extent that the liability would otherwise have increased because of the revocation of the election under subsection 104(5.3).

New paragraph 104(5.31)(c) requires the Minister to assess each taxation year of any taxpayer to take into consideration the consequences of the revocation of an election under subsection 104(5.3), even if the normal reassessment period for that year has expired.

1995 FINANCE NOTICE OF WAYS AND MEANS MOTION: (10) That

(a) the election that allows for the postponement of the day on which trust assets are considered by the 21-year rule to be disposed of not be available after 1998, and

(b) capital property, land inventory and resource property held on January 1, 1999 by a trust that has made that election be deemed to be disposed of by the trust on that day for proceeds equal to its fair market value.

1995 BUDGET SUPPLEMENTARY INFORMATION: The Taxation of Family Trusts

Family trust arrangements allow property to be held by a trust for the benefit of beneficiaries under the trust. Trusts are used for many purposes, including succession planning for businesses and dealing with the needs of beneficiaries in special circumstances, such as age and disability. The budget proposes two changes to the taxation of family trusts to ensure that they do not provide any undue tax advantages.

21-Year Deemed Disposition Rule

The existing provisions relating to the taxation of trusts generally require trust assets to be treated for tax purposes as if they were disposed of every 21 years. This measure accompanied the introduction of capital gains taxation in 1972 to prevent trusts from being used to avoid the taxation of capital gains on death.

The previous government enacted a special election that permitted an extension of the 21-year rule and the postponement of capital gains taxation on trust property until the death of the last "exempt beneficiary" under the trust. An exempt beneficiary is essentially a family member no more than one generation removed from the person who established the trust.

Effective January 1, 1999, the budget proposes to eliminate this special election. Those trusts which have at any time before that date elected to postpone capital gains taxation will be subject to a deemed realization of trust assets at fair market value on that date. This will not apply where all the trust property has been distributed to beneficiaries before that date. Where property is distributed from a trust to an exempt beneficiary, capital gains would be realized when the exempt beneficiary disposes of the property or when the exempt beneficiary (or the exempt beneficiary's spouse) dies.

June 1992 FINANCE TECHNICAL NOTES: Subsection 104(5.3) is introduced to provide a further exception to the 21-year deemed realization rule.

This exception applies where a trust so elects in prescribed form, filed with Revenue Canada Within 6 months after the end of its taxation year that includes the day that, but for the election, would be its first deemed realization day (or its second deemed realization day in the case of a post-1971 spousal trust to which the rules in paragraph 104(4)(a) apply) Where the trust elects and; at the end of such day, any individual is an exempt beneficiary under the trust, the deemed realization day is postponed to the first day of the first taxation year of the trust beginning after the first day throughout which there is no exempt beneficiary under the trust. (This deemed realization day may be advanced under new subsection 104(5.8), however, if property is transferred to the trust from another trust.) Thus, a deemed realization of a trust's property would generally be postponed to the, first day of the first, taxation year following the death of the last-surviving exempt beneficiary.

Where an election is made by a trust under subsection 104(5.3), a rollover of trust property, to a beneficiary on a tax-free basis under subsection 107(2) may, in the period after the otherwise determined 21-year deemed realization, date and before the day after the newly determined 21-year deemed realization date, be made only to an individual who is an exempt beneficiary. Any other distribution of trust property in that period would be treated as a disposition at fair market value under subsection 107(2.1).

A further consequence of an election by a trust under subsection 104(5.3) is 'that transfers of capital property from one trust to another, in the period described above in respect of the trust, may not be made on a tax-free basis under paragraph 54(c)(v). An exception to this rule is provided where there is merely a change in trustees with respect to transferred property. If the property is regarded as being transferred from one trust to another in these circumstances, subparagraph 54(c)(v) will still apply and the transferee, trust will be regarded as the same trust as the transferor trust.

"Exempt beneficiary"

For the purpose of the rules described above, an "exempt beneficiary" under a trust is defined in new subsection 104(5.4) as a living beneficiary under the trust, where the following two conditions are satisfied:

- (a) in the case of a trust created after February 11, 1991, the beneficiary or a brother or sister of the beneficiary was alive at the time the trust was created (or, if earlier, the creation time of all other trusts transferring land inventory, capital property or resource properties to the trust in circumstances to which new subsection 104(5.8) applies), and
- (b) either

- the beneficiary or the beneficiary's spouse or former spouse was the designated contributor in respect of the trust, or
- the beneficiary or the beneficiary's spouse or former spouse' was a grandparent, parent; brother, sister, child, niece or nephew of the designated contributor of the trust or of the spouse or former spouse of the designated contributor in respect of the trust.

The expressions "beneficiary" and "designated contributor", as used in subsection 104(5.4), are defined in new subsections 104(5.5) and (5.6).

"Beneficiary"

For the purposes of determining whether an individual is an "exempt beneficiary", a beneficiary 'under new subsections 104(5.5) and 248(25) is generally a person who has any contingent or absolute right under the trust. However, under paragraph 104(5.5)(a), no individual will be regarded as an exempt beneficiary under certain trusts in which all of the interests of individuals 'who are exempt beneficiaries(determined without reference to the paragraph) depend on the exercise of discretion. This paragraph applies where this discretion could result in the interests of all such individuals (and other individuals who are children of deceased individuals who were exempt beneficiaries under the trust) terminating before the death of the last survivor of such individuals and the other individuals and without any of such individuals or the other individuals enjoying any future benefit in respect of their interests. This paragraph applies only to trusts created or materially varied after February 11, 1991.

Under paragraph 104(5.5)(b), a beneficiary's right under a trust will also be disregarded for the purposes of the "exempt beneficiary" definition if it is reasonable to consider that one of the main purposes for creating the right was to defer the day determined in respect of the trust under paragraph 104(4)(a.1) or (b). This could be the case, for example, where an individual is given a nominal absolute interest under the trust or a contingent interest which is virtually certain not to vest.

"Designated contributor"

The "designated contributor" in respect of a spousal trust is the individual who created, or whose will created, the trust. Where the trust is a non-spousal testamentary trust, as of the end of a taxation year for which an election is made under subsection 104(5.3), the designated contributor is the individual as a consequence of whose death the trust was created. In any other case, the "designated contributor" in respect of a trust is an individual who was, or was related to a beneficiary under the trust, is designated by the trust and qualifies under subparagraph 104(5.6)(c)(i), (ii) or (iii).

An individual generally qualifies as a designated contributor in respect of an inter vivos trust under subparagraph 104(5.6)(c)(i) where, at each time in the relevant period in respect of the trust (as defined in paragraph 104(5.7)(a)), the total amount of property previously transferred or loaned before that time by the designated individual to the trust

- was greater than the total amount so transferred or loaned before that time by each other individual who was born before the designated individual and who was related to a beneficiary of the trust, and
- was greater than or equal to the total amount so transferred or loaned before that time by each other individual who was born after the designated individual and who was related to a beneficiary of the trust.

Paragraph 104(5.7)(a) provides that the relevant period in respect of a trust, for the purposes of subsection 104(5.6), is the period commencing one year after the day that the trust was created and ending on the day that, but for the trust's election, would be its deemed realization day under paragraph 104(4)(a.1) or (b). In addition, under paragraph 104(5.7)(b), two individuals are considered to be related to each other, for the purposes of subsection 104(5.6), if one of them is the aunt, great-aunt, uncle or great-uncle of the other.

Where no individual qualifies under subparagraph 104(5.6)(c)(i), an individual who transferred or loaned money to the trust may nevertheless be designated under subparagraph 104(5.6)(c)(ii) if he or she was born before all other individuals who are related to the beneficiaries of the trust and who transferred or loaned property to the trust.

An individual also generally qualifies as a designated contributor under subparagraph 104(5.6)(c)(iii) where, throughout the relevant period in respect of the trust, the property of the trust consisted primarily of

- (a) shares of the capital stock of a corporation controlled, at the time the trust was created or at the beginning of the relevant period in respect of the trust, by such individual or, where no single individual controlled such corporation, by such individual and one or more other individuals born after, and related to, such individual;
- (b) shares of the capital stock of a corporation all or substantially all of the value of which derived, throughout the relevant period, from property transferred to the corporation by such individual or by such individual and one or more other individuals born after, and related to, such individual;
- (c) shares in a holding corporation all or substantially all of the value of which derived, throughout such part of that period during which the holding corporation shares were held by the trust, from the shares described in paragraph (a) or (b) above;
- (d) property substituted for the shares described above;
- (e) property attributable to profits, gains or distributions with respect to the properties described above; or
- (f) any combination of the properties described above.

For the purposes of paragraphs (b) and (c) above, new paragraph 104(5.7)(d) provides that, in determining whether the value of shares is derived from other property, the other property is deemed to include property substituted for the other property and property attributable to profits, gains and distributions with respect to the other property and the substituted property.

New paragraph 104(5.7)(c) provides that an individual shall not be considered to be a designated contributor with respect to a trust where it is reasonable to consider that one of the main purposes of a series of transactions or events that includes a borrowing or an acquisition of any property by an individual was to defer the application of the 21-year deemed realization rule under paragraph 104(4)(b). This anti-avoidance rule also applies where an individual is made trustee of a trust to allow the individual to be a designated contributor under subparagraph 104(5.6)(c)(iii).

The application of the new election in subsection 104(5.3) is illustrated below.

Example 1

Trust A is a testamentary trust created on the death of Mrs. A prior to 1972. The beneficiaries of the trust are Mrs. A's children, nieces and grandchildren all of whom are alive on January 1, 1993.

- Result:
1. The trust may elect under subsection 104(5.3) in its 1993 income tax return to defer the application of the 21-year rule deemed disposition rule.
 2. Mrs. A is the "designated contributor" (paragraph 104(5.6)(b)) in respect of the trust. The children and nieces of Mrs. A are "exempt beneficiaries" under paragraph 104(5.4)(b).
 3. The election will result in the deemed realization of the trust property being delayed until the first day of the first taxation year of the trust commencing after the death of all of Mrs. A's children and nieces or the termination of their interests in the trust.

Example 2

Trust B is an inter vivos trust created before 1972 the beneficiaries of which are the children and grandchildren of Mr. B. Mr. B sold property with a fair market value of \$1,000 to the trust 6 months after it was created. Mr. B's two children each subsequently loaned (i) \$600, or (ii) \$1,200 to the trust in 1974 which has been repaid. No other property was transferred or loaned to the trust in the relevant period.

- Result:
1. The trust may designate Mr. B as the designated contributor under paragraph 104(5.6)(c). If \$600 was subsequently loaned by the two children, Mr. B is the designated contributor under subparagraph 104(5.6)(c)(i) by reason of having transferred or loaned more than each of his sons throughout the relevant period. If \$1,200 was subsequently loaned, then Mr. B is the designated contributor under subparagraph 104(5.6)(c)(ii) by reason of being the oldest individual who loaned or contributed property to the trust during the relevant period.
 2. If the trust elects under subsection 104(5.3), it may elect Mr. B as the designated contributor in which case Mr. B's children will be exempt beneficiaries. The grandchildren, will not be exempt beneficiaries.
 3. The election will result in the deemed realization of trust property being delayed until the first day of the first taxation year of the trust commencing after the death of all of Mr. B's children or the termination of their interests in the trust.

Example 3

Opco Corporation is controlled by Mr. K. Opco undergoes a corporate freeze at the end of 1973. In March, 1974 Opco issues common shares to an inter vivos trust created on January 11 1974. The trust beneficiaries are Mr. K's children. The

“Revocation of election – Sec. 104(5.31)”

(5.31) Where a trust that has filed an election under subsection 104(5.3) before July 1995 applies before 1997 to the Minister in writing for permission to revoke the election and the Minister grants permission to revoke the election,

common shares appreciate between 1974 and 1995. The trust's assets in that period consist primarily of those shares and public company shares acquired through dividends paid on Opco shares.

Result:

1. The trust may elect under subsection 104(5.3) in its 1995 income tax return to defer the application of the 21-year rule deemed disposition rule.
2. Mr. K is the "designated contributor" in respect of the trust under subparagraph 104(5.6)(c)(iii). Mr. K's children are "exempt beneficiaries".
3. The election will result in the deemed realization of the trust property being delayed until the first day of the first taxation year of the trust commencing after the death of all of Mr. K's children or the termination of their interests in the trust.

These amendments apply after February 11, 1991, except as noted above.

Feb. 1991 FINANCE TECHNICAL NOTES (trusts): The draft legislation released today responds essentially to five concerns with respect to the 21-year deemed realization rule.

First, the existing rule is unduly broad in its application and, as such, interferes with the use of trusts in non-tax related matters. Thus, for example, trusts established by parents exclusively for the benefit of their disabled children are subject to the rule. If properly were transferred directly to a child in such circumstances, rather than merely made available under a trust, the gain arising after the time of transfer would only be recognized on the death of the child or when disposed of by the child.

Second, the existing rule may impose a tax liability on a trust which does not have any reasonable means by which to satisfy the liability. For example, a trust which holds a control block of shares in a private corporation may be forced to liquidate its holdings to satisfy the tax liability resulting from the rule. This concern is of particular relevance in respect of trusts established before the announcement of the rule in 1971, since such trusts would not have been structured to take into account such a rule.

Third, the existing rule is arbitrary. While other rules in the Income Tax Act deem realizations in the event of death, emigration from Canada or change in property use, such deemed realizations are seen as necessary ways in which the Canadian tax system recognizes real events. By contrast, the 21-year deemed realizations occur on dates that are of relevance solely for tax purposes.

Fourth, the existing rule may result in a deemed realization for tax purposes of property used by a beneficiary as a principal residence. In this regard, it should be noted that trusts are generally not allowed to claim the principal residence exemption even where a beneficiary inhabits property, held by a trust.

The final concern with the existing rule is that transfers between trusts may be arranged to avoid its application. Under such an arrangement, for example, property could be transferred on a tax-free basis from one trust to another trust established shortly before the application of the rule in respect of the first trust. While such an arrangement may now be subject to the general anti-avoidance rule (GAAR), it would not always be clear in what manner a trust's tax liability would be assessed if GAAR were to apply.

The proposals may be summarized as follows.

(1) A trust will generally be allowed to elect to defer the application of the rule where it has an "exempt beneficiary" at the end of the year for which the rule would otherwise apply. An exempt beneficiary includes the spouse and the grandparents, parents, brothers, sisters, children, nieces and nephews of the trust's "designated contributor". The "designated contributor" in relation to a testamentary trust is the individual on whose death a testamentary trust was created or, in the case of an inter vivos trust, generally an individual designated by the trust who contributed or loaned property to the trust from which more than half of the trust property derived. In the event that the trust does so elect, the date of the first 21-year deemed realization will be deferred so that it arises on the first day on which there is no exempt beneficiary under the trust (for example, by virtue of the death of all such beneficiaries). If the trust does so elect, it will be allowed to transfer property on a tax-free basis only to exempt beneficiaries, and it would not be allowed to allocate income arising under the delayed 21-year realization under the preferred beneficiary election rules.

(2) A trust will be allowed to pay the tax arising from the application of the rule, with applicable interest, in up to 10 annual instalments.

(3) A trust will generally be allowed to claim property as a principal residence where the property was used as such by one of its beneficiaries.

(4) A measure is proposed to address transactions involving transfers between trusts which result in a deferral of the application of the rule. A trust which receives property in these circumstances will generally face the application of the rule on the projected date the transferor trust will be subject to the deemed realization. This measure would generally apply only where that date is earlier than the date on which the recipient trust would otherwise have faced the application of the rule.

(a) the election is deemed, otherwise than for the purposes of this subsection, never to have been made;

(b) the trust is not liable to any penalty under this Act to the extent that the liability would, but for this paragraph, have increased because of the revocation of the election; and

(c) notwithstanding subsections 152(4) to 152(5), such assessments of tax, interest and penalties under this Act shall be made as are necessary to take into account the consequences of the revocation of the election.

“Exempt beneficiary – Sec. 104(5.4)”

(5.4) For the purpose of subsection 104(5.3), an “exempt beneficiary” under a trust at a particular time is an individual who is alive and a beneficiary under the trust at the particular time, where

(a) in the case of a trust that was created after February 11, 1991, the individual, or an individual who, otherwise than because of subsection 252(2), is the brother or sister of the individual, was alive at the earlier of

(i) the time the trust was created, and

(ii) the earliest of all times each of which is the time that another trust was created that, before the particular time and the end of the day that would, but for subsection 104(5.3), be determined in respect of the trust under paragraph 104(4)(a.1) or 104(4)(b), transferred property to the trust either

(A) directly, or

(B) indirectly through one or more trusts,

in circumstances in which subsection 104(5.8) applies; and

(b) the individual or the individual’s spouse or common-law partner or former spouse or common-law partner was

(i) the designated contributor in respect of the trust, or

(ii) a grandparent, parent, brother, sister, child, niece or nephew

(A) of the designated contributor in respect of the trust, or

(B) of the spouse or common-law partner or former spouse or common-law partner of the designated contributor in respect of the trust.

“Beneficiary – Sec. 104(5.5)”

(5.5) For the purpose of subsection 104(5.4), a beneficiary under a trust is an individual who is beneficially interested in the trust, except that an individual shall be deemed not to be a beneficiary under a trust at a particular time

(a) where

(i) the interests in the trust at the particular time of all individuals who would, if this Act were read without reference to this paragraph, be exempt beneficiaries under the trust are conditional on or subject to the exercise of a discretionary power by a person,

(ii) by the exercise of (or the failure to exercise) such power under the terms of the trust after the particular time, all interests in the trust of

(A) those individuals, and

(B) other individuals who are children of deceased individuals who, if this Act were read without reference to this paragraph, would have been exempt beneficiaries under the trust at any time before the particular time may terminate before the time at which the last of those individuals and the other individuals dies and without any of those individuals or the other individuals enjoying any benefit under the trust after the particular time, and

(iii) the trust was created after February 11, 1991 or subparagraph 104(5.5)(a)(ii) applies in respect of the trust because of a variation of the terms of the trust occurring after February 11, 1991; or

(b) where it is reasonable to consider that one of the main purposes for the creation of the interest of the individual in the trust was to defer the day determined under paragraph 104(4)(a.1) or 104(4)(b) in respect of the trust.

“Designated contributor – Sec. 104(5.6)”

(5.6) For the purpose of subsection 104(5.4), a designated contributor in respect of a trust is

(a) where the trust is described in paragraph 104(4)(a) or was, on December 20, 1991, a pre-1972 spousal trust, the individual who created (or whose will created) the trust;

(b) where paragraph 104(5.6)(a) does not apply and the trust is a testamentary trust at the end of the taxation year for which it makes an election under subsection 104(5.3), the individual as a consequence of whose death the trust was created; and

(c) in the case of any other trust, the individual who was, or who was related to, an individual beneficially interested in the trust and who is designated by the trust in its election under subsection 104(5.3)

(i) where, at each time in the relevant period, the total amount of property transferred or loaned before that time by the designated individual (either directly or through another trust) to the trust

(A) exceeded the total amount of property so transferred or loaned before that time by each other individual who was born before the designated individual and who, at any time, was related to any individual beneficially interested in the trust, and

(B) was not less than the total amount of property so transferred or loaned before that time by each other individual who was born after the designated individual and who, at any time, was related to any individual beneficially interested in the trust,

(ii) where

(A) no individual may be designated in respect of the trust because of subparagraph 104(5.6)(c)(i),

(B) the designated individual transferred or loaned property (either directly or through another trust) to the trust at any time before the end of the relevant period, and

(C) the designated individual was born before all other individuals who

(I) at any time were related to any individual beneficially interested in the trust or to any individual who transferred or loaned property to the trust before the end of the relevant period, and

(II) transferred or loaned property (either directly or through another trust) to the trust at any time before the end of the relevant period, or

(iii) where throughout the relevant period the property of the trust consisted primarily of

(A) shares of the capital stock of a corporation

(I) controlled, on the day that the trust was created or at the beginning of the relevant period, by the designated individual or by the designated individual and one or more other individuals born after, and related to, the designated individual, or

(II) all or substantially all of the value of which throughout the relevant period derived from property transferred to the corporation by the designated individual or by the designated individual and one or more other individuals born after, and related to, the designated individual,

(B) shares of the capital stock of a corporation all or substantially all of the value of which, throughout the part of the relevant period throughout which the shares were held by the trust, derived from shares described in clause 104(5.6)(c)(iii)(A),

(C) property substituted for the shares described in clause 104(5.6)(c)(iii)(A) or 104(5.6)(c)(iii)(B),

(D) property attributable to profits, gains or distributions in respect of property described in clause 104(5.6)(c)(iii)(A), 104(5.6)(c)(iii)(B) or 104(5.6)(c)(iii)(C), or

(E) any combination of the properties described in clauses 104(5.6)(c)(iii)(A) to 104(5.6)(c)(iii)(D).

“Idem – Sec. 104(5.7)”

(5.7) For the purpose of subsection 104(5.6),

(a) the relevant period in respect of a trust is the period that begins one year after the day on which the trust was created and ends at the end of the day that would, but for the election of the trust under subsection 104(5.3), be determined in respect of the trust under paragraph 104(4)(a.1) or 104(4)(b), as the case may be;

(b) 2 individuals shall be deemed to be related to each other where one of them is the aunt, great aunt, uncle or great uncle of the other individual;

(c) an individual shall be deemed not to be a designated contributor in respect of a trust where it is reasonable to consider that one of the main purposes of a series of transactions or events that includes

(i) an individual becoming a trustee in respect of trust property, or

(ii) an acquisition of property or a borrowing by any individual

was to defer the day determined under paragraph 104(4)(b) in respect of the trust; and

(d) in determining whether all or substantially all of the value of shares of the capital stock of a corporation is derived from other property, the other property shall be deemed to include property substituted for the other property and property attributable to profits, gains or distributions in respect of the other property and the substituted property.

“Trust transfers – Sec. 104(5.8)”

(5.8) Where capital property (other than excluded property), land included in inventory, Canadian resource property or foreign resource property is transferred at a particular time by a trust (in this subsection referred to as the “transferor trust”) to another trust (in this subsection referred to as the “transferee trust”) in circumstances in which subsection 107(2) or 107.4(3) or paragraph (f) of the definition “disposition” in subsection 248(1) applies,

(a) for the purposes of applying subsections 104(4) to 104(5.2) after the particular time,

(i) subject to paragraphs (b) to (b.3), the first day (in this subsection referred to as the “disposition day”) that ends at or after the particular time that would, if this section were read without reference to paragraphs (4)(a.2) and (a.3), be determined in respect of the transferee trust is deemed to be the earliest of

(A) the first day ending at or after the particular time that would be determined under subsection 104(4) in respect of the transferor trust without regard to the transfer and any transaction or event occurring after the particular time,

(B) the first day ending at or after the particular time that would otherwise be determined under subsection 104(4) in respect of the transferee trust without regard to any transaction or event occurring after the particular time,

(C) the first day that ends at or after the particular time, where

(I) the transferor trust is a joint spousal or common-law partner trust, a post-1971 spousal or common-law partner trust or a trust described in the definition “pre-1972 spousal trust” in subsection 108(1), and

(II) the spouse or common-law partner referred to in paragraph (4)(a) or in the definition “pre-1972 spousal trust” in subsection 108(1) is alive at the particular time,

(C.1) the first day that ends at or after the particular time, where

(I) the transferor trust is an alter ego trust, a trust to which paragraph (4)(a.4) applies or a joint spousal or common-law partner trust, and

(II) the taxpayer referred to in paragraph (4)(a) or (a.4), as the case may be, is alive at the particular time, and

(D) where

(I) the disposition day would, but for the application of this subsection to the transfer, be determined under paragraph 104(5.3)(a) in respect of the transferee trust, and

(II) the particular time is after the day that would, but for subsection 104(5.3), be determined under paragraph 104(4)(b) in respect of the transferee trust, the first day ending at or after the particular time, and

(ii) where the disposition day determined in respect of the transferee trust under subparagraph 104(5.8)(a)(i) is earlier than the day referred to in clause 104(5.8)(a)(i)(B) in respect of the transferee trust, subsections 104(4) to 104(5.2) do not apply to the transferee trust on the day referred to in clause 104(5.8)(a)(i)(B) in respect of the transferee trust;

(b) paragraph (a) does not apply in respect of the transfer where

(i) the transferor trust is a post-1971 spousal or common-law partner trust or a trust described in the definition “pre-1972 spousal trust” in subsection 108(1),

(ii) the spouse or common-law partner referred to in paragraph (4)(a) or in the definition “pre-1972 spousal trust” in subsection 108(1) is alive at the particular time,

and

(iii) the transferee trust is a post-1971 spousal or common-law partner trust or a trust described in the definition "pre-1972 spousal trust" in subsection 108(1);

(b.1) paragraph (a) does not apply in respect of the transfer where

(i) the transferor trust is an alter ego trust,

(ii) the taxpayer referred to in paragraph (4)(a) is alive at the particular time, and

(iii) the transferee trust is an alter ego trust;

(b.2) paragraph (a) does not apply in respect of the transfer where

(i) the transferor trust is a joint spousal or common-law partner trust,

(ii) either the taxpayer referred to in paragraph (4)(a), or the spouse or common-law partner referred to in that paragraph, is alive at the particular time, and

(iii) the transferee trust is a joint spousal or common-law partner trust;

(b.3) paragraph (a) does not apply in respect of the transfer where

(i) the transferor trust is a trust to which paragraph (4)(a.4) applies,

(ii) the taxpayer referred to in paragraph (4)(a.4) is alive at the particular time, and

(iii) the transferee trust is a trust to which paragraph (4)(a.4) applies; and

(c) for the purposes of subsection 104(5.3), unless a day ending before the particular time has been determined under paragraph 104(4)(a.1) or 104(4)(b) or would, but for subsection 104(5.3), have been so determined, a day determined under subparagraph 104(5.8)(a)(i) shall be deemed to be a day determined under paragraph 104(4)(a.1) or 104(4)(b), as the case may be, in respect of the transferee trust. ⁸³⁸

838 March 2001 FINANCE TECHNICAL NOTES: Subsection 104(5.8) is a special rule designed to prevent the avoidance of the 21-year rule through the use of trust-to-trust transfers that do not involve dispositions of property at fair market value. Subsection 104(5.8) generally provides for a transferee trust to assume the next deemed disposition day of the transferor, if that day is earlier than the transferee's next deemed disposition day. In the case of trusts for the benefit of a spouse or common-law partner under which the beneficiary spouse or common-law partner is still alive, subsection 104(5.8) provides a deemed disposition as soon as the transfer is completed unless relief is provided under paragraph 104(5.8)(b). Paragraph 104(5.8)(b) provides relief where both the transferor and transferee trusts are trusts to which paragraph 104(4)(a) or (a.1) applies and under which the spouse or common-law partner beneficiary is alive.

Subsection 104(5.8) is amended to eliminate a reference to trust transfers under paragraph (e) of the definition "disposition" in section 54, as a consequence of the repeal of that definition. Subsection 104(5.8) is also amended so that it now covers transfers under new paragraph (f) of the definition "disposition" in subsection 248(1) and under new subsection 107.4(3). Subsection 104(5.8) is amended so that it does not apply to transfers between trusts, if the transferee trust was, at the time of the transfer, described in paragraph (g) of the definition "trust" in subsection 108(1). This amendment, which is made as a consequence of the introduction of subparagraph (g)(iv) of that definition, applies only to transfers made after February 11, 1991 and before December 24, 1998. Subparagraph (g)(iv) of that definition has the effect of limiting an exemption from the 21-year deemed disposition rule for a trust in which interests are vested indefeasibly, in the event that non-resident beneficiaries own more than 20% of the interests in the trust.

Subparagraph 104(5.8)(a)(i) is amended to ensure that the determination of a deemed disposition day for a transferee trust will not preclude any earlier deemed disposition day under new paragraph 104(4)(a.2) or (a.3).

“Trusts in favour of spouse, common-law partner or self – Sec. 107(4)”

(4) Subsection (2.1) applies (and subsection (2) does not apply) at any time to property distributed to a beneficiary by a trust described in paragraph 104(4)(a) where

(a) the beneficiary is not

(i) in the case of a post-1971 spousal or common-law partner trust, the spouse or common-law partner referred to in paragraph 104(4)(a),

(ii) in the case of an alter ego trust, the taxpayer referred to in paragraph 104(4)(a), and

(iii) in the case of a joint spousal or common-law partner trust, the taxpayer, spouse or common-law partner referred to in paragraph 104(4)(a); and

Subsection 104(5.8) is further amended to extend its existing rules for transfers from trusts for the benefit of a spouse or common-law partner to transfers from other specified trusts. The additional trusts so specified are:

- those created after 1999 by a settlor (Aged 65 years or more) for the exclusive benefit of the settlor during the settlor's lifetime (i.e., an "alter ego trust", as newly defined in subsection 248(1)) or for the joint benefit of the settlor and the senior's spouse or common-law partner during their joint lifetimes (i.e., a "joint spousal or common-law partner trust", as newly defined in subsection 248(1)); and
- trusts to which paragraph 104(4)(a.4) applies (i.e., a trust to which property was transferred by a taxpayer who is an individual (other than a trust) in circumstances in which section 73 or subsection 107.4(3) applied, where the transfer does not result in a change in beneficial ownership of that property and no person (other than the taxpayer) or partnership has any absolute or contingent right as a beneficiary under the trust (determined with reference to subsection 104(1.1)).

Where the settlor of an alter ego trust is still alive (or, in the case of a joint spousal or common-law partner trust, where the senior or the spouse or common-law partner is still alive), a deemed disposition day for the trust may occur once a transfer from the trust is completed. However, amended paragraph 104(5.8)(b) and new paragraphs 104(5.8)(b.1) to (b.3) provide for no deemed disposition day in the case of a transfer from one of the additional specified trusts where the transferee trust is the same type of specified trust to which paragraph 104(4)(a) or (a.4), as the case may be, applies and the senior (or, in the case of a joint spousal or common-law partner trust, either the senior or that spouse or common-law partner) or taxpayer, as the case may be, is alive. These amendments apply to transfers made after 1999. For further detail on new rules for alter ego trusts and joint spousal or common-law partner trusts, see the commentary on amended subsection 73(1) and paragraph 104(4)(a). For further detail on paragraph 104(4)(a.4), see the commentary on that paragraph. These amendments also reflect changes effected by the Modernization of Benefits and Obligations Act.

June 1992 FINANCE TECHNICAL NOTES: New subsection 104(5.8) is a special rule designed to prevent the avoidance of the 21-year deemed realization rule through the use of trust transfers. It generally applies where a trust transfers property to which the 21-year deemed realization rule applies to another trust on a rollover basis and the first deemed realization date after the transfer in respect of the transferee trust would otherwise occur after such date determined in respect of the transferor trust.

In these circumstances, the first deemed realization date for the transferee trust is generally advanced to such date in respect of the transferor trust. However, the deemed realization date for the transferee trust is advanced to the day after the transfer in two cases. The first case is where the transferor trust is a pre-1972 spousal trust described in paragraph 108(1)(f.2) [now 108(1)"pre-1972 spousal trust" - ed.] or a spousal trust described in paragraph 104(4)(a) the beneficiary spouse of which is still alive at the time of the transfer from the transferor trust. The second case is where the deemed realization date of the transferee trust is determined (without reference to the transfer rule in subsection 104(5.8)) as of the time of the transfer under new subsection 104(5.3). In neither of these cases would it be possible to determine whether a deemed realization in respect of the transferee trust would occur, without reference to the transfer rule in subsection 104(5.8), before or after a deemed realization in respect of the transferor trust.

Paragraph 104(5.8)(b) applies where paragraph 104(5.8)(a) would otherwise apply in the first case described above. In these circumstances, paragraph 104(5.8)(b) provides that paragraph 104(5.8)(a) does not apply where the transferee trust is also a spousal trust described in paragraph 104(4)(a) or (a.1) in respect of which the beneficiary spouse is still alive at the time of the transfer.

Paragraph 104(5.8)(c) provides that an advanced deemed realization date under subparagraph 104(5.8)(a)(i) is considered for the purposes of subsection 104(5.3) to be a day determined under paragraph 104(4)(a.1) or (b). The purpose of this rule is to allow a transferee trust to which subsection 104(5.8) applies the capacity to make a subsection 104(5.3) election. However, the election will not be available where the transferee trust has previously had a deemed realization under paragraph 104(4)(a.1) or (b) and thus previously had the opportunity to make such an election.

This amendment is applicable in respect of property transferred after February 11, 1991. However, the rules do not apply to transfers on or before December 20, 1991 where either the transferor trust or the transferee trust is a spousal trust in respect of which the beneficiary spouse is still alive.

**(b) a taxpayer, spouse or common-law partner referred to in subparagraph (a)(i),
(ii) or (iii), as the case may be, is alive on the day of the distribution.** ⁸³⁹

It should be noted that when one sees the term variation in a trust to cause it to have the same identity as that from which it was varied such doesn't apply to a special power of appointment that operates to resettle the property under a different trust per the parameters of the special power grantor. It is recognized that the beneficiaries or statute law are not making the variation, but the property is being resettled pursuant to the intentions of the settlor inherent in the special power.

⁸³⁹ Following the reasoning in *Pexton v. Bell*, 1976 2 All E.R. 914, and *Crowe v. Appleby*, 1975 3 All E.R. 529, it's important to ascertain exactly the extent of the singular spousal trust which is to suffer the dispositions. If the head trust settles cash on a sub-trust taking back an income interest the interest wouldn't be subject to Sec. 104(4) nor would the sub-trust's property. If a will creates more than one trust, with one being spousal and the others feeding income interests to it the spouse may be provided for through the head trust only but the only property which will gain roll-over treatment is that which was transferred to the head trust.

Principal Residence Trust Transfers.

In computing the taxable capital gain on the disposition of property which is a principal residence paragraph 40(2)(b) provides an exempting provision whereby where the disposer is an individual, his gain otherwise computed from the disposition of the property which is/was a principal residence at any time after Dec. 31st, 1971 and the day on which he last acquired it, whichever is later, will be the gain otherwise determined under the Sec. 40(1) rules less that proportion thereof that one plus the number of taxation years **ending** after the acquisition date for which the property was his principal residence and during which he was resident in Canada is of the number of tax years **ending** after the acquisition date during which he "**owned**" the property whether jointly with another person or not. Obviously this provision can quite easily negate a possible gain from being recognized if the conditions are maintained by the owner while para. (c) thereunder provides an ancillary rule concerning the disposition of land used in a farming business carried on by the taxpayer which includes such a principal residence. Under that rule his gain for the year is his gain otherwise computed from the disposition of **just the land**, (not including the principal residence), plus the gain computed as per the just mentioned rule in respect of his principal residence, or, if the taxpayer elects in respect of the land and the principal residence as a unit the total gain otherwise computed as per the general Sec. 40(1)(a) rules, less the aggregate of \$1,000 and \$1,000 for each tax year **ending** after the acquisition date during which the property was his principal residence and in which he was resident in Canada. A further technical exemption comes in the form of subsection 40(6) whereunder if the property (principal residence) was owned, jointly or otherwise, at the end of the 1981 calendar year, and continuously until it was disposed by the taxpayer the amount of capital gain determined as per the rules in Sec. 40(2)(b) shall not exceed the aggregate of two amounts which exceeds a third amount. The first amount equals the gain that would have been recognizable after the application of Sec. 40(2)(b) had the taxpayer disposed of the property for proceeds equal to its fair market value on Dec. 31st, 1981, and the second amount equals the gain otherwise computed under Sec. 40(2)(b) on the assumption that the taxpayer acquired the property on Jan. 1st, 1982, for a cost equal to the proceeds previously recognized, as if the apportioning numerator in Sec. 40(2)(b) were read without the reference to the singular additional year, and the third amount which reduces the gross amount is equal to the amount if any by which the fair market value of the property on Dec. 31st, 1981, exceeds the proceeds of disposition that the taxpayer actually realized on the disposition of the property after 1981.

These three provisions provide the basis by which principal residences can be transferred effectively tax-free in Canada, while under paragraph 54(g) a "principal residence" is defined to be a housing unit, a leasehold interest therein, or share of the capital stock of a co-operative housing corporation, which was owned jointly or otherwise but only if the housing unit was, or the share acquired for the sole purpose of acquiring the right to inhabit a housing unit owned by the corporation that was, **ordinarily** inhabited in the year by one of several parties now provided for if Press Release 91-018 dated Feb. 11th, 1991, becomes law.⁸⁴⁰

The old rules provided that the property had to be ordinarily inhabited by the taxpayer, taxpayer's spouse, former spouse, or child or a property in respect of which the taxpayer has elected upon under Sec. 45(2) or (3) where there was a change of use.⁸⁴¹ By definition a principal residence is a non-listed personal property and thus any loss recognized on a disposition isn't deductible against Division B income. The definition went on to provide that except where section 54.1 concerning changes of residence upon employment relocation is applicable a housing unit or share or interest etc. would not be considered a principal residence unless it was designated as such by the disposer in prescribed form for a particular year and no other potential residence has been designated by him for the particular year, or by his spouse or child, (unless the spouse was throughout the year living apart from and was separated pursuant to a judicial separation or written separation agreement or the child was 18 years or older or married). If the designator wasn't married at any time during

840 A "superficiarie" under Quebec civil law owns the building which is situated upon the land owned by another and as per the Bilingual Services & Resource Industries Division on March 14th, 1990, the owner thereof will be able to recognize it as a P.R. if the building has the appropriate character. It opined however, that the taxpayer must have all the incidents of ownership of the building in order for it to qualify and that if the taxpayer can't dispose of, or mortgage it, or if he doesn't suffer from all of the burdens of ownership of it it may not be regardable as owned for the purposes of the subsection.

841 See *Thomson v. M.N.R.*, 1946 C.T.C. 15 (SCC), for a definition of ordinarily inhabited.

the year, and was under 18 years old, a person who was his mother, father, brother or sister and who was not during the year a married person or a person 18 years old or over was also precluded from designating another P.R. if he designates one.

With the Press Release the number of parties who can designate the property as a P.R. has been substantially extended, primarily in the case of trusts.⁸⁴² Where the taxpayer is an individual other than a personal trust the former parties will be eligible to designate the property. If the taxpayer disposing of the property is a personal trust and "a specified beneficiary", his spouse, former spouse or child ordinarily inhabited the property in the calendar year ending in the particular year the trust designates for P.R. treatment the property will gain P.R. treatment. Where the disponent is a personal trust or an individual other than a personal trust the property need not be ordinarily inhabited by anyone if there has been a Sec. 45(2) or (3) election made preserving its P.R. status for 4 years.

These rules are further exemplified in that where the taxpayer is an individual other than a personal trust the property must be designated by the disposing taxpayer as being his principal residence for the calendar year and no other property has been so designated by the taxpayer, the taxpayer's spouse if she was such **throughout** the year designated⁸⁴³, by the taxpayer's child, (other than those who were at any time in the year married or over 18 years of age or older), while if the disponent was not married or 18 or older at any time in the designated year a designation cannot have been made by his mother or father, brother or sister, (if they were under 18 or not married at any time in the year designated). The primary thrust of the new legislation allows personal trusts to designate property it owns that was ordinarily inhabited by a beneficiary and while this treatment was formerly available to only Sec. 70(6) or 73(1) spousal trusts, with the amendments, all personal trusts will qualify if they can meet very limited conditions. The property in the year of disposition must be designated by the trust to be its principal residence for a given designation year while the trust must also designate each individual who had a beneficial interest in the trust at any time in the calendar year ending in the designated year and who ordinarily inhabited the housing unit, or had a spouse, former spouse, or child who inhabited it during that time.⁸⁴⁴ To restrict the exemption from being available in respect of corporations and partnerships such parties cannot hold beneficial interests in the trust during the calendar year ending in the designated year though of course they may have previous to the acquisition of the property or after its disposition. Trusts that hold interests in trusts that hold principal residences can have as their beneficiaries partnerships or corporations without effect apparently. The trust's designation will not be valid if for the calendar year ending in the trust's particular designated year another property was designated by **any** specified beneficiary⁸⁴⁵, by a person who was his spouse,⁸⁴⁶ by the specified beneficiary's child⁸⁴⁷, while if the specified beneficiary isn't 18 or older nor married at any time in the calendar year, by his parents or siblings.

If the trust wasn't personal all is not lost, but the P.R.E. is very limited in that if the trust is *inter vivos*, other than a Sec. 73(1) spousal trust, the property owned by the trust must have been contributed to it by an individual, and either that individual **and** any spouse or former spouse of the individual held no beneficial interest in the trust during its designation year or that individual or spouse or former spouse **but not child** was a specified beneficiary for that calendar year ending in the trust's tax year for which the designation is made.⁸⁴⁸

Pursuant to paragraph (vi) a property designated by a personal trust for a year shall be deemed to be a property designated by **each** specified beneficiary of the trust for the calendar year ending in the trust's tax year designated hence the P.R.E. cannot be excessively accessed through the use of the trust. A very similar result was created in respect of a spousal trust prior to the amendments.

⁸⁴² The new rules apply to dispositions after 1990.

⁸⁴³ unless the couple were living apart **throughout** the year pursuant to a judicial or written separation agreement

⁸⁴⁴ The inhabitant need not have a beneficial interest if she falls under the latter larger category.

⁸⁴⁵ past or present?

⁸⁴⁶ other than those living part and separated pursuant to a judicial or written agreement **throughout** the calendar year

⁸⁴⁷ other than those during the year who were 18 or older or married

⁸⁴⁸ Of course interests in the *inter vivos* trust can be held by other trusts for the benefit of the contributor individual while this treatment does not apply to spousal trusts though it doesn't make the P.R.E. available to non-personal trusts since a non-personal trust cannot "inhabit" a building within the context of the Sec. 54(g)(i) paragraph.

Subparagraph (v) provides that the principal residence is deemed to include, except where it is a share of a cooperative housing corporation, the land adjacent to the housing unit or that which is contiguous that may reasonably be regarded as contributing to the use and enjoyment of the building as a residence, while if such land exceeds a half hectare the taxpayer will have to prove that the excess contributes to the use and enjoyment thereof in order to be treated as part of it. It should be noted that the designation of years applies only back to 1982 whereby in respect of years prior to that time the taxpayer could possibly have designated in respect of two principal residences however he can designate only one in respect of each tax year. In order to appreciate the intricacy of the mechanics of the provision one should study I.T. 120R3, since the general mechanics are far too complex to go into it in length here however it can be generalized that in designating properties which are to be disposed of one would want to designate in respect of any particular year the property in which the largest gain accrued as based on the potential capital gains to be realized on all properties divided by the number of years of ownership.

The section 40 and 54 provisions allow the P.R. exemptions to be available to owners of the property and while they specify that such ownership may be jointly with others they do not preclude beneficial ownership while para. 5 of I.T. 437 expresses the Department's opinion that if a beneficiary under a trust has the right of possession and use of the property, control over the trust and its property can be sold/mortgaged only upon the beneficiary's concurrence or direction, or the trust can be wound up by the beneficiary, he will be considered to be the owner of the P.R. and not the trust for purposes of sections 40 and 54. Thus by transferring the legal ownership of the P.R. to a trust in which the taxpayer takes back a life interest for the use of the property and satisfies the above conditions the property will be able to continue to benefit from the P.R. provisions when disposed of by the trust. The same may apply where he didn't normally use (inhabit) the property but his spouse or underage unmarried child did and the right he takes back allows them to continue to inhabit it. If the contributor acquires beneficial ownership as evidenced by the abilities expressed in the I.T. the trust will be able to have another P.R. subject to certain restrictions in Sec. 54(g)(v).

In *Smellie v. M.N.R.*⁸⁴⁹ a testator allowed his wife as per the terms of the will, to inhabit his house, (her being also one of two executors), which she did until 1974, three years after the death of the taxpayer. The house was provided under a tainted spousal trust situation. When the house was subsequently sold after her death the tainted spousal trust was denied the application of the principal residence designation even though the widow had satisfied the criteria (ordinary inhabitation) in her personal capacity and as an executor of the trust. The tainted spousal trust, however, had never filed any of the required forms declaring the property in question to be its principle residence and thus, as a requirement of a very literal interpretation supposedly demanded of the provisions the property could not serve as either a P.R. for the trust or the spouse.

Under subsection 40(4) where a taxpayer has disposed of property to an individual in circumstances where Sec. 70(6) or 73(1) applied being spouse, former spouse, spousal trust, or certain dependant recipients, for purposes of computing that individual's gain from the disposition of the property under the main Sec. 40(2)(b) or (c) P.R. rules **that** spousal recipient individual will be deemed to have owned the property throughout the period in which the taxpayer owned it, the property shall be deemed to have been that individual's principal residence in, in the case of an *inter vivos* spousal transfer, any tax year for which it was the taxpayer's P.R. while, in the case of a testamentary spousal transfer, for any tax year for which it would have been the taxpayer's principle residence had he designated it so in prescribed manner, and if the individual above is a trust, the trust shall be deemed to have been resident in Canada during each tax year during which the - taxpayer settlor was resident in Canada.⁸⁵⁰ If the settlor becomes non-resident then the *inter vivos* trust will not be considered to be non-resident for purposes of the general P.R. rules. If the property is transferred under Sec. 73(1) the settlor should fill out an election form prescribed and hand it over to the trustees, though it need not be immediately filed while if it is transferred via Sec. 70(6) a listing of the testator's previously elected designation years in respect of other property disposed of when he owned the particular P.R. should be

⁸⁴⁹ 1 E.T.R. 74

⁸⁵⁰ Why is the latter treatment not available in respect of spouses? Obviously if the spouse was non-resident during a previous designation period it would be preferable to transfer the property to a spousal trust resident in Canada since the P.R. exemption would be maintained.

obtained by the trustees so that they'll know what years they can designate and decided whether there is to be a disposition of the property.

“Disposal of principal residence to spouse or trust for spouse. – Sec. 40(4)”

(4) Where a taxpayer has, after 1971, disposed of property to an individual in circumstances to which subsection 70(6) or 73(1) applied, for the purposes of computing the individual's gain from the disposition of the property under paragraph (2)(b) or (c), as the case may be,

(a) the individual shall be deemed to have owned the property throughout the period during which the taxpayer owned it;

(b) the property shall be deemed to have been the individual's principal residence

(i) in any case where subsection 70(6) is applicable, for any taxation year for which it would, if the taxpayer had designated it in prescribed manner to have been his principal residence for that year, have been the taxpayer's principal residence, and

(ii) in any case where subsection 73(1) is applicable, for any taxation year for which it was the taxpayer's principal residence; and

(c) where the individual is a trust, the trust shall be deemed to have been resident in Canada during each taxation year during which the taxpayer was resident in Canada.

“Where principal residence is property of trust for spouse. - Sec. 40(5)”

(5) For the purposes of determining whether any property of a trust described in subsection 70(6) or 73(1) was its principal residence for any taxation year, the reference in subparagraph 54(g)(i) to “the taxpayer” shall be read as if it were a reference to the spouse referred to in subparagraph 70(6)(b)(i) or 73(1)(c)(i), as the case may be.

“Distribution of principal residence – Sec. 107(2.01)”

(2.01) Where property that would, if a personal trust had designated the property under paragraph (c.1) of the definition “principal residence” in section 54, be a principal residence (within the meaning of that definition) of the trust for a taxation year, is at any time (in this subsection referred to as “that time”) distributed by the trust to a taxpayer in circumstances in which subsection (2) applies and the trust so elects in its return of income for the taxation year that includes that time,

(a) the trust shall be deemed to have disposed of the property immediately before the particular time that is immediately before that time for proceeds of disposition equal to the fair market value of the property at that time; and

(b) the trust shall be deemed to have reacquired the property at the particular time at a cost equal to that fair market value.

If upon the transfer to the trust the settlor or personal representative through the power instilled in him chooses not to have Sec. 73(1) or 70(6) apply to the transfer, as is possible under the Sec. 73(1) and 70(6.2) elections, the spousal trust will not benefit from the Sec. 40(2)(b) & (c) rules when it disposes of the property subsequently. The Sec. 73(1) or 70(6) provisions must apply to the **particular** property which becomes the trust's deemed principal residence **for those prior years** as per Sec. 40(4)(b), in order for the carry-through to apply, and while those two provisions operate to cause a disposition for proceeds equal to the property's ACB, thus avoiding a gain and bump up in ACB, Sec. 40(4)(a) provides effectively that the trust will be allowed

to designate years in which the taxpayer-contributor owned it, hence the taxpayer's position in respect to the P.R. is entirely transposed to the trust without tax consequences.

Spousal Recipients.

Under **former** Sec. 40(5), for purposes of determining whether a property was a spousal trust's principal residence to which it was transferred via Sec. 70(6)-73(1), the spouse under the trust must have ordinarily inhabited the property, or her spouse, former spouse or child must have done so, as per the application of para. (i) of the Sec. 54(g) definition.⁸⁵¹ Although the balance of the restrictive definition other than that under para. (i) didn't apply directly to the spouse, under para.(vi), specifically for purposes of para. (iii) which served to limit a designation of a singular P.R. to one family etc., where a property was designated as a P.R. by a spousal trust it would be **deemed** to have been also designated by the spouse who is a beneficiary under the trust, while if he made a designation in respect of it the trust would be **deemed** to have designated in respect of the property. Thus even though the spouse under the trust benefitted from the provisions they also limited the designations that could be made by related parties, including other spousal trusts. A spouse would not be able to designate in respect of a principal residence certain years for which a spousal trust under which she is a beneficiary designated in respect of another principal residence. If the spouse ceased to be a beneficiary under the trust it would cease to be a spousal trust described in Sec. 73(1), (though not in Sec. 104(4)), and thus the trust would not be able to benefit from a P.R. exemption in respect of its own property. Alternatively if the property is subsequently rolled out after the spouse's death Sec. 107(2.01) cannot apply. Subparagraph 54(g)(i), then read in conjunction with Sec. 40(5), required the "trust's spouse", her spouse or her child to reside in the trust's dwelling in order for it to qualify as a P.R. however their relationship to the property was not specified; could they rent it from the trust, inhabit it while making payments to other beneficiaries, etc.? It was questionable whether they had to reside in it by virtue of the rights they had under the trust agreement, by virtue of a beneficiary status, however the agreement could require, in the author's opinion, them to make payments to other beneficiaries for the dwellings' use without harming the P.R. status. Distinguishing between an equitable charge and a rental charge may be difficult in such an instance, however if it is paid directly to a Canadian resident beneficiary Sec. 105(1) will apply to it. With the draft legislation of Feb. 11th, 1991, effective for dispositions occurring after 1990 subsection 40(5) is repealed and thus the spousal preservation of the P.R. as such is eliminated though it is replaced with the new rules previously described which offer the P.R.E. to certain trusts. Understandably where the trust isn't spousal the testator/settlor would have usually suffered a FMV disposition of the property on its contribution to the trust.

The property need not have been situated in Canada though its ownership must have been resident in order to gain the P.R.E.. In the case of personal trusts the property could be situated anywhere and the inhabiting beneficiary could be non-resident and the resident trust would still benefit from the P.R.E.. There is no qualification placed on the residency of the specified beneficiary though the trust must have been resident during the designated years. The use of a personal trust in a situation where the parents of a family are to become non-resident for any length of time while the kids stay to study in Canada is obvious: rolled to a personal trust the P.R.E. is initially utilized by the parent while the kids continue to inhabit it and thus the personal trust can recognize the property as a P.R.. the parents are then free to "become permanent beach fixtures" without the fear of losing the P.R.E. on the disposal of the property: the tax free proceeds could be rolled out to them as residual beneficiaries under Sec. 107(5) after the property is realized. In the case of spousal trusts and the Sec. 40(4) carry through of the P.R. from the contributor/giftor residency of the parties is a more complicated issue. If the trust is to become non-resident for an extended period of time, as per the favourable provision under Sec. 40(7), it could transfer the property out to the spouse in satisfaction of her capital interest or part thereof whereby if the trust is personal and the recipient is the spouse identified with respect to the spousal trust described under Sec. 70(6) or 73(1); the spouse will be deemed to have owned the property continuously since the trust acquired it which **will include** the period during which the settlor/testator owned it, as per Sec. 40(4)(a). Of course this will only be beneficial if the spouse herself

851. It would appear that the inhabitation need not be provided for by the trust deed but possibly via alternate arrangement: see *Samson and Anor. v. Peay*, 52 T.C. 1, for some issues.

continues to be resident in Canada, and where during that period otherwise eligible for designation stretching **all the way back to the time the settlor originally acquired the property** she, her spouse, or former spouse or a minor unmarried child of hers did not make a designation in respect of another P.R., since in doing so, as per new para. (iii.1) of the definition of P.R.⁸⁵² it would restrict her ability to designate in respect of the P.R. distribution. If the spouse wasn't resident throughout the designation years since the original settlor acquired the property then she will not be able to designate in respect of the years she wasn't resident in that although Sec. 40(7) allows her to be deemed to have owned the property since the resident trust acquired it it does not deem her to have been resident during the time in which the settlor or trust owned it. Subsection 40(4)(c) deems **a trust** which received the P.R. on a Sec. 70(6)-73(1) roll to have been resident during the years in which the contributor was resident but such treatment is not afforded to the spousal beneficiary. She herself must be resident in those years during which the contributor and trust were resident in order to take the maximum P.R.E., otherwise it could prove beneficial to have the trust dispose of the property or take the new Sec. 107(2.01) election. In such a case the trust would absorb any P.R. gain and the spouse would start off with a clean slate **or** receive the proceeds.

Subsection 40(7) allows a capital beneficiary who has received property in satisfaction of part or all of his capital interest in a **personal** trust to be recognized as having acquired the property at the time the trust acquired it and does not apply only in respect of spousal trusts, but applies wherever Sec. 107(4), providing special capital distribution rules for spousal trusts, doesn't apply.⁸⁵³ If the property when transferred to the trust could not receive Sec. 70(6) or 73(1) treatment the settlor would have recognized a capital gain,⁸⁵⁴ and Sec. 40(4) would not have applied to allow for the transposing of the ACB/P.R. position to the trust. Upon a transfer of the property out to the non-spousal beneficiary whereby he would recognize it as his principal residence only at that time the denominator in respect of the Sec. 40(2)(b) computation for the recipient at the time of a subsequent disposition **will be extended by the years that the trust owned it** and the numerator would be restricted to the number of years in which it was **his** principal residence, which results in the gain from the property upon its disposition to a third party by the beneficiary being reduced less.⁸⁵⁵ This only arises where the property received the tax-free distribution afforded capital interest under personal trusts while it would be possible to inflate the ACB of the capital interest, before it is satisfied, above the ACB of the property, whereby the ACB of the property to the recipient would be bumped by the excess as per the Sec. 107(2)(b) rule.⁸⁵⁶ It is also to be noted that the Sec. 40(7) provision does not equate the residence of the recipient beneficiary with that of the trust for the years in which the trust owned the property thus the beneficiary would have to also be resident during the relevant years to obtain the maximum P.R. exemption.⁸⁵⁷ If the recipient had beneficial ownership of the P.R. from the moment the trust acquired it, as per Sec. 54(g), it would appear that it could qualify as his P.R. for those years when it was owned by the trust, when he subsequently disposes of it only if he or his spouse/offspring ordinarily inhabited it. This isn't the case with just being merely beneficially interested in it. Subsection 40(7), the cause of the potential problem, will not apply where the property is distributed in satisfaction of an income interest as per Sec. 106(3) whereby the recipient will not recognize any tax consequences, however the trust will be deemed to have disposed of it for its fair market value at that time and thus it will possibly become liable for the tax expense. With the new rules it is possible for the trust to designate in respect of the property if a specified beneficiary resided in it during the designation year.

“Property in satisfaction of interest in trust - Sec. 40(7)”

(7) Where property has been acquired by a taxpayer in satisfaction of all or any part of his capital interest in a trust, in circumstances to which subparagraph 107(2) applies and subsection 107(4) does not apply, for the purposes of paragraphs (2)(b) and 54(g) he shall be deemed to have owned the

852 which describes the one residence per year designation limit

853 The provision applies for purposes of the Sec. 54(g) definition and Sec. 40(2)(b), (the exemption).

854 or benefit from the P.R.E. himself.

855 in which case he could have to recognize more capital gain

856 One can't create a deductible capital loss with a principal residence: personal use property.

857 He could be non-resident for one year without tax effect actually.

property continuously since the trust last acquired it.

With respect to property flowing through a spousal personal trust the beneficiary, if he is to receive the property in specie in satisfaction of his capital interest and recognize it as his principal residence upon a subsequent disposition, (due to the fact that he, his spouse, or his child ordinarily inhabited it), one would be acting prudently with respect to dispositions of property that qualify as a principal residence by him in the interim, to measure the gain accruing on the property in the trust and the gain accrued to him with respect to the property he disposes of, on an annual basis, and designate the years to the respective property which showed the largest gain increment in the designation year. He would thus be wiping out the largest amount of gains allowable to be realized from the two properties.

Regulation 2300 prescribes the manner in which the election under Sec. 40(2) or 54(g) must be made however it should be recognized that they only apply when the disposer wished to elect upon the occurrence of a gain upon disposition.

Both the section 40 computation provisions and the Sec. 54(g) definition recognize that a property which serves as a principal residence of one joint owner may not carry the status for the other joint owner(s) however if a joint owner is to be able to designate the property as such he, his spouse, or underaged unmarried child must have ordinarily inhabited the property. Where the property is sold to a third party the gain would be apportioned on the basis of the ownership and the respective taxpayer could elect under section 40-54 etc. however as per para. 6 and 11 of I.T. 366R the Department's opinion seems to be that once a singular designation in respect of the P.R. is made it causes the property in its entirety to be treated as such for both owners and this can have advantages and disadvantages. Since the second joint owner or his spouse or child has to be ordinarily inhabiting the property in order for him to have the property gain the P.R. status his otherwise fully taxable gain could be favourably negated, however, although he hasn't himself made the appropriate election he should none-the-less be recognized to have treated the property as a P.R. in the subject years so that when he disposes of another property which is in fact his P.R. he will not be able to apply the designation years in respect of it.

Under subparagraph 49(1)(a) the granting of an option to acquire or dispose of a principal residence is not considered a disposition of property for purposes of subdivision C and thus doesn't cause tax consequences to the option grantor. It also offers an incidental method by which capital may be obtained by a trust and allows an otherwise testamentary trust to retain its status.

With the 1990 amendments the Department introduced Sec. 107(2.01) which allows a spousal trust to roll property out to any beneficiary in instances where Sec. 107(2) would have applied and if Sec. 107(4) doesn't and recognize a deemed disposition thereof for proceeds equal to the P.R.'s FMV when distributed. The deemed disposition is not mandatory but is to be elected by the trust and the trust must be of the character described in Sec. 70(6) or 73(1) at the time of the distribution and not simply Sec. 104(4) and essentially when elected for the trust is allowed to recognize a spontaneous deemed FMV disposition and thus take the P.R. exemption itself so as to negate any income inclusion and consequently cost bump the property.⁸⁵⁸ The Sec. 107(2) provision then operates to allow the beneficiary to acquire the property for its ACB to the trust, which is its FMV and thus the beneficiary can start with a "clean slate" without any implicit tax liability however the property must have the characteristic of a P.R. in the trust's hands thus the spouse couldn't have made a Sec. 54(g) designation in respect of another property during the years that the trust designated the property in order to be a tax free roll out. If she has then there will not be a virtual tax free disposition by the trust. Actually the spouse may designate one year in respect of another property without affecting the Sec. 107(2.01) roll-over. The provision definitely allows the spouse to remain or become non-resident in the period in which the trust holds the property without sacrificing the P.R. exemption on a subsequent roll out to her. If she wasn't resident she can't designate the property but the Sec. 107(2.01) provision bumps the cost up for her.⁸⁵⁹

⁸⁵⁸. Implicitly the P.R. need not have been rolled into the trust via Sec. 73(1)-70(6) in order for the trust's P.R.E. to be maintained though the trust must have been spousal.

⁸⁵⁹ The offspring can reside in it in order for it to qualify. The author doesn't understand why the draftsmen didn't number the provision 107(2.000001) so as to be sure to maintain numerical continuity and "leave space for other provisions".

Although the new rules are meant for pre-1972 trusts under which the spouse has died and which have not recognized the Sec. 104(4) deemed dispositions they may be applied in respect of any spousal trust to which the Sec. 107(2) distribution provision would apply.⁸⁶⁰ It's applicable in respect of distributions occurring after May 9th, 1985 however the election can be back dated to apply to distributions occurring before Royal Assent if notice is made by the trust to M.N.R. in writing before Apr. 1st, 1992.

Principal Residence - Transfer to Spouse, Spouse Trust or Certain Other Individuals

IT-366R

Date: May 4, 1984

This bulletin replaces and cancels Interpretation Bulletin IT-366 dated March 38, 1977. Current revisions are designated by vertical lines.

1. This bulletin outlines the effect of subsection 40(4) in the computation of the principal resident exemption under paragraph 40(2)(b) or (c) where an individual disposes of a principal residence which was previously acquired in a transaction described in 2 below. In addition, new provisions relating to the disposition of a principal residence after 1981 are also dealt with herein to the extent that they affect this bulletin. IT-120R3, "Principal Residence," discusses other matters concerning the principal residence exemption.
2. Subsection 40(4) applies on the disposition of a principal residence by an individual only if that principal residence was previously acquired from a taxpayer in a transaction to which the rollover provisions of subsection 70(6) or 73(1) applied. Subsection 70(6) applies to a transfer of property on death to a spouse or spouse trust while subsection 73(1) applies (in the absence of an election to the contrary thereunder) to an *inter vivos* transfer of property to a spouse, a former spouse in settlement of rights arising out of their marriage, a spouse trust or, after 1977, to an individual referred to in paragraph 73(1)(d), such as a former common-law partner, by virtue of a court order under certain provincial legislation. For the purpose of this bulletin, the person who made the original transfer 73(1) is referred to as "the taxpayer" and the person to whom the principal residence was transferred is referred to as "the individual".
3. Subsection 40(4) provides that, for the purpose of computing the gain under paragraph 40(2)(b) or (c) on the subsequent disposition of a property by an individual, the property is deemed
 - (a) to have been owned by the individual for the period during which it was owned by the taxpayer, and
 - (b) to have been the principal residence of the individual for any year in the period in (a) above if, in respect of that year, the taxpayer
 - (i) has designated it to be a principal residence, in the case of an *inter vivos* transfer, or
 - (ii) was eligible to designate it to be a principal residence, in the case of a transfer on death.
4. Pursuant to the provisions described in 3 above, the number of taxation years ending after the taxpayer's acquisition date during which the taxpayer owned the property are included in the denominator of the fraction used when computing the individual's exemption under paragraph 40(2)(b) or subparagraph 40(2)(c)(i) on the disposition of the property. The acquisition date is the later of December 31, 1971 or the date on which the taxpayer last acquired or reacquired the residence or is deemed to have last acquired or reacquired it. Also, the numerator of that fraction (or where subparagraph 40(2)(c)(ii) applies, the number of years for which the individual is entitled to the \$1,000 per year exemption) includes the number of taxation years ending after the taxpayer's acquisition date during which the taxpayer was resident in Canada and the property was his principal residence.
5. If the transferred property is not deemed to be the principal residence of the individual (i.e. the requirements of 3(b) above are not met) for each year after the taxpayer's acquisition date, a gain arising on the disposition of the property by the individual will not be fully exempt under paragraph 40(2)(b) or (c) unless the conditions described in 6 below are met.

Co-Ownership of Property

6. Where the taxpayer and the individual (spouse, former spouse, spouse trust, former common law partner,

⁸⁶⁰ It's intended to correct the technical deficiency whereby as a consequence of Sec. 40(7) the beneficiary's P.R. denominator increased by the period of trust ownership which reduces the P.R.E. available to him.

etc.) had co-ownership of the transferred property (as joint tenants or tenants in common or, in Quebec, as co-owners or having undivided ownership) in a year prior to the transfer and during that year the individual ordinarily inhabited the property, the individual is entitled to designate it to be a principal residence for that year in the normal way. If the individual is so entitled in respect of the years referred to in 5 above, a gain on the disposition of the transferred property may thus be fully exempt. However, where the individual is the taxpayer's spouse, the comments in 11 below should be noted for the 1982 and subsequent taxation years.

Transfer to Spouse Trust

7. For purposes of paragraphs 40(2) and (c), paragraph 40(4)(c) deems a spouse trust (as described in paragraph 70(6)(b) or subsection 73(1)) to have been resident in Canada for each year in which the taxpayer was so resident. Therefore, where subsection 40(4) deems a spouse trust to have owned a property during a period prior to its transfer from a taxpayer, the trust will meet the residence requirements of paragraphs 40(2)(b) and (c) for any year in that period during which the taxpayer owned the property and was resident in Canada.
8. As provided in subsection 40(5), a property transferred to a spouse trust may qualify as a principal residence of the trust for each year while owned by it
 - (a) during which the taxpayer's spouse ordinarily inhabited the property and
 - (b) for which both the spouse and the trust designate the property to be their principal residence.

Thus, for each year subsequent to the year of transfer to the spouse trust, the taxpayer's spouse may designate as a principal residence either the trust property (to meet the condition in (b) above) or another property which otherwise qualifies under paragraph 54(g), but the taxpayer's spouse may not designate both such properties in respect of the same year.

Designation as a Principal Residence

9. It is the Department's administrative position that the designation of a property as a taxpayer's principal residence in respect of one or more years (form T2091) is required to be filed with the return of income for the year in which the property was disposed of only where a gain remains after applying the exempting provisions of paragraph 40(2)(b) or (c). Thus, on an *inter vivos* transfer to which subsection 40(4) applies, the designation need not be filed at that time, although the taxpayer may do so. However, if the taxpayer chooses to designate the property as a principal residence for one or more of the years during which the taxpayer owned it, the taxpayer should, in any case, complete the designation form. It should be retained by the individual referred to in subsection 40(4) and filed, if necessary, on the subsequent disposition of the property. At that time, if a gain remains after applying paragraphs 40(2)(b) or (c), both the taxpayer's designation and the designation of the individual, where applicable, should be filed accordingly. If no gain remains, the individual should, in any case, retain these designations to support the underlying calculations.

Attribution Rules

10. When property transferred *inter vivos* is disposed of by the spouse or spouse trust, the provisions of subsection 74(2) will apply during the lifetime of the taxpayer, while the taxpayer is resident in Canada and the transferee is the taxpayer's spouse. However, the amount of taxable capital gain which would be attributed to the taxpayer is based on the calculation of the gain under paragraph 40(2)(b) or (c), and thus may be nil. Whether or not there is an amount attributable pursuant to subsection 74(2), where the proceeds of disposition are used by the transferee to purchase other property, part or all of any income or capital gain realized from that substituted property may be attributed to the taxpayer (the transferor). (See IT-258R2, "Transfer of Property to a Spouse", for a discussion of these provisions.)

Dispositions after 1981

11. The definition of "principal residence" contained in paragraph 54(g) was amended effective January 1, 1982. This amendment limits the designation to one principal residence per family unit. Consequently the

comments in 6 above will be affected after 1981 as a result of this amendment. Where a property is held under co-ownership it will continue to be fully exempt with only one designation required but, where two such properties are held under co-ownership, or both husband and wife each own such a property outright, only one will qualify for principal residence status after 1981.

12. Because of the amendment to paragraph 54(g), dispositions after 1981 of a property that previously qualified as a principal residence may result in a part of the capital gain otherwise determined being taxable. For example, where a husband and wife living together throughout the period each owned a property from 1981 through 1983, when one of the properties is disposed of, both properties may have qualified for principal residence status up until 1982 but from 1982 to the time of disposal, the family is restricted to claiming principal residence status on only one of the properties. Accordingly, in disposal of the non-qualifying property in 1983, a portion of the capital gain will be taxable.

13. The transitional rules for determining the capital gain on the disposition, after 1981, of a principal residence owned at the end of 1981, are contained in subsection 40(6). This subsection, in effect, provides that the capital gain realized after 1981 on the disposal of a property which is, or was before 1982, a principal residence, cannot exceed the amount of the gain calculated as if it were determined in two parts - that part of the accrued gain, if any, calculated to the end of 1981 on the basis of the old principal residence rules, plus the gain, if any, accrued after 1981 in accordance with the new rules.

Income Tax Interpretation Bulletin **Ownership of Property (Principal Residence)**

IT-437R

DATE: February 21, 1994

SUBJECT: INCOME TAX ACT

Ownership of Property (Principal Residence)

REFERENCE: Paragraph 54(g) and subsection 248(3) (also subsections 40(7), 248(22) and 248(23))

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This document is also available for download in PDF format.

Ownership of Property (Principal Residence)

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Application

This bulletin cancels and replaces Interpretation Bulletin IT-437, *Ownership of Dwelling Property*, dated September 10, 1979.

Summary

This bulletin provides guidelines for determining ownership of property for purposes of claiming a principal residence exemption. The bulletin should be read in conjunction with the current version of IT-120, *Principal Residence*, which fully discusses the principal residence exemption, including the types of property which qualify for that exemption.

The concepts of "beneficial ownership" and "legal ownership" as recognized under the common law jurisdictions are discussed in this bulletin. Also discussed are provisions in the *Income Tax Act* which particularly relate to the province of Quebec because it is a civil law jurisdiction.

The bulletin also contains comments concerning membership in a corporation or association holding residential property (including co-operative housing corporations), as well as comments regarding

condominiums, agreements for sale, lease-option agreements and other related topics.

The final two paragraphs of the bulletin briefly mention rules that are relevant if the property is held by a personal trust, including a spousal trust, and refer the reader to other materials published by the Department which set out those rules.

Discussion and Interpretation

General

¶ 1. Paragraph 54(g) of the *Income Tax Act*, which determines whether a property is a taxpayer's "principal residence" for a particular taxation year, requires that the property be owned by the taxpayer at any time in the year. (All of the requirements, including this ownership requirement, that must be satisfied for purposes of claiming the principal residence exemption are discussed in the current version of IT-120, *Principal Residence*.) The Act does not define the term "owned"; however, for purposes of claiming the principal residence exemption, the ownership requirement in paragraph 54(g) is met where the taxpayer is the legal owner or the beneficial owner of the property. These terms are discussed in detail below.

¶ 2. In the common law jurisdictions, two forms of property ownership are recognized -- legal and beneficial. Normally "legal ownership" exists when title is transferred to, recorded in, registered in or otherwise carried in the name of a person. Legal owners are generally entitled to enforce their ownership rights against all other persons.

¶ 3. One person's legal ownership of a property may, however, be subject to another person's beneficial ownership of that property. The term "beneficial ownership" is used to describe the type of ownership of a person who is entitled to the use and benefit of the property whether or not that person has concurrent legal ownership. A person who has beneficial ownership rights but not legal ownership can enforce those rights against the holder of the legal title. For example, beneficial ownership frequently arises when property is held in trust for a person in circumstances where, according to the terms of the trust, that person has authority to instruct the trustee to deal with the property as requested. (Where a personal trust, including a spousal trust, is involved, see also the rules mentioned in ¶s 16 and 17 below.)

¶ 4. Beneficial ownership must be distinguished, however, from the other types of physical possession of property which a person may enjoy. For example, a tenant of a property, or a person who is allowed to occupy it only because the true owner has no objection, is not the beneficial owner of the property. In determining whether a person has beneficial ownership, one should consider such factors as the right to possession, the right to collect rents, the right to call for the mortgaging of the property, the right to transfer title by sale or by will, the obligation to repair, the obligation to pay property taxes and other relevant rights and obligations. Not all of these incidents of ownership need occur concurrently before it is concluded that the person has beneficial ownership of the property, which is a question of fact in each particular case (subject to any determination under the law regarding beneficial ownership such as, for example, in the manner described in ¶s 6, 8 or 9 below).

¶ 5. Since in most cases the same person has both legal and beneficial ownership, determining ownership on the basis of beneficial ownership alone is not often required. Comments below deal with some situations where a taxpayer is considered to own, and other situations where a taxpayer is considered not to own, a property for purposes of the principal residence exemption.

¶ 6. Because the province of Quebec is a civil law jurisdiction, not a common law jurisdiction, subsection 248(3) of the *Income Tax Act* provides a special set of rules for income tax purposes in relation to that province. Subsection 248(3) deems

(a) a usufruct (see ¶ 7 below);

(b) a right of use or habitation; or

(c) a substitution (see ¶ 7 below);

to be a trust. The trust is deemed to be created by will where (a), (b) or (c) was established by will. The property subject to (a), (b) or (c) is deemed to have been transferred to, and to be held in trust by, the trust. The transfer is deemed to have occurred on, and as a consequence of, the death of the testator where (a), (b) or (c) arises on the death of that person. If the property is the type of property that can otherwise qualify as a principal residence (i.e., a housing unit, leasehold interest or co-operative housing corporation shares -- see the current version of IT-120 and also ¶ 10 below), the deemed trust may be able to use the

rules referred to in ¶17 below to claim the principal residence exemption to reduce or eliminate any gain that would otherwise occur (for tax purposes) as a result of a disposition of the property. Subsection 248(3) also deems any person who has a right (whether immediate or future and whether absolute or contingent) to receive all or any part of the income or the capital in respect of property subject to (a), (b) or (c) to be a person who is beneficially interested in the deemed trust. Finally, subsection 248(3) deems property in relation to which any person has, at any time,

(d) the right of ownership;

(e) a right as a lessee in an emphyteutic lease (see ¶17 below); or

(f) a right as a beneficiary in a trust (including a right as a deemed beneficiary of a deemed trust described above);

to be beneficially owned by that person, whether or not the property is subject to a servitude. Thus, if a person sells his or her rights with respect to property which is subject to (a), (b), (c), (d) or (e) above and the property itself is a property that can otherwise qualify as a principal residence (i.e., a housing unit, leasehold interest or co-operative housing corporation shares), that person might be able to use the principal residence exemption to reduce or eliminate any gain that would otherwise occur (for tax purposes) as a result of that disposition of rights. In order for this to occur, of course, all the other requirements of paragraph 54(g), as described in the current version of IT-120, would have to have been met. (For example, the "ordinarily inhabited" requirement could have been satisfied by the person who sold the rights with respect to the property having inhabited the property during the relevant years.)

¶ 7. Some of the legal terms used in ¶6 above are briefly explained as follows:

An **emphyteutic lease** is a lease of real property for a relatively long period of time -- as of the date of issuance of this bulletin, there may be emphyteutic leases in existence in the province of Quebec with terms ranging anywhere from "more than 9 years" to 100 years in length. During the term of the emphyteutic lease, the lessee has the full benefit and enjoyment of the real property and undertakes to make improvements to the property and, generally, to pay annual rent to the owner. The current version of IT-324, *Capital Cost Allowance -- Emphyteutic Lease*, discusses this matter in greater detail.

Under a **usufruct**, the **usufructuary** has a right to enjoy all the benefits, advantages and profits of property that is owned by another person.

Under a **substitution**, a designated person, called the **institute**, inherits property under a will, or acquires it as a gift *inter vivos*, but with a directive that he or she shall pass it over to another designated person, who is called the **substitute**.

¶ 8. For purposes of claiming the principal residence exemption for a property, paragraph 54(g) requires that the taxpayer own the property "jointly with another person or otherwise". These words include sole ownership, joint tenancy, tenancy-in-common and co-ownership. Provincial laws relating to marital property are often relevant in determining the ownership of property for this purpose and should, therefore, be considered along with the comments in this bulletin. In the province of Quebec, the question as to whether spouses own real property "jointly with another person or otherwise" may depend upon

(a) the matrimonial property regime which applies to them (e.g., involving community of property);

(b) the family patrimony (if applicable); or

(c) the terms of their marriage contract.

It should be noted, however, that subsections 248(22) and (23) of the *Income Tax Act* contain provisions that can "deem" (determine) for purposes of the Act which spouse is the owner of a property at any particular time after July 13, 1990 if the property is or was the subject of a matrimonial property regime in Quebec (or another civil law jurisdiction) involving some common interest between the spouses, such as community of property. For further discussion on these provisions, see the current version of IT-325, *Property Transfers After Separation, Divorce and Annulment*.

¶ 9. When a taxpayer's ownership of property is in dispute or in doubt, he or she may resort to the courts for a resolution of the question. In a situation involving a marriage dissolution, for example, one spouse may request the courts to resolve the ownership of property considered to be owned by the other spouse. In such a case, where the first-mentioned spouse acquires ownership pursuant to a court order, such ownership will generally be considered to have been acquired on the effective date specified in the court

order regardless of the legal basis or reasons for the order, or on such other date as is considered reasonable if no effective date is specified in the order.

¶ 10. A share in the capital stock of a co-operative housing corporation can qualify as a principal residence property provided that the share was acquired for the sole purpose of obtaining the right to inhabit a housing unit owned by the corporation and the other requirements of paragraph 54(g), as discussed in the current version of IT-120, are met. In any event, where a corporation or an association formed solely to hold residential property is really a bare trustee of the property and the terms of the trust arrangement give the beneficiary, i.e., shareholder of the corporation or member of the association,

(a) the same rights of possession and use of a particular housing unit as the beneficial owner of any housing unit would normally enjoy, and

(b) the right to require the corporation or association to deal with the housing unit (e.g., sell or mortgage it) as instructed by the shareholder or member,

the shareholder or member is considered to be the beneficial owner of the housing unit. These comments do not apply to ownership of a condominium unit that usually vests in the person acquiring it. However, see ¶ 12 below concerning the time of acquisition of ownership of a condominium unit.

¶ 11. A purchaser's interest in property under an enforceable agreement for sale will, subject to ¶ 12 below, be considered to constitute ownership of the property. A purchaser's interest in a house bought under the *Veterans Land Act* will also be considered to be ownership of property. In these instances, the taxpayer has made a down payment and entered into an obligation to make monthly payments. When the total purchase price is paid, the taxpayer is entitled to acquire title in his or her name.

¶ 12. When acquiring a residential condominium unit, it is not unusual for a taxpayer to make a down payment, to enter into an agreement of purchase and sale, to enter into an occupancy agreement and to take possession prior to the registration of the condominium. The occupancy agreement may provide for payments which reflect the carrying costs of the condominium until the purchase transaction can be completed. Normally in such a situation, the taxpayer does not own (either beneficially or legally) the condominium unit until the condominium is registered under the relevant provincial legislation and the purchase transaction has closed.

¶ 13. A taxpayer may in some cases be considered to own, for purposes of the principal residence exemption, a housing unit situated on land not owned by the taxpayer in circumstances where, by reason of the law or according to the terms of the lease, he or she has a leasehold interest in the land. This can occur, for example, in any of the following circumstances:

(a) the taxpayer is assigned the leasehold interest in government-owned land and pays a builder to construct a house on the land,

(b) the taxpayer builds a house on leased land, or

(c) the taxpayer "purchases" (i.e., pays what amounts to a purchase price for) a house on leased land.

¶ 14. A taxpayer who occupies a housing unit under a genuine lease-option agreement is not considered to be the owner of the housing unit. On the other hand, the taxpayer is considered to be the beneficial owner of the housing unit where the agreement is a conditional sales contract. It is always a question of fact, based on the written terms of the agreement as well as the circumstances under which it is made and the manner in which it is executed, as to whether the agreement is actually a lease for the property with an option to buy or an agreement for sale. The current version of IT-233, *Lease-Option Agreements; Sale-Leaseback Agreements*, discusses this subject in greater detail.

¶ 15. A taxpayer acquires ownership of property by way of gift or inheritance on the date he or she obtains a right to possess the property for his or her enjoyment.

¶ 16. Where a personal trust, including a spousal trust, distributes a property to a beneficiary who subsequently disposes of the property, the beneficiary may be deemed by subsection 40(7), for the purposes of claiming the principal residence exemption, to have owned the property since the trust last acquired it. An illustration of how this provision works is contained in the current version of IT-120.

¶ 17. As indicated in ¶ 1 above, the ownership requirement for the principal residence exemption contained in paragraph 54(g) can be met by the legal owner of the property. This is so even where the legal owner, e.g., a trust, is not the beneficial owner. However, as discussed in the current version of IT-120, there are

other requirements that must be satisfied for a taxpayer to be able to claim the principal residence exemption. There are special provisions in the Act which make it possible for any personal trust, including a spousal trust, to claim the principal residence exemption if it disposes of the property. For more information on these rules, see Form T1079, *Designation of a Property as a Principal Residence by a Personal Trust*.

Explanation of Changes

Introduction

The purpose of the *Explanation of Changes* is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised departmental interpretations.

Overview

This bulletin discusses ownership of property for purposes of claiming the principal residence exemption. We have revised the bulletin primarily:

because of changes, in S.C. 1991, c. 49 (formerly Bill C-18), to provisions in the *Income Tax Act* that pertain to the ownership of property in the province of Quebec; and to discontinue the discussion of ownership of property as it pertained to the Registered Home Ownership Savings Plan (RHOSP) rules, which have been repealed.

The comments in the bulletin are not affected by proposed amendments to the *Income Tax Act* contained in Bill C-9, which received first reading in the House of Commons on February 4, 1994, or in the draft legislation released on August 30, 1993 (a Bill for this legislation will likely be introduced in the House in the current session of Parliament).

Legislative and Other Changes

New ¶ 1 (replaces old ¶ 1): The introduction in new ¶ 1 replaces the introduction found in old ¶ 1 and part of the first sentence of old ¶ 2. The old introduction indicated that the term "ownership" in the *Income Tax Act* should be given the meaning of "beneficial ownership". This position was particularly important in applying the RHOSP rules. In new ¶ 1, we have removed the reference to the repealed RHOSP provision and have now indicated that the ownership requirement under the principal residence rules is met where the taxpayer is the legal owner or the beneficial owner of the property. (The reference to "legal ownership" is significant when the property is held by a personal trust, as briefly mentioned later in the bulletin.)

New ¶s 2 to 5 (replace old ¶ 2): We have split up old ¶ 2 into new ¶s 2 to 5 for easier reading. These paragraphs describe and compare "legal ownership" and "beneficial ownership" as those two terms are used in common law jurisdictions. We have made some wording changes and rearranged some of the sentences for purposes of clarification only, without changing the substance of what was said in old ¶ 2.

New ¶s 6 and 7 (replace most of old ¶ 3): These paragraphs replace the major part of old ¶ 3. New ¶ 6 discusses the principal residence exemption in relation to a residence property which is subject to subsection 248(3) as amended under Bill C-18. That provision specifically governs the income tax treatment of property subject to certain types of legal relationships in the province of Quebec, which is a civil law jurisdiction. The explanations found in new ¶ 7 of three of these types of legal relationships are essentially the same as found in old ¶ 3.

New ¶ 8 (replaces old ¶s 11 and 14 and the second sentence of old ¶ 3): The first three sentences of new ¶ 8 are similar to old ¶s 11 and 14 except that they do not contain a reference to the repealed RHOSP provision and they now tie in more specifically with the principal residence rules. The fourth sentence of new ¶ 8 is similar to the second sentence of old ¶ 3. The last part of new ¶ 8 mentions provisions added to the *Income Tax Act* under Bill C-18 that can deem which of two spouses is the owner of certain property in Quebec and refers the reader to another bulletin which discusses these provisions in detail.

New ¶ 9 (replaces old ¶ 13): The words in the last sentence of old ¶ 13 "or on the date on which the order is made if no effective date is specified in the order" reflected an administrative position that was favourable to some taxpayers for purposes of the RHOSP rules. However, as the RHOSP legislation has been repealed and the above-mentioned administrative position could actually be unfavourable in some cases for purposes of claiming the principal residence exemption, it is replaced in new ¶ 9 with the words "or on

such other date as is considered reasonable if no effective date is specified in the order".

New ¶ 10 (replaces old ¶ 4): This paragraph has been revised to more specifically tie in with the principal residence rules. Also, the comments in old ¶ 4 that were particularly relevant for the repealed RHOSP rules have not been continued in new ¶ 10.

Old ¶ 5: This paragraph is not continued in the new bulletin because the RHOSP legislation has been repealed and because the paragraph now has little, if any, relevance with respect to principal residences because of the rules mentioned in new ¶s 16 and 17 that can apply where the property is held by a personal trust.

New ¶s 11 to 14 (replace old ¶s 6 to 9): We have made some wording changes for purposes of clarification only.

Old ¶ 10: This paragraph was written specifically with regard to the repealed RHOSP provisions and is therefore not included in the new bulletin.

New ¶ 15 (replaces old ¶ 12): There have been some wording changes for purposes of clarification only.

New ¶s 16 and 17: These paragraphs briefly mention rules, enacted under Bills C-72 and C-92, that can apply for purposes of the principal residence exemption where the property has been held by a personal trust, including a spousal trust. The reader is then referred to other materials published by the Department that set out these rules.

Notice -- Bulletins do not have the force of law

Interpretation bulletins (ITs) provide Revenue Canada's technical interpretations of income tax law. Due to their technical nature, ITs are used primarily by departmental staff, tax specialists, and other individuals who have an interest in tax matters. For those readers who prefer a less technical explanation of the law, the Department offers other publications, such as tax guides and pamphlets.

While the ITs do not have the force of law, they can generally be relied upon as reflecting the Department's interpretation of the law to be applied on a consistent basis by departmental staff. In cases where an IT has not yet been revised to reflect legislative changes, readers should refer to the amended legislation and its effective date. Similarly, court decisions subsequent to the date of the IT should be considered when determining the relevancy of the comments in the IT.

An interpretation described in an IT applies as of the date the IT is published, unless otherwise specified. When there is a change in a previous interpretation and the change is beneficial to taxpayers, it is usually effective for all future assessments and reassessments. If the change is not favourable to taxpayers, it will normally be effective for the current and subsequent taxation years or for transactions entered into after the date of the IT.

A change in a departmental interpretation may also be announced in the *Income Tax Technical News*.

If you have any comments regarding matters discussed in this IT, please send them to:

Director, Business and Publications Division

Income Tax Rulings Directorate

Policy and Legislation Branch

Revenue Canada

Ottawa ON K1A 0L5

Changes in Use and the Deemed Disposition.

Subsection 45(1) provides disposition rules applicable where a property's use has been changed from the use which was the purpose of its acquisition, to some other use, (such as from income producing to personal use and vice versa), and thus it clearly applies where a trust has acquired a property that is to be used as a principal residence, in the common sense of the term, by one of its beneficiaries, and subsequently uses it as a rental property, or vice versa.

As per para. (a) of Sec. 45(1) where the change in use occurs the taxpayer will be deemed to have disposed of the property, (or a part thereof as computed under para. (b)), for proceeds equal to its fair market value at that time, and to have acquired it immediately after that time at a cost equal to its fair market value. Obviously this will cause deemed dispositions to occur when a beneficiary ceases to use it as a personal residence

provided under a trust, (such as when a spouse commences habitation of a retirement home etc.), but only when the trust itself ceases to treat the property as a benefit to be provided under the agreement and starts to use it to produce income/gain etc.. Subsection 45(2) provides an exception to the deemed disposition which can apply where the property was acquired for personal use and then was used to produce income, (but not the other way around), if the taxpayer elects in his return for the year in which the change occurred, whereby the change will be deemed not to have occurred, except where subsequently the taxpayer rescinds his election, whereby the deemed disposition will be recognized prospectively in the year of rescission. As per Sec. 54(g)(ii) the property may be considered a principal residence while the election is effective while under para. (iv) the property will not be considered a P.R. if **by virtue of subpara. (ii)** the dwelling would have been his P.R. for four or more previous tax years. Thus the life of the election in Sec. 45(2) (and 45(3)) is limited to four years before its effect, vis-a-vis the P.R. exemptions, is lost. It should be noted that there is no need apparently to satisfy the other conditions described in subpara. (i)-(iii), since subpara. (i) and (ii), (iii) and (iv) operate mutually exclusively.

Under subsection 45(3), the only exception allowed, where the use of property upon its acquisition was changed from that of producing income to personal use, is extended in respect of property which becomes a principal residence of the taxpayer and only when the taxpayer notifies the Minister in writing on the earlier of 90 days after the Minister demands one or April 30 following the year in which the property is actually disposed of. Again there is a maximum time period during which the property could produce income/gain before it irreparably disqualifies itself, (four years as per Sec. 54(g)(iv)), however, Sec. 45(4) provides that such an election will not be valid where a deduction has been taken in respect of the property, after 1984 and on or before the change in use, as allowed under the regulations relating to Sec. 20(1)(a), (C.C.A.), by the taxpayer, his spouse, or a trust under which he or his spouse is a beneficiary.

Reserves on Death.

Subsection 72(1) provides that a taxpayer who has died will not be allowed to take certain income reserves in the year of death, such as those provided in Sec. 20(1)(n), 32(1), 64(1), 64(1.1) and most notably the specified capital gains reserve in Sec. 40(1)(a) as well as that in Sec. 44(1)(e)(iii), hence the testator may recognize significant increases in his terminal income regardless of whether the rights to the reserve amount become immediately enforceable by his estate or not. Both the capital gains reserve in respect of normal capital property and that adapted under Sec. 40(1.1) in respect of farm property can be rolled. Under subsection 72(2) some roll-through ability is extended to the testator where the right to receive the reserve amount is transferred or distributed on or after and as a consequence of his death to his spouse as described in Sec. 70(6)(a) or spousal trust described in Sec. 70(6)(b) however this is available only when the testator was resident in Canada at the time of death and his legal representative and transferee have jointly elected for the roll-through to apply on Form T2069 a copy of which must be filed with both the testator's normal return and the recipient's normal return for the first tax year ending after the date of death. Where the election is made any specified reserve other than the capital gains reserve, may be deducted by the testator in his terminal return and will be included in computing the transferee's income in the first tax year ending after the year of death while its character will also be maintained in that person's hands. In the case of the capital gains reserve the spouse or spousal trust will recognize the amount of reserve in its first tax year ending after the year of death and the testator will enjoy the respective reserve in the year of death, while as per paragraph (c) the spouse or spousal trust is placed in a position identical to that formerly of the testator and may claim the Sec. 40(1)(a)(iii) or Sec. 44(1)(e) reserves in the balance of the years.⁸⁶¹

The provisions do not specify any particular time limit after death within which the right must be transferred or distributed nor does it require that if transferred to the spousal trust it must vest indefeasibly in it. The subsection 70(6) character of the recipients is described but the only operative terms similar to Sec. 70(6) is that the right be transferred or distributed as a consequence of the death on or after the death. It can't be redirected through will variation though a taxpayer may have a special power of appointment over it. In the case of the capital gains reserve the note receivable substantiating the right would be considered a capital property subject to the roll-through provision in Sec. 70(6) and also eligible for Sec. 70(7) listing to untaint tainted spousal trusts. The note receivable would have an ACB equal to the FMV of the property given being equal to the taxpayer's cost but its FMV could be argued to be less depending on the prevailing interest rates applicable on the inherent risk of the instrument and the length of the deferral in payment. The fact that the testator hasn't recognized the inherent tax liabilities in the creation of the instrument's cost should not reduce it.

In the year before death a capital property is disposed of for a note to be extinguished 5 years later and the testator takes the maximum Sec. 40(1)(a) reserve possible in respect of the proceeds deferred. On his death it is rolled to a spousal trust and his executors list it as a Sec. 70(7) untainting property. The underlying property has already been transferred to the non-spousal family member/acquaintance and the note cleanses non-qualifying debt going into the spousal trust. Since the whole amount isn't receivable for another 4 years the FMV of the note may be less than its ACB and will such create a capital loss when listed? How discounted can you make a 5 year note receivable create a capital loss in the testator's hands, be used to cover non-qualifying debt being assumed by a spousal trust, and again, if you desire, have it terminate with resulting loss in the trust by being forgiven per trust deed or discretion, when the spouse dies from under the spousal trust, as you've avoided the FMV disposition on property that wasn't going to the spouse anyway? The debtor would recognize full inclusion but the trust would recognize full deduction if that were to happen: it's a question of what you want to happen.

"Reserves, etc., for year of death – Sec. 72(1)" **(1) Where in a taxation year a taxpayer has died,**

861. This is also the case in respect of the Sec. 20(1)(n) and section 64 reserves.

- (a) paragraph 20(1)(n) does not apply to allow, in computing the income of the taxpayer for the year from a business, the deduction of any amount as a reserve in respect of property sold in the course of the business;**
- (b) no amount is deductible under subsection 32(1) as a reserve in respect of unearned commissions in computing the taxpayer's income for the year;**
- (c) no amount may be claimed under subparagraph 40(1)(a)(iii), paragraph 40(1.01)(c) or subparagraph 44(1)(e)(iii) in computing any gain of the taxpayer for the year;**
- (d) subsection 64(1) does not apply to allow, in computing the income of the taxpayer for the year, the deduction of any amount as a reserve in respect of the disposition of any property; and**
- (e) subsection 64(1.1) does not apply to allow, in computing the income of the taxpayer for the year, the deduction of any amount as a reserve in respect of the disposition of any property.**

“Election by legal representative and transferee re reserves – Sec. 72(2)”

(2) Where property of a taxpayer that is a right to receive any amount has, on or after the death of the taxpayer and as a consequence thereof, been transferred or distributed to the taxpayer's spouse or common-law partner described in paragraph 70(6)(a) or to a trust described in paragraph 70(6)(b) (in this subsection referred to as the “transferee”), if the taxpayer was resident in Canada immediately before the taxpayer's death and the taxpayer's legal representative and the transferee have executed jointly an election in respect of the property in prescribed form,

(a) any amount in respect of the property that would, but for paragraph 72(1)(a), (b), (d) or (e), as the case may be, have been deductible as a reserve in computing the taxpayer's income for the taxation year in which the taxpayer died shall,

(i) notwithstanding subsection 72(1), be deducted in computing the taxpayer's income for the taxation year in which the taxpayer died,

(ii) be included in computing the transferee's income for the transferee's first taxation year ending after the death of the taxpayer, and

(iii) be deemed to be

(A) an amount that has been included in computing the transferee's income from a business for a previous year in respect of property sold in the course of the business,

(B) an amount that has been included in computing the transferee's income for a previous year as a commission in respect of an insurance contract, other than a life insurance contract,

(C) an amount that by virtue of subsection 59(1) has been included in computing the transferee's income for a preceding taxation year, or

(D) for the purposes of subsection 64(1.1), an amount that by virtue of paragraph 59(3.2)(c) has been included in computing the transferee's income for a preceding taxation year and to be an amount deducted by the transferee pursuant to paragraph 64(1.1)(a) in computing the transferee's income for the transferee's last taxation year ending before the death, as the case may be;

(b) any amount in respect of the property that could, but for paragraph 72(1)(c), have been claimed under subparagraph 40(1)(a)(iii) or 44(1)(e)(iii) in computing the amount of any gain of the taxpayer for the year shall,

- (i) notwithstanding paragraph 72(1)(c), be deemed to have been so claimed, and**
 - (ii) for the purpose of computing the transferee's income for the transferee's first taxation year ending after the death of the taxpayer and any subsequent taxation year, be deemed to have been**
 - (A) proceeds of the disposition of capital property disposed of by the transferee in that first taxation year, and**
 - (B) the amount determined under subparagraph 40(1)(a)(i) or 44(1)(e)(i), as the case may be, in respect of the capital property referred to in clause (A); and**
 - (c) notwithstanding paragraphs 72(2)(a) (b), where any property had been disposed of by the taxpayer, in computing the income of the transferee for any taxation year ending after the death of the taxpayer,**
 - (i) the amount of the transferee's deduction under paragraph 20(1)(n) as a reserve in respect of the property sold in the course of business,**
 - (ii) the amount of the transferee's claim under subparagraph 40(1)(a)(iii) or 44(1)(e)(iii) in respect of the disposition of the property, and**
 - (iii) the amount of the transferee's deduction under section 64 as a reserve in respect of the disposition of the property**
- shall be computed as if the transferee were the taxpayer who had disposed of the property and as if the property were disposed of by the transferee at the time it was disposed of by the taxpayer.**

How will CRA assess a taxpayer when such a note, payable by an offspring, is rolled to a spouse directly but it must be forgiven by her, following a payment of interest by the offspring, as a condition subsequent if she is to receive a certain amount of proceeds from a spousal trust or from the estate directly? Subsection 72(2) doesn't require indefeasible vesting so the roll-over is available while since the cancellation of the debt can be described as a bequest conditional on the spouse's desire for the greater benefits Sec. 80(1)(h) should operate to prevent the debtor from recognizing an income inclusion and the spouse will recognize the balance of the reserve in her income after the note is forgiven even though no proceeds are realizable. The Sec. 40(1)(a)(iii) reserve is equal to the amount of proceeds not realizable/receivable or 1/5th of the proceeds. If the note is rolled to a spousal trust the trust must be structured so as to prevent it from being forgiven prior to the death of the spouse since such would operate as a distribution of property to a beneficiary (as a bequest). If the property is acquired by the spouse on a FMV sale and the note is the consideration on the death it can be transferred to a spousal trust to be realized subsequently and access the Sec. 72(2) reserve roll through while if the trust must forgive the debt as a condition if the spouse accepts to perform or not perform certain activities such as making of an election under the FLA Sec. 80(1)(h) will prevent the spouse from recognizing an income inclusion, the spousal trust won't be structured so as to be tainted, the reserve roll-over will be preserved so as to prevent the testator from recognizing the gain, the underlying property will have its cost bumped accordingly to its FMV, and the trust will have to recognize the balance of the reserve. Until the note is forgiven its tax cost (FMV thereof at the time of the testamentary transfer) will substantiate the Sec. 108(1)(d) tax cost of other capital interests allowing the interests acquisition by the spouse to produce less tax consequences to their disponers whereby subsequently the property can be distributed to the spouse under Sec. 107(2) allowing

a cost bump if the property with less tax consequences. Spreading the migrated tax cost of a large note receivable transferred into a spousal trust around the non-spousal beneficiaries for tax-free dispositions of their interests on all-fold-back to spouse and then collapse of trust with losses in spouse's hands is an interesting premise, Thanks for the reserves.

The fact that the debt may be forgiven may materially reduce the FMV and thus proportionate tax costs of the non-spousal capital interests and if the debt is to substantiate an exclusive interest its reduced FMV may shift the debt's tax cost to substantiate interests based on other trust property and when they are purchased by the spouse and commutated the subsequent forgiving of the spousal debt will result in a tax free cost bump of the trust property realized by the spouse under Sec. 107(2)(b). Does this abuse or misuse any of the provisions of the Act and was it not structured with a bona fide purpose other than a tax motivation?

There is no provision in the Act that allows a trust to roll a reserve out to its beneficiaries on a wind-up or otherwise hence even though proceeds from a sale of property are not fully recognizable in computing income, if the underlying right/note receivable is distributed to the beneficiary the trust will not have the reserve available thus the deferral will be lost while the beneficiary will not be able to take any sort of reserve even if a Sec. 104(21) taxable capital gains designation has been made in respect of the amount and beneficiary since that provision applies only for purposes of sections 3 and 111 bypassing the Sec. 40(1)(a) reserve deduction. If the property is to be disposed of so as to distribute the proceeds as per the trust deed this aspect may represent a serious problem even if the note received by the trust can be divisible so as to be distributed to a group of beneficiaries individually. If the property is distributed out to a beneficiary on condition that he sell it and pay a tax adjusted share of the proceeds to the other beneficiaries with respect to their trust entitlements Sec. 105(1) will apply to the proceeds transferred to cause full income inclusion as benefits, even though the Sec. 40(1)(a) reserve could be available, (unless the recipients were non-resident); definitely not a tax effective strategy. It would be possible to transfer co-ownership interests in the property to the beneficiaries in satisfaction of their interests whereafter they may dispose of them as they wish to recognize the gains though given the Department's opinion in the answer to Question 55 of the 1990 Roundtable Discussions⁸⁶² the Sec. 107(2) roll-out treatment may not be gained in such an instance.

862 The Sec. 70(6.2) election cannot be made in respect of **part** of the property rolled to a spousal recipient.

Deductibility of Executor, Trustee, and Probate Fees.

In No. 579 v. M.N.R.⁸⁶³ the fees payable to the two groups of trustees were to be measured on two bases, a percentage of the income accruing to the trust plus a percentage of the book value of non-income producing property, and a percentage of the book value of its property and the Minister disallowed the trust from deducting that amount paid that related to the book value of the properties **but** did allow the deductions of that amount computed upon the income accruing. The trustees were unsuccessful in attempting to convince that their advice constituted advice of investment counsel, which was granted at the time special deduction status, (equivalent to that under Sec. 20(1)(bb) presently). R.S.W. Fordham Q.C. provided that:

"Be all this as it may, the fact remains that, strange as it may seem, the Income Tax Act contains no provision for the deduction of trustee's fees **as such**. In order to qualify as deductible items, compensation paid to trustees must be readily classifiable as "an outlay or expense" identifiable with the income-earning process. Unless this test is met, there can be no deduction from taxable income.

...The settlor may allow to the trustees whatever fees he pleases, of course, but their deductibility, or otherwise, from the income of the trust is quite another matter."

The reason why the "investment counsel" argument failed is because the particular trustees attempting to use it did not carry on **as a principal business**, the provision of investment advice, as was needed under Sec. 11(14) at that time, and would apply the same way as per present Sec. 20(1)(bb). The important note to be made is that the Minister in that case did allow the deduction of remuneration calculated upon the income accruing to the trust, even though there was not at question the issue of whether the trustees activities were directly related to and needed for the production of that income.

In A.B. Bardsley Trust v. M.N.R.⁸⁶⁴ two apparently very competent trustees instituted investment decisions, their remuneration to be based on the awarding compensation afforded trustees on the passing of accounts pursuant to The Trustee Act R.S.O., 1970 Ch. 470 (being a mix of income and book value basis). The Minister did not allow a deduction to the trust under neither Sec. 18(1)(a) nor 20(1)(bb) on the grounds that the trustee's principal business was other than the providing of investment advice, (essentially what is required under the Sec. 20(1)(bb) deduction), while J.B. Goetz, the Chairman of the Tax Review Board, quoting from No. 579 v. M.N.R. provided:

"There is much to be said for the appellant's submission that the manner in which the trustee's fees were calculated **does not settle the purpose for which the fees were paid**."

It is with respect to this latter point that the fees were not deductible under Sec. 18(1)(a) being that the fees were paid to the trustees, **as trustees**, while they were not paid to the trustees as an expense incurred to produce business or property income.⁸⁶⁵ Regardless of how effective the trustees exercised their discretion, and regardless of the amount of income earned by the trust, if it did any, there was no direct link between the realization of that income and payment of the fees. **The payment of the fees had as its purpose the remuneration of trustees, not investment counsel.**⁸⁶⁶

In Greenstone Estate v. M.N.R.⁸⁶⁷ an executor attempted to deduct from his estate's taxable income \$12,500 in administrator's fees that he had charged the estate while the estate consisted of some income producing property. The Tax Court judge would have allowed for their deduction as per a reading of Sec. 9(1) however he didn't seem to recognize Sec. 18(1)(a) as restricting such or any of the reasoning in Bardsley Trust cited. (The expense was not deductible eventually due to vague vouchering.)

The fact that the estate/trust consists exclusively of businesses or income producing property does not warrant the deduction of administrator's fees as such. The fees are paid to administer the estate as such; they

⁸⁶³ 58 D.T.C. 734

⁸⁶⁴ 82 D.T.C. 1659 (TRB)

⁸⁶⁵ See subsequent sub-chapter on how to avoid this reasoning by altering the capacity in which the trustee receives the income.

⁸⁶⁶ See Revenue and Customs Comrs v. Peter Clay [2009] 2 All E.R. 683 CA, where the court had to consider whether to apportion the trustee, investment, bank, custodian and professional accountancy and administration fees between income and capital of a trust. One must be careful of exactly why a fee was incurred. This case is very relevant in the Cdn. context since even if a fee is generally deductible under a provision in the ITA the aspect of the trust to which it was incurred must be considered: for capital or income beneficiaries.

⁸⁶⁷ 90 D.T.C. 1001

are not paid to a taxpayer as an agent to carry on the business/attend to the property since such services are not that which the administrator has offered per se; and they certainly weren't incurred **for the purpose** of gaining or producing income.⁸⁶⁸

868 See also *Clapham's Trusts v. Belton*, 37 T.C. 26, and *C.I.R. v. McIntosh*, 36 T.C. 334. This was certainly properly provided in *The Estate Of Sholto Walmsley v. MNR*, 97-1557-IT-G, whereby the Tax Court provided:

8. In so assessing the Appellant, the Minister relied, on, *inter alia*, the following assumptions:

a) the facts stated and admitted herein;

b) trustee fee expenses in excess of the amount allowed by the Minister were not incurred for the purpose of gaining or producing income from a business or property;

c) trustee fee expenses in excess of the amount allowed by the Minister were not current expenses, but were expenses that were capital in nature;

d) trustee fee expenses in excess of the amount allowed by the Minister were not expenses that were reasonable in the circumstances;

e) the trustee fees paid by the Appellant in the 1992 and 1994 taxation years were not paid to a person whose principal business is advising others as to the advisability of purchasing or selling specific shares or securities;

f) the trustee fees paid by the Appellant in the 1992 and 1994 taxation years were not paid to a person whose principal business includes the provision of services in respect of the administration or management of shares or securities.

B. ISSUE TO BE DECIDED

9. The issue is whether the Minister properly disallowed expenses for trustee fees claimed by the Appellant in the amounts of \$916.00 and \$69,892.00 in the 1992 and 1994 taxation years, respectively.

C. STATUTORY PROVISIONS RELIED ON

10. He relies on sections 3, 9 and 67, subsection 20(1) and paragraphs 18(1)(a), 18(1)(b) and 18(1)(h) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), as amended (the "*Act*").

D. GROUNDS RELIED ON AND RELIEF SOUGHT

11. He respectfully submits that the disallowed trustee fee expenses were not incurred for the purpose of gaining or producing income from a business or property within the meaning of paragraph 18(1)(a) of the *Act* but were expenses that were capital in nature within the meaning of paragraph 18(1)(b) of the *Act*.

12. He respectfully submits that the trustee fee expenses disallowed by the Minister were not expenses that were reasonable in the circumstances within the meaning of section 67 of the *Act*.

13. He respectfully submits that the trustee fees paid by the Appellant in the 1992 and 1994 taxation years were not paid to a person whose principal business is advising others as to the advisability of purchasing or selling specific shares or securities pursuant to subparagraph 20(1)(bb)(iii) of the *Act*.

14. He respectfully submits that the trustee fees paid by the Appellant in the 1992 and 1994 taxation years were not paid to a person whose principal business includes the provision of services in respect of the administration or management of shares or securities pursuant to subparagraph 20(1)(bb)(iv) of the *Act*.

Paragraphs 13 and 14 of the Reply are correct. Mark's occupation did not fall within subparagraphs 20(1)(bb)(iii) or (iv) of the *Act*.

[7] The Appellant called Mr. Yuile of Victoria who testified as to fees he charges for professional investment advice. Essentially he charges an annual fee based on the total value of assets administered. It is 1% of the first \$250,000, ¾ of 1% of the second \$250,000; ½ of 1% of the third \$250,000 and ¼ of 1% thereafter. In Vancouver and in the investment advisor industry the fees generally range from 1% to 2% per annum based on the value of the financial assets administered.

[8] Mark Walmsley did not break down his services or fees among the portions spent attending to Margery Walmsley's needs, the portion spent on income matters, on capital matters or on administrative or any other matter or matters. Essentially he simply charged his fees based upon the terms of Exhibits A-1 and A-2 which are quoted on a gross basis.

[9] Mark did not give any detail respecting his fees to the auditor when he was asked for detail. As a result, the auditor calculated the fees he allowed based upon the Ontario tariff of fees allowed for executors and administrators, based upon the income of the estate and the taxable capital gains of the estate. Although Mr. Poon's calculations based upon taxable capital gains may be questionable, the Appellant did not present detailed evidence in support of an alternative method of calculating the fees related to income or other gains earned by the estate. The rationale presented by the Appellant was that the estate increased remarkably in value and therefore the fees are deductible. **The failure in this rationale is that the trustee had to administer the care of Margery and administer the estate generally (and wind it up) in addition to attempting to earn income and to**

Perhaps the opinion of the Tax Court in *Pappas Estate v. M.N.R.*⁸⁶⁹ will conclude the matter of the deductibility of probate/estate expenses from the estate's income, (though perhaps not). In this case the estate incurred probate fees, legal expenses ascertaining beneficiaries' entitlements, "management costs", and tax planning costs and the executors attempted to deduct all \$132,000 thereof against the estate's income. The Minister denied the deduction and T.C. Judge Bonner concurred. The executors relied upon the possible deduction under Sec. 18(1)(a) but the judge held quite accurately;

"The taking of possession of the property of the deceased, the obtaining of probate and, where required, supplementary or foreign probate, the location and payment of creditors and the distribution of the property of the deceased to persons beneficially entitled are actions quite unrelated to the earning of income from a business or property. Such operations are not commercial in nature. **They do not involve the generation of fees or other revenues payable to the estate and therefore are not carried on with view to earning a profit. From the standpoint of the estate such activities are a cost of distributing the worldly possessions of the deceased in accordance with his wishes.**"

It was also held that the Sec. 20(1)(bb) deduction in respect of investment counsel was not available since such activity was not the principal activity of the executors. The executors/estate had also incurred expenses in managing and supervising the activities of corporations the shares of which were held and were to be distributed and these as well were found not to be deductible since as per the precedent in *D.W.S. Corp. v. M.N.R.*⁸⁷⁰ "the possibility that a shareholder may receive dividends or other income arising from expenditures made by him for his company's benefit is too remote to warrant a finding that the expenditures are made to earn income." He did say, "distributing", accurately.

In *C.I.R. v. Richard's Executors*⁸⁷¹ the executors attempted to take two deductions: the cost of the taking of the inventory of the estate so as to make appropriate estate tax returns so as to secure their title to the property while also commissions paid to them to sell the property were also contended to be deductible against a deemed disposition of the estate's property. Argued to the House of Lords it was finally concluded that the costs incurred to take inventory so as to gain valid title to dispose of the inventory amounted to costs deductible under the particular taxation Act by the estate on a disposition. Such was by analogy said in respect of the securing of probate to prove the will and allow the legitimate dealing with of the estate.⁸⁷² The commissions

retaining or increasing the value of the estate assets. He performed a mixture of duties, only some of which were related to earning income. But he did not give any evidence which broke down the fees he charged for activities performed in order to earn income for the estate.

869 90 D.T.C. 1646

870 68 D.T.C. 5045

871 46 T.C. 626 H.L.

872 The particular provision of the Act allowed costs incurred to protect one's title to be deductible against the proceeds of disposition when the property was disposed of but the same could be said viz-a-viz the securing of title so as to deal with the property so as to dispose of it. The ITA allows such to be deductible. On a further point regarding this see *Estate Of Gordon Noik And Her Majesty The Queen*, 2008TCC109, where the TCC considered the instance where an executor had to defend challenges to the wealth of the estate and attempted to deduct the legal costs. It held:

[6] The legal bill dated May 28, 2003 (see item (iv) in paragraph 4 above) was based almost exclusively on services rendered defending the Estate against Klara's claim before the hearing judge in May 2003. Gad Noik, as Executor of the Estate, settled the legal bill of May 28, 2003 by making one lump sum payment of \$15,000. The aggregate legal expenses of \$18,770 in dispute in this appeal comprise the following amounts paid by the Executor of the Estate:

(i) Legal bill December 19, 2002 \$1,459.62

(ii) Legal bill February 25, 2003 \$1,276.70

(iii) Legal bill April 28, 2003 \$1,033.79

(iv) Legal bill May 28, 2003 \$15,000.00

Total \$18,770.11

[7] Exhibit R-3 is the T3 Trust Income Tax Return for the first fiscal period of the Estate from October 19, 2002 to May 31, 2003. Exhibit R-3 shows that the income of the Estate for that fiscal period was derived from only four sources:

Taxable capital gains	\$15,365

Investment Income (Interest)	2,341

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paid to the executors were also held to be deductible, again, on the FMV disposition, notwithstanding that such were also paid to them quo executor.

There are **two** dispositions the ITA recognizes in any situation where the testator's property devolves to a non-spousal recipient: that under Sec. 70(5) and under section 107. While it has been held that legal title transfer fees incurred on a distribution cannot be deductible against a Sec. 70(5) deemed disposition, (since they are incurred by a party which isn't technically recognizing the Sec. 70(5) disposition), all probate/administration fees related to property that passes through a section 107 disposition/commutation should be deductible **as an outlay incurred for the purpose of making the disposition as described in Sec. 40(1)(a)(1) and may create a capital loss for the estate in the instance where the Sec. 107(2) roll out applies**⁸⁷³. **The obtaining of probate, advertising and administration fees as described in the quote**

Net Rental Income	5,960
CPP Death Benefit	<u>2,094</u>
Total Income	<u>\$25,760</u>

[8] There is no evidence that any part of the aggregate legal fees in dispute (\$18,770) was paid or incurred for the purpose of gaining or producing income from property. Those legal fees were all paid to a Toronto law firm. Any legal fees paid in connection with the disposition of the rental properties in North Bay were probably paid to a North Bay lawyer and, in any event, would have been taken into account in determining the capital gain or loss realized on the disposition of each property.

[9] **There is evidence that the aggregate legal fees in dispute were paid to obtain probate of Gordon Noik's will, and to defend an action brought by his widow (Klara) for monthly payments of \$1,300 under paragraph 3(e) of the will.** Legal fees paid for those purposes are not ordinarily deductible in computing income. In *Pappas Estate v. M.N.R.*, [1990] T.C.J. 601, Bonner J. considered whether certain legal fees were deductible in computing estate income and stated:

It is clear that the costs falling into the first two categories are not deductible. Indeed counsel for the Appellant conceded that the portion of the fees of the estate solicitors related to the securing of probate are not properly deductible. Paragraph 18(1)(a) of the *Income Tax Act* provides:

18(1) In computing the income of a taxpayer from a business or deduction shall be made in respect of

(a) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property."

The taking of possession of the property of the deceased, the obtaining of probate and, where required, supplementary or foreign probate, the location and payment of creditors and the distribution of the property of a deceased to persons beneficially entitled are actions quite unrelated to the earning of income from a business or property. Such operations are not commercial in nature. They do not involve the generation of fees or other revenues payable to the estate and therefore are not carried on with a view to earning a profit. **From the standpoint of the estate such activities are a cost of distributing the worldly possessions of the deceased in accordance with his wishes.**

It's interesting that the TCJ didn't recognize that the obtaining of probate is to enable statutory disposition of the estate property under s. 107(2), even when Pappas Estate made the connection very accurately. And, argument could be further made that costs to protect the estate have direct effect on the gains to be recognized on that disposition.

873 This is further provided for in the recent case of *Estate of David Currie v. Her Majesty the Queen*, 2004TCC125, where the TCC refused to allow such as outlay or expense **though only for lack of proper documentation** with:

[9] The remaining issue is whether legal fees in the amounts of \$2,620.91, \$458, and \$1,633.56 as well as the balance of the administrator's fees have been properly established as expenses incurred on the disposition of the land. **The provisions of subsection 40(1) provide that any outlay or expense, including items such as legal or accounting fees, incurred for the purpose of making the disposition of a property may be added to the adjusted cost base of the property in calculating the amount of the capital gain, capital loss, terminal loss or business investment loss, as the case may be, arising from the disposition. Counsel for the Minister quite properly noted that the circumstances in this case necessitated that a second administration of David Currie's estate had to be undertaken and that was the reason why Salmon was appointed administrator and a portion of the legal fees must have been incurred in this context. There is no evidence before the Court from which one could reasonably determine the extent to which the expenses related to the**

in Pappas are all incurred to convey the property to the beneficiaries (prove the will, satisfy the creditors and maintain the property) and without them the property may not have been capable of being transferred in the form it is. Probate has as its purpose the proving of a document that provides how property is to be disposed of by technically both the testator and his estate and if it is not proven the latter disposition, (from the estate to the beneficiary recognized separately under the ITA), may be invalidated/ineffective or not made at all.⁸⁷⁴ In the absence of a will the intestate laws will become applicable to effect dispositions to alternate parties. **The purpose for which the fees are incurred is to distribute the property to the beneficiaries under section 107 or to solidify the executor's title so as to allow for the dealing with the estate property and its disposition exactly within the Richard's Executors context.**⁸⁷⁵

The same could be said about fees paid to tax counsel for tax minimization planning involving which beneficiary receives what property, and if the will is of the character, the magnitude of the benefit. In Pappas the tax minimization fees were partially related to the conveyance of the testator's property but in fact fees paid to wind down the corporations and tax planning being the reason could be argued to be related to the distribution of the assets and their preparation for distribution if the property/shares were not to be held but conveyed as specific bequests. When the estate is to be held on residuary trust the tax minimization fees leading to the disposition of the property/winding up of the corporation should be deductible as ordinary under Sec. 40(1)(a).

In respect of probate, administration, trustees' and executors', and investing fees incurred in respect of a residuary trust that are or are not directly related to delivering legal title to the beneficiaries one could still argue that the reason for which that were incurred were to effect a testamentary disposition of property regardless of how long the trust existed. If the estate is for conversion could it be argued that probate fees were incurred to prove that direction and thus as a cost of disposing of the property?⁸⁷⁶

If the expenses are deducted against a tax free roll-out the estate will recognize a capital loss on the distribution and to utilize it either the estate must have capital gains that will be taxed or Sec. 164(6) may be utilized in limited situations to carry back the nominal loss to the testator. Fees related to the assenting to the disposition of personal use property or any property for that matter should be deductible against the tax free roll-over of that property.

If the Sec. 70(6) roll over in respect of spousal trusts is attempted **unfortunately** there will not be the second disposition against which the fees may be deducted: subsection 70(6) sets up the receipt by the spouse and the disposition by the testator **as one disposition**. This would make a spousal roll over an obvious deterrent to the deduction of fees allocated to particular property transferred to a spousal recipient. Whether or not fees related to the roll over or recognition of rights or things under Sec. 70(2)-(3) are deductible against a section 107 distribution depends on whether or not section 107 can even apply to the receipt of the right or thing. Rights or things recognized by the testator under Sec. 70(2) arguably become estate capital and when

acquisition and the taking possession of the property of David Currie, the obtaining of letters of administration, the distribution of the assets to the legal heirs, etc. While some of the expenditures incurred might properly come within the purview of subsection 40(1) of the Act, the evidence before the Court falls far short of providing the information necessary to enable the Court to determine which expenses or a portion thereof fall within the context of that subsection. Absent such evidence, the Appellant's claim with respect to these expenses must be dismissed.

874 In C.I.R. v. Richard's Exors. it was provided by Lord Upton:

"My Lords. as everyone knows, on every death, **in order to obtain confirmation in Scotland or probate in England**, the personal representatives of the deceased have to present an Inland Revenue affidavit in the proper form which sets out the value of the estate, and this, together with a remittance of the estate duty thereby found to be due, has to be sent to the Estate Duty Office. When that has been done and accepted then confirmation or probate follows, and **only then have the executors legal power to deal with the estate**, where proof of title is required, sell assets, assent to the vesting of property and so on."

In Richard's Exors. there had to be dealt with the very contentious issue of whether the inventory valuations, investigations, etc. which had to be made in order that estate duty be paid so that probate could be obtained were incurred "wholly and exclusively" to establish, preserve and defend the executors' title. Even in that case the purpose of the sustaining of the expenses was to obtain probate ... and probating a will validates a disposition and allows for it.

875 Pursuant to C.I.R. v. Chubb's Exors., 47 T.C. 353, costs incurred to vary a settlement which gives rise to a deemed disposition on a distribution of property to a beneficiary will be deductible against the deemed proceeds of the disposition.

876 Definitely as per the House of Lords in Richard's Exors..

distributed should fall under section 107 and can thus create a disposition against which the related fees may be deducted. *Rights rolled through under Sec. 70(3) do not give rise to a disposition at any point and thus expenses related to such will not be deductible against a notional or real disposition since neither is recognized under the Act. In such a case, if they are to have any tax effect, the will should be written to require the beneficiary to satisfy them themselves: that way they become an expenditure described in Sec. 69(1.1)(b).*

Effect on Trust Law Income Filters Through, in Splintering

The ITA does not restrict the settlor/testator's ability to provide that the above fees be deducted by the trustees at computing **trust law income payable** thus if they reduce the trust law income payable they will also reduce the tax law income recognized as payable under Sec., 104(24)-(13). **However, this merely shifts the revenue recognition from in the beneficiaries' hands into that of the trust's.** Taken to the extreme, if investment/repair/trustee fees totally eliminate the amount of trust law income payable to the spouse so that she cannot receive any income from the trust how much tax law income recognized by the trust will be payable to her? Actually as per the commentary on reconciliations between tax law and trust law income payable described in a following chapter the inherent taxable amount of the revenue will be recognized by her if the revenue is **receivable at trust law by her**, however she will simply not benefit from a reduced taxable element due to the non-deductibility of the expenses. Since she will, at trust law, be entitled to less revenue, (due to the real payment of the expenses), she will also be required to recognize a lesser absolute amount of taxable element in respect that revenue amount. Thus although the deductions are not available under Division B directly they will filter their way in to cause a reduced Sec. 104(13) recognition.⁸⁷⁷ Whether or not the trust will have to continue to recognize the income that is payable/paid to the trustee is debatably as per the following. The exact same can be said about non-spousal trusts: by taking a trust law based deduction of trustee fees the actual income that becomes payable is also reduced leading to a reduced Sec. 104(6)-(13) flow-through of that income in the beneficiary's hands.

Depending on whether the trustee or executor recognizes the income from an office/employment or from a business is critical when it is expected that it will incur expenses on its personal behalf in executing the function. In Q. 39 of the 1979 Roundtables the Department opined that legal fees incurred by an executor who holds **an office** rather than carries on the activity as a business would not be deductible against his office income however it provided "It would seem that if the advice aids the estate as well as the executor then the expense might be charged to the estate", and if it wasn't, and it was incurred exclusively with respect to the executor's performing of his functions he should have rights of indemnity to collect the amount from the estate. Whether or not he can also collect a reimbursement for the tax the lack of deductibility causes is an interesting question.

Trustee Income and the Alteration in Character of Trust Income Payable to "Beneficiaries".

If the trustee is made an income beneficiary with his nominal entitlement based on the amount of income earned by the trust is a Sec. 104(6) deduction available to the trust?⁸⁷⁸ In what capacity is the taxpayer receiving the income payment; by virtue of a gift charged with an ongoing condition or as remuneration for the office of the trustee?

In *Baxendale v. Murphy*⁸⁷⁹, *Hearn v. Morgan*⁸⁸⁰, & *Clapham's Trustees v. Belton*⁸⁸¹ it was held that income received by trustees conditional on their performance of trustees' duties was received as essentially a beneficiary though the opposite conclusion was reached in *Dale v. I.R.C.*⁸⁸² in a similar situation.⁸⁸³ In that case the executors suggested that they realized the income from the office of the executorship as "earned income and not investment income having as its source an annuity or bequest as the tax authorities contended.

⁸⁷⁷ See *Nelson v. Adamson*, 24 T.C. 36.

⁸⁷⁸. See *In the Will of Oddie*, 1976 1 N.S.W.L.R. 371, *Re: Ross*, 1976 3 W.W.R. 465, *Re: Wolff*, 1960 32 W.W.R. 550, & *Re: Lendrum*, 1915 9 W.W.R. 245, for general remuneration issues.

⁸⁷⁹ 9 T.C. 76

⁸⁸⁰ 26 T.C. 478

⁸⁸¹ 37 T.C. 26 (CA)

⁸⁸² 34 T.C. 468 (HL)

⁸⁸³ See also *White v. Franklin*, 42 T.C. 283 (CA), *Re: Thurley*, 1891 2 Ch. 613, *Re: Pooley*, 40 Ch. D. 1, *Re: White*, 1898 2 Ch. 217, *Jones v. Wright*, 13 T.C. 221, *O'Reilly v. Casey*, 1942 I.R. 378.

The will provided that £1000 was to be paid to each such trustee as long as he performed the office and finally decided in the House of Lords Lord Normand held:

"I think there is confusion here between the source of the payment, which is the testator's bounty as expressed in his will, and the quality of the payment as earned or not earned. **There need be no incompatibility in saying that the income is the conditional gift of the testator but that it has to be earned by compliance with the testator's condition of serving as a trustee.**

I would observe more generally that the question whether income is earned or not is a question which arises between the trustee and the Inland Revenue, and it has no relation either to the legal duty which a trustee owes to the trust and the beneficiaries, or to the legal conception that such a payment as that under consideration derives from a testator and can be regarded as a legacy. The source of the sum and its character as a receipt in the hands of the trustee are two separate and unconnected things."

In *Capital Trust Corp. Ltd. v. M.N.R.*⁸⁸⁴ the Supreme Court of Canada provided that the test to determine whether a payment to an executor, contingent on him functioning as an executor, is a bequest or a payment for services is to determine whether the entitlement of the taxpayer can be enforced if he refuses to act as executor.⁸⁸⁵ This was also endorsed in *Buckley v. M.N.R.*⁸⁸⁶. In both cases the payment contingent on them functioning as executors was found to be for services and not as a testamentary gift.⁸⁸⁷ In *Capital Trust Corporation* the issue of litigation was whether the income had the character of that received from an office which it does as can be readily admitted but the structure of the Income Tax Act provisions in that case concerned with were not of the character existing presently and at that time the receipt could either be one or the other.⁸⁸⁸

⁸⁸⁴ 1 D.T.C. 312-4 (SCC)

⁸⁸⁵ In that case the reasoning was also based with a view to the fact that the testator had recognized that by appointing additional executors the particular executor's remuneration would decrease thus the need to make that additional to what the Surrogate Judge would prescribe.

⁸⁸⁶ 61 D.T.C. 476

⁸⁸⁷ See also *Widdifield on Exors. Accounts*, 5th Ed. pg. 311-316 for comparisons of remuneration cases. Enormous importance seems to be placed on the wording of the expressions made in the will as reflecting the testator's intentions. This was expressly considered in *Capital Trust Corp.*, *Dale v. I.R.C.*, and *Clapham's Trustees v. Belton*, though the phrasing in the latter, treated as containing an element of benevolence, when the recipient was to act expressly "as agent". See also *Goldman v. Minister of National Revenue*, [1953] 1 S.C.R. 211 for some incidental material on determination of via gift or service for acting for committees.

⁸⁸⁸ See also *Goldman v. Minister of National Revenue*, [1953] 1 S.C.R. 211 for some issues of how remuneration from office vs. gift were evaluated from the stand-points of the parties (payor/payee) looking to substantial jurisprudence though heard only at the Exchequer Court level. See also *Jean-Claude Messier v. The Queen*, 2007-3624(IT) for a similar situation in the Quebec environment where the testator knit the office of executor to the gift. The Tax Court held:

[6] In the case at bar, the question that arises is whether the amount of \$15,000 that each of the Appellants received constitutes remuneration for the performance of the duties of their office (a remunerative legacy) or, rather, a particular legacy (a mere liberality) in which case the amount received would not be taxable because it would not be income from an office within the meaning of section 5 of the ITA.

[7] The best guidance in drawing this distinction is the testator's intent, as expressed in the provision of the will. Here is what one author has stated on the subject:

[TRANSLATION]

How does one distinguish between a remunerative legacy and a mere liberality contained in a particular legacy? The testator's intent, as expressed in the provision of the will, remains the best guide, and it is only if the terms are worded carefully and precisely that this intent can be understood clearly.^[56] [1]

56. M. Roy, "Chronique testamentaire – La rémunération de l'exécuteur testamentaire" (1983) 5 R.P.F.S. 206-207.

[8] Another author writes:

[TRANSLATION]

Consequently, in interpreting the provisions of the will as a whole, a certain amount of caution must be exercised with respect to the compensation of testamentary executors. The testator's intent is very important in this regard, and it is only through careful drafting that this intent will

emerge clearly from the terms used in a will that provides for such remuneration.

For example, a specific legacy of \$1,000 to an executor cannot be considered remuneration if the provisions of the will as a whole do not appear to refer to the executor's office. Rather, one would have to conclude that the legacy in question was merely a particular legacy that stems from a truly gratuitous intent to give. The situation is different if the will provides that the executor is entitled to a fee of \$1,000 for work done as an executor. Even if the amount is not characterized as a fee, the fact that the testator intended to condition the payment upon acceptance of the office of executor would show that gratuitous intent was wholly lacking.

. . . . the provision of the will remains the sole writing capable of distinguishing between a remunerative legacy and mere liberality expressed in the form of a particular legacy. . . [2]

[9] In the instant case, the two Appellants are among 15 universal legatees of the succession of Raoul Messier. The will also provides for a whole series of particular legacies to nieces and nephews by marriage, and to various public institutions.

[10] In Article V of the will (Exhibit A-4), the two Appellants are designated liquidators of the succession. Article V reads:

[TRANSLATION]

ARTICLE V
LIQUIDATOR

1. DESIGNATION

I designate the said **Jean-Claude and Pierre MESSIER** as liquidators of my succession, and, if one of them should die, refuse to act or become legally incapable of acting, the remaining liquidator may act alone.

Should it be impossible to replace my liquidator as stated hereinabove, my legatees, by majority vote, shall make such replacement by notarial deed *en minute*, provided that they have all attained the age at which they may take their share and that none of them has been declared incapable; otherwise, the court may, upon an application by an interested party, appoint a liquidator.

2. RESIGNATION

My liquidator may, at any time, even after liquidation has begun, resign his office providing he renders an account of his administration, and such resignation is evidenced by notarial deed *en minute*. The cost of rendering account shall be borne by the succession.

3. LIQUIDATOR'S REMUNERATION

For the services to be rendered to my succession, whether in liquidating my succession or in administering the whole or part of the property thereof, my liquidator shall, upon submission of supporting documents, be entitled to the reimbursement of his expenses, travelling costs and loss of salary.

Each of my liquidators shall receive, for fulfilling the duties of his office, a legacy in the amount of fifteen thousand dollars (\$15,000), which may be collected from the succession capital.

4. PARTITION

My liquidator shall have the full power to carry out the partition of my succession whether in money or in kind.

He may carry out the composition, evaluation and allotment of shares alone and under the terms and conditions that he deems fair and reasonable.

Notwithstanding what is stipulated in my said Will, my liquidator may, as required to ensure the proper administration of my succession, defer the partition of the succession property in whole or in part.

5. ALIENATION

My liquidator may, alone, alienate by onerous title all my movable and immovable property, encumber it with real rights or change its destination, and perform all acts which are necessary or useful, including all manner of investments.

However, he shall not alienate property bequeathed as a particular legacy to a legatee of full age who is fully capable, but shall execute the delivery of such legacy as soon as conveniently possible, subject to the provisions pertaining to the reduction of particular legacies.

6. FULL ADMINISTRATION

My liquidator shall be charged with the full administration of the property of my succession.

7. RELEASE

My liquidator may grant releases with or without consideration.

8. LEGATEES WHO ARE NOT YET OF REQUISITE AGE OR ARE INCAPABLE OR UNDER PROTECTIVE SUPERVISION

My liquidator shall have the administration of all the property bequeathed herein to legatees who are not yet of requisite age, or are incapable or under protective supervision.

He shall deliver to each legatee their respective share at the time that they have attained the age of majority or when such incapacity has ceased. In the interval, my liquidator shall administer each of my said legatee's shares and may use the income or even encroach on the capital, if necessary, for such legatee's maintenance, support, education or other needs.

Until final delivery of each of my legatees' shares, my liquidator shall act as administrator charged with the full administration of the property of others.

However, my liquidator may terminate his administration in respect of a legatee who is under protective supervision, or is incapable and has a homologated mandate in the event of incapacity, by effecting remittance and rendering accounts to the legatee's tutor, curator or mandatary.

[11] Paragraph 3 of Article V specifically provides for the liquidator's remuneration. The liquidator is entitled not only to be reimbursed for his services to the succession, but also, to \$15,000 in compensation for fulfilling the duties of his office.

[12] The Appellants submit that since the will states that the amount is [TRANSLATION] "a legacy", it does not constitute remuneration, but, rather, a particular legacy or a mere liberality. In my opinion, the Appellants' position does not reflect the testator's intent. The particular legacies are specifically set out in Article III of the will (Exhibit A-4).

[13] The amount of \$15,000 allotted to each Appellant is referred to in Article V under the heading "Liquidator's Remuneration". In addition, the testator clearly states that [TRANSLATION] "[e]ach of my liquidators shall receive, for fulfilling the duties of his office, a legacy in the amount of fifteen thousand dollars (\$15,000). [Emphasis added.]

[14] Moreover, Marielle Gagné, the notary who drafted this will, acknowledged in her testimony that the Appellants would not have been entitled to this amount if they had renounced the duties of their office. It is true that she testified that, in her view, the testator, Raoul Messier, was very grateful to his two nephews (the Appellants) and that he probably wanted to give them an additional gift. She also said that if the Appellants had renounced their responsibilities as liquidators, the other legatees would undoubtedly have agreed to give each of them \$15,000.

[15] In my opinion, these last comments made by Ms. Gagné are mere assumptions, and do not reflect what is set out in the will.

[16] Ms. Gagné said that she usually employs different terminology where the testator wishes to remunerate the liquidator. She gave the following examples (Exhibit A-3):

[TRANSLATION]

For the services rendered to my succession by my liquidator, whether in liquidating my succession or in administering the whole or part of the property thereof, my liquidator shall be entitled, in addition to the reimbursement of his expenses, travelling costs and loss of salary, to a remuneration of _____ dollars (\$).

As a token of my gratitude for the services to be rendered to my succession, whether in liquidating my succession or in administering the whole or part of the property thereof, my liquidator shall be entitled, in addition to the reimbursement of his expenses, travelling costs and loss of salary, to the sum of ____ hundred dollars (\$ ____), which shall be indexed according to the inflation rate as established by Statistics Canada, the reference year being 2008.

Any person, other than my spouse, who acts as liquidator, shall receive the sum of _____ for fulfilling the duties of his office. Should there be more than one executor, the said amount shall be shared equally by them.

My liquidator shall not be remunerated for the services to be rendered to my succession, whether in liquidating my succession or in administering the whole or part of the property thereof; however, he shall be entitled to the reimbursement of his expenses, travelling costs and loss of salary.

[17] A reference was also made to the will of Albertine Messier, Raoul Messier's sister, which was also prepared by Ms. Gagné. Under the heading [TRANSLATION] "Liquidator's Remuneration", the following is stated:

3. LIQUIDATOR'S REMUNERATION

For the services to be rendered to my succession, whether in liquidating my succession or in administering the whole or part of the property thereof, my liquidator shall, upon submission of supporting documents, be entitled to the reimbursement of his expenses, travelling costs and loss of salary.

If the said Jean-Claude and Pierre Messier act as liquidators, they shall receive, for

fulfilling the duties of their office, a legacy in the amount of ten thousand dollars (\$10,000) each, which may be collected from the succession capital.

...

[18] Albertine Messier died in 1999, and the Appellants each received \$10,000 under the above provision of the will. The Minister later reassessed the Appellants on the same basis as the instant matter, but, at the objection stage, the Minister ultimately agreed to consider the amount as a legacy (Exhibit A-1, Document F).

[19] The Minister is not bound by a previous decision of one of its officials, if that decision was erroneous. (For example, see *Brenda G. Klassen v. The Queen*, 2007 FCA 339, at paragraph 27.)

[20] In my opinion, Ms. Gagné's testimony cannot serve to put a different gloss on a testamentary provision which in my view speaks for itself. On the one hand, Ms. Gagné says that Raoul Messier's intent was to make a particular legacy, and that, if this had not been the case, she would have drafted differently the clause by which \$15,000 is bequeathed to each of the Appellants.

[21] At the same time, she acknowledges that if the Appellants had refused to act as liquidators, they would not have been entitled to \$15,000 each under the will. The other legatees' consent would have been required in such an event.

[22] Thus, Ms. Gagné implicitly acknowledges that the amount of \$15,000 was bequeathed to each Appellant for fulfilling the duties of their office, which is what is clearly stated in the will. Unlike remuneration for the fulfilment of the duties of an office, a particular legacy does not entail any obligation or responsibility for a legatee.

[23] In my view, the will is clear enough in stating that the testator bequeaths \$15,000 to each of the Appellants for their services to the succession, despite the use of the words [TRANSLATION] "a legacy", which follow the reference, at paragraph 3 of Article V of the will, to the fulfilment of the duties of their office.

[24] Given the way in which the will is drafted, I find that the amount of \$15,000 received by each Appellant during the 2005 taxation year constitutes income from an office, which is taxable under the terms of paragraph 3(a), section 5, and the definition of "office" in section 248 of the ITA.

While see also *Guy Boisvert v. The Queen*, 2009-2005(IT)G, whereby the fact that the "fee"/inheritance was **exceptionally large in relation** to the effort extended allowed the Tax Court to consider with:

[16] Here, the appellant maintains that the legacy is inadequately described as, in reality, it was not a remunerative legacy but merely a particular legacy subject to some conditions that were not very onerous.

[17] The main argument in support of his claims is the fact that the value of what was received by way of the legacy, that is, the amount of the remuneration, is disproportionately higher than the value of the work performed and services rendered. It was even suggested that a reasonable consideration might have been around \$15,000, whereas it was determined to be almost \$70,000.

[18] The appellant's argument is certainly interesting, but, on the one hand, it is definitely not sufficient to allow the Court to find in his favour, and, on the other hand, it implies that the Court should disregard or brush aside the content of several clear and precise documents that are both relevant and significant with respect to the appellant's argument.

[19] Indeed, to begin with, the will, an authentic deed prepared by a notary, sets out and states in a precise and clear manner the nature and quality of the bequest to the appellant. Not only did the appellant expressly agree to the terms and conditions of the legacy, but he also actually performed the tasks and assumed the responsibilities that were his and which resulted from the office he had accepted.

[20] In hindsight, now that his obligations have been fulfilled, it is easy to argue that the consideration was substantially greater than the value of the services rendered. However, given the significant assets, it is equally easy to imagine the numerous potential problems that liquidating the estate could have involved.

[21] The testator, in his wisdom, being advised by a legal practitioner, set out and stated his wishes. His ability to pay enabled him to express his gratitude through generosity.

[22] It is not for the appellant to question the will of the deceased or to cast doubt in particular on the following documents:

- the authentic will bearing the Minister's number 13 663, signed before the notary Richard Doucet on September 3, 2004;
- the notarized estate inventory bearing the Minister's number 14 619, signed by the appellant before the notary Richard Doucet on October 16, 2006;
- the declaration of transmission signed by the appellant personally and as liquidator on November 23, 2007;
- the accounting in November 2008;
- the professional services contract signed by the appellant on May 18, 2006.

[23] As for the will, it has the merit of being based essentially on documents prepared by a legal practitioner with the knowledge and experience needed to express the testator's last wishes.

So, can you describe your trustee as a beneficiary and have the Sec. 104(6)-(13) mechanics apply on the flow-through of the recognition of the income? And if not, where is the line?

If there is a line somewhere, can you not shift it by changing hats and having the trustee act as an employee of the trust for high employment salary coupled with low trustee fee?⁸⁸⁹

Subsection 105(1) prevents any income from being included in any taxpayer's income as essentially income from a trust interest if it was included in computing the particular taxpayer's income **under any provision in the Act not merely those described in subdivision K**. Subsection 104(13) requires that a beneficiary recognize in his income the income of the trust that is payable or paid to him ... and it **does not then state that such will not include that which was included under any other provision in the Act in computing his income**. While the legislators felt compelled to ensure that Sec. 105(1) did not lead to a double inclusion they did not feel so with respect to the Sec. 104(13) inclusion by virtue of their lack of preparation for it hence it is possible to suffer a double income inclusion if the trustee is made a beneficiary under the trust entitled to income: the quality of the receipt in the trustee's hands does not detract from the fact that it was a payment of the trust's income to him **quo beneficiary**. Subsection 104(6)(b) offers to the trust a deduction in respect of the income that became payable to a **beneficiary** in its tax year and there is no qualification placed on the type of inclusion the payment must have caused in respect of the beneficiary though there is if it was expended to maintain a property. The fact that the trustee-beneficiary recognizes the payment as from an office or employment by virtue of other provisions in the Act does not prevent his status from being a beneficiary or the taking of the Sec. 104(6)(b) deduction since **the quality** of the payment must not be confused with **its source and it is the source** (the trust's income) that is of concern exclusively in Sec. 104(6).⁸⁹⁰

[24] Up to that point, the appellant had had no input. However, on the opening of the succession, the appellant could have renounced his legacy and thereby avoided all the consequences inherent in that legacy. Instead, he clearly accepted it willingly and, as a result, did all that was necessary to liquidate the estate and to be entitled to the remuneration stipulated.

[25] The two liquidators, one of whom was the appellant, went through the many steps in the liquidation process leading up to the settlement.

[26] According to a letter sent to the notary, everything proceeded normally and to the heirs' satisfaction.

[27] The testator had high regard and also a great deal of respect for the appellant and a colleague, who acted as co-liquidators. The responsibility he asked them to take on was significant and the context was special as well: the legatees were brothers, sisters, nieces and nephews and the amount to be shared was substantial.

[28] Given the estate assets, which exceeded \$2 million, the remunerative legacy was not unreasonable. It was a reasonable consideration, especially if the testator had assumed that the legacy would be taxable. Of course, this is conjecture, but I reiterate that the will was prepared by a notary.

[29] The characterization of income is not based on its amount, but rather on its source: no formula or recipe exists for determining the reasonableness of remuneration, which is very often a function of an infinite number of particularities.

[30] In this case, the size of the estate to be settled, the estate's ability to pay, the testator's generosity and the kind of relationship that existed between the appellant and the deceased are all factors that reflect a reality that the appellant would like to depict differently. The appellant's arguments are not very convincing; they are rather feeble and have no legal basis, as they are founded essentially on what he defines as reasonableness, a subjective concept interpreted by a person strongly motivated by self-interest.

[31] In addition, the words used are not such as to create confusion. In a situation where a party dies after consulting a specialist to help that party formulate the party's last wishes with regard to its assets, it is foolhardy for the appellant to hypothesize, especially since his criticisms of the documents are essentially based on arguments whose basis is rather weak and certainly not very convincing.

889 See also *Liedig v. FCT* 121 A.L.R. 561 FC Aust. and *FCT v. Gulland* 160 A.L.R. 545 HCA for instances where the beneficiary was also the settlor and realized employment income.

890 The trustee still realizes the income **as a beneficiary**, the opinion of Lord Normand and latterly Lord Oaksey in *Dale v. C.I.R.* at 34 T.C. 493 & 494 may prevent this however when the former held:

"Second, it is said, that if the Appellant is to succeed, any bequest of an annuity to a trustee payable so long as he continues to be a trustee will be earned income within the meaning of Rule 14 (3), without any inquiry as to the amount of work done to earn it. This is, I think, true, and it must clearly be understood that the Appellant succeeds because he has complied with the condition by continuing to act as trustee, and not because he has in fact performed very valuable and unusual services outside the ordinary scope of a trustee's duty. But if the Crown is right, we have the anomaly that the Appellant must be regarded as having received investment income and as having earned nothing by his services, though it is obvious from the testator's will that he expected services from his trustees."

What the statute law wouldn't allow directly, might be acceptable if structured indirectly. The fact that a beneficiary will receive income from a trust only if **another** party performs a certain office such as the holding of the office of trusteeship may prove to be one way of structuring around the problems in the deductibility of trustee fees. If the trustee is prevented from being entitled to any consideration from the trust in respect of his services and renounces any that may be provided to him under statute law but has a perhaps non-arm's length party be an income beneficiary under the trust in respect of income of a similar value the trust can obtain a Sec. 104(6) deduction in respect of the income at the same time that the recipient would have to recognize it under Sec. 104(13).

*White v. Franklin*⁸⁹¹ concerned whether a beneficiary's entitlement under a settlement was of a character that caused him to recognize "earned income" from an office or employment rather than from his trust interest when pursuant to its terms he would be entitled to the dividends from the shares held thereunder only "so long as he shall be engaged in the management of the (particular family) Company." The beneficiary argued that the income from the trust was earned only through such an engagement and not as a beneficiary. Ungeod-Thomas J. in the Chancery citing *Hochstrasser v. Mayes*⁸⁹² held:

"Thus, in my view, the test whether payment is remuneration from any office or employment is whether the *causa causans* or decisive reason for payment is as reward for serving in that office or employment. How is this *causa causans* to be ascertained? The terms of the settlement and the circumstances in which it was made are clearly relevant and important."

In the Court of Appeal Willmer L.J. held with respect to *Hochstrasser*:

"I do not propose to quote from that decision, save to say that both the members of this Court and some of the members of the House of Lords held that the test was whether the fact of the employment was the *causa causans* of the payment, as opposed to a mere *sine qua non*. That is, I think, another way of saying that it has to be shown that the payment is a payment made by way of reward for the employee's services. As has been pointed out in the authorities to which I have already referred, it does not matter that the payment in question may have been received from persons other than the employer; nor does it matter that it may have been a voluntary payment if it is a payment made as a reward for services.

...

The nearest case on the facts is that of *Dale v. Commissioners of Inland Revenue*, 34 T.C. 468, and indeed it seems to me that that case provides such a close analogy that, unless we can distinguish it, it really concludes the case in favour of Mr Franklin. That was a case in which a testator had bequeathed 1000 pounds a year to each of the trustees of his will "so long as he shall continue to act as trustee". It

The basis of ascertaining the quality of the receipt in the trustee-beneficiary's hands does not look to the value of services provided. Lord Oaksey held:

"It is said that the special dispensation proceeds from the bounty of the testator, but, in my opinion, it is no more a matter of bounty that the appointment of a particular person to any office may be said to be the bounty of the person who makes the appointment. The condition upon which the appointment is made is the performance of the office. The words "office of profit" do not relate to the creator of or appointer to the office but to the holder of the office, and whether the emoluments of the office come from the bounty of the creator of or appointer to the office or not they are profits of the office from the point of view of the holder of the office, who is entitled to consider, as it seems to me, that the profits are paid to him as remuneration for performance of the office and not as the bounty of anyone."

but in the author's opinion that test is incomplete: there is a considerable element of benefaction in an instance where the testator knowingly provides for unreasonably excessive allowances to "trustees" in relation to the value of services they provide. While they may recognize the proceeds by virtue of the holding of an office the testator's intention was to provide excessive benefits to that "trustee" and this should be enough, in the author's opinion, to bring his relationship well within the Sec. 108(1)(b) definition of "beneficiary" for purposes of Sec. 104(13). As Lord Normand held: "There need be no incompatibility in saying that the income is the conditional gift of the testator but that it has to be earned by compliance with the testator's condition of serving as a trustee."

The "beneficiary" described is also, for purposes of the entirety of subdivision k, defined to "include" "a person beneficially interested therein." The broadness of the definition, (it could have been structured "to mean" those designated under the document to be the primary expressed recipient of the benefits), does not prevent those parties who must provide nominal services for enormously generous rewards from being "beneficiaries". The character of the expressions made in the will will also indicate how the testator intends the recipient to take the reward: certain terms such as "remuneration", "hold the office", "salary", denote employee status while "as a condition precedent", "as a benefit", etc. denote the taking as a beneficiary. The context in which the reward is to be taken with respect to other bequests and alternate arrangements is of course relevant.

⁸⁹¹ supra.

⁸⁹² 38 T.C. 673

was held by the House of Lords that the payment of that 1000 pounds a year constituted remuneration from the office of trustee and as such amounted to earned income. *Moreover, Lord Normand went on to indicate that so long as the trustee was in fact continuing to act as trustee, it was not relevant to consider the amount of work which he had to do, or the value of his services. It was sufficient that he complied with the condition of continuing to act as a trustee. It has been sought to distinguish that case on the ground that there the remuneration was provided for by the very instrument which created the office - that is to say, the office of trustee and the remuneration for it both arose out of the will of the testator. Here, on the other hand, the office or employment is that provided by the company, whereas the income in question arises from quite another source, namely, from the settlement made by Mr Franklin's mother and brother. I have considered that distinction which has been sought to be drawn, but for my part I do not see that it is a distinction which can make any difference in principle.*"

Harman L.J. incidentally commenting on the importance of the work performed by the recipient while accurately noting the source of the payment was from employment held:

"It was so held in the House of Lords but Lord Normand, it is true, did say one was not to inquire whether Sir Henry Dale did important or unimportant work as trustee. It was from the office of trustee that the money payment flowed and therefore it was payment to him as a holder of that office, and therefore was earned, as opposed to investment, income for the purposes of the Special Contribution, which was the subject matter in question in that case."⁸⁹³

As per Lord Normand held in Dale:

"I think there is confusion here between the source of the payment, which is the testator's bounty as expressed in his will, and the quality of the payment as earned or not earned. **There need not be no incompatibility in saying that the income is the conditional gift of the testator but that it has to be earned by compliance with the testator's condition of serving as a trustee"**

Would the fact that any condition attached to the bequest or gift of income from an estate or trust that compels the **beneficiary** to perform a function that on its own would create income from an office or employment cause the income from the trust or estate to **cease** to be Sec. 104(13) income but that which is from an office or employment? Both subsection 104(13)(a) and (6)(b) refer to payment and receipt in the capacity of a beneficiary but as per above the income can be recognized as both from a gift and earned through an office. The fact that the beneficiary recognizes the income as from the performance of an employment or the holding of an office would tend to negate the recognition of its receipt as a benefaction: to obtain it he must provide some consideration. The magnitude of the effort expended in the author's opinion would have to be compared to the amount of entitlement to ascertain whether there was a de facto benefit to be obtained. As per Clapham's Trustees⁸⁹⁴ there is a rule of presumption of benefaction when a will states that to receive a conditional bequest the recipient must execute some performance and the element of bounty must be measured. However he may still be seen to receive it as a beneficiary under the trust notwithstanding the provision of nominal or considerable consideration since his relationship to the trust is to be concerned with and not his status within the whole arrangement of which the trust is but one of the two parts. Is the beneficiary an employee of the trust by the fact that the trust provides him consideration for the holding of an office even when that office has nothing to do with the trust? It would seem that such is irrelevant as per above: the payor of the consideration is irrelevant in determining its character and thus the fact that a receipt is adjudged to be of a certain character shouldn't influence the status of the payer viz-a-viz the recipient. Consequentially the trust should still be able to take a Sec. 104(6) deduction in respect of income that it has to pay to a taxpayer due to the fact that he has

⁸⁹³ Even if Sec. 7(2) didn't exist this reasoning would be applicable, in the author's opinion, to tax the benefits of share options under Sec. 6(1)(a) where the shares are held in a trust distributable to an employee for extended service etc. regardless of when the trust subscribed for them. Subsection 7(2) provides that for the purposes of assessing a taxable benefit under Sec. 7(1) an employee will be deemed to have acquired the shares held by a trust when they are so acquired by the trust and the employee will be deemed to have exchanged or disposed of them when the trust does. If the trust distributes the shares to the employee Sec. 107(2) will create a disposition but will not create immediate tax consequences as provided in Sec. 7(2)(b). The applicability of Sec. 7(2) or the above common law prevents an employee from avoiding a taxable benefit when shares are issued to him, or when he receives them, in conjunction with a share option plan or as pure remuneration through the use of a trust.

⁸⁹⁴ *supra*

satisfied some condition such as the holding of an office while the beneficiary will recognize the income under Sec. 104(13) proper notwithstanding that it may also, **at common law**, be recognized as from employment/the holding of an office⁸⁹⁵.

As a concluding comment by hooking up a holding of an office/maintaining of specific employment condition to a gift of income through the trust it is arguable whether the beneficiary recognizes the income from those sources while the trust would obtain a Sec. 104(6) deduction in respect of the payment of the income but not any other if the beneficiary is engaging in activities that produce income for the trust and which under the general rules in subdivision B it could deduct the costs.

Also, by knitting the duties of the relevant "trustee" to be larger than merely attending to the trust itself - but instead all of the interests of the environment in the beneficiaries there is valid argument that the "fees" are a gift given the enlarged special relationship this person has with the parties. This was exactly the case in *Peter Au and Her Majesty The Queen*⁸⁹⁶ where the Tax Court attended to where a testator had made a bequest of a considerable sum to one of his corporate employees, a trusted friend, on condition that he continue his activity looking out for the interests of the testator's family. CRA attempted to assess the employee on the income from an office while the employee argued that the sum was a bequest. The TCC held:

[9] He did not ask for the promise by Mr. Johnson to grant him one-ninth of his estate nor did he undertake to do anything in consideration for the promise. It was a gratuitous and unilateral gesture although with an ulterior motive. He was to be well paid for the services to be rendered to the Insurance Group and representing the Johnson Financial Limited and family interests in Insurance Group. There is no mention of services required of the Appellant to Mr. Johnson and family in consideration for a one-ninth estate interest.

[10] In a memo to his lawyer dated February 29, 1988, [8] respecting his last Will, Mr. Johnson stated at paragraphs 5, 6 and 7 as follows:

5. Where the complexities begin is with my intention that Peter's involvement is intended to be committed (both ways) starting right now. I believe that maybe we need what I would call an "Estate and Management Agreement" (EAMA) between myself and Peter, and Johnson Financial Limited. EAMA might serve as a contractual summary of Peter's responsibilities toward me, my Family, the Estate, and JFL (and vice versa). There must be no uncertainties or misunderstandings about Peter's absolutely key role, nor his entitlements - - committed through EAMA now, as well as through the Will.

6. Peter is to have a 10% beneficial ownership of the estate, after specific bequests and real estate are settled. That 10% will grow (or shrink) according to the fortunes of the estate. Peter is going to be the manager of JFL and the estate, in close consultancy with the other trustees/owners. Whether and how that 10% ownership is to be committed and constituted, will take careful consideration, including the tax considerations. Having entitlement to income from JFL now and/or deferred income and/or capital now and/or later from the estate; needs exploration and skillful planning.

7. I can understand the thought involved for having Peter's 10% interest "earned" over 5 years. But, I believe I would like to have my commitment to Peter established now. I want his

⁸⁹⁵ See 9098-9005 *Quebec Inc And Her Majesty The Queen*, 2012 TCC 324, where the TCC considered the CRA's argument that an officer who carried on the activities of an estate, though not a named liquidator, could not obtain the SBD since it was a personal services corporation. It held:

[50] Could the function held by Mr. Gitman in relation to the estate be considered as an office as defined by the *Act*? I am of the opinion that, it were not for the existence of the Appellant, Mr. Gitman could reasonably be regarded as an officer of the estate for the following reasons:

- (i) Mr. Gitman was entitled to a fixed remuneration (a yearly fee of \$150,000).
- (ii) The function he held in relation to the estate was a subsisting (for the duration of the estate) and substantive position which had an existence independent of the person who filled it.
- (iii) The function was created by the will.

eventual "stake" and interest to be significant, and linked directly and long-term to the welfare and fortunes of Joy and the children.

[11] Through the promise of a one-ninth share of his estate, Mr. Johnson believed he was securing the loyalty and commitment of the Appellant towards the benefit of his and his family's financial interests in Johnson Financial Limited. **It is evident from this memo that Mr. Johnson did not believe that there was an existing contractual relationship between himself personally and the Appellant. In stating: "whether and how that 10% is to be committed ... will take careful consideration ..." indicates that the decision with respect to the estate interest was within his discretion. The Estate and Management Agreement was never created and the Appellant never spoke of it. Clearly Mr. Johnson did not consider the one-ninth interest to be a contractual term of the 1987 letter and nor did the Appellant. Mr. Johnson retained control of his estate bequests and the Appellant had no input.**

[12] Thereafter, the Appellant was given a draft of Mr. Johnson's last Will[9] and Testament wherein his interest was 10% and not one-ninth of his estate, and it was conditional on the Appellant being an employee of Johnson Financial Limited at the time of Mr. Johnson's death. This unilateral change of Mr. Johnson's will is further evidence that it was not a contractual term of the employment between the Appellant and Mr. Johnson or the Insurance Group. **The granting of an estate interest to the Appellant evolved from the personal relationship between the two men and Mr. Johnson's desire to cultivate their friendship and continued business relationship. Testimony was given of several situations which exemplify this. When Mr. Johnson's wife died in 1988, the Appellant looked after him in personal ways. When Mr. Johnson remarried several years later, the Appellant was his best man or witness.**

[13] In 1995, Mr. Johnson provided the same familiar support for the Appellant when the Appellant's wife died. She had been diagnosed with breast cancer a few years earlier. Mr. Johnson assisted the Appellant by sending meals and allowing him flexible hours to look after his then four children. The Appellant testified that he suffered physically and emotionally after his wife's death. In 1998, he was diagnosed with depression after seeing a psychiatrist. I do not believe he has worked outside his home since 1997.

[14] While working for Johnson Financial and the Insurance Group, the Appellant also assisted Mr. Johnson and family in financial matters and philanthropic endeavours.[10] I have no doubt that these services were invaluable. In a letter dated September 25, 1990 addressed to Mr. Johnson's four children, he stated, in part:[11]

I have already spoken with Peter and he is prepared to provide such consultation with you, individually and privately. You are already aware of his outstanding, professional and friendly expertise, and of his long-term and heartfelt dedication to our family. His interests are exactly the same as mine, and your own, and I would like you to work with him, for everyone's comfort and advantage.

[15] In the late fall of 1996, Johnson Financial sold its interest in the Insurance Group to Royal Insurance for \$78,000,000. Mr. Johnson and the Insurance Group no longer needed the Appellant's expertise. His expectations of working the rest of his days with the Insurance Group ended. At this time, the Appellant spoke to Mr. Johnson's lawyer, Mr. Chalker, who advised him that he had no claim upon Mr. Johnson's estate and that Mr. Johnson retained sole discretion over any amount he chose to disburse and bequeath.

[16] Reluctantly, in 1997 the Appellant sought the advice of a labour lawyer, Randell Earle. Having knowledge of Mr. Johnson's reluctance towards litigation and the potential publicity it could bring, Mr. Earle took a very aggressive approach. He commenced an action against Mr. Johnson, Johnson Financial (in 1997, Johnson Estate Inc.), The Johnson Corporation, and Johnson Incorporated. The Statement of Claim, Statement of Defense and Amended Statement of Claim are found at Tabs 20, 21 and 22 of Exhibit A-1. The action against the Johnson Estate Inc. and the Insurance Group was for wrongful dismissal.

[17] In his Statement of Claim, the Appellant alleged that he had an employment contract with all

four defendants. This would come back to haunt him when, for the purposes of issues in the present dispute, he maintains that he had no contract of employment with Mr. Johnson. In the action against the four named defendants, he sought general damages for loss of permanent employment and for breach of agreement to provide one-ninth interest in the estate or a declaration of constructive trust for a one-ninth interest in Mr. Johnson's estate.

[18] In the Statement of Defense, the corporate defendants admitted that the Appellant had an employment contract with Johnson Financial (Johnson Estate Inc.) and the Insurance Group. Mr. Johnson consistently denied that the Appellant had a contract of employment with him personally and insisted that an interest in his estate was not a term of the employment contracts.

[19] The parties agreed to mediation headed by a retired judge in Montreal and they settled upon the terms set out in two Releases. Under the first Release, the following amounts were paid to the Appellant:

- (i) Johnson Financial (Johnson Estate Inc.) - \$598,000;
- (ii) Insurance Group - \$418,000;
- (iii) Costs - \$150,000;

Under the second Release, Mr. Johnson paid the Appellant the amount of \$3,080,000.

[20] The Appellant reported the amounts of \$598,000 and \$418,000 in his 1998 income tax return. He did not report the \$3,080,000 paid by Mr. Johnson. This amount represented approximately 10% of the net value of Mr. Johnson's estate in 1997. This was a mitigated settlement with the intent that the Appellant not be included as a beneficiary in Mr. Johnson's last Will and Estate. The Appellant stated that he did not consider this amount to have the character of income under the *Income Tax Act* either as employment income under section 5 or 6 or income from a business under section 9 or a retiring allowance pursuant to subparagraph 56(1)(a)(ii).

[21] The Respondent counters this with the position that the Appellant admitted in his Statement of Claim that he had a contract of employment with Mr. Johnson and that the \$3,080,000 was employment income.

[22] In summary, the facts as I find them include the following. In a letter dated March 11, 1987, Mr. Johnson on behalf of his corporations entered into a preliminary agreement to retain the Appellant's services. In the same letter he outlined the intended terms of his last Will and Testament. He informed the Appellant of his intent to grant him a one-ninth interest in the remainder of his estate. Mr. Johnson unilaterally changed his last Will between 1987 and 1997 and the Appellant's share varied from one-ninth to 10%. The changes to it over time, reflected the personal relationship between the Appellant and Mr. Johnson.

[23] The Appellant became director of Johnson Financial, which essentially owned all the shares of the operating insurance companies. These shares were the bulk of Mr. Johnson's net worth. The Appellant also became a senior manager of the Insurance Group and was probably essential in directing the 1996 sale of the Insurance Group. After the sale, the assets of Johnson Financial, then Johnson Estate Inc., were liquid and the Appellant's services were no longer required.

[24] In 1998, a settlement was reached wherein, *inter alia*, the Appellant received a cheque from Mr. Johnson in the amount of \$3,080,000. The question is whether this amount is taxable.

[25] Again the Respondent's most dominant argument is that the Appellant is bound by the submission in his Statement of Claim stating that he had a personal contract with Mr. Johnson with respect to his inclusion in the Will as to a one-ninth interest. The Statement of Claim was prepared by Mr. Earle. This was an unproved allegation that was categorically and consistently denied by Mr. Johnson. This denial is more significant given that, for the most part, all other of the Appellant's allegations are admitted.

[26] Subsequent to the hearing, the Supreme Court of Canada issued the decision in *Tsiaprailis v. Canada*, 2005 SCC 8, and both parties presented further submissions. The Respondent stated, in part:

It is important to note that what determines taxability is not what interest or legal right could have been sued upon but was not, but rather what interest or legal right was in fact sued and settled upon.

The undisputed facts of the present appeal are that the Appellant received the amount in issue in settlement of the claim he made against Paul Johnson and for no other reason, and that the Appellant sued Paul Johnson under an employment contract. The interest or legal right that was in fact sued and settled upon was, therefore, employment income or benefits. The amount in issue is, therefore, taxable as employment income or benefits under the *surrogatum* principle.

Also, the Appellant stated in part:

In paragraphs 3 and 7, the Respondent asserts that the amount received by the Appellant from Paul Johnson must have been employment income or benefits because: (i) the Appellant's Statement of Claim asserted a contract between the Appellant and Paul Johnson; and (ii) as a result of subsequent negotiations, a settlement amount was paid. This is an incorrect conclusion of law, as submitted at paragraphs 1 through 5 herein. However, in contrast to the *Tsiaprailis* case and in contrast to the amounts paid to the Appellant by Johnson Estate Inc. (formerly Johnson Financial Limited) and Johnson Incorporated (formerly Unified Service Company Limited) *in which, on the facts, the existence of a contract between the payer and the payee was not disputed and the right to compensation under that contract was not disputed*, in the Appellant's tax appeal the very existence of a contract of employment between the payer (Paul Johnson) and the payee (the Appellant) is in issue. This question, and the further question of what the payment to the Appellant was intended to replace, falls to be decided on the basis of *all* the relevant evidence before this Honourable Court, as was the case in *Tsiaprailis*, and not simply on the basis of the assertions of the Appellant's Statement of Claim.

...

The Appellant never disputed that it was Paul Johnson's wish that the Appellant stay around after his death to look after his estate. *Even if this Honourable Court were to find that such wish attained the threshold of a contract between the Appellant and Paul Johnson*, the rights and obligations of such a contract would take effect only after Paul Johnson's death. On the basis of the *Tsiaprailis* decision, a payment to replace an obligation to make a payment in the future would be a capital payment. In *Tsiaprailis*, it was only that part of the settlement amount allocated *to the arrears owing by the insurer* that were considered income. The part of the settlement amount located *to the right to future benefits* was considered a capital receipt, not an income receipt. Indeed, it was precisely on this basis that the majority judgment in *Tsiaprailis* (Paragraphs 8 to 11) distinguished the Supreme Court's previous decision in *M.N.R. v. Armstrong*.

[27] For the reasons that follow, I accept the position of the Appellant with respect to his interpretation of the *Tsiaprailis* tests. Ms. Tsiaprailis was seriously injured in a car accident and received long-term disability benefits in accordance with her employer's insurance policy. When the insurer terminated her benefits more than eight years later, she sued the insurer for a declaration that she was entitled to a continuation of these benefits. The parties settled and Ms. Tsiaprailis received a lump sum payment after signing a release in which the insurer denied all liability. The Court had to determine if a portion of the settlement was to compensate the Appellant for past disability benefits "payable on a periodic basis ... pursuant to a disability insurance plan" and thus taxable within the meaning of paragraph 6(1)(f). At paragraph 13 of *Tsiaprailis*, the majority of the Court held that the taxability of damages or a settlement amount will depend on the nature of the settled interest. At paragraph 15, Charron J. outlined the test as:

... (1) what was the payment intended to replace? And, if the answer to that question is sufficiently clear, (2) would the replaced amount have been taxable in the recipient's hands?

[28] In the present case, the Respondent argued that I must determine the taxability based upon the cause of action that the Appellant sued upon, namely an employment contract. The Respondent emphasized that Charron J. quoted with approval the Federal Court of Appeal's statement:^[12]

... Ms. Tsiaprailis cannot assert the insurer's liability under the policy in her action, recover an amount from the insurer in that action, and then argue that the payment does not flow from the obligations of the insurer under the policy.

The Respondent concluded that this statement applies equally to the present facts. I do not agree.

The taxability of the settlement is based upon the taxability of the amount that the settlement ultimately replaced.^[13] For sure, the Appellant's counsel did allege in his Statement of Claim that a contract existed between the Appellant and Mr. Johnson legally obligating Mr. Johnson to include the Appellant in his last Will and Testament. It is also true however that the Appellant alleged that Mr. Johnson and the Insurance Group owed him damages for breach of an employment contract. Although the latter was admitted by the defendants, the first allegation was only set out in the Statement of Claim. It was never proved and it was continuously denied by the Respondent. Surely it is the trial judge's prerogative, based on all of the evidence, to decide whether or not Mr. Johnson had a personal contract with the Appellant with regard to an estate bequest.

[29] It is also clear that the Appellant was paid two amounts in two separate releases. In the first release, he received a total of \$1,116,000 from the Insurance Groups and he waived any claims against his past employers. He properly included these amounts as income from employment. In the second release, the Appellant received \$3,080,000 in exchange for a waiver to any right to the estate of Mr. Johnson. The taxability of this amount is in dispute.

[30] In answering the first test in *Tsiaprailis*, what was the payment intended to replace, I find that the \$3,080,000 was paid to compensate the Appellant for the loss of his interest in the estate of Mr. Johnson. This is sufficiently clear to allow me to move to the second test, which determines the outcome of this appeal. Would the interest in the estate of Mr. Johnson have been taxable in the recipient's hands?

[31] Generally, the payment of a bequest from an estate is not taxable under the *Income Tax Act*. Therefore, unless the bequest was made to fulfill a contractual obligation that arose from the employment contract this appeal must be allowed. Lacking a final contract between the Appellant, Mr. Johnson and the Insurance Groups, I must turn to the letter of March 11, 1987 and the subsequent documentation regarding Mr. Johnson's last Will and Testament to determine if the interest in the estate was granted to the Appellant as a term of his employment contract. I find that there was no legally binding contract with respect to the legacy for the following reasons:

(i) The statement in the March 11, 1987 letter was an expression of intention and not a final contract. The conditions of employment were still to be finalized and did in fact vary from those outlined in the letter. That the interest in the estate was mentioned in the Statement of Claim does not provide evidence that it became a final term of the employment contract.

(ii) I accept the Appellant's testimony that an estate interest was not a condition of the employment in the negotiations. He took it to be an intention from Mr. Johnson of what may or may not happen.

(iii) Although it is possible that the bequest could be interpreted as a financial incentive to ensure the Appellant fulfilled his corporate duties, it is more likely that this incentive was actually provided by the QSO. The QSO was not initially offered to the Appellant but was subsequently granted to him as a part of the employment contract.

(iv) In the statement of defense, the corporate defendants and Mr. Johnson admitted to all the allegations in the Statement of Claim regarding the employment contract while denying that the bequest was a term of the contract. This evidences Mr. Johnson's intention regarding the contract, and lacking a formal and written employment contract, I give it more weight than the interpretation provided by the Respondent.

(v) It was not until the memo of February 29, 1988 that Mr. Johnson finally gave his lawyer instructions to grant an interest in his estate to the Appellant. He also made it clear that he rejected the idea of having the Appellant "earn" the interest, and asked his lawyer to make the change to his Will effective immediately. It was also in this memo that Mr. Johnson decided to "link" the interest to the long-term welfare of his wife and children. The earliest evidence that this term had made it into a draft last Will and Testament of Mr. Johnson dated March 3, 1989, was produced at trial, and it read:^[14]

... subject to the proviso hereinafter contained in this Clause ..., on the date of my death (such date in this Clause ... called the "Date"), I hereby direct that my Executors transfer, transmit or set over unto the said Peter W. Au, or in the event the said Peter W. Au should die prior to

the Date, to his estate in specie from my Estate that portion of my Estate determined by multiplying the net value of my Estate as at the Date by ten percent (10%). For the purposes of calculation of the net value of my Estate, I hereby direct that my Executors shall deduct from the value of my Estate:

- (i) all taxes either paid prior to or payable by my Estate as at the Date,
- (ii) all such sums as may be properly payable by my Estate whether pursuant to ... this my Will or otherwise, and
- (iii) all such sums of money or the value of all such assets distributed in specie pursuant to the specific bequests ... of this my Will.

PROVIDED ALWAYS THAT the devise and bequest contained in this Clause ... shall terminate and be void unless the said Peter W. Au shall be an employee of Johnson Financial Limited on the Date, or in the event the said Peter W. Au should die prior to the Date an employee of Johnson Financial Limited on the date of his death.

(vi) I believe that Mr. Johnson, in his personal capacity, treated the Appellant as a son and friend and not as an employee.

[32] On the evidence, it is clear that the letter of March 11, 1987 outlined the potential terms of an employment contract with the Appellant. However it is also clear that these terms were not the final terms. Based on the evidence before me, it appears that although Mr. Johnson might have offered the promise of an interest in the estate to the Appellant to ensure he fulfill his corporate duties, I believe, in the end, the QSO was made a condition of the contract, and the interest in the estate was not.

[33] Having concluded that since the interest in the estate existed independently of the Appellant's employment, I find that the settlement amount was paid in lieu of Mr. Johnson's bequest. Had the 10% interest been paid to the Appellant in the normal course of events, upon the death of Mr. Johnson, it would not have been employment income. It is perhaps unfortunate that the communication from Mr. Johnson to the Appellant regarding his interest in the estate was often included in letters about his employment. This only reflects the intertwined nature of the Appellant and Mr. Johnson's relationship. At the time of settlement, the Appellant received an amount that was rightly included in his taxable income, and an amount that was not paid to replace a source of employment income. It was rightfully not included in his taxable income.

Even if Canadian courts start to find that a trust expense is deductible per se there is the secondary argument that relates to whether and how it should be apportioned for the benefit of the capital or/and income beneficiaries. If it's related to capital, then it can only add to the cost of the capital within specific provisions in our ITA, if it's related to income production, it can be deducted against that income either at the trust level or to be apportioned to the income beneficiaries' entitlements on a ratio basis (sometimes reducing their Sec. 104(13) income).. If it inures to the benefit of the capital of the trust can it be deductible against the trust's income? This was the case in *Commissioners for HM Revenue & Customs v. Trustees of the Peter Clay Discretionary Trust*⁸⁹⁷ where the tax authorities argued that expenses⁸⁹⁸ were to be borne by the capital beneficiaries exclusively while the trustees argued apportioning between income and capital. The case is important since it not only serves to illustrate the trust law entitlements that the classes of beneficiaries benefit from, but also, in tax law, the source for which the expenses were incurred: expenses incurred in Canada to produce taxable income may be deductible under certain provisions. The U.K. Ct. of Appeal opined that:

"The dispute between the trustees and the Revenue was whether it was proper for trustees to charge part of certain annual expenses to the income of the trust on the footing that that was what the proper application of the general law as to the incidence of trustees' expenses required.

897 [2008] EWCA Civ 1441, [2007] UKSPC SPC00595, [2007] EWHC 2661 (Ch)

898 "(i) trustees' fees, (ii) investment management fees, (iii) bank charges, (iv) custodian fees and (v) professional fees for accountancy and administration"

Put shortly, the trustees contended that, where a particular expense of managing the trust related partly to income, that expense could and should be apportioned fairly between income and capital; so that part was attributed to income. The Revenue contended that apportionment between capital and income was not permissible in such a case: it was only those expenses which related wholly and exclusively to income that could be attributed to income: an expense which related partly to income and partly to capital was to be charged wholly to capital.

...
The Revenue appealed to the High Court from the Special Commissioners' decision that a proportion of those expenses which related partly to income and partly to capital could be attributed to income. It was made clear, however, in the skeleton argument filed on their behalf in support of that appeal (at paragraphs 22, 49 and 50) that – although contending that the Special Commissioners had erred in principle in that respect – the Revenue did not challenge the conclusion that a proportion of expenses within categories (iv) and (v) – custodian fees and accountancy and other professional fees – could be attributed to income. It was accepted that a part of those fees could be said to relate exclusively to income: so satisfying the principle for which the Revenue contended. The Revenue appealed, also, in respect of the decision that expenses be allocated on the accruals basis. The trustees cross-appealed in respect of the decision that no part of fixed fee payable to non-executive trustees or of investment management fees could be attributed to income.

...
In reaching that conclusion the judge accepted (at paragraph [47] of his judgment) that it was unnecessary for him to hold, as a rule without possible exception, that trustees' remuneration in discretionary trusts falling within section 686 TA 1988 should always be regarded as having been incurred for the benefit of the estate as a whole. He recognized that "in exceptional circumstances and on particular evidence some exceptions may be discovered with respect either to some particular remuneration ascribable to the doing of a particular task, to an unusual trust provision or to the activity of some particular trustee such that it could clearly be seen that the service rendered and remunerated was not incurred for the benefit of the estate as a whole and was of an income character". But he did not find there to have been evidence of that nature before the Special Commissioners in this case. He went on to say this:

"[48]. Moreover, the very 'even hand' requirement emphasised by the Trustees ... assists the Revenue as it may tend to show how, at the level of the Trustees in a properly administered trust, consideration of the respective interests of capital and income are often inseparable. Even a decision which has seemed at first glance to relate only to capital will, if considered properly in an even-handed way, be likely to have involved a consideration of who, if anyone, for the time being is or should be entitled to income, what his, her or their needs are and whether, having regard to them, it is nevertheless right to do as was being considered with capital. Of course, the test, in relation to a trustee's expense, is whether it was incurred for the benefit of the whole estate not whether its outlay involved consideration of both the interests of capital and income but that the whole estate falls to be considered will often point also to the whole estate being intended to be benefited."

...
The expenses under consideration in *Carver v Duncan* included (so far as material in the present context) premiums paid in respect of life assurance policies, and the fees of professional investment managers. The question whether those expenses were chargeable against income arose under section 16(2)(d) of the Finance Act 1973 – which, for present purposes, posed a test indistinguishable from that under section 686(2AA)(b) TA 1988. Lord Templeman (with whose speech three other members of the House, Lord Fraser of Tullybelton, Lord Roskill and Lord Brandon of Oakbrook, expressed agreement) explained the nature of those expenses in the following passages ([1985] 1 AC 1082, 1120C-E and 1120H-1121A):

"In the present appeals, the appellant trustees of the Paul settlement paid the annual premiums on assurance policies effected by the trustees in order to obtain policy moneys

corresponding to the amount of capital transfer tax payable out of the trust fund in the event of the death of the settlor before 20 November 1979. The appellant trustees of the Devonshire settlement paid the annual premiums on endowment policies assigned to the trustees and on other endowment policies effected by the trustees. All these premiums were paid by the Paul settlement trustees and the Devonshire settlement trustees *for the benefit of the whole of their respective trust funds* because the capital of the trust will be augmented by the policy moneys which will be received if and when the policies mature, and the income of the trust will be increased as and when such augmentation of capital takes place, but not before that event takes place." [emphasis added]

"The Devonshire settlement trustees also paid annual fees to a firm of investment advisers to keep under review and to advise changes in investments comprised in the trust fund. This was a recurrent charge but not an ordinary outgoing *and was incurred for the benefit of the estate as a whole* because the advice of the investment advisers will affect the future value of the capital of the trust fund and the future level of income arising from that capital." [emphasis added]

It is important to note that, in the paragraphs of his speech which I have just cited, Lord Templeman set out the reason why the expenses under consideration were incurred for the benefit of "the whole of their respective trust funds" or "the estate as a whole": expressions which, as the context shows, he must be taken to have treated as synonymous with the expression "the whole estate". In the first of those two paragraphs he explained that the premiums paid in respect of the life assurance policies were for the benefit of the estate as a whole *because* "the capital of the trust will be augmented by the policy moneys which will be received if and when the policies mature, and the income of the trust will be increased as and when such augmentation of capital takes place, but not before that event takes place." In the second of those paragraphs he explained that the annual fees paid to the investment advisers were for the benefit of the estate as a whole *because* "the advice of the investment advisers will affect the future value of the capital of the trust fund and the future level of income arising from that capital." As in *Bennett*, the relevant expenses were incurred for the benefit both of the income beneficiaries and of those entitled to capital on the determination of the income trusts.

Lord Templeman then cited the passages from the judgments of Lord Justice Lindley and Lord Justice A L Smith in *Bennett* to which I have already referred. He went on to say this (*ibid*, 1121G-H):

"*In re Bennett* [1896] 1 Ch 778 which has been accepted law for nearly 90 years affirms the trust principle that expenditure incurred for the benefit of the whole estate is a capital expense. In accordance with the authorities and in accordance with principle, the premiums paid by the Paul and Devonshire settlement trustees in respect of capital transfer tax protection and on endowment policies and the fees paid to investment advisers were capital expenses and not income expenses."

In the light of those passages in the judgments in *Bennett* and the speech of Lord Templeman in *Carver v Duncan* it is, I think, beyond argument that an expense is incurred "for the benefit of the whole estate" in the present context when the purpose or object for which that expense is incurred is to confer benefit both on the income beneficiaries and on those entitled to capital on the determination of the income trusts. The expression "expenses incurred for the benefit of the whole estate" must be understood in that sense. It is common ground – and, if it were not, this Court would be bound by the authority of *Carver v Duncan* so to hold – that expenses which are of that nature are to be charged against capital. It follows, in my view, that it was not open to the Special Commissioners to approach their task on the basis that: "... in the light of the general principle of fairness 'expenses incurred for the benefit of the whole estate' should not be understood widely as meaning anything that is for the benefit of both the income and capital beneficiaries should be charged to capital and should not be attributed": paragraph 17 of their decision. The judge was correct to hold (at paragraph [36] of his judgment) that the Special Commissioners had erred in law in that respect. They were required to accept that, under the general

law, expenses incurred for the benefit of both the income and capital beneficiaries must be charged against capital. It is only those expenses which are incurred exclusively for the benefit of the income beneficiaries that may be charged against income.

The fee of the executive trustee

It seems to me, if I may say so, that a challenge to the Special Commissioners' decision that a proportion of the fee paid to the executive trustee is properly chargeable to income was incapable of being sustained once the Revenue had accepted (as it did before the judge) that a proportion of the trustees' expenses under head (v) - professional fees for accountancy and administration - were properly so chargeable. To put the point shortly: if professional fees incurred by the trustees for accountancy services can properly be apportioned (on a time basis) between fees attributable to dealing with the income of the trust fund and fees attributable to dealing with the capital of the fund, then it is impossible to see why the fees charged by the executive trustee for time spent in applying his professional judgment to the matters in relation to which those accountancy services are required should not also be capable of a proper apportionment.

The fee paid to the non-executive trustees

The Special Commissioners made no finding as to the proportion of the time spent by the non-executive trustees in addressing matters which were exclusively for the benefit of the income beneficiaries. As I have said, they took the view (at paragraph 19(3) of their decision) that the fact that the fee paid to the non-executive trustees was fixed in amount was sufficient, of itself, to preclude apportionment. For the reasons just set out, I am satisfied that they were incorrect in that view. It is, I think, self-evident that - in the administration of discretionary trusts of income - the trustees may be expected to spend part of their time in addressing matters which are exclusively for the benefit of the income beneficiaries. By way of example, if the circumstances of individual beneficiaries are such as to require the trustees (in a proper exercise of their discretion) to make a distribution of income, they may be expected to spend time considering to whom and in what amounts such distribution should be made. As it seems to me, the Special Commissioners needed to make a finding whether, in the present case, the non-executive trustees did devote part of their time addressing such matters; and, if so, what proportion of their time was devoted to that task. It is, I think, no answer to say that, in the absence of time records, determination of that proportion will, necessarily, be imprecise: a realistic estimate can be made.

The fees of investment advisers

In my view the Special Commissioners' analysis is correct. The first question is whether the expenses incurred in connection with the investment of income were incurred before or after the trustees had made the decision to accumulate that income. If the expenses were incurred after the trustees had made the decision to accumulate, they cannot, as it seems to me, be said to be expenses incurred exclusively for the benefit of the income beneficiaries. They must be charged against the capital of the accumulated funds. If the expenses were incurred before the trustees had made the decision to accumulate - and can be properly be characterised as expenses incurred for the purpose of temporarily investing income while deciding whether or not to distribute that income to the income beneficiaries - then (at least to the extent that the income was, in the event, distributed and not accumulated) the expenses could be said to have been incurred exclusively for the benefit of the income beneficiaries. But that is not said to be the present case."

And the Trustee acts For....?

Corporate directors act for their shareholders and trustees act for their beneficiaries, exclusively. In trust law, once the trust is settled the settlor ceases to be a party who can interfere in almost any way with the functioning of her creation unless ancillary provisions are made for such. **The trustee acts exclusively for the beneficiaries, so, if the beneficiaries pay the trustee fees for the continual actions of the trustee can it not be said that they are paying for the activities of the party that is enhancing their economic reality?** Is there enough of a direct causation between their payment of the relevant fees and the result either in the form of enhanced capital appreciation or immediate income realization? In such cases while the trustee has been created by another, the settlor, is it not the beneficiaries who are paying

her for the maintenance of that office for their benefit given that in trust law they could, all acting in concert, call for the dissolution of the trust at any time?

The author doesn't know of any case that speaks of the integrity of the trustee being drawn into issue when it is the beneficiaries who pay her remuneration.

While the trust deed would want to be specific on how the proportionality would work, between capital and income beneficiaries, for the payment of the fees etc., on the immediate realization of the income the beneficiary would have an immediate deduction for the realization of taxable income and the capital beneficiary would have a stacked up history of such payments that would be a factor on eventual application of the section 107 mechanics that would create, possibly, a non tax-neutral result because of the present wording of those provisions, on eventual property distribution or capital interest sale.

Since a trustee must report trustee and other fees paid to her from her trust as income from an office and not trade there are limits that she can claim as allowable expenses to off-set that income, if they were necessarily incurred, as an employee. See the recent UK case of *HM Revenue & Customs v Banerjee*⁸⁹⁹ where the UK Court of Appeal considered the issue of trust employee deductions.

Subject: Director's, Executor's and Juror's Fees.

IT-377R Date: January 27, 1989

Application

This bulletin replaces and cancels Interpretation Bulletin IT-377 dated May 24, 1977.

Summary

This bulletin discusses the taxability of director's, executor's and juror's fees earned or received by a taxpayer in the course of conducting such activities or duties. It also discusses deductions that may be claimed by taxpayers earning income from these sources.

Discussion and Interpretation

1. Pursuant to paragraph 6(1)(c), fees received by a taxpayer in respect of, in the course of, or by virtue of an office or employment are required to be included in computing the taxpayer's income for the taxation year in which they are received and are classified as income from an office or employment. By virtue of subsection 8(2), the only deductions that may be made in computing the income of a taxpayer from such fees are those provided in section 8.
2. Income from fees related to an office or employment is included in "salary or wages" as defined in subsection 248(1) and for purposes of calculating a taxpayer's "earned income" under paragraph 146(1)(c) (registered retirement savings plans).

Director's Fees

3. The position of a corporate director is an "office", as defined in subsection 248(1) and, therefore, director's fees received by such a person are related to an office or employment. Thus, the only deductions that may be made in computing the income of a director from such fees are those provided in section 8, as indicated in 1 above.
4. Where an individual is acting on behalf of or representing a corporation (or partnership) as a director and the fees in respect of such services are paid directly, or are turned over by the individual, to the corporation (or partnership), those fees are considered to be income of the corporation (or partnership) and not of the individual. Of course, where such fees are received by an individual or credited, either directly or indirectly, to the individual's account for his or her personal benefit, they will be included in that individual's income.

Executor's Fees

5. A fee earned for the administration of an estate by an executor thereof will be treated either as income from a business or income from an office, depending on the particular circumstances of each case. Fees earned by a taxpayer for acting in the capacity of executor in the course of business form part of the business income of the taxpayer, and expenses incurred in this connection are deductible in the usual way in computing

899 [2010] EWCA Civ 843 (28 July 2010)

such income, to the extent they are not recoverable from the funds of the estate. Where the executor is a person who does not act in this capacity in the course of carrying on a business, the fee for acting as executor is considered to be income from an office. (Such a situation could exist even where the executor is a lawyer if the normal practice does not include executorships and the lawyer was appointed on personal grounds, perhaps because he or she was a friend or relative of the deceased.)

Juror's Fees

6. A taxpayer who receives an amount per diem for acting as a juror is considered to be in receipt of a fee for services rendered, which is required to be included in the taxpayer's income pursuant to sections 3 and 4. Appropriate expenses incurred in respect of the jury duty (in excess of any reimbursement or allowance received therefor) may be deducted in computing the taxpayer's income from this source, to the extent that they are reasonable in the circumstances.

Income Tax Interpretation Bulletin

NO.:	IT-99R5 (Consolidated)	DATE: See <u>Bulletin Revisions</u> section
SUBJECT:	INCOME	TAX
	Legal and Accounting Fees	ACT
REFERENCE:	Paragraph 18(1)(a) (also sections 9 and 239; subsections 13(12), 20(9), and 40(1); paragraphs 6(1)(f), 6(1)(j), 8(1)(b) and (c), 20(1)(b), (e) and (cc), 56(1)(b), (l) and (1.1), 60(o) and (o.1) and the definitions of "cumulative eligible capital" and "eligible capital expenditure" in subsection 14(5) and "exempt income," "retiring allowance," and "salary or wages" in subsection 248(1))	

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This document is also available for download in PDF format.

Legal and Accounting Fees

Latest Revisions -- ¶s 17 and 18

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Application

This bulletin is a consolidation of the following;

- IT-99R5 dated December 11, 1998; and
- subsequent amendments thereto.

For further particulars, see the "Bulletin Revisions" section near the end of this bulletin.

Summary

This bulletin contains a general discussion of the treatment for tax purposes of legal and accounting fees. The bulletin addresses a number of specific situations and explains when and how these fees may be deducted as an expense in earning income from a business or property, as well as from other sources of income. The limited circumstances in which legal and accounting fees may be deductible from employment income are discussed, as is the treatment of legal and accounting fees in certain capital transactions.

Discussion and Interpretation

General Deductibility

¶ 1. Except where there is a specific provision in the Act dealing with legal or accounting fees, such as paragraphs 8(1)(b) or 60(o.1) (see ¶s 22 to 27 below), legal and accounting fees are deductible only to the extent that they

- (a) are incurred for the purpose of gaining or producing income from a business or property, and
- (b) are not outlays of a capital nature, see ¶s 14 to 16 below.

¶ 2. Generally, legal and accounting fees are allowable deductions where they are incurred in connection with normal activities, transactions or contracts incidental or necessary to the earning of income from a business or property. A deduction may therefore be taken for legal and accounting expenses in connection with a broad range of routine business functions, such as

- (a) preparing contracts in relation to the sale of inventory,
- (b) obtaining security for and collecting trade debts owing,
- (c) preparing financial records and minutes of shareholders' and directors' meetings,
- (d) making annual corporate filings,
- (e) routine or regular audits of financial statements,
- (f) conducting appeals in respect of, for example, sales tax including Goods and Services Tax/Harmonized Sales Tax, excise, municipal, or property taxes, and
- (g) watching legislation (including customs and other regulations) affecting the business operations of the taxpayer.

See ¶s 6 to 8 below for comments on legal and accounting fees in connection with income and other taxes and government levies.

¶ 3. In limited circumstances, legal fees have been held to be deductible where they are incurred in connection with the defence by a taxpayer against a charge of performing illegal actions in the operation of a business or in defence of the day-to-day methods of carrying on business. See, for example, the decision of the Exchequer Court in *Rolland Paper Co. Ltd. v. MNR*, [1960] CTC 158, 60 DTC 1095, in which legal fees to defend against a successful prosecution for anti-competitive trade practices were allowed as a deduction. In each case, the issue of whether or not a payment of fees to defend against criminal prosecution can meet the conditions of deductibility set out in ¶ 1 above is a question of fact which depends upon the relationship of the conduct in question to the taxpayer's income-earning activities. (See also the comments in ¶ 33 below regarding prosecutions for tax evasion.)

¶ 4. Legal costs to prosecute or to defend most tort, contract or other civil claims arising in the ordinary course of business will generally be deductible. Subject to the comments in ¶ 8 below, if the taxpayer is successful in a legal proceeding, the gross amount of the legal fees which are otherwise deductible must be reduced by any legal costs awarded by the court which are received by the taxpayer. The treatment of damages or settlements paid by a taxpayer is discussed in the current version of IT-467, *Damages*,

Settlements and Similar Payments; fines and penalties are dealt with in the current version of IT-104, *Deductibility of Fines or Penalties*.

Financing Expenses

¶ 5. Legal and accounting fees incurred in connection with

- (a) issuing bonds, debentures or mortgages,
- (b) borrowing money for certain business or property purposes,
- (c) incurring indebtedness that is an amount payable for certain business or property purposes, and
- (d) rescheduling or restructuring a debt obligation

may also be deductible within the limitations of paragraph 20(1)(e). The current version of IT-341, *Expenses of Issuing or Selling Shares, Units in a Trust, Interests in a Partnership or Syndicate and Expenses of Borrowing Money*, discusses this subject in more detail.

Income Tax Returns

¶ 6. Reasonable fees and expenses incurred for advice and assistance in preparing and filing of returns for income tax purposes are normally deductible by virtue of section 9 and are not limited under paragraph 18(1)(a) in computing business or property income to which such tax returns relate. A taxpayer who is employed in connection with selling property or negotiating contracts and who is entitled to deduct expenses pursuant to paragraph 8(1)(f) (see the current version of IT-522, *Vehicle, Travel and Sales Expenses of Employees*), may deduct a reasonable amount paid during the year to comply with the requirement to file an income tax return.

¶ 7. Under paragraph 60(o), all taxpayers, including those persons who report income from sources other than business or property (such as salary or capital gains), may deduct fees or expenses incurred and paid for advice or assistance in preparing, instituting or prosecuting an objection or appeal in respect of

- (a) an assessment of tax, interest or penalties under the *Income Tax Act* or a similar provincial law,
- (b) a decision of the Canada Employment and Immigration Commission, the Canada Employment and Insurance Commission, or a board of referees or an umpire under the *Unemployment Insurance Act* or the *Employment Insurance Act*,
- (c) an assessment of income tax, interest or penalties levied by a foreign government or political subdivision thereof, if the tax is eligible for a foreign tax credit, or
- (d) an assessment or decision under the Canada Pension Plan or a similar provincial plan.

A taxpayer may deduct amounts expended in connection with legal and accounting fees incurred for advice and assistance in making representations after having been informed that the taxpayer's income or tax for a taxation year is to be reviewed, whether or not a formal notice of objection or appeal is subsequently filed.

¶ 8. Any costs awarded or reimbursed to a taxpayer in respect of expenses deducted or deductible under paragraph 60(o) must be included in income by virtue of paragraph 56(1)(l) for the year in which the award was received. As indicated in ¶ 4 above, where other legal and accounting expenses were deducted under the general provisions of the law, any recovery of such expenses will reduce the expenses originally allowed.

Advance Income Tax Rulings

¶ 9. The cost of advance income tax rulings include the following:

- (a) the cost of preparing an advance ruling request letter to Revenue Canada, including out-of-pocket expenses to prepare additional copies of documents,
- (b) the cost of attending interviews with rulings officers of the Department, and
- (c) Revenue Canada's charge for the ruling.

Such costs may be deductible under certain conditions within the provisions of the Act. Where the transactions proposed in the advance ruling request are of an income nature, the costs may be deductible by virtue of section 9 and are not limited under paragraph 18(1)(a), provided that the proposed transactions are for the purpose of gaining or producing income from a business or property. If the transactions proposed in the advance ruling request are of a capital nature, the advance rulings costs may be deducted within the provisions of paragraph 20(1)(cc) (see ¶s 11 to 13 below), provided the proposed transactions relate to a business carried on by the taxpayer.

The costs of obtaining an advance ruling are generally accepted as being a cost related to the business of a taxpayer even though there may be some argument that the proposed transactions themselves do not relate to a particular business carried on by the taxpayer. For example, an advance ruling may involve the incorporation of a new subsidiary corporation or an estate freeze which involves a new corporation. The costs of such a ruling would generally be deductible under paragraph 20(1)(cc).

¶ 10. The cost of advance rulings as described in ¶ 9 above do not include "transaction costs" which would have been incurred whether or not an advance ruling had been requested. Transaction costs include (a) the fees of legal, accounting and other consultants relating to the structuring of the transactions, (b) the cost of negotiating contracts, and (c) the cost of obtaining letters patent, supplementary letters patent, amendments to them, etc.

The deductibility of transaction costs will depend on the nature of the underlying transactions (as income or capital) and the applicability of the provisions of paragraphs 18(1)(a), 18(1)(b), 20(1)(e), or 20(1)(cc), or the definition of "eligible capital expenditure" in subsection 14(5), as the case may be.

Expense of Representation

¶ 11. Paragraph 20(1)(cc) allows a deduction to a taxpayer for certain expenditures, generally of a capital nature, incurred and paid in making any representation relating to a business carried on by the taxpayer (including any representation made for the purpose of obtaining a licence, permit, franchise, patent, or trademark) to a government or public body or to a regulatory agency thereof. Expenses of litigation are not allowable deductions under this paragraph since a court of law does not form part of a government, nor is it a public body performing the function of a government. Also not deductible are expenses incurred (including legal fees) to negotiate with, for example, a manufacturer for an exclusive right or licence to handle the manufacturer's products in a specified territory. Since a representation must be related to a business carried on by the taxpayer, an expense incurred prior to the taxation year in which the taxpayer commenced business operations is not deductible under paragraph 20(1)(cc). A discussion of when a business commences is contained in the current version of IT-364, *Commencement of Business Operations*.

¶ 12. Pursuant to subsection 20(9), a taxpayer who is entitled to deduct an amount under paragraph 20(1)(cc) may in lieu of that deduction elect in the manner prescribed in Part XLI of the *Income Tax Regulations* to deduct one tenth of the amount in each of the ten consecutive years beginning with the year in which the expenditure is made.

¶ 13. Where a deduction under paragraph 20(1)(cc) or subsection 20(9) is taken and the cost of representation is on account of the capital cost of depreciable property, subsection 13(12) deems the amount to have been deducted as capital cost allowance. The effect of this deeming provision is to render any amount so deducted under paragraph 20(1)(cc) or subsection 20(9) liable to recapture in the event of a subsequent sale of the property.

Capital Expenditures

¶ 14. Legal and accounting fees incurred on the acquisition of capital property are normally included as part of the cost of the property. In the case of depreciable property, the claim for capital cost allowance is based on the total capital cost including such fees. Pursuant to subsection 40(1), any outlay or expense (including legal or accounting fees) incurred for the purpose of making the disposition of a property is added to the adjusted cost base of the property in calculating the amount of the capital gain, capital loss, terminal loss or business investment loss, as the case may be, arising from the disposition.

Eligible Capital Expenditures

¶ 15. Legal and accounting fees that are "eligible capital expenditures" within the meaning of that term in subsection 14(5) are included in the "cumulative eligible capital," of the taxpayer in the manner provided in subsection 14(5) (see the current version of IT-143, *Meaning of Eligible Capital Expenditure*). A deduction in respect of such expenditures is allowed under paragraph 20(1)(b). Legal and accounting fees directly associated with the purchase of goodwill qualify as eligible capital expenditures. Where, however, an expenditure is deductible under some provision of the Act other than paragraph 20(1)(b) or is added to the cost of property (see ¶ 14 above), it does not qualify as an eligible capital expenditure.

Corporate Take-overs

¶ 16. Legal and accounting costs incurred to fight a bid to take over control of a corporation are not deductible as current expenses or as eligible capital expenditures. Such costs relate to the ownership of the shares themselves (that is, the capital structure of the corporation) and are not laid out for the purpose of gaining or producing income from a business. Legal and accounting costs incurred in successful corporate acquisitions will generally be capital expenditures which may be added to the cost base of the shares acquired. The treatment of legal and accounting fees in the case of abortive attempts to acquire shares is discussed in the current version of IT-143, *Meaning of Eligible Capital Expenditure*. That bulletin also deals with the legal and accounting expenses of incorporation, reorganization and amalgamation.

Support Amounts

¶ 17. Legal costs incurred in establishing the right to spousal support amounts, such as the costs of obtaining a divorce, a support order for spousal support under the *Divorce Act* or a separation agreement, are not deductible as these costs are on account of capital or are personal or living expenses. However, since children have a pre-existing right, arising from legislation, to support or maintenance, legal costs to obtain an order for child support are deductible. Legal costs of seeking to obtain an increase in spousal or child support, or to make child support non taxable under the *Federal Child Support Guidelines*, are non-deductible.

¶ 18. Legal costs incurred to enforce pre-existing rights to interim or permanent support amounts are deductible. A pre-existing right to a support amount can arise from a written agreement, a court order or legislation such as sections 11 and 15.1 of the *Divorce Act* with respect to child support, or Part III of the *Family Law Act* of Ontario, and enforcing such a right does not create or establish a new right; see *The Queen v. Burgess*, [1981] CTC 258, 81 DTC 5192 (F.C.T.D.). In addition, legal expenses incurred to defend against the reduction of support payments are deductible since the expenses do not create any new rights to income; see *The Attorney General of Canada v. Norma McCready Sembinelli*, [1994] 2 CTC 378, 94 DTC 6636 (FCA.).

¶ 19. The legal costs described in ¶ 18 above are deductible even though an amount received as a "child support amount," as described in subsection 56.1(4), is not included in the income of the recipient. While "exempt income" in subsection 248(1) is defined as property received or acquired that is not included in income, the definition excludes "support amounts"; therefore, the deduction of costs incurred in respect of support amounts is not denied by virtue of paragraph 18(1)(c) as being exempt income. For a discussion of "support amount" and "child support amount," see the current version of IT-530, *Support Payments*.

¶ 20. A person who incurs legal expenses is not entitled to deduct them when they are incurred in connection with the receipt of a lump sum payment which cannot be identified as being a payment in respect of a number of periodic payments of support amounts that were in arrears. The lump sum payment however is generally not required to be included in income.

¶ 21. From the payer's standpoint, legal costs incurred in negotiating or contesting an application for support payments are not deductible since these costs are personal or living expenses. Similarly, legal costs incurred for the purpose of terminating or reducing the amount of support payments are not deductible since success in such an action does not produce income from a business or property. Legal expenses relating to obtaining custody of or visitation rights to children are also non-deductible.

Collection of Salary and Wages

¶ 22. Paragraph 8(1)(b) permits a deduction in computing income from an office or employment, for legal expenses paid by a taxpayer in the year to collect or to establish a right to salary or wages owed by an employer or former employer. Paragraph 6(1)(j) requires a taxpayer to include in income any award or reimbursement received in respect of amounts for which a deduction under paragraph 8(1)(b) is available. These amounts must be included in income to the extent that they are not otherwise so included or taken into account in computing the amount deducted under subsection 8(1).

¶ 23. A deduction under paragraph 8(1)(b) is allowed only in respect of an amount "owed" by an employer or a former employer. If the taxpayer is not successful in court or otherwise fails to establish that some amount is owed, no deduction for expenses is allowed. However, failure to collect an amount established as owed to the taxpayer does not preclude a deduction under this paragraph. Pension benefits and retiring

allowances do not come within the definition of "salary or wages" in subsection 248(1); legal expenses in respect of such income are discussed in ¶s 25 to 27 below.

¶ 24. Paragraph 8(1)(b) does not permit a deduction for legal fees paid to obtain benefits under a "wage loss replacement plan" as described in the current version of IT-428, *Wage Loss Replacement Plans*. While the amount received under a wage loss replacement plan is included in income under paragraph 6(1)(f) and therefore falls within the definition of "salary or wages" in subsection 248(1), the benefit is generally received from an insurer and the insurer is not the "employer or former employer" referred to in subsection 8(1)(b).

Retiring Allowances and Pension Benefits

¶ 25. Within the limits set out in paragraph 60(o.1), a taxpayer may deduct legal expenses paid to collect or establish a right to a pension benefit or retiring allowance. The term "retiring allowance" is defined in subsection 248(1) and is broad enough to include damages or settlements for wrongful dismissal of the taxpayer (see also the current version of IT-337, *Retiring Allowances*). Legal fees to collect or to establish a right to a pension benefit or retiring allowance of a deceased individual are also eligible expenses under paragraph 60(o.1) where the taxpayer who made the payment and who claims the deduction was a dependant, relation or legal representative of the deceased. Eligible legal expenses under paragraph 60(o.1) do not include legal expenses relating to a division or settlement of property arising out of, or on a breakdown of, a marriage. By virtue of paragraph 252(4)(b), the breakdown of a marriage includes the breakdown of a conjugal relationship between two parties described as spouses of each other in paragraph 252(4)(a). Legal fees in respect of benefits under the *Canada Pension Plan* or similar provincial plan are not eligible under paragraph 60(o.1), but a deduction for such expenses may be available under paragraph 60(o) (see ¶s 7 and 8 above).

¶ 26. The amount of the eligible legal fees paid that may be deducted under paragraph 60(o.1) is limited to the following amount:

(a) the amount of any retiring allowance or pension benefit related to those legal fees which is received and included in the taxpayer's income for the year or a previous year,

plus

(b) any reimbursement of legal expenses included in the taxpayer's income under paragraph 56(1)(l.1) (see ¶ 27 below) for the year or a preceding year,

minus

(c) transfers to a Registered Pension Plan or Registered Retirement Savings Plan deducted pursuant to paragraphs 60(j), (j.01), (j.1) or (j.2); this reduction is only required to be made to the extent that the amounts so transferred are amounts for which legal expenses eligible for deduction under paragraph 60(o.1) were incurred.

Only legal fees paid in connection with the income described above are eligible for deduction. Any otherwise eligible legal fees which are not deductible because they exceed such income may be carried forward and may be deducted in any of up to seven subsequent years, to the extent that further related income arises and to the extent that the amounts in question were not previously deductible.

¶ 27. Under paragraph 56(1)(l.1), amounts received by the taxpayer as an award or reimbursement of the types of eligible legal expenses described in ¶s 25 and 26 above must be included in income. This inclusion in income may be offset by the deduction available under paragraph 60(o.1).

Example

In 1994, Mr. Superannuate incurred legal expenses of \$3,000 and, in 1995, an additional \$6,000 in an attempt to establish a right to receive a retiring allowance from his former employer.

In 1996, he incurred further legal expenses of \$1,000 to establish his right to and to collect a retiring allowance. In 1996, Mr. Superannuate's former employer paid him a retiring allowance of \$15,000 and a \$7,500 reimbursement of legal expenses and agreed to pay him further retiring allowances of \$10,000 in 1997 and \$5,000 in 1998. Mr. Superannuate transferred the \$15,000 received in 1996 to his RRSP.

In 1997, Mr. Superannuate received \$10,000 under the agreement with his former employer and he transferred it to his RRSP.

In 1998, Mr. Superannuate received the final \$5,000 under the agreement with his former employer and he transferred \$2,500 of it to his RRSP.

In 1994 or 1995, Mr. Superannuate was not entitled to deduct any of the legal expenses that he incurred to establish a right to a retiring allowance because he had not received a reimbursement of those legal expenses or a retiring allowance in either of those years.

In 1996, Mr. Superannuate is required to include the \$7,500 reimbursement of legal expenses in income pursuant to paragraph 56(1)(1.1). While he has incurred legal expenses of \$10,000 in establishing the right to, and collecting the retiring allowance, his deduction under paragraph 60(o.1) is limited to \$7,500—the aggregate of the retiring allowance received in the year and the reimbursement of legal expenses, less the amount transferred to his RRSP. The \$2,500 of legal expenses that were not deductible in 1996 may be carried forward and deducted in later years to the extent that Mr. Superannuate receives a further retiring allowance or reimbursement of legal expenses from his former employer and to the extent that those payments can be associated with the legal expenses incurred in 1994 to 1996.

In 1997, Mr. Superannuate was unable to deduct any part of the \$2,500 in legal expenses that he carried forward since he transferred all of the retiring allowance that he received in that year into his RRSP.

In 1998, pursuant to paragraph 60(o.1), Mr. Superannuate will be able to deduct the \$2,500 of legal expenses that he carried forward since he transferred only \$2,500 of the retiring allowance that he received in that year into his RRSP.

"Legal" Fees in Paragraphs 8(1)(b) and 60(o.1)

¶ 28. It is not always necessary that the fees relating to matters described in paragraphs 8(1)(b) or 60(o.1) be paid to a lawyer. For example, an employee whose services are being terminated could obtain the services of a consultant in labour relations to negotiate a severance package. The fees paid to the consultant in that case will be accepted as legal fees, deductible under paragraph 8(1)(b) or 60(o.1), depending on the circumstances.

Employees Selling Property or Negotiating Contracts

¶ 29. An employee who is entitled to deduct expenses pursuant to paragraph 8(1)(f) (see the current version IT-522, *Vehicle, Travel and Sales Expenses of Employees*) may deduct reasonable amounts paid during the year in respect of legal costs arising from an event that by its nature is a risk normally incidental to the income earning activity. For example, a real estate agent may deduct legal fees in a defence against charges of misrepresentation in connection with an aborted sale of property. The legal expenses would not be deductible, however, if they were of either a capital or personal nature. An outlay incurred to protect the agent's licence to earn real estate commissions and an outlay directly attributable to an automobile accident which occurred while the automobile was being used for personal purposes are examples of expenditures of a capital and personal nature, respectively.

Legal Expenses of Employees Paid by Employers

¶ 30. An employer may deduct the legal expenses incurred in defending an employee, officer or director against charges of having committed an illegal or wrongful act in the ordinary course of carrying on the employer's business. This could include expenses incurred in relation to allegations of offences under business practices or competition law. See for example, the criteria set out in *The Car Strip Ltd. v. MNR*, [1967] Tax A.B.C. 361, 67 DTC 259 and the decision of the Federal Court, Trial Division, in *Border Chemical Company Ltd. v. The Queen*, [1987] 2 CTC 183, 87 DTC 5391.

¶ 31. An employer may deduct premiums under an insurance policy which provides for the reimbursement of legal expenses incurred by officers or directors in defending themselves against claims made against them by reason of their positions with the employer.

¶ 32. Where personal legal expenses of an employee (or of his or her family) are paid or reimbursed by the employer, the amount paid is a taxable benefit to the employee. To the extent that the amount so paid does not exceed a reasonable amount, it will normally be deductible to the employer as a business expense on account of the employee's wages or benefits.

Criminal Prosecutions Under Section 239

¶ 33. Legal and accounting fees incurred in connection with a prosecution under section 239 (tax evasion) are generally not allowable expenses since in most cases they are not laid out to earn income. These fees are not deductible under paragraph 60(o) inasmuch as the information laid with respect to the charge is not an assessment within the meaning of that paragraph. Pursuant to the comments in the current version of IT-104, *Deductibility of Fines or Penalties*, any fine in such a situation would not be deductible either. However, in limited circumstances, such as those in *Ben Matthews & Associates v. MNR*, [1988] 1 CTC 2372, 88 DTC 1262 (T.C.C.), legal and accounting fees incurred to defend against a section 239 prosecution may be considered to have been laid out to earn income. These expenses may be allowable deductions where they can be shown to relate to the defence of practices which arise in the normal course of the taxpayer's income-earning activities, such as the manner of preparing financial records, provided that there has been full disclosure of information by the taxpayer.

Bulletin Revisions

¶s 1 to 16 and 19 to 33 have not been changed since the issuance of IT-99R5 dated December 11, 1998. ¶s 17 and 18 have been revised to clarify that legal fees incurred in establishing the right to spousal support under the *Divorce Act* are not deductible. For greater certainty, the Canada Customs and Revenue Agency accepts the position that children have a pre-existing right, arising from legislation, to maintenance regardless of whether the support is obtained pursuant to the *Divorce Act* or provincial legislation. [December 5, 2000]

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The Basic Mechanics of the Recognition of Trust Income under Subsection 104(6)-(13),(24)

The Initial General Overview.

Subsections 104(13), (6), and (24) provide the main provisions applicable to transferring the tax liability in respect of income realized by a trust that is currently payable to the beneficiaries, as income, however they do not have any effect in instances where income is being realized by the trust and held for or accumulated for a beneficiary when he doesn't have an immediately enforceable right to a distribution.

Basically, subsection 104(13) requires a beneficiary to recognize as income from the trust, income of the trust, (or other amounts when it isn't resident in Canada throughout its tax year), that becomes "payable" to him while subsection 104(24) provides a definition of "amount payable" for these purposes, which is defined to include amounts actually paid or amounts which he is entitled to enforce a payment of in the particular year. Subsection 104(6) provides the provision whereby the trust **may** claim a deduction of **any** amount not exceeding an amount that became payable in the year as income to the beneficiary or for the beneficiary's benefit that was included in computing the income of a beneficiary under Sec. 105(2).

This transfer of liability process is complicated by the fact that it operates on the amount of Division B tax law income, (as computed under section 3), recognizable by the trust, while the beneficiary's trust law entitlements to "trust income" may be based on and enforceable in respect of income computed by another means and thus most probably different from Division B income. Where a beneficiary's trust law income payable (payment) exceeds that of his tax law income payable, computed under Sec. 104(13), the excess **may** be fully included in income under Sec. 105(1) as a benefit from a trust. In the author's opinion the Department should not attack such excess income since it arises only due to the method of trust accounting adhered to and fundamentally the appropriate amount of economic benefit is being taxed one way or another.

The Subsection 104(13) Inclusion.

The subsection 104(13) inclusion does make reference to the Sec. 108(1)(e) definition of income interest which, as per Sec. 108(3), is a right based on trust law income payables. One cannot always say that if an amount isn't included in the trust's Division B income, but is payable to a beneficiary, it will be treated under Sec. 105(1) since this clearly doesn't account for capital distributions. If the trust recognizes the particular item as income and the beneficiary realizes it as income as well, then Sec. 105(1) can apply to it if it is payable and is not included in the trust's Division B income thus making it subject to Sec. 104(13). The same does not hold true if the trust realizes it as capital as does the beneficiary, and the beneficiary has a right thereto, having the nature described in Sec. 108(1)(c), in that its payment may cause an adjustment in the ACB of the capital interest held, actual or hypothetical, that will preclude Sec. 105(1) from applying to cause a full income inclusion.

If the trust is personal and the capital interest wasn't purchased by its holder the distribution will be tax free to the recipient.

Subsection 104(13) provides two applicable paragraphs in terms of this discussion, one of which will apply depending on whether the trust was resident throughout its taxation year in Canada. Paragraph 104(13)(a) provides in effect that where the trust was resident in Canada throughout its tax year that **ended in the beneficiary's tax year**⁹⁰⁰ such part of the trust's income for the particular year, prior to any Sec. 104(6) or (12) deductions taken by the trust, that became payable in the particular year to the beneficiary, will be included in that beneficiary's income and thus the Division B income for the tax year of the trust which ends in the beneficiary's tax year will be net of all the deductions allowed under the Division **except** any amount deducted under Sec. 104(6) or 104(12), (the preferred beneficiary election), by the trust.⁹⁰¹ Paragraph 104(13)(c) applies

900. See *Helliwell v. M.N.R.*, 1985 2 C.T.C. 2188, for the significance of when the trust's tax year ends with respect to dividend tax rates as well as *Marshall v. I.R.C.*, 1960 N.Z.L.R. 972, for an opposite statutory provision. In Australia they apportion the taxable income flowing through a trust, here in Canada we've mis-matched it due to simply recognizing that trust income is statutorily not Division B income though not made provision for instances where it significantly differs.

901 Rent and interest deductions in respect of taxpayers who are also income beneficiaries, if they are deductible, provide an interesting mechanism by which the amount of Sec. 104(13) income payable can be regulated, and this is something to remember when evaluating the application of the attribution provisions in particular Sec. 74.3(1)(a). Income paid quo beneficiary but conditional on the holding of an office or engaged in an employment will not be altered to income from an

where the trust wasn't resident in Canada through its tax year that ended in the year of the beneficiary and provides, in effect, that all amounts that become payable in **the beneficiary's tax year** by the trust in respect of the beneficiary's interest therein, **other than** amounts representing proceeds of disposition of any part of the beneficiary's interest or as a distribution of capital by a personal trust, will be included in the beneficiary's Division B income.⁹⁰²

"Income of beneficiary – Sec. 104(13)"

(13) There shall be included in computing the income for a particular taxation year of a beneficiary under a trust such of the following amounts as are applicable:

(a) in the case of a trust (other than a trust referred to in paragraph (a) of the definition "trust" in subsection 108(1)), such part of the amount that, but for subsections (6) and (12), would be the trust's income for the trust's taxation year that ended in the particular year as became payable in the trust's year to the beneficiary; and

(b) in the case of a trust governed by an employee benefit plan to which the beneficiary has contributed as an employer, such part of the amount that, but for subsections (6) and (12), would be the trust's income for the trust's taxation year that ended in the particular year as was paid in the trust's year to the beneficiary.⁹⁰³

office or employment: the terms of Sec. 104(13) are wide enough to disallow it.

902 Subsection 108(5)(a) effectively provides that amounts required to be included in a beneficiary's income under Sec. 104(13), (as well as the other income inclusion provisions under subdivision k), will be considered as income from property which is a trust interest and not from the trust's source itself, however, this rule doesn't apply for purposes of the attribution rules.

903 March 2001 FINANCE TECHNICAL NOTES: Subsection 104(13) sets out amounts included in computing the income of a beneficiary under a trust. Where a trust is not resident in Canada, paragraph 104(13)(c) provides that the beneficiary must include in computing income all amounts payable in respect of the beneficiary's interest in the trust, otherwise than as proceeds of disposition or amounts paid in satisfaction of the distribution of capital by a personal trust. There is uncertainty in this regard under the existing law, given that different types of distributions from a trust to a beneficiary might arguably be viewed as resulting in proceeds of disposition with respect to all or part of a beneficiary's interest in the trust. Subsection 104(13) is amended so that it requires a beneficiary to include in income under that subsection only current income payable from a non-resident trust. For this purpose, a non-resident trust's income is intended to be determined in accordance with Canadian income tax rules. See also, in this regard, the commentary on new section 250.1.

1988 FINANCE TECHNICAL NOTES: Existing subsection 104(13) requires the inclusion of trust income distributions in the income of the beneficiaries who are entitled to receive such distributions. This inclusion corresponds to the deduction provided to the trust in respect of such distributions under subsection 104(6), except that where the trust has itself deducted amounts in respect of capital cost allowance or terminal loss in computing its income for tax purposes, the amount included in a beneficiary's income is the amount of the distribution out of the trust's income computed before any deduction for capital cost allowance or terminal loss. Under the existing provisions, while the gross amount is included in the beneficiary's income, the trust may allocate to its beneficiaries the capital cost allowance deductions to which it would otherwise have been entitled in accordance with the rules in subsections 104(16), (17.1) and (17.2), and these amounts are deductible by the beneficiary.

Two changes to subsection 104(13) are proposed. First, the special treatment which allows capital cost allowance and terminal losses to be flowed out to beneficiaries will no longer apply. Capital cost allowance will be deductible only by the trust, and the income of the trust, determined in accordance with Part I after deducting capital cost allowance, is the maximum amount that will be taxed in the beneficiaries' hands under subsections 104(13), 104(14) or paragraph 212(1)(c). As a consequence, subsections 104(16), (17.1) and (17.2), which provide for the flow-through to beneficiaries of capital cost allowance, are repealed.

The second change reflected in paragraph 104(13)(c) provides that all amounts that become payable to a beneficiary by a non-resident trust will be included in the beneficiary's income. However, such amounts will not include proceeds arising on the disposition of all or part of an interest in the trust or, where the trust is a personal trust, distributions of capital.

1983 FINANCE TECHNICAL NOTES: Paragraph 104(13)(b) provides that trust income payable to a beneficiary generally is taxed in the hands of the beneficiary. However, this conflicts with the objective of the rules relating to employee benefit plans which is to tax the employee only when amounts are paid to him and deductible to the employer. Accordingly, paragraph 104(13)(b) is amended to exclude amounts payable by a trust governed by an employee benefit plan. As a result such benefits will be taxed under paragraph 6(1)(g) only when paid.

Timing and Deferral.

With respect to trusts which are resident in Canada throughout their tax years which end in the beneficiary's year, it should be obvious that a considerable deferral of the recognition of income by the beneficiary may be possible where the trust's tax year ends just at the beginning of the beneficiary's tax year while where the trust isn't resident throughout the particular tax year the beneficiary will recognize income at the time it becomes payable to him, not in the period in which the trust's tax year ends.

Unfortunately this deferral is available only in respect of testamentary trusts since *inter vivos* trusts have tax years determined but Sec. 249(1)(b) to be the calendar year which is identical to individual beneficiaries' tax years.⁹⁰⁴ Subparagraph 104(23)(c) provides a special rule in respect of testamentary trusts, which are defined in Sec. 108(1)(i), which overrides **any other provision in the Act**, whereby the beneficiary will recognize the trust income payable in his tax year in which the trust's tax year ends hence Sec. 104(13)(c) causes early possible recognition in respect of *inter vivos* trusts only.⁹⁰⁵

“Testamentary trusts – Sec. 104(23)”

(23) In the case of a testamentary trust, notwithstanding any other provision of this Act, the following rules apply:

(a) the taxation year of the trust is the period for which the accounts of the trust are made up for purposes of assessment under this Act, but no such period may exceed 12 months and no change in the time when such a period ends may be made for the purposes of this Act without the concurrence of the Minister;

(b) when a taxation year is referred to by reference to a calendar year, the reference is to the taxation year or years coinciding with, or ending in, that year;

(c) the income of a person for a taxation year from the trust shall be deemed to be the person's benefits from or under the trust for the taxation year or years of the trust that ended in the year determined as provided by this section and section 105;

(d) where an individual having income from the trust died after the end of a taxation year of the trust but before the end of the calendar year in which the taxation year ended, the individual's income from the trust for the period commencing immediately after the end of the taxation year and ending at the time of death shall be included in computing the individual's income for the individual's taxation year in which the individual died unless the individual's legal representative has elected otherwise, in which case the legal representative shall file a separate return of income for the period under this Part and pay the tax for the period under this Part as if

(i) the individual were another person,

1982 FINANCE TECHNICAL NOTES: Subsection 104(13) of the existing Act applies to trusts other than a trust under an employee benefit plan. It requires the trust income that is payable to a beneficiary and deductible to the trust under subsection 104(6) to be included in the beneficiary's income whether or not it is actually paid in the year. The amendment to subsection 104(13) allows a deduction to an employee benefit plan trust only for income actually paid by the trust in the year.

This amendment provides a means for relieving the double taxation that can result when the income of an employee benefit plan is not fully distributed in a year to employees. By providing for such income to be paid out to an employer and paid back by it as an additional contribution, the employer will include such income in the computation of income under paragraphs 104(13)(a) and 12(1)(m) and will be entitled to a deduction for the additional contribution in accordance with section 32.1.

904 When the beneficiary is a taxpayer without a calendar year tax year, possibly such as a corporation or partnership, there can be deferral.

905. Since an *inter vivos* trust's tax year is the calendar year an individual taxpayer and *inter vivos* trust will usually have the same tax year, however this isn't the case with testamentary trusts or partnerships.

(ii) the period were a taxation year,

(iii) that other person's only income for the period were the individual's income from the trust for that period, and

(iv) subject to sections 114.2 and 118.93, that other person were entitled to the deductions to which the individual was entitled under sections 110, 118 to 118.7 and 118.9 for the period in computing the individual's taxable income or tax payable under this Part, as the case may be, for the period; and

(e) in lieu of making the payments required by sections 155, 156 and 156.1, the trust shall pay to the Receiver General within 90 days after the end of each taxation year, the tax payable under this Part by it for the year.⁹⁰⁶

The Department has taken the position that an amount of income included in computing the beneficiary's income under Sec. 104(13) or 105(2) will be earned on the last day of the trust's tax year for purposes of certain provisions. This opinion however doesn't take into account the differing jurisprudence with respect to differing trust settings. It has been held that when a proprietary income interest is held by a beneficiary he is entitled to the income the moment it is realized (while there is some opinion that such applies only when it is

906 July 2010 FINANCE TECHNICAL NOTES (Part 1 -technical): Subsection 104(23) provides special rules that apply to testamentary trusts. Paragraph 104(23)(a) defines the taxation year of a testamentary trust to be the period for which the accounts of the trust are made up for purposes of assessment under the Act. For this purpose, that paragraph also provides that no such period may exceed 12 months and: no change in the time when such a period ends may be made for the purposes of the Act without the concurrence of the Minister of National Revenue. Paragraph 104(23)(b) provides that, in the case of a testamentary trust when a taxation year is referred to by reference to a calendar year, the reference is to the taxation year or years coinciding with, or ending in, that year.

Paragraphs 104(23)(a) and (b) are repealed.

This amendment applies after December 20, 2002. For a related set of amendments, see the commentary on section 249 and the definition "testamentary trust" in subsection 108(1).

Dec. 1995 FINANCE TECHNICAL NOTES: Subsection 104(23) provides rules that apply to testamentary trusts. Paragraph 104(23)(a), which defines the taxation year of a testamentary trust, is amended consequential on the new definition of "fiscal period" in new section 249.1 (formerly in subsection 248(1)).

Feb. 1994 FINANCE TECHNICAL NOTES: Paragraph 104(23)(e) provides that instead of making quarterly instalment payments a testamentary trust must pay its tax owing for a taxation year within 90 days after the end of that year. Paragraph 104(23)(e) is amended, for the 1994 and subsequent taxation years, to exempt a testamentary trust, the chief source of income of which is farming or fishing, from the requirement to make a December instalment payment.

1988 FINANCE TECHNICAL NOTES: Subsection 104(23) provides for an election to file, a separate return where a beneficiary of a testamentary trust died after the end of the trust's fiscal period and before the end of -a calendar year. In such cases, the separate return must be filed as if the beneficiary's only income were his income from the trust and, the beneficiary were entitled to the personal exemptions and certain other deductions.

Subparagraph 104(23)(d)(iv) is amended to include a reference to new section 118.12 dealing with separate tax returns, to delete the reference to sections 109, 110.1 and 110.2 (concerning personal exemptions, the \$1,000 interest and dividend: income deduction and the \$1,000 pension income deduction, respectively) and include a reference to new sections 110, 118 to 118.7 and 118.9, which govern, the remaining deductions in computing taxable income and the various personal tax credits, including the pension income credit.

Sept. 1985 FINANCE TECHNICAL NOTES 104(23) provides special rules that are applicable to testamentary trusts. One of these rules allows the legal representative Of a beneficiary of a testamentary trust- who died after the end of the trust's taxation year but before the end of the calendar year to file a separate return of income for the beneficiary that reports the beneficiary's income from the trust for the period from the end of its taxation year to the date of death. The Act does not provide for any deductions from income in computing taxable income for the purposes of that separate return. This amendment, together with new section 114.2, expressly allows for the deduction of the personal exemptions of the deceased and further allows the legal representative to claim in the separate return of income the, various other deductions ordinarily allowed in computing. taxable income of an individual to the extent that they are not claimed on another return of the individual's income for the year. These other deductions include those relating to charitable donations and the \$1,000 investment and pension income deductions.

in distributable form), net of expenses incurred to produce it. There are yet other characters of trust rights that will not entitle their holders to enforce a distribution until the fiscal year end of the trust such as where they are entitled to net income of the fund regardless of its composition while there are yet other instances where trustees must exercise their discretion at various times with respect to the determination of proper expensing and revenue recognition etc. that will solidify the income to which the beneficiaries are entitled as well as their ability to enforce a distribution of it. The policy is administrative in the author's opinion and the terms of the trust deed and long-standing jurisprudence govern when the beneficiary is to recognize a Sec. 104(13) inclusion.⁹⁰⁷ This isn't important in respect of which tax year an *inter vivos* or testamentary trust beneficiary will recognize a Sec. 104(13) inclusion since both are arbitrarily governed by Sec. 249(1) or 104(23) but it is important in determining the timing of the applicability of Part XIII withholding tax for instance. (Subsection 104(11) on the other hand provides that dividends received by a trust created essentially for the exclusive benefit of non-residents from a non-resident owned investment corporation will be deemed to have been paid for purposes of Part XIII to the beneficiary on the last day of the trust's tax year. Note that Finance has extended a statutory response in light of this issue.)

Where the trust is resident but the income beneficiary is non-resident subsection 214(3)(f) provides for purposes of Part XIII **only**, an amount of income that when payable would cause a Sec. 104(13) inclusion in respect of the non-resident beneficiary if he were resident, will be deemed to have been paid or credited on the earlier of the day that it was actually paid and 90 days after the end of the trust's tax year.⁹⁰⁸ This provision applies only for purposes of Part XIII and not the Act as a whole and it sets the time frame for making the remittances required to be withheld by the trustee by virtue of the Part on the payment without affecting the beneficiary's trust-law right to payment. When income is currently payable throughout the year as realized by the trust a deferral can be obtained by simply foregoing payment until 90 days after the trust's year end since the timing basis is amounts **paid**. This would be advantageous when the non-resident will be becoming resident prior to the end of the 90 day period since Part XIII would apply to subsequent payments regardless of when they were paid. If the beneficiary is non-resident when the income becomes payable Part XIII applies to it, but Sec. 214(3)(f) only moderates the timing of the remittances. Subsection 104(6) offers a deduction to the trust in respect of income that has become **payable** in the year to the beneficiary regardless of when it was paid, (unless Sec. 104(7) applies).

Non-Resident Trusts with Resident Beneficiaries and Differing Income Bases.

While the object of the resident trust which is payable is the trust's Division B income, if the trust isn't resident throughout its tax year ending in the beneficiary's tax year **any amount** other than the two described amounts will be includable in the beneficiary's income when they are payable under Sec. 104(13) regardless of whether or not they represent Division B (or D) income to the trust.

There are thus two inclusion bases depending on the residency of the trust; the first being Division B income that is just flowed through to the beneficiary without any net addition to the tax base while the latter may introduce into the tax base all those amounts which would have been exempt had the trust been resident throughout its tax year, once they become payable to the beneficiary as income.

The distinction between capital and income obviously becomes critical in this respect in that trust law income payables will be added to the Canadian tax base even though had the trust been resident in Canada they may have been exempt. In respect of non-resident trusts income accounting becomes critical if the income is to be

907. There seems to be some consideration of this principle in a Technical Interpretation provided in August, 1990 by the F.I.D. when it held that a trust could make a Sec. 104(21) designation in respect of a beneficiary even if that beneficiary subsequently becomes non-resident before the end of the calendar year, if they were resident at the time of the disposition by the trust. It was held that the Sec. 104(21) designation can only be made in respect of beneficiaries who were resident at the time of the disposition by the trust resulting in the gain. Since the basis of the designation must be a Sec. 104(13)-(14) or section 105 income inclusion it is obviously inferred that the beneficiary would recognize such, by virtue of Sec. 114(a), during the period of time he was resident in Canada. On these same grounds the author submits that this will not always be the case since the basis of the Sec. 104(13) inclusion is that the amount be payable, ie subject to a present right to enforce a distribution, and when the trust terms allow the withholding of such an amount until the end of the trust's tax year. The ultimate hard rule should be based on where the beneficiary was resident when his right to enforce the distribution by the trust of a current receipt became enforceable.

908 See T.I. 912029 from the Foreign Section to the Non-resident Taxation Section Aug. 23, 1991.

paid to a Canadian resident beneficiary as income since if capital payments lose their trust law capital nature they will be includable in income under Sec. 104(3)(c).⁹⁰⁹ This makes it difficult for a Canadian resident to invest in an offshore investment trust in that in subscribing for interests the trust will lose its personal nature and any subsequent capital distributions will be subject to income inclusion as per Sec. 104(13)(c) or 107(2.1). If a non-resident trust is used as an intermediary then this can be avoided in that the trust will not be subject to Sec. 104(13) or Canadian income taxation and it will also be personal thus allowing capital distributions to the Canadian resident to proceed tax free. Section 94 and 94.1 may have some effect here so as to preclude or drastically reduce the type of tax free flow through that can be accomplished. Capital distributions to the intermediary trust may prove to be a method of going around those rules.⁹¹⁰

Payments Made in Error.

Subsection 104(24) provides that for purposes of Sec. 104(13), (6), and 53(2)(h)(i.1) an amount shall be deemed to have become payable to a beneficiary in a tax year if it was paid in the year to him or if he was entitled in the year to enforce a payment of it⁹¹¹. The subsection 104(24) provision thus requires the inclusion in income of all amounts paid to a beneficiary, regardless of whether he was entitled to enforce their payment or if they were paid to him **in error**.

Unlike the pre 1988 reform Sec. 104(24) definition referring to only those amounts of income paid **to a person to whom they were payable**, the present Sec. 104(24) allows the trust to make an "erroneous" distribution and still obtain the Sec. 104(6) deduction.⁹¹² Previously such amounts were includable in the recipient's income under Sec. 105(1) whereby the trust wouldn't obtain a Sec. 104(6) deduction, resulting in double taxation. Presently, regardless of if action is taken against the apparent breach of trust by the trustee, the trust will still obtain the deduction and full integration will exist. This provides a considerable amount of flexibility but is still limited in certain aspects.⁹¹³ As will be seen from a review of Sec. 104(6)(b), a deduction can be made by the trust only if the payment in error was made to "a beneficiary", (but this provision doesn't restrict the nature of this beneficiary to being capital or income), while it should be recognized that a payment in error does not preclude the beneficiary to whom the income would continue to be otherwise payable from recognizing it under Sec. 104(13) whereafter the trust could receive another second equivalent Sec. 104(6) deduction.⁹¹⁴ In this respect, although the same income amount would be includable in two beneficiaries' Division B incomes, (the income and a capital beneficiary), a double deduction, under Sec. 104(6) will be resultantly available to the trust.

If the trustees pay income to a capital beneficiary equal to an amount that can be eliminated by unused credits, then essentially the trust can obtain a second Sec. 104(6) deduction which can reduce its Division B income, but not create a loss, while the original income beneficiary will be required to recognize the original amount under Sec. 104(13) and the trust will obtain additional Sec. 104(6) deductions. With the 1988 reform Parliament enacted a bit of leniency towards the deduction of income payments in error however they did not go so far as to allow the trust to create losses. The "deficiency" in the statute is obviously that the Sec. 104(24)-(13)-(6) mechanism works upon income paid as well as payable to any beneficiary, both those entitled to it and those not, while it should also be recognized that if the income is paid to a non-beneficiary person then the mechanism will not work favourably and the taxpayer will recognize a Sec. 105(1) inclusion. The Sec. 104(6) deduction is limited to the amount of income recognized by the trust hence a loss cannot be created on the income payment to a beneficiary.

909. The provision refers to a distribution of trust law capital not a receipt of capital in respect of the beneficiary.

910 See Non-Resident Trusts.

911. however it falls slightly short of the mark in respect of the latter instance in that it doesn't indicate **when** the enforcement of the right to payment shall take place

912 This was precisely the point in T.I. B-6366 the Deferred Income Plan and Trusts Section provided to the Saint John District Office in May 1986 while see also T.I. 5-0051 provided in March 1981 by the Non-corporate Rulings Division to the Technical Applications Section for identical opinion.

913 The Act, as stated in French, has not apparently been adjusted, in Sec. 104(24), for this fact in that it still refers to "Si la fiducie l'a payé au cours de l'année à la personne à laquelle il était payable..." Hopefully the Department can "get its Act together" and make the necessary adjustment.

914 This was exactly the case in Case R32, 84 A.T.C. 298.

“Income of beneficiary – Sec. 104(13)”

(13) There shall be included in computing the income for a particular taxation year of a beneficiary under a trust such of the following amounts as are applicable:

(a) in the case of a trust (other than a trust referred to in paragraph (a) of the definition “trust” in subsection 108(1)), such part of the amount that, but for subsections (6) and (12), would be the trust’s income for the trust’s taxation year that ended in the particular year as became payable in the trust’s year to the beneficiary; and

(b) in the case of a trust governed by an employee benefit plan to which the beneficiary has contributed as an employer, such part of the amount that, but for subsections (6) and (12), would be the trust’s income for the trust’s taxation year that ended in the particular year as was paid in the trust’s year to the beneficiary.

“Deduction in computing income of trust – Sec. 104(6)”⁹¹⁵

915 Sept. 10, 2010 FINANCE TECHNICAL NOTES (Part 1 - non-resident trusts): Subsection 104(6) generally permits a trust to deduct, in computing its income for a taxation year, an amount not exceeding the portion of its income otherwise determined for the year that becomes payable in the year to a beneficiary under the trust. Subsection 104(6) is amended so that it is expressly subject to subsections 104(7) to 104(7.1). This amendment applies to taxation years that end after 2006. It also applies to each earlier taxation year of a trust to which subsection 94(3) applies (because of a valid election by the trust under the coming-into-force provision for new section 94) and each taxation year of a beneficiary under the trust in which one of those earlier taxation years of the trust ends.

June 2007 FINANCE TECHNICAL NOTES (SIFTS): Subsection 104(6) generally permits a trust to deduct, in computing its income for a taxation year, any income payable to a beneficiary under the trust. Paragraphs 104(6)(a) to (o) apply to various special kinds of trusts, while paragraph 104(6)(b) applies more generally. Paragraph 104(6)(b) calculates the amount that a trust can deduct against its income. Generally, the deductible amount is the amount of the trust's income that is payable to the beneficiaries and the amount included in the income of the beneficiaries under subsection 105(2); As part of a series of measures to implement new rules for "SIFT trusts" (defined in subsection 248(1)), paragraph 104(6)(b) is amended in two respects.

First, subparagraph 104(6)(b)(i) is amended to add the term "adjusted distributions amount" to refer to the amount determined under that subparagraph.

Second, new subparagraph 104(6)(b)(iv) is added. This new provision limits the deduction that a SIFT trust can claim under subsection 104(6). The provision's general effect is to prevent a SIFT from deducting under subsection 104(6) any amount of its "non-portfolio earnings" (defined in new subsection 122.1(1)) that it has made payable to a beneficiary. The structure of the provision has the result of applying an ordering as between non-portfolio earnings (NPE) and other income, such that NPE is the last income to be considered to have been distributed. This result will typically be beneficial to the SIFT trust, as it will allow it to use deductions in computing taxable income - notably non-capital loss carryovers from other taxation years - to reduce the amount of its NPE that are subject to tax.

Specifically, new subparagraph 104(6)(b)(iv) reduces the amount that a SIFT trust can deduct under subsection 104(6), in computing its income for a taxation year, by the excess of the SIFT trust's adjusted distributions over that part of its income that is not NPE. This second amount is in turn computed through subtraction: it is the amount by which the SIFT trust's gross income for the taxation year (that is, before the subsection 104(6) deduction itself) exceeds its NPE for the taxation year.

This amendment is deemed to have come into force on October 31, 2006. As a practical matter, the amendment will have effect no earlier than the 2007 taxation year, since the new defined terms "SIFT partnership" and "SIFT trust" apply, at the earliest, to taxation years that end after 2006. For more information, refer to the commentary to the definition "SIFT trust" in subsection 122.1(1) and the application rule in subsection 122.1(2).

March 2001 FINANCE TECHNICAL NOTES: Subsection 104(6) generally allows a trust to deduct an amount for a taxation year not exceeding its income for the year that became payable to its beneficiaries. However, in the case of a trust for the benefit of a spouse or common-law partner there are restrictions designed to ensure that the trust cannot claim a deduction under subsection 104(6) in respect of income allocated to non-spouse or non-common-law partner beneficiaries to the extent the income accrues during the lifetime of the spouse or common-law partner beneficiary. (With regard to income for the year in which a spouse or common-law partner beneficiary dies, this restriction only applies in connection with income from dispositions of capital property, land inventory and Canadian and foreign resource property that occur before the end of the deemed disposition day caused by the death of the spouse or common-law partner.) There is also a restriction in subsection 104(6) designed to limit the extent to which a trust can claim a deduction in respect of distributions by the trust of amounts paid to the trust from the trust's NISA Fund No. 2 (as defined in subsection 248(1)).

Dec. 1995 FINANCE TECHNICAL NOTES: Subsection 104(6) generally permits a trust to deduct any trust income payable

(6) For the purposes of this Part, there may be deducted in computing the income of a trust for a taxation year

(a) in the case of an employee trust, the amount by which the amount that would, but for this subsection, be its income for the year exceeds the amount, if any, by which

(i) the total of all amounts each of which is its income for the year from a business exceeds

(ii) the total of all amounts each of which is its loss for the year from a business;⁹¹⁶

(a.1) in the case of a trust governed by an employee benefit plan, such part of the amount that would, but for this subsection, be its income for the year as was paid in the year to a beneficiary;

(a.2) where the taxable income of the trust for the year is subject to tax under this Part because of paragraph 146(4)(c) or subsection 146.3(3.1), the part of the amount that, but for this subsection, would be the income of the trust for the year that was paid in the year to a beneficiary;⁹¹⁷

(a.3) in the case of an *inter vivos* trust deemed by subsection 143(1) to exist in respect of a congregation that is a constituent part of a religious organization, such part of its income for the year as became payable in the year to a beneficiary; and⁹¹⁸

(b) in any other case, such amount as the trust claims not exceeding the amount, if any, by which

(i) such part (in this section referred to as the trust's "adjusted distributions amount" for the taxation year) of the amount that, but for

(A) this subsection,

(B) subsections 104(5.1), 104(12), and 107(4),

(C) the application of subsections 104(4), 104(5) and 104(5.2) in respect of a day determined under paragraph 104(4)(a), and

in the year to a beneficiary under the trust. However, a post-1971 spousal trust described in paragraph 104(4)(a) is not allowed to deduct amounts payable in a taxation year to any except the beneficiary spouse, if the beneficiary spouse is alive throughout the year.

916 1982 FINANCE TECHNICAL NOTES: Subsection 104(6) permits a trust to deduct in a year any income payable in the year to a beneficiary. Paragraph 104(6)(a.1) is added to provide that an employee benefit trust established by an employer may only deduct income paid in the year to a beneficiary. This matches the timing of the trust deduction with the employee inclusion - only when amounts are actually paid out of an employee benefit trust are they included in an employee's income.

917 Dec. 1997 FINANCE TECHNICAL NOTES (technical): Subsection 104(6) is amended to provide that, once a trust governed by an RRSP or RRIF is no longer exempt from tax after the death of the RRSP or RRIF annuitant, only trust income actually paid to a beneficiary in a taxation year is deductible in computing income. Because subsection 104(13) does not apply to trusts governed by RRSPs and RRIFs such amounts paid would be included in income under subsection 146(8) or 146.3(5).

918 March 2001 FINANCE TECHNICAL NOTES: Paragraph 104(6)(a.3) is introduced so that the restrictions with regard to a trust's NISA Fund No. 2 do not apply to any trust deemed to exist because of the special rules for communal organizations in section 143. This amendment applies to the 1998 and subsequent taxation years.

(D) subsection 12(10.2), except to the extent that that subsection applies to amounts paid to a trust described in paragraph 70(6.1)(b) and before the death of the spouse or common-law partner referred to in that paragraph, would be its income for the year as became payable in the year to a beneficiary or was included under subsection 105(2) in computing the income of a beneficiary exceeds

(ii) where the trust

(A) is a post-1971 spousal or common-law partner trust that was created after December 20, 1991, or

(B) would be a post-1971 spousal or common-law partner trust if the reference in paragraph (4)(a) to “at the time it was created” were read as “on December 20, 1991”,

and the spouse or common-law partner referred to in paragraph 104(4)(a) in respect of the trust is alive throughout the year, such part of the amount that, but for

(C) this subsection,

(D) subsections 104(12) and 107(4), and

(E) subsection 12(10.2), except to the extent that that subsection applies to an amount paid to a trust described in paragraph 70(6.1)(b) and before the death of the spouse or common-law partner referred to in that paragraph,

would be its income for the year as became payable in the year to a beneficiary (other than the spouse or common-law partner) or was included under subsection 105(2) in computing the income of a beneficiary (other than the spouse or common-law partner),

(ii.1) where the trust is an alter ego trust or a joint spousal or common-law partner trust and the death or later death, as the case may be, referred to in subparagraph (4)(a)(iv) has not occurred before the end of the year, such part of the amount that, but for this subsection and subsections (12), 12(10.2) and 107(4), would be its income as became payable in the year to a beneficiary (other than a taxpayer, spouse or common-law partner referred to in clause (4)(a)(iv)(A), (B) or (C)) or was included under subsection 105(2) in computing the income of a beneficiary (other than such a taxpayer, spouse or common-law partner),

(iii) where the trust is an alter ego trust, a joint spousal or common-law partner trust, a trust to which paragraph (4)(a.4) applies or a post-1971 spousal or common-law partner trust and the death or the later death, as the case may be, referred to in paragraph (4)(a) or (a.4) in respect of the trust occurred on a day in the year, the amount, if any, by which

(A) the maximum amount that would be deductible under this subsection in computing the trust's income for the year if this subsection were read without reference to this subparagraph exceeds the total of

(B) the amount that, but for this subsection and subsections (12), 12(10.2) and

107(4), would be its income that became payable in the year to the taxpayer, spouse or common-law partner referred to in subparagraph (4)(a)(iii), clause (4)(a)(iv)(A), (B) or (C) or paragraph (4)(a.4), as the case may be, and

(C) the amount that would be the trust's income for the year if that income were computed without reference to this subsection and subsection (12) and as if the year began immediately after the end of the day, and

(iv) where the trust is a SIFT trust for the taxation year, the amount, if any, by which

(A) its adjusted distributions amount for the taxation year exceeds

(B) the amount, if any, by which

(I) the amount that would, if this Act were read without reference to this subsection, be its income for the taxation year

exceeds

(II) its non-portfolio earnings for the taxation year.⁹¹⁹

919 March 2001 FINANCE TECHNICAL NOTES: Paragraph 104(6)(b) is amended to extend the restrictions for a trust for the benefit of a spouse or common-law partner to other specified trusts. The trusts so specified are:

- trusts created after 1999 by a settlor (aged 65 years or more) for the exclusive benefit of the settlor during the settlor's lifetime (i.e., an "alter ego trust", as newly defined in subsection 248(1)) or for the joint benefit of the senior and the senior's spouse or common-law partner during their joint lifetimes (i.e., a "joint spousal or common-law partner trust", as newly defined in subsection 248(1)); and
- trusts to which paragraph 104(4)(a.4) applies (i.e., a trust to which property was transferred by a taxpayer who is an individual (other than a trust) in circumstances in which section 73 or subsection 107.4(3) applied, where the transfer does not result in a change in beneficial ownership of that property and no person (other than the taxpayer) or partnership has any absolute or contingent right as a beneficiary under the trust (determined with reference to subsection 104(1.1)).

The restrictions for alter ego trusts and trusts to which paragraph 104(4)(a.4) applies apply until the death of the settlor. The restrictions for joint spousal or common-law partner trusts apply until the later of the death of the senior and the death of the spouse or common-law partner. For further detail on new rules for these specified trusts, see the commentary on amended subsections 73(1) and 104(4).

Clauses 104(6)(b)(ii)(A) and (B) are amended to refer to a post-1971 spousal or common-law Partner trust, as a consequence of the new definition of this term contained in subsection 248(1). For further detail, see the commentary on amended subsection 248(1).

Subparagraph 104(6)(b)(iii) is amended to extend the restrictions for deductions under subsection 104(6) in the taxation year in which the relevant beneficiary dies. The intended effect of the new restrictions is that post-1971 spousal or common-law partner trusts, alter ego trusts, joint spousal or common-law partner trusts and trusts to which paragraph 104(4)(a.4) applies cannot deduct an amount under subsection 104(6) in respect of income accrued up to the end of the deemed disposition day caused by the death of the spouse, common-law partner or other relevant beneficiary.

These amendments also reflect changes effected by the Modernization of Benefits and Obligations Act.

Example

The spouse beneficiary of a post-1971 spousal or common-law partner trust dies in the 2001 taxation year of the trust. Before distribution to beneficiaries, the trust's total income for the year (determined without reference to any deemed disposition under subsection 104(4) and any deduction under subsection 104(6)) is \$100, of which \$20 is payable to the spouse prior to the spouse's death and of which the remaining \$80 is payable to the surviving beneficiaries. \$40 of the \$100 income accrued before the spouse's death.

Results:

1. Under subparagraph 104(6)(b)(i) the trust's income for the year that became payable in the year to beneficiaries is \$100.
2. The amount determined under subparagraph 104(6)(b)(iii) is \$20 (i.e., [$\$100 - (\$20 + \$60)$]).
3. The total amount deductible by the trust cannot exceed the amount by which the amount determined under subparagraph 104(6)(b)(i) exceeds the amount determined under subparagraph 104(6)(b)(iii).
4. Consequently, the trust's maximum deduction for the year is \$80 (i.e., $\$100 - \$20$). The trust is not allowed a deduction in respect of the \$20 portion of trust income accrued to the end of the deemed disposition day caused by the spouse's death but payable only after the death.

Dec. 1995 FINANCE TECHNICAL NOTES: Subsection 104(6) generally permits a trust to deduct any trust income payable in the year to a beneficiary under the trust. However, a post-1971 spousal trust described in paragraph 104(4)(a) is not allowed to deduct amounts payable in a taxation year to anyone except the beneficiary spouse, if the beneficiary spouse is alive throughout the year.

Subparagraph 104(6)(b)(iii) is introduced to provide that, where the beneficiary spouse under such a post-1971 spousal trust died on a day in the trust's taxation year, the trust is not allowed to deduct income for that year that is payable to a beneficiary (other than the deceased spouse) that relates to any disposition by the trust, before the end of that day, of capital property (other than excluded properties), land described in an inventory of the trust, Canadian resource property or foreign resource property. The purpose of this amendment is to ensure that the gains recognition for spousal trusts under subsections 104(4), (5) and (5.2) cannot be avoided by actual dispositions by the trust before the beneficiary spouse dies.

June 1992 FINANCE TECHNICAL NOTES: Paragraph 104(6)(b) provides that a trust may deduct, in computing its income, amounts that become payable or are paid out of trust income to or for the benefit of beneficiaries. However, the deduction does not allow a post-1971 spousal trust described in paragraph 104(4)(a) to reduce its income below the amount included in its income by reason of the deemed disposition of properties under subsections 104(4)(5) and (5.2)

Paragraph 104(6)(b) is amended to provide that no deduction may be claimed by a trust in respect of trust income derived from a payment out of a NISA Fund No. 2 (as defined in subsection 248(1)) unless the payment is made to a spousal trust described in paragraph 70(6.1)(b) and during the lifetime of the beneficiary spouse.

Paragraph 104(6)(b) is also amended so that the restriction with respect to post-1971 spousal trusts applies only in respect of a deemed disposition that occurs on the day the beneficiary spouse dies. This amendment recognizes that there is no reason that income distributions to non-spouse beneficiaries should not be deducted under subsection 104(6) once gains accruing up to the death of the beneficiary spouse have been realized for tax purposes. It applies to 1993 and subsequent taxation years.

Paragraph 104(6)(b) is also amended so that post-1971 spousal trusts are not allowed to deduct amounts payable in a taxation year ending after December 20, 1991 to anyone except the beneficiary spouse if the beneficiary spouse is still alive. The rule does not, however, apply to spousal trusts that have been varied on or before December 20, 1991 to allow for such distributions. This amendment is consistent with subsection 107(4) which provides for no rollover of trust property by a post-1971 spousal trust to a non-spouse beneficiary until after there has been a deemed disposition pursuant to paragraph 104(4)(a) at the time the spouse dies.

1988 FINANCE TECHNICAL NOTES: Subsection 104(6) provides that a trust may deduct, in computing its income, amounts that become payable or are paid out of the trust income to or for the benefit of beneficiaries. Under the existing rules, the maximum amount that may be deducted under subsection 104(6) is the trust income determined under Part I, before deducting distributions to beneficiaries and allocations to preferred beneficiaries. However, a deduction is not allowed to permit a spousal trust to reduce its income below the amount included in its income by reason of the deemed disposition of certain properties pursuant to subsections 104(4) and (5). This rule does not similarly restrict the deduction in respect of income arising on the deemed disposition of resource properties.

The amendment to paragraph 104(6)(b) corrects this deficiency in relation to resource properties by adding a reference to subsection 104(5.2). This reference is strictly consequential on the introduction of that provision in 1985.

In addition, paragraph 104(6)(b) is amended to permit the deduction, at the discretion of the trust, of an amount that is less than the amount of its income distributions. To the extent such distributions are not deducted by the trust, they will not be taxable in hands of the beneficiaries provided the requirements of new subsection 104(13.1) or (13.2) are met. This change will enable trusts to utilize in a particular year losses from prior years without affecting the ability of the trust to distribute its income currently. Also, testamentary trusts will also be able to choose to be taxed at the trust level rather than at the beneficiary level by using subsection 104(13.1). Distributions of income in excess of the amount deducted by the trust will, however, reduce the adjusted cost base of the beneficiary's capital interest in the trust unless the interest is in a personal trust (as newly defined in subsection 248(1)) and was acquired for no consideration. (See comments on the amendments to paragraph 53(2)(h).)

Nov. 1984 FINANCE TECHNICAL NOTES: Paragraph 104(6)(b) was amended by subclause 60(2) of Bill C-139 to limit the deduction of certain income paid to the beneficiaries of a spousal trust. The effective date of the amendment to this paragraph is changed to remove the limitation where the income is paid by a trust created before November 13, 1981 to a person referred to in any of subparagraphs 110(l)(a)(i) to (vii) or to Her Majesty in right of Canada or a province.

1984 FINANCE NOTICE OF WAYS AND MEANS MOTION: That the amendment to paragraph 104(6)(b) of the Act that came into force with respect to dispositions occurring after November 12, 1981 not apply in respect of a disposition to a specified tax exempt entity or Her Majesty after that date by a trust created before November 13, 1981.

1982 FINANCE TECHNICAL NOTES: Paragraph 104(6)(b) is amended so that a spousal trust cannot deduct taxable capital gains or other income payable to a beneficiary where the income arose as a consequence of a disposition of property under subsection 104(4) or (5). The amendment also denies a deduction, from the amount included in the income of a spousal trust, arising from the deemed disposition under subsection 107(4) on a distribution of trust property to a person other than the spouse. The amendments to paragraph 104(6)(b) thus require such income to be taxed as income of the spousal trust rather than as income of the beneficiaries.

The Trust's Subsection 104(6) Deduction.

Subsection 104(6) para. (b) provides the provision by which the trust may deduct the amount of income recognized by a beneficiary under Sec. 104(13) and 105(2). The provision effectively allows the trust to claim a deduction in computing its Division B income equal to **any** amount but not exceeding an amount equal to its income for the year computed as if there were no deductions taken under Sec. 104(6) or (12)⁹²⁰, or, where the trust was a spousal trust, its income not including that caused by the deemed dispositions under section 104, and upon distribution of capital under Sec. 107(4), but the deduction can only be up to an amount that became **payable in the year to a beneficiary** or that was included in computing the income of the beneficiary by virtue of Sec. 105(2)⁹²¹. First of all it should be recognized that the trust need not take a Sec. 104(6) deduction equal to the amount of income included in computing the beneficiary's Division B income however where it doesn't double taxation will result⁹²².

Where the trust is a spousal or common-law partner trust described under Sec. 104(4) the income from deemed dispositions required to be recognized by such trusts under Sec. 104(4), (5), (5.2) upon the death of the spouse, or upon a distribution of capital under Sec. 107(4), will not be included in the deductible amount under Sec. 104(6), and since such amounts represent "book" taxable income and cannot be paid or considered "payable" to the beneficiaries they will not be included in their income under Sec. 104(13), hence they will be taxed in the hands of the trust.

Subsection 104(13) recognizes that amounts which the income beneficiary can enforce a distribution of so as to only be paid to third parties shall not be includable in his income however if the beneficiary can enforce a distribution of income so as to have it **paid** in respect of the upkeep, maintenance, or tax expenses of a property to be maintained for his use as per the trust deed then under Sec. 105(2) he will have to recognize the inclusion and it should be noted that this is **the only case** where entitlements to have the income applied for one's benefit **indirectly** obtain equitable treatment. If the beneficiary has a right to have amounts of **income** paid to a university to extinguish his tuition fees eg., but not to him directly, once such **payments are made**, he will be required to include them in income under Sec. 105(1), **however** the trust will not obtain a deduction under Sec. 104(6) in respect of them since they were not "payable in the year to a beneficiary", nor were "included in computing the income of a beneficiary for the year **by reason of subsection 105(2)**". Double taxation will clearly result where a beneficiary has an income right enforceable in such a way as to cause income to be payable on his behalf and not to him directly **and income is paid**.⁹²³

Indirect Payment to Minors – CRA's Interpretation

The following is a Technical Opinion provided by CRA with respect to the indirect application of income for the benefit of a minor. It is interesting that CRA would provide so specific parameters for accepting indirect payments only for a minor: it begs the question on what conditions apply to adults.

"Technical News No. 11

September 30, 1997

Payments Made by a Trust for the Benefit of a Minor Beneficiary

920. the preferred beneficiary election trust deduction

921 property upkeep benefits

922 even when the income is negated with loss carry forwards

923 See *Sacks v. Gridiger*, 1991 22 N.S.W.L.R. 502, at 511, where it was held with respect to the Australian Income Tax Assessment Act and the jurisprudence relating to "presently entitled":

"It would be wrong to treat this formulation as excluding from the expression "presently entitled" a case where the relevant entitlement under the trust was to have a payment made not directly to the beneficiary but otherwise for his benefit."

The actual provisions of that Act in relation to the beneficiary's income recognition did not differentiate implicitly between the two. The ITA does however distinguish between the two forms of entitlement both, for example, in comparing the income attribution rules to the inclusion bases and the substance of Sec. 105(2) directly supports this. If all indirect applications are to be handled by Sec. 104(13) there would be no need for Sec. 105(2). It is this that "sinks the Bismarck".

See *East Finchley Pty. Ltd. v. F.C.T.*, 90 A.L.J.R. 457, *Faucilles Pty. Ltd. v. Commr. of Taxn.*, 1989 90 A.T.C. 4,003. Powers of appointment may be particularly useful, here and Sec. 107(2) or Sec. 53(2)-105(1) tax free capital distributions could be enjoyed. Title to the income need not vest though see Case W51, 89 A.T.C. 475, Case W48, 89 A.T.C. 460, for sham discretionary income distribution resolutions precluding streaming off of tax exemptions certain minimal amounts of income; nothing was paid nor was it intended to be paid. See also Case W51, 89 A.T.C. 479, for instance of documentary evidence supporting discretionary distribution deferred where proceeds held as "loan" washed out by a section 245-like provision though held to actually create legitimate arrangement.

The trustee of a discretionary trust may prefer not to make payments of the trust's income directly to a beneficiary who is a minor (a "child") for a variety of reasons and instead may wish to make the payments to:

- the child's parent or legal guardian (the "parent") to reimburse the parent for an expenditure made for the benefit of the child; or
- a person (a "third party") that provided or will provide goods or services for the benefit of the child.

In view of certain *obiter dictum* in *Langer Family Trust*, 92 DTC 1055, [1992] 1 CTC 2119 (TCC), concern has been expressed that such payments would not be considered an allocation of a trust's income to the child for the purposes of subsections 104(6), (13) and (24) of the *Income Tax Act* since those provisions refer to amounts that became payable by a trust "to a beneficiary."

With respect to indirect payments, where an amount of income is not paid directly to the individual so entitled, but is paid to another person for the benefit of the individual pursuant to the individual's direction or concurrence, that amount will be included in the individual's income. In the case of a child, the person with the legal authority to consent to and direct such payments on behalf of the child will usually be the legal guardian of the child's property. For the purposes of paragraphs (a) and (b) below, we have assumed that the person with such authority is the parent.

The trustee of a discretionary trust may decide to allocate trust income for the benefit of a beneficiary who is a minor by making a payment to a third party or to the parent as a reimbursement for an expenditure. Alternatively, the parent may seek the trustee's agreement to make such a payment and, at the same time, provide direction to pay the amount to the appropriate person (i.e., the third party or the parent). The Department will consider such a payment to be deductible from the trust's income as an amount paid to the child in the year (pursuant to subsection 104(6)) and included in the child's income in the year (pursuant to subsection 104(13)) where:

- (a) the trustee exercised his or her discretion pursuant to the terms of the trust indenture or will to make the amount of the trust's income payable to the child in the year before the payment was made;
- (b) the trustee initiated the steps to make the payment, the trustee notified the parent of the exercise of the discretion and the parent directed the trustee to pay the amount to the appropriate person before the payment was made; or the payment was made pursuant to the parent's request and direction, the parent was advised of the exercise of discretion and payment of the amount either before or after the payment was made; and
- (c) it is reasonable to consider that the payment was made in respect of an expenditure for the child's benefit; i.e., amounts paid for the support, maintenance, care, education, enjoyment and advancement of the child, including the child's necessities of life.

The above comments assume that the attribution rules do not apply. Where the actions taken by the trustee and parent described in (a) and (b) above are not evidenced in writing, the trustee and parent should be prepared to provide other satisfactory evidence that the requirements were met. Records kept by the trustee to support that a payment was made in respect of an expenditure for the child's benefit should include the receipt issued by the third party, or where the parent was reimbursed for the expenditure, the receipt obtained by the parent for that expenditure.

Where an expenditure (or a portion thereof) is not for the benefit of the child, the Department will not consider the payment (or a portion thereof) made by the trust as an amount paid to the child. Consequently, the amount will not be deductible from the trust's income and will not be included in the child's income. However, that amount will be included in the income of the person who received or enjoyed the benefit of the payment pursuant to subsection 105(1).

It is our opinion that a taxable benefit under subsection 105(1) will not arise to the parent as a consequence of the trust paying (in accordance with the terms of the trust indenture or will) the expenditures described in (c) above for the benefit of the child, including those that the parent would otherwise have been legally obligated to incur for the support, maintenance, etc., of the child pursuant to applicable provincial and/or federal statutes.

However, payments made by the trust meeting the requirements outlined above will be included in the child's income."

The Beneficiary Deduction of Trust Interest Cost.

Pursuant to Sec. 106(1) the income beneficiary may deduct against a **Sec. 104(13) inclusion only** the cost of his income interest and if a deduction of that cost is missed in a year it will *still* grind down the deductible cost.

It's to be noted that the deduction of income interest cost is not offered in respect of a preferred beneficiary election inclusion or a Sec. 105(2) "upkeep benefit" inclusion where a dwelling is to be maintained for the beneficiary out of trust income streams. This should prompt for a tailoring of streaming of the rights to trust income if alternative objectives are contemplated such as dealing in income interests for such severely limits the deductibility of costs when they are transferred while not preventing their inclusion when transferred.

"Income interest in trust - Sec. 106(1)"

(1) Where an amount in respect of a taxpayer's income interest in a trust has been included in computing the taxpayer's income for a taxation year by reason of subsection 106(2) or 104(13), except to the extent that an amount in respect of that income interest has been deducted in computing the taxpayer's taxable income pursuant to subsection 112(1) or 138(6), there may be deducted in computing the taxpayer's income for the year the lesser of

(a) the amount so included in computing the taxpayer's income for the year, and

(b) the amount, if any, by which the cost to the taxpayer of the income interest exceeds the total of all amounts in respect of the interest that were deductible under this subsection in computing the taxpayer's income for previous taxation years.

Deduction for Upkeep Benefits for Non-residents.

The subsection 104(6) deduction is available to trusts the income of which became payable to a beneficiary or which was included in computing the beneficiary's income under Sec. 105(2), however where the beneficiary is non-resident the deduction will be available only in respect of income that became **payable or was paid to him**, while it will not be available in respect of upkeep expenses incurred and extinguished out of income by virtue of the fact that Sec. 105(2) can not apply to cause an inclusion in the beneficiary's income under Sec. 115(1) nor will Sec. 212(1)(c)⁹²⁴ cause withholding to be applied on the amount since it refers only to Sec. 104(13) inclusions. Since the amount was not "included in computing the income of a beneficiary for the year by reason of subsection 105(2)" the trust will not obtain a deduction in respect of the upkeep expenses. It can be paid to a non-resident trust as a beneficiary the terms of which provide for the up-keep of the Canadian or foreign situated property however and be deducted.

Restrictions and Deductions re: Non-resident Beneficiaries.

Subsection 104(6) is a subdivision k deduction applicable in computing "income for the year" of the trust, as described in section 3, under Division B, while under Sec. 104(7) a deduction will not be available to a trust in respect of amounts of its income that became payable in the year to a "designated beneficiary", (as defined in section 210), unless the trust was resident **throughout** its tax year in Canada.

924 "Estate or trust income – Sec. 212(1)(c)"

(c) income of or from an estate or a trust to the extent that the amount

- (i) is included in computing the income of the non-resident person under subsection 104(13), except to the extent that the amount is deemed by subsection 104(21) to be a taxable capital gain of the non-resident person, or
- (ii) can reasonably be considered (having regard to all the circumstances including the terms and conditions of the estate or trust arrangement) to be a distribution of, or derived from, an amount received by the estate or trust as, on account of, in lieu of payment of or in satisfaction of, a dividend on a share of the capital stock of a corporation resident in Canada, other than a taxable dividend;

“Non-resident beneficiary – Sec. 104(7)”

(7) No deduction may be made under subsection 104(6) in computing the income for a taxation year of a trust in respect of such part of an amount that would otherwise be its income for the year as became payable in the year to a beneficiary who was, at any time in the year, a designated beneficiary of the trust (as that expression applies for the purposes of section 210.3) unless, throughout the year, the trust was resident in Canada.⁹²⁵

925

1988 FINANCE TECHNICAL NOTES: Subsection 104(7) currently denies the deduction under subsection 104(6) to a trust of income distributions to non-resident beneficiaries unless the trust is resident in Canada.

Under the proposed changes, subsection 104(7) will require that a trust be resident in Canada throughout the year in order to obtain subsection 104(6) deductions in respect of its income distributions to designated beneficiaries. As amended, subsection 104(7) will also apply to deny the deduction by a non-resident trust of income distributions, not only to non-residents, but also to other persons that were "designated beneficiaries" of the trust (within the meaning of the definition for the purposes of section 210.3).

104(7.01)

Sept. 10, 2010 FINANCE TECHNICAL NOTES (Part 1 - non-resident trusts): Subsection 104(6) generally permits a trust to deduct, in computing income for a taxation year, an amount not exceeding the portion of its income for the year that becomes payable in the year to a beneficiary under the trust. Because of subsection 104(24), trust income is deemed not to have become payable in the year to a beneficiary unless it is paid in the year to the beneficiary or the beneficiary was entitled in the year to enforce payment of the amount.

New subsection 104(7.01) restricts the amount that a trust, that is deemed by subsection 94(3) to be resident in Canada (referred to in this commentary as a "subsection 94(3) trust"), can deduct under subsection 104(6) in computing its income in the event that the trust has Canadian-source income and makes distributions to beneficiaries not resident in Canada.

In effect, subsection 104(7.01) acts as a proxy for taxes under Parts XII.2 and XIII of the Act in connection with Canadian-source income earned by a subsection 94(3) trust that has become payable by the trust to its non-resident beneficiaries.

New subsection 94(3) deems a trust to which it applies to be resident in Canada for certain purposes, not including Part XII.2. Accordingly, a trust that is resident in Canada solely because of the deeming provision in subsection 94(3) would generally be non-resident for purposes of Part XII.2. Because of an existing exemption for non-resident trusts in Part XII.2, the tax under that Part does not apply to such a trust. (A subsection 94(3) trust remains a non-resident also for purposes of determining whether any other trust is liable to tax under Part XII.2 in respect of distributions to the subsection 94(3) trust.)

A subsection 94(3) trust is also exempt from Part XIII withholding obligations on Canadian-source income earned by it that becomes payable by it in the year to non-resident persons.

However, to ensure that subsection 94(3) trusts are not inappropriately used to distribute Canadian-source income free of tax to non-resident beneficiaries, subsection 104(7.01) limits the amount of any trust deduction under subsection 104(6) for such distributions, thereby ensuring the income is subject to Part I tax in the trust.

It should also be noted that persons that pay or credit an amount to a subsection 94(3) trust are still subject to a withholding obligation under section 215 notwithstanding that the trust itself is exempt from Part XIII tax. This is because new paragraph 94(4)(c) provides that the deemed Canadian residence under subsection 94(3) does not apply for the purposes of determining withholding obligations under section 215. The CRA will hold the withholding taxes paid and, as required by paragraph 94(3)(g), apply them on account of the trust's Part I tax liability, but only to the extent the amount on which Part XIII tax is paid is an amount included in the trust's income. The existing provisions of the Act do not expressly give a Part XIII exemption in this regard to trusts that are subject to existing subsection 94(1).

Instead, existing subparagraph 94(1)(c)(ii) allows a tax credit to be claimed by those trusts under section 126 in connection with Part XIII tax on payments made to those trusts.

As mentioned above, subsection 104(7.01) reduces the maximum deduction under subsection 104(6). More specifically, the amount by which the maximum deduction under subsection 104(6) for a taxation year is reduced under subsection 104(7.01) is equal to the total of:

- the portion of the trust's "designated income" for the year (as defined in Part XH.2) that became payable in the year to a non-resident • beneficiary (including another subsection 94(3) trust) under the trust in respect of, an interest of the non-resident as a beneficiary under the trust, and
- all amounts each of which is the product obtained by multiplying a specified factor by each particular amount that is paid or credited in the year to the trust that would, disregarding express provisions to the contrary in the Act, be subject to Part XIII tax and that is payable in the year to a non-resident beneficiary (including another subsection 94(3) trust) under the trust in respect of an interest of the non-resident as a beneficiary under the trust.

The specified factor in respect of each particular amount described in the second paragraph above is 0.35, if the trust can establish to the satisfaction of the Minister of National Revenue that the non-resident beneficiary to whom the particular amount is payable is resident in a country with which Canada, has a tax treaty under which the income tax that Canada may impose on the beneficiary, in respect of the amount is limited. In any other case, the specified factor is 0.6.

This amendment applies to taxation years that end after 2006. It also applies to each earlier taxation year of a trust to which subsection 94(3) applies (because of a valid election by the trust under the coming-into-force provision for new

"Designated beneficiary" is a beneficiary which has certain non-resident or non-taxable characteristics as described in section 210, and in this regard it should be obvious that the purpose of Sec. 104(7) is to preclude the deduction by a non-resident trust of Canadian taxable income that was payable to a non-resident beneficiary, thus disallowing the trust from reducing its Division B taxable income or Division D taxable income earned in Canada and causing that amount deducted to be exposed, at most, to the 25% withholding rate applied under Sec. 212(1)(c). The Sec. 104(7) reference to designated beneficiary is "(as that expression applies for purposes of section 210.3)" while it doesn't provide that Sec. 210.3(2) shall have any effect on the status.

Subsection 210.3(2) provides that parties that are otherwise designated beneficiaries, but who are required to compute Canadian taxable income under Sec. 2(3) and who are not exempt from taxation under Part I by virtue of a tax treaty, will be deemed **not** to be designated beneficiaries however **only for purposes of Sec. 210.3(1)**, whereby Part XII.2 tax may be avoided by the trust on those grounds. Subsection 210.3(2) does not apply for purposes of Part I hence those parties just described may cause Sec. 104(7) to apply to income payable to them whereby the trust would not realize a Sec. 104(6) deduction and the designated beneficiary would be taxed on the Sec. 104(13) inclusion⁹²⁶. If the reference in Sec. 104(7) had read "as the expression applies for purposes of subsection 210.3(1)" then subsection 210.3(2), being a subsection in section 210.3, would have had the opportunity to adapt the definition. The way the provisions are structured presently would preclude the sheltering of Part I income through payment to those described tax entities.

If the trust became non-resident at any time within its tax year such income that became payable to a, (essentially), non-resident or non-taxable beneficiary would not be deductible and would thus be taxed in the trust's hands under Part I, regardless of the time at which the income became payable. If it became payable prior to the time at which the trust became non-resident the Sec. 104(6) deduction will not be available, even

section 94) and each taxation year of a beneficiary under the trust in which one of those earlier taxation years of the trust ends.

The example below illustrates the operation of new subsection 104(7.01).

Example

Trust X is an offshore trust established by Stefan, a long-term resident of Canada. The primary beneficiaries under the trust are Linda (a resident of Canada), Tim (a resident of non-Treatyland) and **Bart** (a resident of the United States).

Trust X receives \$1,600 of income in its 2007 taxation year. This income consists of \$400 of taxable dividends received from a taxable Canadian corporation. The remaining \$1,200 of income is from other sources, none of which is "designated income" (as defined in Part XII.2) of the trust.

\$1,050 of Trust X's income for 2007 is made payable in the year to Bart. Of this amount, \$100 represents the taxable dividends. Trust X makes payable \$200 of its income to Tim. Of this amount, \$200 represents the taxable dividends. The remaining \$350 of the trust's income is made payable in the year to Linda. Of this amount, \$100 represents the taxable dividends.

Trust X is assumed to have designated the \$400 of taxable dividends under subsection 104(19). (Where a designation under subsection 104(19) is available and the designation is made, the designated portion of the dividend income of the trust will, for the purposes of the Act (other than Part XIII), maintain its character, as dividend income, in the hands of the beneficiary.)

Results

1. Because Trust X has a resident contributor at the end of its 2007 taxation year, the trust is deemed by new subsection 94(3) to be resident in Canada for the purposes of computing its income.
2. Before taking into account any deduction under subsection 104(6), Trust X's income is \$1,600. Note that the \$400 in dividends is included in computing the trust's income.
3. Before taking into account new subsection 104(7.01), the maximum deduction under subsection 104(6) is also \$1,600.
4. Because of subsection 104(7.01), the maximum deduction under subsection 104(6) is reduced to \$1,445 (i.e., \$1,600 minus the total nil + ((.60 x \$200) and (0.35 x \$100))).
5. Assuming that the trust claims a deduction of \$1,445 under subsection 104(6), the trust would consequently have income of \$155. If a tax rate of 42.92% were assumed (i.e., combined federal rates of 29% (because of subsections 122(1) and 117(2)) and 13.92% (because of subsection 120(1))), the trust would be liable for Canadian-income tax of approximately \$67. Note that the trust is exempt from having to collect a Part XIII tax in respect of the amounts made payable to Bart and Tim that are referred to in paragraph 104(7.01)(b) in respect of the trust for 'the' particular taxation year, because these are exempt amounts for the purposes of subparagraph 94(3)(a)(ix). In the absence of this exemption, the Part XIII tax that would have had to have been collected by the trust in respect of the amounts made payable to Bart and Tim would have been \$65 (i.e., 25% of \$200 and 15% of \$100), which is approximately equal to the tax that the trust must pay, as a result of the application of subsection 104(7.01).

926. unless the Sec. 104(13.1)-(13.2) mechanics are relied upon

though the amount will be subject to withholding as per Sec. 212(1)(c) and 214(3)(f)⁹²⁷, a very harsh result.

If the trust was not non-resident **throughout** its tax year⁹²⁸ then the amount of income that did become payable to a designated beneficiary or for his benefit under Sec. 104(13) or 105(2) may cause the trust to incur Part XII.2 tax as applied under Sec. 210.2(1). If the trust **was resident** at the time that a portion of its Division B income became payable to a non-resident beneficiary then Part XIII, under Sec. 212(1)(c), will cause withholding tax to be applied on that amount equal to 25%, (but not where it is the subject of a Sec. 104(21) designation causing it to have the character of a taxable capital gain which only occurs in the case of mutual fund trusts).

Obviously, it is quite technically possible to have the income amount payable to a designated beneficiary by a trust that became non-resident within its tax year being exposed to Part I tax in the trust's hands by virtue of the restrictions in Sec. 104(7) preventing the Sec. 104(6) deduction, and being subject to withholding tax under Sec. 212(1)(c), while **also** causing the trust to pay Part XII.2 tax on one of the tax bases described in Sec. 210.2(1))⁹²⁹. Obviously care should be taken in planning a time for a change in residency of a trust with the time at which income amounts actually became payable and paid to non-resident or designated beneficiaries being an intricate consideration.

Subsection 104(6) is a subdivision K deduction applicable in computing "income for the year" as described in section 3, under Division B, while if the trust becomes non-resident in the year its income is apportioned under section 114 only if it doesn't continue to carry on a business in Canada. Where section 114 is applicable the trust's Division B income for the periods in which it was resident in Canada will be computed as if those periods were the **whole taxation year** thus the trust will obtain a Sec. 104(6) deduction in respect of income amounts that became payable before it became non-resident, or in respect of amounts expended on upkeep that were included in the beneficiary's income under Sec. 105(2). This applies only where if during the time the trust wasn't resident in Canada it also did not carry on a business in Canada, which is the requirement for the application of section 114. It also doesn't apply to income payments to designated beneficiaries whereby Sec. 104(6) will not be available, due to Sec. 104(7), in respect of payments made prior to the cessation of residency since Sec. 104(7) overrides the prorating feature of section 114 restricting all part year payments. Although the trust's tax year doesn't end on becoming non-resident it will cause the recognition basis for the beneficiary to change, accelerating the recognition of amounts payable to the beneficiary's year in which they became payable from the beneficiary's tax year in which the trust's tax year ends (as per Sec. 104(13)(c)-(a)). Where the trust is non-resident throughout its tax year, with respect to the beneficiary income recognition the same will result however the trust will be able to claim a Sec. 104(6) deduction against its taxable income earned in Canada, if it has any, though under Sec. 115(1) by virtue of paragraph (d), (e), & (f) therein, and by virtue of the fact that subdivision K, Division B, it would appear otherwise. This is the informal opinion of the Department when the beneficiary is a Canadian resident recognizing Part I income. This won't preclude the trust from possibly obtaining a deduction under the applicable Act of the foreign jurisdiction.

Possible Double Inclusions.

The courts have had to wrangle with the interaction of the substance of the Sec. 104(6), (13), (18), & (24) mechanism, in its various forms, in the past and it was in *Grant C. Brown v. The Queen*⁹³⁰ that it was held effectively that if a trustee, in filing the T.3 of the trust for the period, does not take the Sec. 104(6) deduction in respect of Sec. 104(13) income recognized by the beneficiary, then double taxation would result in that both trust and beneficiary would be taxed on the same income. Cattanach, J. of the Federal Court-Trial Division held incidentally:

"...if the estate does not see fit to avail itself of the alleviation provided by subsection 104(6) by claiming the deduction then the estate is liable for the tax and the beneficiary also remains liable therefor.

⁹²⁷ or be included in computing the beneficiary's Part I income

⁹²⁸ nor was a testamentary trust **throughout** its tax year

⁹²⁹ depending on whether the designated beneficiary is in fact non-resident, as per the criteria described in section 210, and whether the trust had "designated income" in the year, a requirement under Sec. 210.2(1)

⁹³⁰. [1979] C.T.C. 476

It may be that the remedy of a beneficiary should the trustees of an estate not claim the deduction under subsection 104(6), would be by action against the trustees sounded in negligence."

In that case the Minister reassessed the estate, deducting from its income that was assessed to a beneficiary through Sec. 104(13), although clearly he is not compelled to do so.

When an Amount becomes Payable.

A very basic question concerning the recognition of an "amount payable" as income to a beneficiary was brought up in *Ansell Estate v. M.N.R.*⁹³¹ wherein a taxpayer had a vested contingent, albeit, future right to income being accumulated in the trust for it (but which was not payable or paid to it in the tax year) and the trust attempted to transfer the tax liability for it to the taxpayer contending that the income should be recognized by the beneficiary under the equivalent of present Sec. 104(13)(a), whereby the trust would obtain the deduction under the Income War Tax Act equivalent to Sec. 104(6). The issue of the case rested on whether or not the amount of income accumulated could be recognized as an "amount payable" to the beneficiary and it's important to note that the trust deed provided that the income earned was to be accumulated and subsequently paid to the taxpayer but in the interim the taxpayer could not enforce a distribution, while it could lose its right to the amounts, upon the occurrence of a contingency. Subsection 63(7)⁹³² was examined in detail and Thurlow, J. of the Exchequer Court of Canada provided:

"The argument was that having a vested interest in the amounts the charities were the legal owners of the money and that at any time in the year they were entitled to enforce the due performance of the trust and for that purpose, if necessary, to restrain the trustee from paying the money to anyone in breach of the trust and that such a right was sufficient to bring the positions of the Charities vis-a-vis the amounts in question within the meaning of "entitled in the year to enforce payment thereof" in section 63(7). **The precise point was put very neatly by counsel when in reply he said that there is a difference between being "entitled in a year to enforce payment thereof" and being entitled to enforce payment thereof "within that year" and that if the words "in that year" came at the end of Section 63(7) he would agree that the words would not fit the present situation.**

In my view whatever the rights of the charities were with respect to enforcing the due performance of the trust **they did not include a right in the year of the kind required.** No doubt a right to prevent payment to anyone else may be indirectly a way of enforcing payment ultimately to the charities but such a meaning seems out of context in a section which refers first to actual payment in the year and then a right in the year to enforce payment. **In any event, however, Section 63(7) as I read it is merely restrictive and the expression "entitled in the year to enforce payment" in that subsection does not amplify the ordinary meaning of "payable in the year" in Section 63(4).**" ((Section 63(4) is the equivalent of Sec. 104(6)(b).) "It follows that the submission cannot prevail."

Following the valid commentary of Thurlow, J. will result in taxpayers not being able to recognize income which is accumulated for them if it isn't paid to them while as per Sec. 104(6) the trust will not obtain a deduction unless it is. Since the income is to be accumulated in the trust, out of their reach in the interim period until their rights become enforceable this would seem to be a correct result since if it wasn't, and the beneficiaries had to recognize the accumulating amount as payable to them, tax burdens could be sustained well in advance of the realization of the substance of the taxed benefit. Alternately, the rights of the charities were to receive the accumulated income as capital, not as income. The important note to make about *Ansell*, which is still tremendously relevant when one examines the present Sec. 104(24)-(13) mechanism, is that while the definition of "amount payable" vaguely recognizes amounts to which the beneficiary was "entitled in the year to enforce payment", the Sec. 104(6) deduction recognizes only those amounts that "...became payable **in the year** to a beneficiary or was included in computing the income of a beneficiary for the year by reason of subsection 105(2)". The term "became" payable in the year was inserted in replacement of "was" payable which the provision read prior to the 1988 reform. Consequently there can be little doubt that an income amount must be subject to a right to enforce a distribution in the year, in order to be recognized as an amount payable

931. 66 D.T.C. 5508

932 essentially equivalent to the present Sec. 104(24) definition

in the year.

In *F.C.T. v. Whiting & Ors.*⁹³³ the High Court of Australia had to ascertain whether a beneficiary, (under an unadministered estate), was entitled to the income from the estate so as to be assessed pursuant to a mechanism substantially similar to Sec. 104(24). Latham C.J. and William J. held:

" The words '**presently entitled**' .. refer to a right to income 'presently' existing – i.e., a right of such a kind that a beneficiary may demand payment of the income from the trustee... A beneficiary who has a vested right to income...is entitled to income, but cannot be said to be 'presently entitled' as distinct from merely 'entitled'... Thus in order to ascertain whether such a present right exists, it is necessary to look at the state of the administration of the trust estate."⁹³⁴

In *D.J. Caldwell Trust v. M.N.R.*⁹³⁵ the Tax Court demolished a financing scheme that allowed trust-owned corporations to maintain their working capital while declaring dividends payable to the trust, purported to be recognized as payable to minor beneficiaries within the Sec. 104(24) definition thus causing them to be taxed in the kids' low marginal rates while in fact the funds were never paid to the trust but instead were credited to the corporation's loan accounts as being advances from the kids. It was held that the mere declaration by the corporation and the bookkeeping entries by the trust recognizing the artificial receipt and loan to the corporation did not make the amounts have the character of being received for purposes of the Sec. 104(13)-(6) mechanics and the trust was allowed the Sec. 104(6) deduction only up to the amount of income that was actually paid to the beneficiaries.⁹³⁶

There is a fundamental flaw with the definition of "Amount Payable": it cannot apply to notional income, it can only apply to income in-hand that a court action would compel payment of as got-in and in *in-specie* form. And this causes serious problems in using trusts as intermediaries in a stream of recognition such as from partnership to beneficiary. What happens when, pursuant to the partnership agreement, the trust partner is prevented from withdrawing income but must make up short in the capital account: the trust still recognizes the income, but has nothing to actually pay out. Is there a legislative reason for this or do we simply not want the use of trusts to pervade more into commercial settings in an *inter vivos* or testamentary environment? This causes that notional income to be taxed in the hands of an *inter vivos* trust subjecting it to the highest tax rate and some could argue prevents the more pervasive use of *inter vivos* trusts in Canada.⁹³⁷

933 68 C.L.R. 199

934 See *I.R.C. v. Hamilton-Russell Executors*, 1943 1 All. E.R. 474, *Dreyfus v. I.R.C.*, 1963 41 T.C. 441, *Dewar v. I.R.C.*, 1935 1 All. E.R. 568, *Max Margles v. M.N.R.*, 85 D.T.C. 703, *M. Johnson v. M.N.R.*, 58 D.T.C. 592, *Wood v. M.N.R.*, 1964 TABC 37, at 47 & *Hobbs v. Commr.*, 98 C.L.R. 151 (HCA), Re: *J. Bibby & Sons Ltd. Pensions Trust Deed*, 1952 2 All E.R. 483, *Sacks v. Gridiger*, 90 A.T.C. 4299, *Harmer v. F.C.T.*, 90 A.T.R. 4672, *Nelson v. Adamson*, 24 T.C. 36, *C.I.R. v. Sir Kenneth Berrill & Gumb*, 55 T.C. 429 (powers to accumulate), *Taylor & Anor. v. F.C.T.*, 70 A.T.C. 4026, Case R105, 84 A.T.C. 692, Case T21, 86 A.T.C. 214, and latterly, Case R71, 84 A.T.C. 498, for contingently arising entitlements on lack of current distributions. See also the Aust. cases of AX01C and AX01D and Commissioner of Taxation [2001] AATA 996; (2001) 48 ATR 1200; 2001 ATC 150 (5 December 2001), *Zeta Force Pty Ltd v Federal Commissioner of Taxation* 98 ATC 4681, *Doherty v Federal Commissioner of Taxation* [1933] HCA 10; (1993) 48 CLR 1, Case Z35 92 ATC 326 and Case 6 2000 ATC 168 and *Ian Richardson v Commissioner of Taxation* [1997] FCA 1273 (25 November 1997).

935 1990 1 C.T.C. 2310 TCC

936 See also VT 94/24-39, 1996 96 A.T.C. 296 (Cth AAT), and VT 94/222-227, 1996 96 A.T.C. 443, where an Australian trustee attempted to place the tax liability of income realized in his hands in the hands of his beneficiaries but was disallowed given that he did not give them any present entitlement to the income, did not make them aware of the act, and had the attempt considered as a sham.

937 See the recent case of *Commissioner of Taxation v Bamford*; *Bamford v Commissioner of Taxation* [2010] HCA 10 (30 March 2010) for additional issues. See the recent cases of AX01C and AX01D and Commissioner of Taxation [2001] AATA 996; (2001) 48 ATR 1200; 2001 ATC 150 (5 December 2001), *Antonopoulos and Commissioner of Taxation* [2011] AATA 431 (22 June 2011), *Colonial First State Investments Limited v Commissioner of Taxation* [2011] FCA 16 (18 January 2011), *Di Lorenzo Ceramics Pty Ltd v Commissioner of Taxation* [2007] FCA 1006 (5 July 2007), *Howard v Commissioner of Taxation* (No 2) [2011] FCA 1421 (14 December 2011) – discretionary beneficiaries, *Sayer and Secretary, Department of Family and Community Services* [2003] AATA 891 (20 August 2003), and for sham assertions of income payable see also VT94/276-304 and Commissioner of Taxation [1996] AATA 270; 33 ATR 1140; 96 ATC (2 August 1996), *Raftland Pty Ltd as trustee of the Raftland Trust v Commissioner of Taxation* [2008] HCA 21 (22 May 2008).

"Amount payable – Sec. 104(24)"

(24) For the purposes of subsections (6), (7), (13), (16) and (20) and subparagraph 53(2)(h)(i.1), an amount is deemed not to have become payable to a beneficiary in a taxation year unless it was paid in the year to the beneficiary or the beneficiary was entitled in the year to enforce payment of it.⁹³⁸

"Retroactive" Income Entitlements.

In *Tindal v. F.C.T.*⁹³⁹ a decretal order had been made to provide a life tenant with £1844 per annum since the death of her spouse to be satisfied out of income though capital as well if income wasn't sufficient in any particular year. Due to the length of the proceedings a £27,189 liability was immediately created but was satisfied partially in payments prior to the relevant tax year. In the year £2858 was paid though the life tenant was entitled only to £1844 plus arrears per year and the Commissioners attempted to assess her on the full amount even though she contended that £1014 was received as capital. Latham C.J. eventually agreed that she was assessable on the full amount all the way back to the date of death even though it wasn't paid to her in those periods. He agreed that it was a payment of capital on other grounds. The rest of the High Court of Australia disagreed with him and provided that, essentially, although the decretal order did confer a right on the life tenant for the amount in the previous years she was to be liable only to the amount that was actually payable out of income in respect of it, and that the notional annual amount could not be includable in a previous year's income since it wasn't realizable then. Following the reasoning in *Brodie v. I.R.C.*⁹⁴⁰ the capital paid in respect of the income interest was fully includable in income anyhow. In the Canadian context the life tenant would have both rights to income and capital to the extent that income wasn't sufficient to cover the annual amounts while since resorting to capital may have been needed Sec. 105(1) would not apply since such sums are paid in respect of a capital interest. Pursuant to the reasoning, even though the decretal order was *nunc pro tunc* (to operate retroactively to the date of death), since the right was not realizable **within** those previous periods latent liabilities could not be assessed.⁹⁴¹

938 Sept. 101:2010 FINANCE TECHNICAL NOTES (Part 1 - non-resident trusts): The determination of when an amount becomes payable in a taxation year to a beneficiary under a trust is relevant for a number of purposes, including the determination of the amount deductible under subsection 104(6). Under subsection 104(24), an amount is deemed not to have become payable in the year to a beneficiary unless it was paid in the year to the beneficiary or the beneficiary was entitled in the year to enforce payment of the amount.

Subsection 104(24) is amended so that it also applies for the purposes of subsection 94(8) and subsection 104(7.01). For more information, see the commentary on those provisions.

This amendment applies to taxation years that end after 2006. It also applies to each earlier taxation year of a trust to which subsection 94(3) applies (because of a valid election by the trust under the coming-into-force provision for new section 94) and each taxation year of a beneficiary under the trust in which one of those earlier taxation years of the trust ends.

June 2007 FINANCE TECHNICAL NOTES (SIFTS): Subsection 104(24) is relevant in determining when an amount has become payable to a beneficiary under a trust, for the purposes of certain provisions of the Act. New subsection 104(16) is added to the list of those provisions. This amendment is deemed to have come into force on October 31, 2006. As a practical matter, the amendment will have effect no earlier than the 2007 taxation year, since the new defined terms "SIFT partnership" and "SIFT trust" apply, at the earliest, to taxation years that end after 2006. For information, refer to the commentary to the definition "SIFT trust" in subsection 122.1(1) and the application rule in subsection 122.1.

1988 FINANCE TECHNICAL NOTES: The definition of "amount payable" in subsection 104(24) is relevant for the purpose of determining amounts that are deductible by a trust and included in the income of beneficiaries: This subsection is amended to make the definition applicable also for the purposes of new rules in subparagraph 53(2)(h)(i.1) relating to the computation of the adjusted cost base of a capital interest in a trust. In addition, the references to subsections 104(8), (25) and 212(11.1) are deleted as a consequence of the repeal of those subsections.

939. 72 C.L.R. 608

940 17 T.C. 432

941 See also Finlay and Gresson J. comments in *Commr. of Taxn. v. Luttrell*, 1949 N.Z.L.R. 828 (CA): the beneficiary did not have a right capable of enforcement in the assessment period. This principle has been recognized in other instances. In *Morley-Clarke v. Jones*, 1985 3 All E.R. 193, the Court of Appeal held with respect to the retroactivity of a maintenance order:

"The argument on behalf of the Crown is a very simple one. Liability to income tax, except in the case of profits of trade, depends not on receivability but on payment in a relevant year of assessment. This, in the absence of statutory provision to the contrary, tax payable on that which is received as income in the year in which it is actually received, even though the obligation to make the payment arose and could have been enforced in some previous year. A retrospective order may, when it is made, create a present obligation to make a payment in respect of a past period, but when that obligation is discharged by payment the payment is received, both for fiscal purposes and in actuality, when it is received and it is taxable accordingly as part of the income for the year of receipt.

Lawyers' Trust Accounts During Litigation.

Tindal, an instance where the Court created a retroactive right to income, is to be compared with Harmer and Ors. v. F.C.T.⁹⁴² where solicitors were to hold funds in trust pending the determination of proceedings between two arguing parties. Interest was earned on the sums and the authorities attempted to assess it in the trustees hands though the trustees contended that the contingent beneficiaries were 'presently entitled' to it. The Court held:

"The enjoyment of a right to demand and receive payment may be deferred by a dispute or uncertainty as to its existence. If by a judicial resolution that right is found to have existed that is a determination of what was the **true position** at the time of the dispute or uncertainty. In the present case it is clear that certain of the parties to the interpleader proceedings were at all material times in the years of income entitled to immediate payment of parts of the capital of the fund and interest earned by it in the redeemable investment account. The fact that that entitlement was not ascertained until the determination of the proceedings in 1985 does not alter its character. The trust fund, to use the language of Lord Halsbury, 'was constituted'. It was to determine the entitlements to that fund that the action was begun. The order made by the court in 1982 does not alter them. In my opinion the beneficiaries of the trust were at all material times presently entitled to its income..."

This opinion was overturned on appeal⁹⁴³ where Wilcox and Lee J.J. held:

" It was argued that a trust was created in favour of persons whose identity was yet to be determined but would be determined by reference to existing extrinsic facts; accordingly, it was said, the eventual identification of those persons would merely confirm that a vested present interest was held by those persons throughout, no new interest would be created at the time, and by the process of identification.

However, the terms of the trust were not so defined. The moneys were paid into court after Riverhall sought a declaration as to whom it could pay moneys so as to receive a discharge from its indebtedness. The eventual answer to that question was In Residence and Amberwood. But the issues for hearing were much wider, involving the claim "in personam" by Sweeney against In Residence and possible orders for the payment, out of the fund, of costs. **It was left to the court to determine how the trust fund and its income might be applied to accommodate any orders the court might make. None of the parties had a right to any part of the income of the trust fund. The further court orders established those rights.** The creation of the trust established the litigants as a class of persons from which the eventual beneficiaries would emerge upon determination of the pending litigation. Members of that class had an interest in due administration of the trust and preservation of the trust fund. **However, in no sense could it be said that any one of the litigants in any of the years of income had a present right to demand and receive payment of the whole, or part, of the income of the trust estate received by the trustee in that year. This was not a case of the postponement of the enjoyment of the benefit of a right to income but rather the postponement of the vesting of a right to the income of that trust fund.** The parties may have compromised their claims at any time and approached the court to obtain an order distributing to them the trust fund and its income pursuant to the terms of the compromise, but as far as the terms of the trust were concerned, the vesting of the rights to the corpus and income of the trust fund

Equally, even in cases where statute provides, as it does in the case of some maintenance payments, that a payment shall be treated for tax purposes as if it had been received in the year in which it fell due, rather than the year in which it was received, a payment made under an order with retrospective effect does not and cannot fall due at any earlier date than the date when the order is made and the obligation attaches to the payer. A retrospective order cannot, any more than a retrospective agreement, undo the past and convert something that has already happened, and to which legal consequences have been attached, into something else which never in fact did happen. Thus, even though the 1980 order created, when it was made and by way of variation of a previous obligation to pay sums to the taxpayer, a new obligation on the husband to pay to his child sums at a given rate from a date in 1969, it did not and could not alter the fact that the taxpayer had actually received sums which, when received, were undoubtedly her income and on which she was taxable."

In that case the order was made to award the offspring an annuity rather than the spouse who was originally the recipient and when the retroactive order was made to delete the spouse's rights and replace them with the offspring's the spouse was not successful in arguing that the prior year's recognitions should be reduced to nil.

942. 89 A.T.C. 5180

943 94 A.L.R. 541

would occur upon the making of that order of the court. That approach to the court would not be an exercise of any right arising out of an absolute entitlement created by the trust." ⁹⁴⁴

Question 21 of the 1990 Roundtable Discussions concerned this issue and the Department held that where money is kept by the law firm and invested the income would be recognizable by the beneficiary under Sec. 75(2), if he was resident, whereby no trust return would be required.⁹⁴⁵ If the beneficiary isn't resident in Canada Regulation 201(2) would apply requiring the law firm to issue a T5 slip to the beneficiary in respect of the investment income, though administratively the Department will waive this requirement if the appropriate Part XIII tax is withheld and remitted pursuant to Sec. 215(1)-(5). Where the eligibility to funds deposited with the law firm to be disbursed to a claimant in settlement of court action is not established the Department will consider the income accrued/realized to be that of the trust though recognizes that the beneficial owner is the eventual recipient of the funds. Consequentially the assessment in respect of that investment income earned during the litigation will be deferred until the beneficial owner thereof has been ascertained through court order/settlement. The income will be assessed in the beneficiary's hands once his entitlement is established though an appropriate question would obviously be in which years the beneficiary will be assessed in respect of, (retroactive) and whether interest/penalties will be levied. Penalties would appear to be out of the question though interest may be applied. In fact the latent assessment practice advocated would seem to be insupportable in the face of the above jurisprudence.

Trustee Confusion as to Receipt Character.

In *Public Trustee and Anor. v. I.R.C.*⁹⁴⁶ trust land was expropriated by the Government of New Zealand subsequent to which compensation was paid however the trustee had some doubt as to who was to receive the interest component of the compensation; the life tenant or the remainderman, and did not distribute it until a later tax year, following the obtaining of the court's opinion, to the life tenant. The tax authorities were successful in assessing the life tenant in respect of the sum subsequently determined to be payable to her in the year in which the trustee received it with the Supreme Court holding that notwithstanding any doubt of the trustee nor the fact that the confirmation from the courts of equity was received in the following period the life tenant still had rights to demand payment thereof of in the particular period.⁹⁴⁷

Ignorance of the Beneficiary of his Rights.

*F.C.T. v. Vegners*⁹⁴⁸ provides effectively that ignorance is no defence against assessment in that in that case an income beneficiary was required to recognize trust income paid to her pursuant to the exercise of a distributive discretionary power. She had not been informed of the exercise and did not actually understand its effect, nor, more importantly in the author's opinion, did she refuse to accept the payments in the three relevant tax years.

In *NT87/1442* and *Ors v. Commissioner of Taxation*⁹⁴⁹, when a taxpayer filed returns which did not state income to which he was entitled since he didn't even know that the trust existed, the Australian Administrative Appeals Tribunal held accurately:

⁹⁴⁴ See also the recent case of *Barnetts (a Firm) v Revenue & Customs* [2010] UKFTT 286 (TC) (22 June 2010) for an instance on the inclusion when the lawyers trust account interest was to be paid to the lawyer.

⁹⁴⁵ Obviously the Department wasn't of the opinion that subsection 75(2) causes double taxation in this instance though its terms allow for such.

⁹⁴⁶ 1960 N.Z.L.R. 365

⁹⁴⁷ The fact that a trading trust doesn't ascertain income until after the end of its tax year does not negate a right to call for its payment within the year as per *Case T21*, 86 A.T.C. 214. See also *Case R105*, 84 A.T.C. 693. In *T.I. B-6366* rendered May 1986 by the Deferred Income Plan and Trusts Section to the Saint John District Office Field Audit Division it was held correctly with respect to the assessment of income in a trust-beneficiaries hands:

"Furthermore, even if he (the trustee) has such a doubt about the nature of any trust amount for the purpose of trust law, such a doubt and his determination thereof do not, in our view, alter the **correct legal nature** of the amount under the law of the Income Tax Act for income tax purposes. The **correct legal nature** of the amount for income tax purposes under the law of the Income Tax Act does not, in our view, depend on his doubt or his determination thereof, but is ultimately determined in income tax law through assessment and appeal through the Courts. His view does not bind the Minister."

⁹⁴⁸ 89 A.T.C. 5274

⁹⁴⁹ [1988] AATA 14; (1988) 19 ATR 3173; 88 ATC 224 (15 January 1988)

23. That John was one of those persons who might benefit under the trust was entirely due to actions on the part of others as to which he was in a state of total ignorance. Following upon the declaration of trust, Fiduciary immediately assumed the responsibilities of a trustee to John. Those responsibilities it could not shed. Those responsibilities were no less because John had no knowledge of them. Upon the determination to distribute income to John, John became entitled to the benefits of the distribution but only if he chose to accept them. No such choice could be made until such time as he learned of the existence of the trust and the passing of the resolution. That knowledge did not come to him until the assessment came to his notice and his enquiries led to discovery of his entitlement. In my view the amounts in question did not become his "income" until he assented to the status of being a beneficiary and to accept the distributions. Prior to that date it could not be said that he "omitted" any income from his returns.

...

25. If anyone ought be answerable for any loss there may have been to the revenue, it ought be the trustee which failed through its officers to make the beneficiaries aware of their status and entitlements and thereby make them aware of their fiscal responsibilities.

26. In my view, in such circumstances, it cannot be reasonably said that John is a person who has omitted from his return any assessable income. Accordingly, in my view, the impositions of additional tax against John are to be set aside.

27. As to Bernard, it was agreed that, although he gave no evidence, the determination in relation to Bernard's applications should be such determination as would be proper upon the application of the same principles as are to be applied in the case of John. Accordingly, the order will be that the impositions of additional tax against Bernard as an individual be also set aside.

Income Tax Interpretation Bulletin

Trusts - Income Payable to Beneficiaries

IT-342R

DATE: March 21, 1990

SUBJECT: INCOME TAX ACT

Trusts - Income Payable to Beneficiaries

REFERENCE: Paragraphs 104(13)(a) and (c) (also subsections 94(3) and (4), 104(6), (13.1), (13.2), (18), (21), (24), (29) and (31), 105(2), 210.2(3) and 248(1) definition of "personal trust" and paragraphs 53(2)(h) and 212(1)(c))

APPLICATION

This bulletin cancels and replaces Interpretation Bulletin IT-342 dated September 7, 1976. The comments in this bulletin do not apply to a trust governed by an employee benefit plan and an employee trust which are discussed in the current version of IT-502.

SUMMARY

In computing the income of a beneficiary under a trust, any trust income for a particular year (as calculated on Form T3 - Trust Income Tax and Information Return) that became payable in the year to the beneficiary is included. This bulletin deals with amounts so included and the meaning of the term "payable". It discusses instances where amounts are deemed to be payable to a beneficiary and certain options that are available to the trust to designate amounts that are payable as not being payable, as well as certain deductions from income that can be flowed out from the trust to the beneficiary.

DISCUSSION AND INTERPRETATION

1. Pursuant to paragraphs 104(13)(a) and (c), an amount payable to a beneficiary out of the income of a trust (see Designations/Allocations to Beneficiaries in the Guide to the T3 Trust Return) for the year is required to be included in computing the income of the beneficiary for the year, whether or not paid to that person in the year, and shall not be included in computing the income of the beneficiary for a subsequent year in which it is paid. In addition, under subsection 105(2) a reasonable portion of amounts paid out of

the income of a trust for the upkeep of property maintained under the terms of the trust arrangement for the use of a life tenant or other beneficiary (page 2 of Form T3) is required to be included in the income of the life tenant or other beneficiary for the taxation year for which the amounts were paid. For taxation years of trusts beginning after 1987 certain designated amounts paid or payable to a beneficiary may be excluded in computing the income of the beneficiary (see 4 below).

MEANING OF "AMOUNT PAYABLE"

2. Pursuant to subsection 104(24), an amount is not considered to be payable in a taxation year unless it is paid in the year to the person to whom it is payable or the person to whom it is payable is entitled in the year to enforce payment thereof. However, subsection 104(18) provides that where a right to the income of a trust has vested in a minor, income of the trust which has not become payable in the year to such beneficiary, solely because the beneficiary was a minor, shall be deemed to have become payable in the year. It should be noted that foreign accrual property income of a non-resident trust is included in the income of a beneficiary pursuant to paragraph 104(13)(c) to the extent that the amount may reasonably be considered to have become payable to a beneficiary within the meaning of subsection 104(24). That amount is deductible by the non-resident trust by virtue of subsections 94(3) and (4).

FLOW-THROUGH OF DEDUCTIONS

3. For taxation years of trusts beginning before 1988, deductions for capital cost allowance and terminal losses, in respect of depreciable property owned by a trust, may be claimed in determining the taxable income of the trust. Alternatively, trustees may designate that a specified amount of capital cost allowance and terminal losses be flowed-out and deducted by beneficiaries in determining their income. Also, for taxation years of trusts beginning before 1988, subsection 104(17) permits a designation of depletion allowance so that depletion on certain types of resource property owned by a trust may be deducted by beneficiaries from the income payable to them by the trust. Effective for taxation years of trusts commencing after 1987, capital cost allowance, terminal losses and depletion are deductible only in determining the income of a trust (page 2 of Form T3). Consequently income payable by a trust to beneficiaries in years commencing after 1987 is no longer eligible for the aforementioned deductions by beneficiaries.

DESIGNATION OF TRUST INCOME PAYABLE TO BENEFICIARIES

4. For taxation years of trusts commencing after 1987, paragraph 104(6)(b) allows a trust to deduct from its income less than the full amount of its income that was paid or payable to its beneficiaries. To facilitate this, subsection 104(13.1) permits a trust resident in Canada throughout the year, other than a trust exempt from tax by reason of subsection 149(1), to designate to its beneficiaries their respective shares of that portion of the trust's income payable to them in the year under subsections 104(13) or 105(2) that has not been deducted by the trust under paragraph 104(6)(b). Similarly, subsection 104(13.2) allows the same type of trust to designate to its beneficiaries their respective shares of that portion of taxable capital gains payable to them in the year under subsection 104(13) pursuant to subsection 104(21) that has not been deducted by the trust under paragraph 104(6)(b) or used in the designation under subsection 104(13.1). The designated amounts under subsections 104(13.1) and (13.2) are deemed not to have been paid or to have become payable in the year to or for the benefit of the beneficiaries for the purposes of subsections 104(13) and 105(2). Consequently, the designated amounts are taxable to the trust and not to the beneficiaries. Subsection 104(13.1) enables a trust which must pay out all of its income to its beneficiaries to use its non-capital losses from prior taxation years without affecting the ability of the trust to distribute its income currently. Subsection 104(13.2) contemplates the situation where a trust has net-capital or non-capital loss carryforwards from a prior taxation year and current taxable capital gains. In such circumstances, the trust may choose not to deduct the full amount to which it is entitled under subsection 104(6) in order to allow the net-capital or non-capital loss carryforwards to absorb the current taxable capital gain (page 3 of Form T3).

For taxation years of trusts beginning before 1988, there is no provision in the Act which permits the taxation to the trust of amounts that are otherwise required to be included in computing the income of a beneficiary. As regards trusts not resident in Canada, all amounts that become payable to beneficiaries are included in their income with the exception of

(a) proceeds of disposition of part or all of the interest of a beneficiary in a trust, or

(b) where the trust is a personal trust, as defined in subsection 248(1) (see 5 below), a distribution of capital.

ADJUSTMENTS TO ADJUSTED COST BASE

5. Amounts designated by a trust pursuant to subsections 104(13.1) or (13.2), as described in 4 above, may reduce the adjusted cost base of the capital interest of the beneficiary in the trust. In the case of beneficiaries of a personal trust, there is no reduction of the adjusted cost bases of their capital interests unless they were acquired for consideration. A personal trust, defined in subsection 248(1), is either a testamentary trust or an *inter vivos* trust in which no beneficial interest was acquired for consideration payable to the trust or to a person who has made a contribution to the trust. However, the mere retention at the time the trust was created of an interest in an *inter vivos* trust by the individual or related individuals who settled the trust will not result in the trust not qualifying as a personal trust. For the purposes of the definition of a personal trust, love and affection will not be regarded as consideration. In general, trusts other than personal trusts may be described as commercial trusts and designations pursuant to subsection 104(13.1) or (13.2) will reduce the adjusted cost base of the capital interest of the beneficiary in such trusts in accordance with paragraph 53(2)(h).

WHEN INCOME IS EARNED

6. The amounts required to be included in computing the income of a beneficiary for a taxation year under subsections 104(13) and 105(2) are considered to have been earned by the beneficiary on the last day of the taxation year of the trust and are thus in respect of the taxation year or years of the trust which ended in the taxation year of the beneficiary. Where the beneficiary is a non-resident of Canada on the last day of the trust's taxation year, the amounts referred to above are subject to withholding tax pursuant to paragraph 212(1)(c), except where the exemptions provided in subsections 212(9), 212(10) and, for 1987 and prior taxation years, 212(11.1) are applicable.

PHANTOM INCOME

7. Pursuant to subsection 104(29), certain income of a trust, sometimes referred to as phantom income, may be designated by the trust and, as a result, is deemed to have become payable to particular beneficiaries by the trust. For taxation years of trusts commencing after 1987, this designation may be made only by a trust for a taxation year throughout which it was resident in Canada. Such designated amounts, which would otherwise be taxable to the trust, may be treated as income of beneficiaries of the trust under subsection 104(13) and may be deducted in determining the income of the trust pursuant to subsection 104(6).

The amount in respect of which a trust may make this designation is the aggregate of

- (a) non-deductible charges under the Petroleum and Gas Revenue Tax Act pursuant to paragraph 18(1)(l.1),
- (b) non-deductible Crown charges under paragraph 18(1)(m), (c) Crown payments included in income under paragraph 12(1)(o), and
- (d) income inclusions resulting from transactions with the Crown which take place at other than fair market value under subsections 69(6) and (7), less the aggregate of
- (e) the resource allowance available to the trust under paragraph 20(1)(v.i), and
- (f) amounts which would be included in the income of the trust but for section 80.2 (reimbursement of Crown charges).

Pursuant to paragraphs 104(29)(c) and (d), the amount of the designation is limited to the proportion of the phantom income, as calculated in (a) to (f) above, that the trust-purpose income payable to all beneficiaries is of the total trust-purpose income for the year. Trust-purpose income is income of the trust determined without reference to the Income Tax Act. The total amount of the designation, subject to the limit imposed above, may be allocated among the beneficiaries provided that the allocation to a particular beneficiary is reasonable having regard to the proportion of trust-purpose income included in the income of that beneficiary.

PART XII.2 TAX

8. Part XII.2 of the Act was added applicable to the 1988 and subsequent taxation years and it assesses a special tax on the designated income, as defined in subsection 210.2(2), of certain trusts. Part XII.2 tax generally applies where designated income of a trust is payable during the year to designated beneficiaries

(generally non-residents and exempt persons) as defined in section 210, but does not apply, where, throughout the year, the trust was

- (a) a testamentary trust,
- (b) a mutual fund trust,
- (c) a trust exempt from tax by reason of subsection 149(1),
- (d) a trust described in subparagraph 108(1)(j)(ii) or (iv), or
- (e) a non-resident trust.

These provisions are intended to ensure that designated income earned by trusts for the benefit of non-residents and exempt persons will be subject to full tax rates rather than the lower non-resident tax rates under Part XIII or no rate at all in the case of exempt persons.

When a trust is subject to Part XII.2 tax and has taxable resident beneficiaries, or non-resident beneficiaries whose tax liability is computed under Part I of the Act, or both, a prorata share of the Part XII.2 tax can be designated by the trust in respect of any of the aforementioned beneficiaries. Such share of tax is then deemed by subsection 210.2(3) to be an amount paid on account of the tax payable under Part I for the beneficiary's taxation year in which the taxation year of the trust ends. The amount deemed by subsection 210.2(3) is also deemed, by subsection 104(31), to be an amount in respect of the income of the trust for the year that has become payable by the trust to the beneficiary at the end of the year. That amount is included in the beneficiary's income under subsection 104(13). Subsection 104(31) applies to taxation years of trusts commencing after 1987. Part XII.2 tax may be calculated on Form T3 Trust Schedule 4.

Income Tax Interpretation Bulletin

Lawyers' trust accounts and disbursements
IT-129R

DATE: November 7, 1986

SUBJECT: INCOME TAX ACT

Lawyers' trust accounts and disbursements

REFERENCE: Subsection 9(1) (also paragraph 12(1)(b))

This Bulletin replaces and cancels Interpretation Bulletin IT-129 dated October 31, 1973. Current revisions of significance are designated by vertical lines.

1. The purpose of this Bulletin is to provide information for lawyers in practice on the proper method of reporting their incomes and expenses for income tax purposes with respect to trust funds and disbursements and with respect to funds held for clients involved in litigation. The following rules are considered applicable to all lawyers in practice who maintain trust accounts.

2. With the exception of advances which the lawyer is entitled to treat as his or her funds by specific agreement with the client and retainers which the lawyer is entitled to keep whether or not services are rendered or disbursements are made, advances received from a client for services to be rendered or disbursements to be made are considered to be trust funds and are not income at the time of receipt. The first day when such advances can be legally withdrawn from the trust account for the use and benefit of the lawyer is regarded as the earliest day upon which an account could have been rendered for the purposes of subparagraph 12(1)(b)(ii) and paragraph 12(1)(a). However, the professional may elect to exclude work in progress from income under paragraph 34(a). (Refer to IT-457). Before 1985 a similar result was obtained under paragraphs 34(1)(b) and (c) subject to an election to exclude work in progress from income under paragraph 34(1)(d).

3. Any amount transferred out of the trust account for the use and benefit of the lawyer must be included in income at the time of such transfer unless a corresponding amount in respect of the same services or disbursements was reported as income at some previous time.

4. Disbursements on behalf of a client which are chargeable directly to funds advanced by a client, or would be so chargeable if such funds had been advanced, are essentially expenditures of the client and are not deductible by the lawyer. Examples of such disbursements that may be made on behalf of clients include

amounts advanced to complete a real estate transaction or an investment transaction, amounts advanced to meet bail, amounts advanced to pay incorporation fees, etc.

5. Similarly, disbursements which are properly chargeable to the client under the terms of an agreement (see 2 above) (such as travelling expenses), are normally charged directly to the trust account. If so charged, the lawyer's account is not affected. If a disbursement made on behalf of a client from whom an advance is received is not so charged in circumstances where it is reasonable to consider that eventually the lawyer can legally withdraw from the trust fund an amount equal to the amount of the disbursement, no amount is deductible by the lawyer for tax purposes in respect of the disbursement.

6. Disbursements that a lawyer customarily makes in the ordinary course of practice which are not chargeable directly to funds advanced by clients are considered to be the lawyer's own expenses which may or may not be recoverable from the clients through regular billings. Consequently, such expenses of a business nature incurred in a taxation year are deductible in computing income for that year for income tax purposes unless the lawyer chooses to defer such expenses that relate to work in progress.

Interest on Trust Accounts

7. Interest on trust accounts which, by provincial law, is required to be paid to a law society or bar association or some foundation or fund related thereto is not taxable.

8. Where no such law is applicable and no arrangement to the contrary exists between the lawyer and client, interest credited on a trust account to which the client's advances have been deposited belongs beneficially to the client; therefore the interest is income of the client and not of the lawyer.

9. If there is a specific agreement between the lawyer and client that the interest credited to a particular trust account accrues to the lawyer's own use and benefit, then the interest is income of the lawyer at the time when it is credited to the account.

Interest on Funds of Litigants

10. Where funds deposited with a lawyer by a litigant or litigants for safekeeping and investment, pending a court order or settlement establishing their proper disposition, earn income the Department considers such income to be income of a trust and recognizes that the beneficial owner is the eventual recipient of the funds. Therefore, conditional upon waivers being filed by each of the litigants and the lawyer-trustee for the relevant taxation years, the Department will defer assessment of the income until the recipient is finally determined. (Refer to Information Circular 75-7R3, paragraph 5).⁹⁵⁰

In trust law an amount becomes subject to a beneficiary's entitlement to enforce a distribution at a time when the beneficiary **could** apply to the court to have the amount distributed and be successful and in order to do so the beneficiary's entitlement must be absolute and immediate. A legal action based on a beneficiary's interest which is contingent awaiting vesting or enforceable only in the future will not result in an order to distribute until the contingency event occurs or the interest matures while if a beneficiary has only a potential to be considered in a distribution, as that of a discretionary interest, then he has no right to call for a distribution until the discretionary power holder acts favourably in respect of him. As per *Cossitt v. M.N.R.*⁹⁵¹ the court has held that until a power of appointment is exercised the recipient does not have a right to sue for the distribution of the trust capital or income.

There are numerous concepts concerning the amount of trust law income (or tax law income) that a beneficiary may be entitled to enforce a distribution of based upon the beneficiary's position with respect to the other beneficiaries, such as those entitled to capital, and the amount of loss carry forwards that the trust must apply in the manner in which income is to be computed however it should be recognized that it is not always that an entire income stream earned in respect of a particular beneficiary will be the amount to which he will become entitled.

⁹⁵⁰. Is there relation back of the beneficial ownership granted by a court order rendering a settlement: the order will either recognize the existing beneficial interests or rearrange them but until the order has been granted hasn't beneficial ownership been severed? A lot depends on the terms of the particular arrangement.

⁹⁵¹ 49 D.T.C. 617 as well as other U.K. jurisprudence of substantial authority.

General Comments.

The basis of "amounts payable" does not include instances where the income was applied at the discretion of the trustees for a beneficiary's benefit without his control hence where he does have the entitlement to have it applied for his benefit, (such as possibly in the case where his apartment rent is to be paid, his tuition fees are to be paid etc.), rather than receive it directly himself, he will **not** be caught by the Sec. 104(24) definition by virtue of the fact that although the entitlement to enforce a payment is expressly qualified as to whom it may be payable in respect of, the provision does not recognize amounts as **payable to a beneficiary** unless one of the two conditions exist. In both cases the amounts paid will be includable in the beneficiary's income under Sec. 105(1) in respect of which the trust may not take an equivalent Sec. 104(6) deduction.

Where the trust isn't resident in Canada throughout its tax year the Sec. 104(24) provision, while applying to Sec. 104(13), may cause capital payments to be included in the beneficiary's income when he may enforce a distribution thereof. The only two exceptions to possible income inclusion are where the amounts were received as proceeds of disposition of part or all of the beneficiary's "interest" in the trust⁹⁵² which would come in the form of a distribution in satisfaction as described in section 106 or 107, or, where the amount paid is as a distribution of capital by a **personal trust**. In the latter case, if the trust **isn't personal**, the capital distributed **other than in satisfaction** of the interest will be **fully includable** in the Division B income of the beneficiary, while in the former case, the section 106 or 107 interest disposition/extinguishment rules may apply on their own to cause significant tax consequences to either, or both, the trust and beneficiary. Thus capital and tax exempt amounts, if otherwise received directly, and not in satisfaction of the interest, may be includable in income if they are received from and through a trust that isn't resident while in respect of the former this may be alleviated by having the trust maintain its personal status.

In recent years some practitioners have contended that one can satisfy the spousal trust requirements of allowing the spouse to be entitled to receive all of the trust's income prior to her death by giving her a right to call for only part of the income of the trust and thus if she doesn't ask for all of it she will not be taxed on all of it under Sec. 104(13). Unless the trust deed specifically provides that income not called for by the spouse will be accumulated and distributable ultimately **to her** this technique suffers from the flaw of disallowing her to be in a position to receive all of the income until she calls for its payment which will thus not allow the trust to qualify for Sec. 70(6)-73(1) treatment. The spouse must either have the right to receive all of the current income of the trust whereby she'll suffer a Sec. 104(13) inclusion or the trust deed must operate to allow withholding until she decides when she wishes to receive the capitalized income, with arbitrary distributions at certain intervals regardless of her expressions to distribute the income to her. If the power isn't phrased correctly she could still be recognized to have the current right to enforce a payment of the income even though she didn't call for it, thus attracting a Sec. 104(13) inclusion. Essentially the power must be in the form of an appointment over income that can create current income rights in her hands (with the distribution of capitalized income in default of exercise) and until she exercises it she mustn't have any right to income as such to avoid a Sec. 104(13) inclusion.⁹⁵³

Pursuant to *Buckley v. Commr. of Taxes*⁹⁵⁴, *I.R.C. v. Blackwell's Minor's Trust*⁹⁵⁵, and *Commr. of Taxes v. Luttrell*⁹⁵⁶ taxable income taxed in the hands of the trust becomes tax capital and is not **normally** taxed again

952. which is not precluded from being a capital interest

953 See T.I. 911730 dated Aug. 1991 by the Reorganizations and Non-Resident Division for a similar though less in-depth opinion. In T.I. 5-9281 of Feb. 1990 rendered by the F.I.D., the Department held:

"Where there is a continuing direction from a beneficiary of a trust (testamentary or *inter vivos*) to reinvest trust income of a taxation year after the beginning of the following taxation year of the trust, it is our position that the income in question will not become an "amount payable" for purposes of subsections 104(6) and (24) of the Act. However, if such income is payable on the last day of the taxation year of the trust, and thereafter the beneficiary elects to retribute his entitlement thereto to the trust we would regard the amount of such income as an amount payable under those subsections. Such an election may, we note, create an undesirable result for your purposes under subparagraphs 108(1)(i)(ii) of the Act in the case of a trust that was otherwise a testamentary trust. Further, where a beneficiary elects to retribute his "amount payable" to the trust we would regard such retribution as a transfer of property for purposes of subsection 74.3(1) of the Act."

See also T.I. B-6366 by the Deferred income Plan and Trusts Section in May 1986.

954 1923 N.Z.L.R. 1180

955 10 T.C. 235

956 1949 N.Z.L.R. 828 (CA)

when distributed.⁹⁵⁷

Payments in Error or Embezzlements.

There has not been any significant Canadian tax cases concerning the tax exposure of income payments made in error to a beneficiary under the trust/estate however *The Queen v. Poynton*⁹⁵⁸ may serve as a valid illustration of some of the principles that may be considered in such an instance. In *Poynton* a taxpayer was both a director and secretary-treasurer of a private company and after having been caught at arranging a kick-back scheme he contended that the gains illegitimately realized from the company were not income in that they were impressed with a trust that required him to repay the company. The company had brought criminal charges against him and he was required to repay the funds he had realized however the Minister was of the opinion that the embezzled amounts were benefits realized by the taxpayer in the capacity of an officer or employee and thus includable in his income. Evans J.A. of the Ontario Court of Appeal cited quite appropriately that, as per the authorities *Partington v. A.G.*⁹⁵⁹ and *Versailles Sweets Ltd. v. A.G.*⁹⁶⁰ there is **no equitable construction** in a taxing statute and cited cases such as *Sura v. M.N.R.*⁹⁶¹ and *Curlett v. M.N.R.*⁹⁶² in respect of instances where even though a taxpayer was required to return payments, contingently or otherwise, they were still treated as income subject to taxation. Concerning the taxpayer's assertion that the repayment of the kick back funds as per a trust could not be taxable as income in his hands the judge held:

"If one receives money under a trust for another he is under an obligation to turn over the proceeds to his cestui qui trust. If he does so then he fulfills his duty and no questions of the taxability qua trustee arises. If however in breach of his duty to account, the trustee converts to his own use he is taxable, not on the basis that the quality of the money or his entitlement thereto has changed, but on the basis that the manner or holding has been altered. The monies are still trust monies and the trustee is liable in law to account but because of the theft or conversion the trustee in reality holds the money for his own account. The fact that a defaulting trustee may be called upon to return his ill gotten benefits flows from his relationship to his cestui qui trust **while his taxability results from the manner in which he actually holds the benefit.**"⁹⁶³ One particular case that was cited by the judge as an authority was *James v. U.S.*⁹⁶⁴ wherein a union officer embezzled 738,000\$ and the Supreme Court in a majority decision held that the amount was includable in his taxable income even though he had to repay the sum. The argument in that case that was advanced by the taxpayer was that the funds could not be considered as taxable since they were not received by their rightful owner and this argument was ruled invalid by the U.S. Court and the Ontario Court concurred with the reasoning. The Ontario Court judge provided:

"The fact that here the stolen money was repaid by Poynton following the institution of a civil action by his employer does not affect the result as the repayment was not made in the years in which the funds were misappropriated and in which they were sought to be taxed." Whether the recipient of an amount paid in error is to be charged with the recognition of the amount may depend on whether or not he has cultivated the frame of mind of tacitly recognizing it as his own as long as the error is not disclosed of to the fiscal authorities and the perpetration of a tax fraud, as described expressly in *National City Bank v. Helvering*⁹⁶⁵ may be grounds for inequitable assessment notwithstanding that a

957 See *Barnes v. Hely Hutchinson*, 1940 A.C. 81, for presumption against double taxation.

958. 72 D.T.C. 6329

959 L.R. 4 H.L. 100

960 [1924] S.C.R. 466

961 62 D.T.C. 1005

962 62 D.T.C. 1320

963 In *Board v. Comm.*, 6 Cir. 51 F.2d 73, a trustee who received payment in error without effort to return it was assessed in the year of the receipt even though the right thereto was not validated through an agreement executed until six years subsequent with the frustrated litigators. The taxpayer contended that he had no right to the sum in the year but only in the subsequent period but the court held with respect to the payment:

"Possibly it may have been recovered in the litigation which was instituted for that purpose, but it was not, and it is at least unusual that a taxpayer should be heard to assert the possibility of an adjudication of alleged misconduct and breach of trust, as relieving him from tax liability which is predicated upon the assumption of the honesty and legality of his acts."

964 (1961) 366 U.S. 213

965 2 Cir, 98 F.2d 93

constructive trust is recognized to arise.⁹⁶⁶ In *North American Oil v. Burnet*⁹⁶⁷ a taxpayer receiving income under a claim of right without restriction as to its disposition is compelled to recognize it and *National City Bank* provides that fiscal authorities are not compelled to take into account private controversies in order to fulfill their public duties in collecting tax: if the taxpayer holds the property under claim of right regardless of the infirmity of his title.⁹⁶⁸

In respect of income payments made in error to a beneficiary obviously Sec. 104(13) may apply and the trust will gain the Sec. 104(6) deduction however if **the trustee** or other non-beneficiary party receives funds "gratuitously" from the trust Sec. 105(1) will apply to include the amount in his income even though he may have to repay them.⁹⁶⁹ The issue of the requirement of repayment doesn't appear to be relevant in determining whether illegitimate receipt of income is taxable for Canadian income tax purposes. In *Havelock v. Grant*⁹⁷⁰ non-resident trustees paid **in error** an amount to cover U.K. income tax to a U.K. resident income beneficiary though they were required to pay the tax directly themselves as per the trust deed. The beneficiary was assessed on the amount paid that shouldn't have been but was successful in convincing the King's Bench that since she was required to reimburse the sums to the trustees, for she held them in trust for them, she should not be taxed on the amounts.⁹⁷¹ In *Ford v. Comm.*⁹⁷² property was prematurely distributed to estate beneficiaries interested in an insolvent estate, an act illegal under the local law, and the court subsequently invalidated the distribution rendering it void and indebteding the beneficiaries to the estate for the amount received. The amounts were never repaid and the court established on the assessability of the receipt that the tax collection system would be impaired if questions of the relevancy of subsequent years possible divesting were to be entertain. It held as to the facts of the particular case:

"The true normal criterion to be applied in this class of case is the actual receipt **and retention** during the year in question of what **was then** considered to be income, not whether the taxpayer exposed himself to personal liability.

If it were to be conceded that a taxpayer who, before making his return, or perhaps even later, discovers that what he thought was income was improperly paid to him, and who must **and does** return it, should be relieved from the tax, the concession does not reach a case where the flaw in his title is only a claim of defect, until at a later time it is established, one way or the other, by a court judgment. **Neither would the concession reach a case where the taxpayer did not repay or give up the income, but only permitted it to be charged against him as a matter of bookkeeping, knowing that his counter**

966 This distinction was also recognized as apparently a worthy consideration in the recent case of *Buckman v. M.N.R.*, 91 D.T.C. 1249 (TCC), where the taxpayer relied upon *Gilbert v. C.I.R.*, 582 F.2d 478, but still did not meet the necessary criteria as laid out in *Gilbert* to avoid income inclusion, an intention to return sums regardless of whether being discovered.

967 286 U.S. 417, 424, 52 S. Ct. 613, 615, 76 L.Ed. 1197

968 See discussion in "Constructive Trusts" for similar Canadian jurisprudence.

969 It could be argued that by the fact that the legislators removed in the 1988 reform the Sec. 104(13) reference to inclusions of payments to parties to whom they were payable that payments in error to a beneficiary will be fully subject to the subsection 104(6)-(13) mechanics even though there would have to be adjustments to the beneficiaries entitlements/return payments subsequently. Would the beneficiary to whom an erroneous payment is made have to return the gross amount or that net of tax he incurred in respect of it?

970 27 T.C. 363 (KB)

971 See also *C.I.R. v. Duncanson*, 31 T.C. 257, for another trustee relationship with respect to tax refunds received by beneficiaries in respect of excess trustee withholdings: not included in computing their income due to required repayment. As per *Chase Manhattan Bank NA v. Israel-British Bank (Ldn) Ltd.*, 1979 3 All E.R. 1025, a remedial constructive trust may arise upon payments made by mistake to third parties. See also *Bk. of Mtl. v. R.*, 1907 38 S.C.R. 258, *Zaidan Grp. Ltd. v. London*, 30 E.T.R. 59, & *Lafarge Cda. Inc. v. Calgary*, 30 E.T.R. 231, regarding over-payment not resulting in unconscionable act hence no unjust enrichment hence no constructive trust but relationship of debtor-creditor, (Zaidan expressly cut down). See also "Mistake of Fact-Tracing in Equity", T.G. Youdan, 6 E.T.R. 72, & *Goodbody v. Bk. of Mtl.*, 1974 4 O.R. (2d) 147. In *Central Trust Co. v. Flynn*, 25 E.T.R. 302, the beneficiary was found not to have an equitable right to funds mistakenly paid to him by the executors. Where the funds are mistakenly paid the trustees have a duty to sue for their recovery: *Watts v. Turner*, 1831 Russ. & M. 634, *Willis v. Hiscox*, 1839 4 My. & Cr. 197, though this doesn't seem to have been of concern in *Case V88*, 88 A.T.C. 603, where superannuation trust funds were appropriated to beneficiaries illegally and included in their income under a provision possessing the clarity and width of Sec. 104(13). See also *Montreal Trust Company et al. v. The Minister of National Revenue*, [1958] S.C.R. 146 where, under the then Dominion Succession Duty Act the duty that was to be paid on a bequest was dutiable itself. The exact same could be said to apply in the case of Sec. 105(1) when a trust is to pay the beneficiary's tax exposure on the beneficiary's income. The same with *Minister of National Revenue v. F. David Malloch Memorial Foundation*, [1971] S.C.R..

972 6 Cir., 51 F.2d 206, 1931

equities were such that the charge against him would be uncollectible.⁹⁷³

In *Countess of Bective v. F.C.T.*⁹⁷⁴ H.C. Judge Dixon held that should a trustee appropriate income for his own use he should be assessed in respect of it.⁹⁷⁵ In the author's opinion however if the beneficiary informs the trustee making the payment as soon as possible about the error, and doesn't benefit from it in the interim before it is returned, an inclusion shouldn't occur.⁹⁷⁶

In the recent case of *Zobory v. F.C.T.*⁹⁷⁷ the Australian Federal Court held, after consideration of extensive authority, that the fact that the taxpayer administered the money's stolen from his employer as his own, to realize interest, which was paid back to his employer upon civil litigation, though declared on his personal tax return, did not draw tax liability as income since the taxpayer was not beneficially entitled to the interest given that a constructive trust had arisen the moment that the principal was embezzled. The fact that the money's had been mixed with other money's of the taxpayer didn't make a difference upon the fact that the constructive trust arose the moment that the employer was wronged, citing *Australian Postal Corp. v. Lutak*⁹⁷⁸ as dictum that all when trustees mix funds with their own personal the trustee can still sever that part of the profits or interest which is beneficially owned by their beneficiary. Burchett J. then went on to provide that the remedy is one which the beneficiary picks, not the trustee, and that that right is given to him at the moment he is wronged. The fact that the trustee does not have clean hands does not limit his argument that the money belongs to someone else, since he is not seeking equitable relief - only the liability for the taxation of income received.

Income Tax Interpretation Bulletin

Gains from Theft, Defalcation or Embezzlement

IT-256R

DATE: August 27, 1979

SUBJECT: INCOME TAX ACT

Gains from Theft, Defalcation or Embezzlement

REFERENCE: Paragraph 3(a) (also section 4, paragraph 15(1)(b) and subsection 163(2) of the Act).

This bulletin cancels and replaces Interpretation Bulletin IT-256 dated October 14, 1975. Current revisions are designated by vertical lines.

1. The treatment of losses from theft, defalcation or embezzlement are dealt with in IT-185. This bulletin deals with the treatment of those amounts in the hands of the recipient, and also covers cash or property received as a result of extortion, blackmail, bribery or other similar acts.
2. These funds or property are income from a source and as such are taxable in the hands of the recipient. The cash or fair market value of property received will be added into the recipient's income in the year of receipt.
3. Taxpayers who receive such funds or property may be subject to a penalty under subsection 163(2) for each year that they were taken and not reported.
4. It is the Department's practice that when amounts that were added to a taxpayer's income under 2 above are repaid, there will normally be a deduction allowed in respect of such repaid amounts for the taxation year in which the repayments are made unless the taxpayer was a major shareholder or senior official of the injured party at the time of the theft or other act to which the comments herein apply.

973 *Knight Newspapers Inc. v. Comm.*, 6 Cir, 143 F.2d 1007, (1944), holds that mistake of fact giving rise essentially to a constructive trust, will not give rise to a liability to recognize when the amount has been repaid.

974 47 C.L.R. 417

975 See also *Yeung & Anor. v. F.C.T.*, 88 A.T.C. 4193, for such an instance.

976 In *Barlow v. C.I.R.*, 21 T.C. 354, a trustee committed a breach in trust through the personal use of its funds sustaining a loss and subsequently covenanted to pay the sum lost **plus interest** at a nominal rate. The interest was found to be deductible for U.K. income tax purposes though the applicability of this decision in light of the Sec. 20(1)(c) requirements is questionable. In *Buckman v. M.N.R.*, 91 D.T.C. 1249, "interest" paid by a solicitor to his clients in respect of funds which he had misappropriated, so as to avoid detection, was held not to be "interest" but it was not stated that it wasn't deductible. See also *Schulze v. Bensted*, 7 T.C. 30, for income inclusions of such interest awarded.

977 129 A.L.R. 484

978 1991 21 N.S.W.L.R. 584

Minor Income Entitlements.

Understandably in respect of a minor a testator/settlor of the trust may not wish income to be paid or payable to the minor until he reaches a mature age at which time he will know how to handle it "properly" however this can cause serious problems with respect to the Sec. 104(6)-(13) tax liability transfer mechanism. Also, since the minor cannot be capable of acting on his own, but must have his tutor or guardian act for him, it will be technically impossible for him to deal with his property rights in a manner similar to an adult and **the minor** will be seen not to be, himself, in a position to sue for the execution of the trust deed.⁹⁷⁹ The minor would also not be able to give the trustee a valid discharge/receipt in respect of a payment.⁹⁸⁰

Subsection 104(18) alleviates just such problems by providing effectively that where part of the **income** of the trust has not become payable in the year but was held in trust for a "minor" whose right thereto has vested, and **the only reason** it has not become payable in that year was because the beneficiary was a minor, for purposes Sec. 104(6) and (13) it will be deemed to have become payable to the minor in the year. This provision applies **only to income of the trust** and not to its capital hence it will not apply to cause an income recognition by a beneficiary in respect of capital or otherwise exempt income of a trust which wasn't resident throughout its tax year as that described under Sec. 104(13)(c). The application of the provision does not follow or depend upon the discretion of any taxpayer but is mandatory.

"Trust for minor – Sec. 104(18)"

(18) Where any part of the amount that, but for subsections 104(6) and 104(12), would be the income of a trust for a taxation year throughout which it was resident in Canada

(a) has not become payable in the year,

(b) was held in trust for an individual who did not attain 21 years of age before the end of the year,

(c) the right to which vested at or before the end of the year otherwise than because of the exercise by any person of, or the failure of any person to exercise, any discretionary power, and

(d) the right to which is not subject to any future condition (other than a condition that the individual survive to an age not exceeding 40 years),

notwithstanding subsection 104(24), that part of the amount is, for the purposes of subsections 104(6) and 104(13), deemed to have become payable to the individual in the year.⁹⁸¹

979. See *Doody v. Commr. of Taxes*, 1941 N.Z.L.R. 452.

980 Though see *Re: Baron Vestey's Settlement*, 1951 1 Ch. 209, *Ledward v. Hussells*, 69 E.R. 825. In *Re: Somech*, 1957 1 Ch. 165, Upjohn J. held:

"I think that the law is accurately stated in one sentence in *Simpson on Infants*, (1926) 4th Ed., p.41: 'An infant is incapable of giving a legal discharge for money paid to him unless the instrument of donation specially provides that his receipt shall be a discharge, or directs payment (eg. of a legacy) at an earlier age than 21.'"

981 Dec. 1995 FINANCE TECHNICAL NOTES: Subsection 104(6) generally permits a trust to deduct any trust income payable in the year to a beneficiary under the trust. Subsection 104(18) provides that, where the only reason that the income of a trust is not payable to a beneficiary under the trust in the year is that the beneficiary was a minor, such amount will be considered to be payable to the beneficiary. The expression "minor" is not defined in the Act.

Subsection 104(18) is amended so that it applies to a trust for a taxation year only where the trust is resident in Canada throughout the year. Subsection 104(18) is also amended to provide that trust income will be considered payable under the subsection to an individual in a taxation year only where

- the individual is less than 21 years of age at the end of the year;
- the individual's right to the income is vested by the end of the year;
- the individual's right to that income did not become vested because of the exercise or the non-exercise of a discretionary power; and
- the individual's right is not subject to any future condition (other than a condition that the individual survive to an age not exceeding 40 years).

Subsection 104(18) is also amended to clarify that it overrides subsection 104(24), under which trust income not paid out in a taxation year is generally considered not to be an amount payable to a beneficiary for the purposes of trust taxation rules.

Sept. 1985 FINANCE TECHNICAL NOTES: Amounts payable to the beneficiary of a trust are generally deductible under the Act in computing the trust's income and are included in computing the income of the beneficiary. Subsection 104(18) provides that where the only reason that the income of a trust is not payable to a beneficiary in the year is that the beneficiary was an infant or minor, such amount will be considered to be payable to the beneficiary. The use of the word

As can be seen the **four** conditions to be met in order for the provision to apply are that the income must continue to be held in the trust, the minor had not reached the age of 21 before the end of the trust's tax year, the right vested to that income did not have anything to do with the exercise of a discretionary power held by anyone and the minor's right does not depend on a future event other than pre-mature death before 40. This provision used to be a lot less tight with restrictions, particularly on issues of vesting.⁹⁸²

If the is distributed to other beneficiaries in the current year Sec. 104(18) will not be available however will the Department reassess the minor and trust a few years after the Sec. 104(18) provision has applied in respect of an amount that has been capitalized and distributed as capital to other beneficiaries? The author thinks not. If the income recognized under Sec. 104(18) is distributed to a guardian of the child to maintain him the child won't recognize a Sec. 105(1) inclusion in respect of the benefit since he has already recognized the sum in his income.

The subsection does have its limits in being useful in an estate-planning environment. A classic example would be where an off-spring is to assume family responsibilities/perform well academically etc. and because of possible loss of the right the provisions applicability is not satisfied. Mind you, the incidents of the provision are to **apply on a yearly basis** to the income right so as long as the minor cannot lose her rights to the income recognized under the provision it will apply to it: the actual income right itself may be defeated by events that transpire in subsequent years to those latter year's income.

Since minors usually are in lower tax brackets than trusts, (especially *inter vivos* trusts), this provision is of major importance in structuring inter-generation rollovers however the conditions will have to be satisfied through the retention of the income in the trust⁹⁸³, in order to have the provision favourably applied.⁹⁸⁴ ⁹⁸⁵ In this respect the subsection is substantially dissimilar to Sec. 70(6) in that in the latter indefeasible vesting of the gift is explicitly required.

The provision speaks nothing of when or if the amount must be distributed although the income that arises when the minor's title is vested can be subject to a court enforced distribution.⁹⁸⁶

A beneficial right that is not enforceable both due to the fact that the beneficiary is underage **and** that depends on a contingency or the exercise of a discretionary power will not satisfy the condition, unless, in the former instance the satisfying contingency has occurred.⁹⁸⁷ In *Tomlinson v. Glyn's Exor. and Trustee Co.*⁹⁸⁸ infancy was not the only bar to the beneficiaries' entitlements but the infants consisted of a class that had not yet closed thus didn't have vested rights. Had the class closed then the only restriction on their rights would be their age.⁹⁸⁹

If income isn't payable to a minor due to a discretionary power, even though the power may not have been exercised because of the minor's age, the reason for not being payable is that of the discretionary power, not

"infant" is redundant, since an infant is necessarily a minor. Accordingly, this amendment removes the reference to infant.

982. See *Montgomerie v. C.I.R.*, 1965 N.Z.L.R. 951, and *Cusden v. Eden*, 22 T.C. 435, for disqualifying application of income. See also *C.I.R. v. Maude-Roxby*, 31 T.C. 388. In T.I. 5-7271 of Feb. 1989 by the F.I.D. it was held that when the trustee had the power to distribute income or capital to the minor but recoup out of subsequent income capital encroached upon the income would not be subject to Sec. 104(18).

983 at least past the reassessment periods described in section 152

984 This is contrary to *Commr. of Taxes v. Johnson and Maeder*, 1946 N.Z.L.R. 446, and *Ward v. C.I.R.*, 1969 N.Z.L.R. 12. **Paragraph 7 of I.T. 286R2** states that indefeasible vesting **isn't** required in order for the provision to apply.

The Department stands valiantly by their opinion! In a Technical Interpretation provided Jan. 1980 by the Non-corporate and Publications Directorate it was held that Sec. 104(18) does not require indefeasible vesting and includes, for instance, cases where the beneficiary's right to income is vested but subject to divestment on failure to reach an expressed age. Taxation Ruling 70 also provides this type of opinion. The Interpretation concludes with:

"Both Interpretation Bulletin 260R (in substance became 286) and ruling TR-70 were given careful study from this point of view and issued when we were satisfied that they properly reflected the provisions of the Act."

985 For exactly such a case see *Commr. v. Hedges*, 1935 3 A.T.C. 255.

986 If the income is appropriated off from the trust and can be recognized to have created another trust can the interest therein held by the beneficiary have a cost? It would appear not since he has not paid anything for it.

987 This was the case in *Hashman Trust v. M.N.R.*, 72 D.T.C. 1191.

988 1970 Ch. 112 (CA)

989 See also *Lynch v. Davies*, 40 T.C. 511 (Ch), for a double contingency preventing vesting. See also *Moore & Osborne v. I.R.C.*, 1984 S.T.C. 236, where income accrued to unclosed class where an unexercised discretionary distributive power prevented the beneficiary from being entitled to the income for tax purposes in similar fiscal mechanics.

of the age or status of the minor.⁹⁹⁰ By basing a contingency upon a routinely reoccurring phenomenon, and providing that the income isn't payable to the minor on those grounds as well, a trust deed could be structured so as to allow the provision to be applicable every second year etc., or as routinely as the contingency event occurs. Levels of income payable could also be striated, each depending on a combination of contingent event occurrences and the classification of rights to that income held in the minor's hands.

Obviously since the provision will apply to cause the beneficiary minor to incur a potential tax liability in the form of a Sec. 104(13) income inclusion the trust deed should allow for discretionary distributions of capital to the minor so as to allow him to have funds to extinguish the resulting liability however, his basic Division C deductions may be able to negate a possible income inclusion, and these too should be considered in determining the amount which will be recognizable as payable.⁹⁹¹

One case that is often referred to is that of *Maloney Trust v. M.N.R.*⁹⁹² where the Tax Review Board had to decide whether a child had a vested interest in interest arising on mortgages held in a trust when the child could only obtain an indefeasible vested interest in the mortgages if she reached 18 years old and if she didn't then there would be a gift over of the mortgages/proceeds therefrom. The Board found that Sec. 104(18) could not apply to allow the child to recognize the interest income and the trust was assessed in respect of it. If a beneficiary's interest is contingent upon his being alive at the end of the vesting period, and it isn't enforceable until then, then he does not have a vested interest in the fund.⁹⁹³

In the present subsection, the age must be 40 years at any time in the trust's tax year – if the sole future condition is that the minor must not survive to age 40 then the recognition, without distribution, can transferred to the minor up to when he turns 21. But again, this is based on a year-by-year basis. Variations can happen at a whim and powers of appointment may come and go.

In *Hashman Trustees v. M.N.R.*⁹⁹⁴ the Tax Review Board had to determine whether income of a trust had vested in children the parents of whom were the trustees. The trust arrangement provided that:

"On or as of December 31st of each year to divide the net income from the trust fund into as many equal shares as there shall be children of the settlor (born prior to the 31st day of December 1964) then living and to hold each such share in trust for each such child and to keep invested and accumulate the income thereon, subject to the provisions thereof, until such child attains the age of 21 years when such income and accumulations thereof shall be paid to such child..."

and although there were four subject children to which this applied none of them had in fact reached the ripe ol' age of 21 in the years of assessment. As a matter of accounting the trustees would have the children declare as taxable in their hands the income of the trust that the trustees had "allocated and set aside" for them thus reducing the trust's Division B income however in all cases the beneficiaries were never entitled to enforce a distribution of that "ear tagged" amount until they became twenty-one years of age. The Minister reassessed the trust for the 1966 and 67 tax years, contending that since the income "allocated" was not payable the trust should recognize it, and not the beneficiaries. The appellants relied upon the application of Sec. 63(10), (very similar though not identical to Sec. 104(18) of today's Act), and provided that although the income wasn't payable, the sole reason it wasn't was because the beneficiary was a minor. *W.O. Davis Q.C.* held that upon a review of the terms of the trust deed stating that the trust is "to hold each such share in trust for each such child and to keep such share invested and to accumulate the income thereof, subject to the provisions of the said trust, until such child attains the age of 21 years.", that: "It appears clear that the interest of a child is contingent until such time as it has attained the age of 21 years, at which time it may very well become vested. It seems that the settlor had it well in mind that the benefit of any beneficiary under the trust agreement was not to be transferred to any one of his children or to the child or children had attained the age of 21 years.", and thus agreed with the Minister.⁹⁹⁵

990 This was the case in *Cole Trusts v. M.N.R.*, 81 D.T.C. 8.

991 See *Waley Cohen v. I.R.C.*, 26 T.C. 471.

992 82 D.T.C. 1823

993 See *I.R.C. v. Abbey*, 22 T.C. 211.

994 72 D.T.C. 1191

995 See also *Edwardes Jones v. Down*, 20 T.C. 279, *Roberts v. Hanks*, 10 T.C. 351, and *C.I.R. v. Kidston and Anor.*, 20 T.C. 603.

A very similar case was *Brotherton v. C.I.R.*, *Mears v. C.I.R.*⁹⁹⁶ where the court had to decide whether a beneficiary's interest was contingent upon the reaching of a certain age, upon the occurrence of which income realized in the interim would be distributable to him, or whether it was vested subject to divestment if the age wasn't reached whereby he would be still receive the income arising in the interim. The former consists of the loss of a beneficial title to all previous income that isn't immediately enforceable while the latter consists of the loss of beneficial title to income arising in the **following period** with the title to the income arising in the interim being absolute.⁹⁹⁷ In *Kilpatrick Policies Trusts*⁹⁹⁸ it was held that:

"If a person is given a vested beneficial entitlement to property subject to divesting in a certain event, prima facie that person is entitled to receive and retain any income that accrues from the property in respect of the period during which her interest is still vested."

A contingent interest on the other hand is not vested if in order to obtain absolute title to income that is to be accumulated the beneficiary must satisfy some requirement such as the execution of a certain performance, or a certain event must occur. If income is to be accumulated in the interim and payable to a beneficiary **only** when **and if** he reaches a certain age then the right thereto is contingent and not vested until the age is reached while if the income is to be accumulated in the interim **and** paid regardless of the circumstances, to the beneficiary upon reaching a certain age, (or to his estate or offspring, etc, if he dies in the interim), then it is vested.⁹⁹⁹ Whether or not the income right held by the beneficiary, to subsequent years' income, is to be defeated by a certain event is another matter however the essential difference between contingent and vested subject to divestment interests is that the former awaits the vesting of absolute title, while in the latter title to subsequent years' income divests upon the occurrence of the event.

Whether Sec. 104(18) requires indefeasible vesting in the absence of such an expression is questionable when the Department expressly doesn't look for it¹⁰⁰⁰ though in some jurisdictions like provisions have been read with the necessity. In *Commr. of Taxes v. Johnson and Maeder*¹⁰⁰¹ a provision essentially equivalent to Sec. 104(18) both in appearance and purpose was questioned and it was held by the Supreme Court of New Zealand that "vested" meant indefeasibly vested and not merely vested subject to divestment.¹⁰⁰² This was also endorsed in *Ward v. C.I.R.*¹⁰⁰³ while see also *Hobbs and Anor. v. F.C.T.*¹⁰⁰⁴ where the reasonable expectation of the destination of the income was held paramount in the face of the principle of accurately targeted taxation. Previously it was pointed out that powers of appointment could be used to alter the direction of accumulating income; such a power of appointment or wide advancement will not prevent vesting but will make it subject to divestment hence if the Department starts to assess on the basis of indefeasible vesting the power would have to be varied into the deed after the income has been accumulated.¹⁰⁰⁵

The construction of the trust deed and most particularly the language/diction used play an important role in expressing the meticulous settlor intention in this case. In *J. Cole and S.L. Cole Trusts v. M.N.R.*¹⁰⁰⁶ the Tax Review Board (D.E. Taylor) had to decide whether a minor's income "rights" under a trust were enforceable if

996 52 T.C. 137 (CA)

997 See also *McGredy and McGredy's Trustees v. C.I.R.*, 32 T.C. 338.

998 [1966] Ch. 730

999 See *I.R.C. v. Blackwell Minor's Trustee*, 10 T.C. 235, *Re: Carlson Estate*, 1975 5 W.W.R. 745 (BCSC), *Whitman v. Hudgins*, 19 E.T.R. 316, *Bain v. Miller*, 18 T.C. 478, *I.R.C. v. Longford*, 13 T.C. 573, and *Cornell v. Barry*, 36 T.C. 268. As per *Stanley v. I.R.C.*, 26 T.C. 12 (CA), an infant was recognized not to have a vested interest in the income accumulating during his infancy pursuant to a Trustee Act provision specifying otherwise, even though the will gave him one. Consequently for tax purposes the child didn't possess a vested interest in the income that would cause him to recognize it under a Sec. 104(18)-like mechanism. Subsection 104(18) isn't discretionary: is there any equivalent provision in a provincial Trustee/Estate Administration Act?

1000 **though this isn't binding.**

1001 1946 N.Z.L.R. 446

1002 See also *Tomlinson V. Glyns Exor. and Trustee Co.*, 45 T.C. 600/1970 Ch. 112 (CA).

1003 1969 N.Z.L.R. 12

1004 98 C.L.R. 151

1005 Understandably the court would have to be satisfied that such would be beneficial to the child for whom it gives consent hence a power to determine his future entitlement altogether could be reserved and released on condition that the power is varied in thus producing a net benefit for Variation of Trust Act purposes. The child would realize a disposition of his indefeasibly vested interest.

1006 81 D.T.C. 8

the beneficiary fails to be subject to the favourable **exercise** of a discretionary power in that under the trust deed his parents, as trustees, were to accumulate the trust income and pay it to S. Cole only when he attains the age of 21 years, but not before. Until that time they may exercise a power of discretion to actually **distribute** income to themselves in their personal capacity as S. Cole's parents for purposes of his maintenance, support, et cetera. The trustees **did not** exercise the discretionary power to distribute for tax years 1972, 1973, or 1974, paid the income of those years out to S. Cole in 1976, **but** for those three tax years filed T.3's as if the income was payable to him. The parents, as trustees, made an "affirmative and unanimous decision" to treat the income for the years in question as the income beneficiary's although they did not disclose the decision in writing, nor did they offer promissory notes to the income beneficiary. The trust deed expressly provided that income was to be accumulated but that as per paragraph 3.6 therein:

"The trustees may **make any payments** to or for any beneficiary under the age of twenty one years or otherwise under disability to the parent or guardian in fact or in law of such person, and the receipt of such parent or guardian shall be a sufficient discharge to the trustees."

The income of the years in question wasn't paid until 1976. The Minister reassessed the trust for the amount that was declared as income by the beneficiary for those three tax years and the trustees contended that since in *Sachs v. The Queen*¹⁰⁰⁷ the allocation of income under discretion without the payment thereof validated the filing of the preferred beneficiary election, then their allocation should be of the same validity, that being that the expression has been made that the income is vested in the beneficiary even though it has not been paid to him nor to which he has acquired an immediate enforceable right. They also contended that the beneficiary's right was enforceable through his parents as guardians, (**but the parents were the trustees**), and that the trust-beneficiary relationship was "normal" in the family setting. As a third position they relied upon the premise that the minor's right to the income had vested, regardless of the effect of the discretionary power, and that under Sec. 104(18) the income must be treated as being payable under Sec. 104(13). Counsel for the Minister provided, with respect to the second basis of beneficiary enforced payment:

"...how could the beneficiary in this appeal, how could the beneficiary enforce the payment. The beneficiary's right was dependent upon the discretion of the trustees and the trustees could change the discretion because the discretion **was to pay**, because something else might come to light and a trustee is not acting in the capacity where he makes one decision and then that decision sticks forever. A trustee does not become functus after having expressed his intention. The trustee can change his mind right up to the time the amount is **paid**. I found no authority which would say that once the trustee has expressed an intention as to hope he is going to exercise the discretion, that there is any way that the beneficiary could enforce that declaration. The discretion given to the trustee is to **make a payment** and until that is done, he could change his mind even if he had decided it to make the payment to the beneficiary at sometime in the future."

Counsel for the appellant had brought forth the statement that:

"I have referred to two cases *Re Vestey's Settlement*, [1950] 2 All. E.R. 891, and *Harold J. Sachs v. Her Majesty The Queen*, 80 D.T.C. 6291. Both are authorities for that proposition as well that the **exercise** of the discretion by the trustees results in a right on the beneficiaries which they are capable of enforcing."

It should be obvious from the comments that until a discretionary power is "exercised" with respect to an amount in trust the recipient beneficiary has no right to or to receive it and it should be equally obvious that the nature of the exercise of the power is as critical as the amount to which it refers.¹⁰⁰⁸ A discretionary power can be referenced to the apportioning of income to be capitalized, the time of payment of a portion of income, and the payment of the income itself to the beneficiary, or to exclusively have it applied for his benefit indirectly. **In other words, watch the scope of sprinkling powers of income as they relate to minor beneficiaries, both directly and indirectly.** In *Cole Trustees* the power of discretion was specifically referenced to only apply **to pay** the income, not to allocate it in any particular manner and thus until the payment was made the power

¹⁰⁰⁷ 80 D.T.C. 6291

¹⁰⁰⁸ See *East Fincley Pty Ltd v. FCT*, 90 A.L.R. 457 HCA, where a letter to a beneficiary detailing that an allocation of income had been made in respect of their rights was acceptable as a payment of the income for purposes of the provisions concerned with. Ostensibly, once the trustee had made his determination of the amount and signified it to the beneficiaries, even though not paid, it was deemed paid.

could not have been said to have been "exercised". If the trust deed had been varied so as to create two distinct discretionary powers ie; the power to apportion income to a particular beneficiary to be held for a time indefinite to which the infant's acquired vested rights, and a power solely to pay amounts from that apportioned amount, the latter power ceasing to be applicable upon the beneficiary reaching a certain age, then once the power concerning apportionment had been exercised at least the minor could have been seen to have acquired a vested right to the apportioned amount, regardless of whether he could enforce the payment thereof prior to attaining the age of majority.¹⁰⁰⁹ D.E. Taylor quoted from the Sachs's decision concerning the expression of intention through the filing of the appropriate documentation that could not be substantiated with the existing nature of the beneficiary's rights under the trust agreement:

"The authority to pay income to beneficiaries, in my opinion, includes the authority to declare or designate income as held for them **to the exclusion of the continuance of the trustees' authority to deprive them of it and to the exclusion of the possibility of their being deprived of it upon the happening of events referred to in the trust deed.**"

Sachs involved a designation under a preferred beneficiary election while Cole Trustees did not and the distinction is important because the opinion of D.E. Taylor of the T.R.B. was that the criteria of the above quote was to apply equivalently to instances where a Sec. 104(13) payable inclusion was to be recognized. He provided, although the strength of the opinion is definitely subject to question, that:

"Accordingly, counsel's argument is that the same actions taken by the trustees noted above (as described in Exhibit A-1)-the "discussion" and the "affirmative and unanimous decision to treat...the income...as the income...of the (beneficiaries)...", together with the preparation and filing of the relevant T-3 Information Returns constituted the "declaration and designation" noted in Sachs (supra). However, the trustees actions **alone** must serve to establish that proposition from the appellants. They cannot rely upon the **filing** of the T-3 returns as proof, and this will be referenced later. **The actions of the trustees must exclude (a) "the continuance of the trustees authority to deprive them of it"; and (b) "the possibility of their being deprived of it upon the happenings of events referred to in the trust deed. (see Sachs references noted above).** On that precise point, it was argued by counsel for the appellant that the parents as guardians would be able to enforce payment (really against themselves) since the actions noted above had been taken by the same parents as trustees. **As I see it, however, the decision recorded in Exhibit A-3 did not remove from the trustees their right and authority to abandon their intention or simply reverse their action.** Neither the Vestey (supra) nor the Sachs (supra) conditions for "payable" therefore have been fulfilled. The filing of the T-3 forms alone merely reports on action taken. It does not initiate or formalize any action. The T-3 forms are a supplement to the resources, financial statements and tax returns of the trust. They can only record events and transactions, they do not become the events and transactions in themselves. Nor do they certify that the events or transactions referenced did in fact occur."

Apparently both Thurlow C.J. of the Federal Court of Appeal in Sachs v. The Queen and Taylor of the T.R.B. in this instance felt that the authority to pay the income of a trust to a beneficiary, and thus have that income treated as payable to the beneficiary, for purposes of Sec. 104(14) in the former and Sec. 104(13) in the latter case, was exhaustively conclusive when the declarations/designations had been made **and** the trustee had discontinued and extinguished any trustee rights in respect of the designated amount and the beneficiary could not be deprived of it by operation of the trust deed.¹⁰¹⁰ It would thus appear that if the trustees had given a written promissory note to the particular beneficiary, enforceable by him, in respect of the income for the particular years, which could not be defeated in anyway, the income would be recognizable by the beneficiary as "payable" to him for that particular year, even though, as in the case, the amount of income had not been ascertained, nor distributable to him in that period.¹⁰¹¹ This premise adds a lot to the second Sec. 104(24)

1009 See Cornell v. Barry, 36 T.C. 268 (Ch), for lack of declaration of an appropriation leaving open the trustees' ability to determine the destination of accumulating income.

1010 The author is not of the opinion that "b" is a valid test to be used in respect of the application of Sec. 104(18). The beneficiary's right to the income must vest but the provision doesn't indicate that it vest indefeasibly.

1011 This was the case in C.I.R. v. Ward, 1970 N.Z.L.R. 1, where an exercise of a power of appointment was held to give the infant beneficiary indefeasible rights and although in the particular case the exercise didn't create a new trust out of the sums, though it could have as per Turner J., a valid debtor-creditor relationship could have been formed if there would have been a deed evidencing the exercise given to the infant.

"payable" basis in that the provision calls for the need that "he was entitled in the year to enforce payment thereof" however the time of payment is not mentioned. As per the reasoning in *Coles Trust et al.* it would appear that the actual payment may be significantly deferred. If the promissory note is forgiven by the beneficiary without payment by the trust then the trust would have to recognize the tax consequences dictated by the effect of the application of section 80.¹⁰¹²

As to the last submission of the counsel for the appellant in *Cole Trustees* the income was not payable to the minor solely because of the fact that the beneficiary was a minor at the time, and in fact in a couple of years after the years in question the income was paid to the beneficiary, he being still a minor at the time, (as pointed out by counsel for the respondent). D. E. Taylor held:

"Turning to the last possibility open to the appellants - subsection 104(18) - it would appear to me that to be "vested" as called for therein any amount first would need to meet all the rigid tests above for "payable" - but in addition, that the constraint against payment would arise out of the terms of the trust deed... However, in this case the evidence was not that such payment was withheld because the beneficiary was an infant. The reason... is that the obligation would be met "as and when required by the parents of the infant beneficiary". In simple terms, the parents or trustees did not pay the funds to the infant because the parents as guardians did not require it in that year for any purposes for which it could be paid. It is not simply because they were constrained from doing so because the beneficiary was an infant."¹⁰¹³

*C.I.R. v. Simpson*¹⁰¹⁴ is an illustration of how income distributions can be 'advantageously' structured using Sec. 104(18). In this New Zealand case a partner set up a trust with nominal consideration for one of his partner's family; the family members, consisting of the partner, his spouse and two **very young** children, were discretionary objects and the two parents were the trustees. The trust deed specifically provided that any income apportioned to any beneficiary would vest indefeasibly therein and that it could be applied for his benefit while it could also be paid to his guardians/parents to be applied for his benefit. In the first tax year of the trust the parents/trustees resolved in writing to apportion all of the income to the offspring subsequent to which the sums were paid to the parents and intermingled with their personal accounts, (the general household account). On the first assessment the trust was assessed to recognize the income though this was canceled and instead the parents were to recognize it in their personal capacity. In the lower court¹⁰¹⁵ the income was held to be the infant beneficiaries' to recognize while at the Court of Appeal level it was held that the income had been legally paid to the parents **as trustees** for the offspring thus precluding them from recognizing it on their personal account. The express terms of the trust deed allowed such to occur: the vesting of interest, and the payment to the guardians. If this arrangement were subject to the ITA the payment to the parents would not be included in their income personally nor in the child's income under Sec. 105(1) as a benefit since it would have already been recognized in computing his income.¹⁰¹⁶ Could the parents be captured by Sec. 105(1) as realizing a benefit from the trust when they are to receive it and apply it in a fiduciary capacity for the benefit of the child?

1012 See *C.I.R. v. Ward*, 1970 N.Z.L.R. 1, for an instance where the trustee created documentation to credit minor's income account with a specifically expressed amount of income though moneys remained generally available in the general account. The trustees' power to reverse or alter an accreditation was found to be nullified and the circumstances were similar to *Cole Trusts*. See also *Davidson v. C.I.R.*, 1976 2 N.Z.L.R. 705, Re: *Vestey's Settlement*, 1951 Ch. 209, and Case No M, 73 A.T.C. 385. See Case E47, [1973] A.T.C. 385, & Case 91, [1973] 18 C.T.B.R. (N.S.) 778, for endorsement of principle & issues of binding authentic declarations as well as Case X22, 90 A.T.C. 242, and Case V160, 88 A.T.C. 1058. See *Cornell v. Barry*, 36 T.C. 268 (Ch), for lack of binding appropriation declaration allowing vesting. In a response to a memorandum of May 1982 the Non-Corporate Rulings Division provided (B-3587) in July 1982 that evidence of trustees exercising a discretion to make income payable to a beneficiary under Sec. 104(13) includes he preparation of T3 supplementaries, treatment of the same as payable on the T3 return but an allocation on the income statement is not sufficient. This is probably the same quality of evidence needed in respect of a discretionary exercise that is suspended by the trust deed preventing actual payment which gives rise to a Sec. 104(18) application.

1013 See also *Taylor v. F.C.T.*, 1970 119 C.L.R. 444, for entitlement but for infancy.

1014 1989 2 N.Z.L.R. 704 (CA)

1015 1987 9 N.Z.T.C. 6, 147,

1016 Subsection 104(18) arguably may not apply in this instance however in that the income isn't held in trust within that provision's context when it is in fact paid to a guardian and thus the minor doesn't technically recognize a Sec. 104(13) inclusion. Notwithstanding this the Department has held that Sec. 104(13) will apply in such a case.

The author thinks not since they are not benefiting from it.¹⁰¹⁷ Revenue could count the pennies however to ascertain exactly what was applied for the benefit of the child but if the parent utilizes the funds to satisfy parental expenses instead of his own has he still not recognized a benefit from the trust?¹⁰¹⁸

In *Blathwayt and Anor. v. I.R.C.*¹⁰¹⁹ a trust deed expressed a power to the trustees to withhold income to establish or increase a reserve fund while in the next paragraph it disentitled the trustees from demanding a receipt from the infant beneficiary in respect of the income paid and expressly allowed the life tenant infant to sue for distribution regardless of his impairment in age. The life tenant infant was found not to have an indefeasibly vested interest in the income, which was required in order for a Sec. 104(18)-like provision to apply, and thus the income was assessed in the trustees' hands. The power to withhold interfered with what would otherwise have been an indefeasibly vested interest.

In *Dalrymple and Anor. v. I.R.C.*¹⁰²⁰ the trustees of a residuary trust were given the power to use their discretion to use income to extinguish debt though failing such a use the income was to be payable to the life tenants. The Tax Man attempted to assess the trustees in respect of income but was unsuccessful when the Court of Appeal held that the trustees could not withhold income unless it was used to reduce debt and since they didn't have the power to accumulate and the debt wasn't reduced the beneficiary was to recognize the income.

In *I.R.C. v. Johnson and Maeder*¹⁰²¹ business property was held in trust with income to be accumulated and used to invest. An infant was a contingent beneficiary, vested with condition subsequent that should he die his next of kin would acquire on gift over. The tax assessors attempted to assess him for tax on the income accumulating on the grounds that the particular provision of the Land and Income Tax Assessment Act, (essentially very similar to Sec. 104(18)), caused him to be liable. Callan J. of the Court of Appeal held that the income didn't vest in the beneficiary **as such** but essentially only as capital and that the particular provision required indefeasible vesting rather than contingent vested interest subject to divestment providing:

"In my opinion since the object of an income tax statute is to tax persons on their respective incomes, the wider meaning of "vested" should be rejected, because its acceptance leads to taxation on money which in no real sense can be fairly described as income of the person to be taxed."

The following is CRA's opinion from Technical News #11 on their interpretation of tax consequences when income is paid in application for the benefit of a minor, but not to the actual minor.

"Technical News No. 11
September 30, 1997

Payments Made by a Trust for the Benefit of a Minor Beneficiary

The trustee of a discretionary trust may prefer not to make payments of the trust's income directly to a beneficiary who is a minor (a "child") for a variety of reasons and instead may wish to make the payments to:

- the child's parent or legal guardian (the "parent") to reimburse the parent for an expenditure made for the benefit of the child; or
- a person (a "third party") that provided or will provide goods or services for the benefit of the child.

1017 In a Technical Interpretation provided in December 1981 the Non-Corporate Rulings Division provided exactly this approach where it was held that Sec. 104(13) will apply to the benefit realized by the minor and Sec. 105(1) will apply to any benefit realized by the guardian.

1018 See *Waley Cohen v. C.I.R.*, 26 T.C. 471 (KB), for a similar U.K. arrangement that went poorly due to a carelessly drafted trust deed allowing the parent to be an income beneficiary. See also *I.R.C. v. Abbey*, 22 T.C. 211 (CA), and *Albert Lee v. C.I.R.*, 25 T.C. 485, and latterly *C.I.R. v. Russel*, 26 T.C. 242 (CA), for an interesting income splitting trust-charge. Unimpeachable documentation attesting to the nature of the trust is quite critical: Case V77, 88 A.T.C. 539.

1019 1974 2 N.Z.L.R. 196

1020 1934 N.Z.L.R. 366

1021 1946 N.Z.L.R. 446 (CA)

In view of certain *obiter dictum* in *Langer Family Trust*, 92 DTC 1055, [1992] 1 CTC 2119 (TCC), concern has been expressed that such payments would not be considered an allocation of a trust's income to the child for the purposes of subsections 104(6), (13) and (24) of the *Income Tax Act* since those provisions refer to amounts that became payable by a trust "to a beneficiary."

With respect to indirect payments, where an amount of income is not paid directly to the individual so entitled, but is paid to another person for the benefit of the individual pursuant to the individual's direction or concurrence, that amount will be included in the individual's income. In the case of a child, the person with the legal authority to consent to and direct such payments on behalf of the child will usually be the legal guardian of the child's property. For the purposes of paragraphs (a) and (b) below, we have assumed that the person with such authority is the parent.

The trustee of a discretionary trust may decide to allocate trust income for the benefit of a beneficiary who is a minor by making a payment to a third party or to the parent as a reimbursement for an expenditure. Alternatively, the parent may seek the trustee's agreement to make such a payment and, at the same time, provide direction to pay the amount to the appropriate person (i.e., the third party or the parent). The Department will consider such a payment to be deductible from the trust's income as an amount paid to the child in the year (pursuant to subsection 104(6)) and included in the child's income in the year (pursuant to subsection 104(13)) where:

(a) the trustee exercised his or her discretion pursuant to the terms of the trust indenture or will to make the amount of the trust's income payable to the child in the year before the payment was made;

(b) the trustee initiated the steps to make the payment, the trustee notified the parent of the exercise of the discretion and the parent directed the trustee to pay the amount to the appropriate person before the payment was made; or the payment was made pursuant to the parent's request and direction, the parent was advised of the exercise of discretion and payment of the amount either before or after the payment was made; and

(c) it is reasonable to consider that the payment was made in respect of an expenditure for the child's benefit; i.e., amounts paid for the support, maintenance, care, education, enjoyment and advancement of the child, including the child's necessities of life.

The above comments assume that the attribution rules do not apply. Where the actions taken by the trustee and parent described in (a) and (b) above are not evidenced in writing, the trustee and parent should be prepared to provide other satisfactory evidence that the requirements were met. Records kept by the trustee to support that a payment was made in respect of an expenditure for the child's benefit should include the receipt issued by the third party, or where the parent was reimbursed for the expenditure, the receipt obtained by the parent for that expenditure.

Where an expenditure (or a portion thereof) is not for the benefit of the child, the Department will not consider the payment (or a portion thereof) made by the trust as an amount paid to the child. Consequently, the amount will not be deductible from the trust's income and will not be included in the child's income. However, that amount will be included in the income of the person who received or enjoyed the benefit of the payment pursuant to subsection 105(1).

It is our opinion that a taxable benefit under subsection 105(1) will not arise to the parent as a consequence of the trust paying (in accordance with the terms of the trust indenture or will) the expenditures described in (c) above for the benefit of the child, including those that the parent would otherwise have been legally obligated to incur for the support, maintenance, etc., of the child pursuant to applicable provincial and/or federal statutes.

However, payments made by the trust meeting the requirements outlined above will be included in the child's income."

Executors' Year and During Estate Administration w/ Specific and Residuary Bequests.

Where the trust is *inter vivos* or a testamentary trust created several years previous and has crystallized into a true trust income will become payable without restriction, once the accounting for the period has been performed, and while at that time, due to the priority of the income beneficiary's equitable right to have the trust

agreement enforced upon the trustee causing distribution, at previous times, in the case of a testamentary trust, (which includes estates as per Sec. 108(1)), the right to do so does not become immediately enforceable upon the death of the testator/deceased.

In Halsbury's Laws of England 4th Ed. vol. 17 para. 1232 it's effectively provided relying on very historic cases that a beneficiary's right to property (income or capital) of the estate cannot be enforced against the executors/personal representatives compelling him/them in equity to make a distribution in the **first year of the estate**¹⁰²². Effectively, until the estate is fully administered, (ie; extinguishment of/provision for liabilities, payment of expenses etc), the beneficiaries have no immediately absolutely enforceable right to the property. In Canada this phenomenon is fully provided for in all of the provincial Estate Administration/Devolution of Property Acts and in common with the common law as just stated, the rights of the beneficiaries are not enforceable until the estate has been **ascertained**, and not ascertainable.¹⁰²³ With respect to the ITA it should be noted that a "testamentary trust" consists of both estates and trusts that arose upon and in consequence of the death of a taxpayer and while property can be severed from an estate, held in trust, and protected to a limited extent from the liabilities of the estate it is only at this time that an income right in respect of that property held in trust becomes enforceable¹⁰²⁴. If the residuary estate is to be split up into or held in trust then the

1022. but only as a consequence of the ongoing administration of the estate

1023 This of course does not preclude the executor from acting on his own discretion and paying out some income/capital in advance of the ascertainment of the debt and extinguishment thereof.

1024 See *Estate Of Roland Aubé v. Her Majesty The Queen*, 98-52-IT-1, where the Tax court had to consider who carried the liability of recognition of an unadministered estate. It held that:

[1] This is an appeal in which the issue concerns the appellant's deduction under subsection 104(6) of the *Income Tax Act* ("the *Act*"), which was disallowed, as well as interest on arrears for the additional tax charged to the appellant, interest on an excess refund and the late filing penalty imposed on the appellant.

[2] This case relates to the succession of Roland Aubé, who died on October 7, 1991.

...

[8] The main issue is whether the Minister of National Revenue ("the Minister") is justified in disallowing the \$24,532 deducted by the appellant under subsection 104(6) of the *Act* for the 1992 taxation year.

[9] The accountant, Paul-Henri Gamache, said that in January 1992 he had already identified and completed the inventory of the assets of the succession. He said that he helped make the formal inventory, which was officially completed on October 12, 1992 (see Exhibit A-5).

[10] The accountant also said that the value of the residuary legacy was known on October 7, 1992.

[11] The appellant argued that the residuary legatee knew very early on that she was entitled to a share in the assets of the succession. Micheline Goulet, who holds a power of attorney from the residuary heir, also testified that she knew in the days following the death that Marie-Paule Giroux-Aubé was fully entitled to a share in the assets of the succession.

...

[13] Counsel for the estate argued that only the quantum of the residuary mass was problematic or uncertain. The appellant argued that the accountant retained by the testamentary executor had completed his administration and the work he had been instructed to do by February 1992.

[14] As of that date, the inventory had been completed and the assets of the succession clearly identified; they basically consisted of a deposit certificate and two immovables, namely the residence and a lodge.

[15] According to the appellant, this was enough to identify the parameters and content of the share due to the residuary legatee. The appellant also argued that once the residuary legatee's assets were identified, she had or ought to have had seizin of them and therefore responsibility for the assets that were ultimately to be transferred to her.

[16] The Department argued that the date on which the succession was liquidated corresponded to the date of the agreement entered into on August 26, 1993. It was a settlement that had been difficult and had taken a long time to negotiate. The transaction dated August 26, 1993, was worded as follows:

...

[17] To give effect to the transaction, some of the particular legatees had to co-operate by drawing on their respective legacies to make up the agreed amount needed for the transaction.

[18] At what point did the testamentary executor finish or complete her administration? I consider it important to go back to the will, which established her rights in terms of the duration of her administration, to determine whether the testator set out any qualifications.

...

income rights are enforceable only when the residue has been ascertained. In the meantime, the Sec. 104(13)-(6) income payable system has a serious problem in that income is not "payable" in that period.

Interpretation Bulletin 286R2 (para. 6) provides the Department's **administrative** position with respect to how the "executor's year" will be handled, whereby, **only where** the initial tax year of the testamentary trust coincides with the "executor's year" and the only reason that the income isn't payable to the income beneficiaries is because of the "executor's year", the Department will consider Sec. 104(24) to apply to income rights **otherwise** enforceable, so as to allow the Sec. 104(13)-(6) mechanism to operate within that period. If the

[24] Can the accountant and the executor claim that their administration had been completed at that time? I do not think so. The parameters, scope and limits of an administration are not determined on the basis of the importance of what has to be completed or finalized as part of the administration.

[25] I do not agree with the interpretation suggested by the accountant, who argued that he had completed his administration because what remained to be done was basically unimportant and required mere formalities.

[26] According to the accountant, all he had to do was make sure that the investments were profitable or yielded a return; he said that he had to wait for the parties to agree before he could issue cheques based on the agreement that had been reached.

[27] Going along with the accountant's interpretation of the concept of administration would have absurd results, as the end of an administration would have to be defined based on the importance of what remains to be done. The duration of an administration is separate from its content, and it seems to me that a mandate to administer property basically ends with the rendering of an account, which is not necessarily subject to special procedures or specific formalities.

[28] One thing is clear: administration of a mass of property or the assets of a succession does not end before the complete and total delivery of the property being administered, unless, of course, the mandator withdraws the mandate while it is being carried out, in which case the mandatory's administration obviously ends.

[29] In the case at bar, it is my view that the administration ended when the transaction was signed on August 26, 1993. This had the effect of liquidating the assets of the succession that was the subject of the administration entrusted to the testamentary executor, who, in turn, had retained the accountant.

[30] Moreover, it was a transaction whose content was clearly defined and stated as far as the capital and interest were concerned.

[31] In this regard, the appellant's interpretation that the \$190,000 in capital included a substantial amount for accrued interest is supported by neither the facts nor the agreement.

[32] According to the balance of the evidence, relations between the particular legatees and the residuary legatee were difficult and strained, and each family was represented by a lawyer. At first, the parties' positions on the value of the residue of the succession were very far apart. The discussions and negotiations finally led to a settlement, which was confirmed by the transaction dated August 26, 1993.

[33] The evidence showed that some of the particular legatees had to make contributions in order to implement the settlement. In other words, the settlement reached in no way resulted from a mere adding up of cash amounts to which interest was added; it was a lump sum that had not been broken down and was somewhat arbitrary, and it was set for the sole purpose of reaching an agreement sealed by the transaction of August 26, 1993.

[34] Accordingly, it is not appropriate to try after the fact to reconstruct the various components that made it possible to put together the capital that was offered and accepted.

[35] This approach also completely rebuts the appellant's argument that the succession had been settled for a very long time. I found it surprising that the accountant took such a position, since the reality was quite different. I understand that he often referred to legal chicanery that he may have considered bizarre and dilatory; however, his opinion that his administration was completed after February since the only remaining assets were deposit certificates and two immovables is just as bizarre and unfounded.

[36] Page 9 of the unaudited financial statements and review engagement reports dated October 7, 1991, indicates that fees of \$21,935 were paid to the accountant. I presume that part of that amount was for work after February 1992. All of the facts brought out by the testimonial evidence and the will clearly showed that certain of the assets of the succession were still being administered until the transaction of August 1993.

[37] Until that time, the estate had custody of and was responsible for the assets dealt with in the transaction of August 1993. It therefore had to bear the tax liability arising from that administration. The agreement, the facts and the *Act* support this conclusion.

reason that the income isn't payable in the period is because of the terms of the beneficiary's right which explicitly preclude him from enforcing a distribution within a one year period after the creation of the estate/trust then the above rule won't apply since it isn't the common law phenomenon of the "executor's year" which is the inhibiting factor. If **one** beneficiary of the trust, which need not be a beneficiary of a particular character¹⁰²⁵ objects to such treatment then Sec. 104(13)-(6) will apply only to those amounts actually paid out to the beneficiaries.¹⁰²⁶

The above rules do not apply to severed pure trusts that are testamentary whereunder the income rights are not hindered from being enforceable by any common or statute law rules while it should also be noted that where the above rules do apply, and the estate is wound-up within the year, the income beneficiaries **may** be forced to recognize income earlier, in their previous tax year, as a Sec. 104(13)(a) inclusion, while if the estate is non-resident they will anyway under Sec. 104(13)(c). I.T. 286R2 para. 6 expresses this rule only in terms of income payable, and not capital payable, however the purpose of the rules is to allow for convenient application of the Sec. 104(13)-(6) mechanism, and thus with respect to the non-resident estates that are not personal trusts the rule will not cause early recognition of "capital" income inclusions, depending of course on whether the capital is payable in the first twelve months of existence of the estate or not.

If the beneficiary is non-resident at the time the income amount becomes payable or paid then the trust will be required to pay withholding tax on it as per Sec. 212(1)(c). If it wasn't taxable Canadian property then the beneficiary will not be liable to withholding an income tax on the gain it produced. If the beneficiary is resident at the time an income amount becomes payable and then becomes non-resident he will still recognize it in taxable income under section 114, even if a portion of it consisted of a capital gain in respect of "non" taxable Canadian property designated out under Sec. 104(21).

If the estate is wound up within the executor's year and all of the property is distributed to its appropriate beneficiaries, depending on the nature of the beneficiaries' rights, all of the income arising in that period may be taxed in the hands of the executors even though it is immediately payable to the beneficiaries. This may also be the case where an amount of estate funds are distributed to the income beneficiaries in respect of their entitlements to income accruing during the administration period as per *Corbett v. C.I.R.*

In *The King v. The Commissioners for the Special Purposes of The Income Tax Acts*¹⁰²⁷ the taxpayer appealed a case from the Divisional Court to the Court of Appeal to the House of Lords where it, as residuary beneficiary, was not able to take a credit/refund of taxes paid by an estate being administered in respect of dividends received due to the fact that the dividends were not collected on behalf of the charity during the administration and all higher courts considered the residuary beneficiary to be barren of rights to the sum of dividends received by the estate, **as dividends**, even when the residue had been ascertained. Going further than simply stating that the residuary beneficiary had no rights to the dividends as such or otherwise until the residue was ascertained the Court of Appeal followed by the House of Lords were of the opinion that even when the residuary beneficiary acquired rights to the sums when the residue was ascertained **his right did not "relate back" to the time at which the dividends were received and that the concept of relation back applied only in respect of specific bequests**.¹⁰²⁸ As per Lord Sterndale M.R. of the Court of Appeal:

"The executors as soon as the residue was ascertained became trustees for the residuary legatees of that fund, but until that was ascertained there was no fund to which they could become, or did become, trustees for the residuary legatees at all. The income that they were receiving in the meantime was income which they were receiving, not on behalf of the residuary legatees at all, but on behalf of themselves as executors for application in the due administration of the estate. I think, therefore, that these dividends, and this income up to December, when the residue was ascertained, were not received on account of the residuary legatees at all, and the residuary legatees were not the persons entitled to that income, or to those dividends, and therefore, the Income Tax was not paid on their behalf; and I think

1025 and which in the author's opinion should include capital beneficiaries

1026 It's questionable whether payments **on account** of income are actually assessable under Part I when made to income beneficiaries prior to the completion of administration.

1027 Ex. parte *Dr. Barnardo's Homes National Incorporated Association*, 7 T.C. 646,

1028 This is extremely relevant when the targeting in respect of testamentary spousal transfers under Sec. 70(6)(a) is examined.

that that is sufficient to dispose of the case. In the Divisional Court the decision went very much upon the doctrine as applied to the assent of the executor to a legacy, and the Court seemed to have held that the executors having assented to the bequest of the residue by the payment of it in December, that assent related back to the testator's death. Now I do not propose to discuss very much whether an executor does or does not or can or cannot assent to a residuary bequest. There seemed to me to be a little difference between the learned counsel who argued the case for the Respondent upon the point. But it seems to me to be obvious that if he can, and if he does, assent in any way, the incidents connected with assent are absolutely different, and the operation is absolutely different, in the case of a residuary bequest, and in the case of a specific bequest. In the case of a specific bequest at the time of the testator's death there does exist the thing he bequeaths. It may be a house. He bequeaths that house, and the testator assenting to that, the title of the legatee to the house dates from the death of the testator. In the case of a residue it does not exist. As I pointed out, there is no such thing until the estate has been administered, and the residue has been ascertained. No assent could possibly take place in this case before December, because there is nothing to which that assent can attach. There might be a promise to pay the residue when ascertained, but that is an entirely different thing from assenting to the bequest of a specific thing. **If there be such a thing as an assent it seems to me it cannot possibly relate further back than the date at which the thing to which the assent attaches comes into existence, and the first date that that can be in this case, I think, would be December.** I prefer not to put my judgment in this case upon the doctrine of assent, or the principle of assent at all. I put it upon the ground that these dividends, and this income, up to December, 1916, were not received on account of these residuary legatees at all, and that therefore the Income Tax that was paid by deduction was not paid on their behalf. The fund they got was the residue when ascertained. It is quite true that in the making up of that fund two things entered, the capital of the testator's estate, and income derived from the testator's estate; but those two things formed but one fund to which these persons were entitled when it was ascertained, and I think, as I have said, that the Income Tax was not paid on their behalf. The income and the dividends were not received on their behalf, and it is practically impossible to tell out of what funds the executors made their payments in the administration of the estate. They received the funds generally, and they made the payments generally, **and there were no specific dividends or income received on account of any particular legatee, certainly not on account of these legatees."**

This was also the opinion of Atkin L.J., and Younger L.J. while Viscount Finlay, Lord Atkinson and Viscount Cave of the House of Lords were all of unanimous opinion concurring with the Appeal Court.

In *Corbett v. C.I.R.*¹⁰²⁹ an estate was to be wound-up and the residue handed over to trustees which was then to be invested to produce income for the life tenant however the will did not give her any right to the income during the administration, but the executors doled out a considerable amount (£6000) to her **during the administration** and the C.I.R. attempted to assess her as receiving taxable income. Lawrence, J. held:

"It is true that a residuary life tenant is entitled to be paid at the time of the ascertainment of the residue, a sum which represents, as between him and the remainderman, his share of the income which has accrued during the period of administration, (See *Allhusen v. Whittell*, (1867), 4 Eq. 295), but **he does not receive that as such income but as a sum equal to the income** (See per Lord Cave in the *Barnardo* case, 7 T.C. at page 669)."

On appeal Sir Wilfred Greene, M.R. provided, quoting from *C.I.R. v. Wahl*¹⁰³⁰:

"Since the case of *Barnardo v. Commissioners of Inland Revenue*", says Lord Buckmaster, "...it has been clearly established that the accumulation of income arising from a residuary estate, before the appropriation of that estate to the residuary legatees does not cause such income to be regarded **as the income of the beneficiary** on its ultimate receipt by him and, therefore, where, as in that case, the beneficiary was a charitable institution, they are not entitled to a return of the sums which have been deducted by way of tax from the income at its source. In that decision, in the Court of Appeal, Lord Justice Atkin pointed out that the result would be that, in similar circumstances, super-tax could not be charged."

1029 21 T.C. 449 (CA)
1030 17 T.C. 744

While quoting from *Barnardo v. C.I.R.* itself:

"Lord Finlay says that this, on page 668 of 7 T.C.:

"It appears to me that the present case is really decided by the decision of this House in Lord Sudeley's case ([1897] A.C. 11). It was pointed out in that case that the legatee of a share in a residue has no interest in any of the property of the testator until the residue has been ascertained. His right is to have the estate properly administered and applied for his benefit when the administration is complete. The income from which this Income Tax was deducted was not the income of the charity, it was the income of the executors. They were, of course, bound to apply it in due course of administration, but they were not trustees of any part of it for the charity. **There had been no creation of a trust in favour of the charity in respect of this income, it was never paid to the charity as income.** What was ultimately paid over on the close of administration was the share of the whole estate, consisting of capital and accumulated income, which fell to the charity. The executors, not the charity, were the recipients of this income, and there was no verbatim back in the case of the bequest of a residue..."

Pausing there for a moment, the language of Lord Finlay is, in my opinion, just as applicable to the case where the residue is settled as to the case where the residue is not settled. In neither case are the executors trustees; in neither case is the income the income of anybody but the executors; in each case the executors and not the beneficiaries are the recipients of the income, and there is no relation back; in each case, if no right of deduction at the source had existed, it is the executors and the executors only who could have been liable for the tax. **I myself attach great importance to the distinction drawn between the position and estate of executors and the position and estate of trustees, for this reason that where trustees are in receipt of income which it is their duty to pay over to beneficiaries, either with or without deduction of something for trustees expenses on the way, that income is at its inception the beneficiaries' income.** It is perfectly true that for assessment purposes the trustees may fall to be assessed but the income is the beneficiaries' income from the very first and the expenses so paid out of it are paid out of it so to speak, on the way. **But in the case of executors, it is not true to say (and this is how I read the opinion of Lord Finlay) that the income received by the executors pending the conclusion of the administration is the income of the beneficiaries in that sense."**

Alternatively the Court provided:

"When the residue is not settled but is given absolutely, the residuary legatee receives, on the conclusion of the administration, a sum of money. There is no necessity in that case for equity to insist upon any splitting up, and dissection, of that sum of money, because the entirety belongs to the residuary legatee. Nevertheless, that sum of money, if its origin is to be traced, represents in part income and in part capital. There can be no question of that. On the other hand, when the residue is settled, it does become necessary to dissect the sum which remains in the executor's hands at the conclusion of the administration, because, if that were not done, the tenant for life would be prejudiced by the act of the administration, and the longer it took, the more he would be prejudiced. Equity then steps in, and says: "as between the tenant for life and the remainderman, we are going to impress, **for our own purposes**, a particular character on this fund. We are going to treat it, as between you two parties, as divisible in part to the tenant for life, and in part for the remainderman.", and the principle on which it is divided is a principle which in effect throws upon the tenant for life the burden of the administration, to this extent, that capital is treated as liable to contribute such a sum as capital as, with the income thereon for the relative period, would provide for the necessary expenses. The effect of that adjustment is that the tenant for life, when he receives that sum, is receiving a sum equal to the income of the estate, less the income which that part of capital notionally applied would have produced. These calculations do not represent anything that has happened in truth and in fact, but are purely notional calculations for the purpose of applying the rule of equity. It is perfectly true, as I have said, that the sum which the life tenant receives on that apportionment as between him and the remainderman, he receives as income, **but that is quite a different proposition for saying that the sum which he receives is his income for purposes of the Income Tax Acts..."**

" The matter can be looked at from a rather different angle, but I think with the same result. A taxpayer

is liable to pay Sur-tax in respect of his income, and when he makes his return of total income for the purpose of Sur-tax, he brings in the whole of his income; and where the income is income which has borne tax at the source, he brings in the gross amount. That is the basis that the income, when received and when struck with tax by deduction, was his income, and that notwithstanding the circumstance that the hand of trustees might be interposed between his hand and that of the payer. But in the present case it is quite impossible to say that, because the income when received by the executors was not the beneficiary's income; it was the executor's income. That was pointed out as clearly as anything could be pointed out in the Barnardo case. It is, of course, impossible for the Crown to suggest that the £6000 that was paid here was a different income from the income received by the executors. It does not claim that the recipient of the £6000 was directly assessable in respect of it, nor does it suggest that, on paying that £6000, the executors ought have deducted tax. In other words, it does not treat that £6000 as being a new income springing up when it was paid, but it links it with the income received by the executors upon the allegation that the income, when received by the executors, was income of the beneficiary for tax purposes. **It seems to me that there is an unbridgeable gap which makes it impossible to link that £6000 to the dividends received by the executors, because it is impossible to trace back the title of the beneficiary to that £6000 into income which the executors received, because the income was the executor's income and nobody else's.**¹⁰³¹"

This case would seem to directly contradict the Department's opinion expressed in I.T. 286R2 concerning actual payments to income beneficiaries made during the estate's administration and if this precedent is exhaustively relevant in the Canadian context then the preferred beneficiary election may be the only method of shifting tax liability for the income recognized by an estate during its administration.¹⁰³² It's important to note that the Corbett case concerned **residuary** legatees and not the rights of beneficiaries to **specific** bequests that didn't make up the residue. In such a case, in the author's opinion, the result may not be the same when payments are made owing to the relation back of the beneficiary's title, thus also to the income **as such**, and if this is the case Sec. 104(13) could apply to payments made to him on account of the property's income. In such a case a trust could actually be found to exist and thus income realized by the executor/trustee could also be found to be payable as such to the specific legatee, (but not where due to the state of the estate the executor retained the income).¹⁰³³

In I.R.C. v. Hawley¹⁰³⁴ the dividends from shares bequeathed as a **specific bequest** were payable to the executors **during** the estate administration while the shares were retained by the executors to extinguish possible debt. The dividends were held assessable in the beneficiary's hands. Rowlatt J. held:

"In this case the respondent was specific legatee under his father's will of certain shares in two private companies. The father died on August 19, 1922, and the will was duly proved. The testator owed large sums of money to the two companies for loans and advances made to him during his life. His executors found a difficulty in paying off these loans and in consequence of this they did not assent to the specific bequest until June 1924, when the respondent became entitled and took the legal rights to the shares as from the testator's death. In the meantime dividends had accrued upon the shares in 1923 and 1924, which were payable to the executors as legal owners before the date of assent. They were not in fact paid, because the companies retained them in part repayment of the loans owing to them from the testator. They were however accounted for by the executors when their assent was given to the legacy. The question is whether the dividends are to be treated as the respondent's income for the years when they accrued **and were payable**, or whether they must be regarded as income for the year when assent

1031 See also Robertson v. Dep. F.C.T., 65 C.L.R. 338 at 346, In re: Gillson, 1949 Ch. 99, Elliott v. Elliott, (1841) 152 E.R. 11.

1032 See F.C.T. v. Whiting, 1943 68 C.L.R. 199, for an Australian unadministered estate situation where the essence of a P.B.E. was attempted to no effect. See also Marie Celeste Samaritan Society v. C.I.R., 11 T.C. 226, where payments made on account of income to a residuary beneficiary prior to the establishment of residue were not recognized as taxable income, and Cunard's Trustees v. C.I.R., 1946 1 All E.R. 159, compared to C.I.R. v. Lady Castlemaine, 25 T.C. 408.

1033 See Lord Sudeley v. A.G., 1897 A.C. 11, Glenn v. F.C.L.T., 1915 20 C.L.R. 490, Executor, Trustee and Agency Co. of South Australia Ltd. v. Deputy F.C.T., 1939 62 C.L.R. 545, and Re: West, 1909 2 Ch. 180.

1034 13 T.C. 327

was given by the executors of the legacy. The doctrine of relation of the assent to the death of the testator is complete and has effect for most purposes. But that does not conclude this question, because here the taxation is in respect of a particular period of time and in respect of events happening within the limits of that period. Did this income accrue within that period or not? It does not follow that for the purpose of answering that question the doctrine of relation back goes far enough. The shares were left to the respondent as a specific legacy, and from the date of death and before the assent they were his property, subject to the right of the executors to keep control of them for the purposes, if necessary, of paying the testator's debts, and for this purpose they had legal title. Counsel for the Crown put the matter in that way, and I think it substantially describes the position. I do not think that *Barnardo's Homes v. Special Income Tax Commissioners* ([1921] 2 A.C. 1) is of any help here. In that case the court was concerned with a gift of residue and therefore the doctrine of relation did not arise. That decision does not throw any light on the exact time at which the legatee must be held to have received the dividends. **Here the income was paid and allowed to the respondent or to the executors as trustees for him. These sums, being income, must not be regarded as having accrued as an accumulated sum at the time the assent was given. The doctrine of relation applies and impresses the dividends that have accrued and been paid in the meantime with the character of income. They must, therefore, be treated as having belonged to the specific legatee all the time, although they were in fact received by the executors. In my view the dividends belonged to the respondent in the respective years when they were paid to the executors, and the appeal of the Crown must be allowed.**"

In a **specific devise** situation if the income isn't paid to the beneficiary and is used to satisfy testamentary debt Sec. 104(13) will not apply to it. Clearly argument could be made for the ranking of claims on the estate and the use of executrix discretion in choosing to contest payment to the beneficiary in light of onerous estate claims.

In *Hebert v. C.I.R.*¹⁰³⁵ a U.K. resident was a **residuary** beneficiary under an unadministered estate which consisted of rental property and interest bearing investments. The death had occurred on Dec. 19, 1914 and prior to the estate being settled in 1919 rent/interest was paid to the residuary beneficiary. The tax authorities attempted to assess the surplus undistributed income of the estate in the beneficiary's hands for income tax but the King's Bench found that his title to it **as income** did not relate back past the completion of administration and in effect he received as a capital distribution. **In the author's opinion this is what the result would be if such case would occur in the Canadian context.**¹⁰³⁶ **Pending complete administration an income beneficiary has a capital interest in the income accumulating during the administration since he has a right to receive only trust capital when the administration is complete. Distributions in respect of the right will not be attract Sec. 53(2)(h) ACB reductions but for purposes of Sec. 105(1) will be treated as if they did thus preventing an inclusion under the latter. Under the ITA the income will be distributable tax free unless the capital interest was acquired for consideration payable or if the trust isn't personal.**

Pursuant to *Corbett* and *Barnardo's* it can easily be seen that, while income realized in the executor's year cannot be considered payable to the **residuary** beneficiaries under Sec. 104(13), it will also not be recognizable by the beneficiaries under the subsection when the estate is fully administered and wound-up within the executor's year and all property is distributed to the beneficiaries. This **isn't the case with specific beneficiaries**. Some could contend that since the income, in specie, is **paid** to the beneficiaries, as per Sec. 104(24), it will be included in the beneficiary's income under Sec. 104(13), however the actual receipts that are distributed are not distributable, paid, nor payable **as income** receipts at that time, but as a capital distribution following the reasoning in *Corbett*. The income would be taxed in the executor's hands in the estate, and distributed to the beneficiaries as residue, the only property to which their rights are enforceable in respect

¹⁰³⁵ 9 T.C. 593

¹⁰³⁶ Though see *Milne's Exors. v. C.I.R.*, 37 T.C. 10, for partial assent and flow through of income character and *Cunard's Trustee v. C.I.R.*, 27 T.C. 122, for instances where residuary income beneficiary's entitlement supplemented by capital and thus includable in income under *Brodie Trustees/Lindus & Hortic dicta* prior to residue ascertainment. On the exercise of the power a new source of income was created. See also *Duncan v. I.R.C.*, 17 T.C. 1, *Nelson v. Adamson*, 24 T.C. 36, *George L. Craig v. Commr.*, 7 B.T.A. 504 (1927), *In the Estate of B. Brasley Cohen*, 8 T.C. 784 (1947)(US), *Re: Cunliffe-Owen*, 1953 Ch. 545 & *Re: Myler*, 1951 C.T.C. 376. *Commr. of Taxes v. Luttrell*, 1949 N.Z.L.R. 828 (CA), contains an excellent discussion of double taxation principles of income accumulating but unapplied in estate administration.

Canadian context. If the estate is wound-up and the amounts realized in and paid for that year, again, the estate is making distributions of capital since the estate has terminal recognition of the income.

The payments are in fact, an advance of capital, since the party to whom they are paid has no right to them, as income, and no one but the executrix can recognize them as income. Legally, the executrix must recognize the receipts as income but cannot transfer them as income to the beneficiary since there's forever the possibility that, until complete administration and settlement of the estate, there is a chance of latent debt ascertainment that would prompt for drawback of those amounts: "the beneficiary" is not thus realizing complete dominion and control of the amounts received pending that ascertainment. It's not a question of amounts, either: it's an issue that in the estate administration environment the executrix is liable for all tax aspects of her estate until fully administered and no one other than her can be held liable, save if she opens up other parties, which she can through capital distribution to the residuary beneficiaries pending settlement. And, the residuary capital recipients can have their entire receipts eliminated through prepayment to which they are not, in the end, entitled because of latent debt/action against the estate.

In the author's opinion the fact that the Sec. 104(6)-(13) mechanics are in subdivision k equating "estates" with "trusts" is of no significance since that final hurdle of a residuary estate in the midst of administration not being able to transfer anything but capital, **unless it's a specific devise with relation back**, applies: it is transferring income that is capitalized in its hands and it is not acting for a beneficiary when it is realized. The title to the income, **as income**, rests exclusively with the executor and **he acts as trustee for no one** hence the income is no one's but his own and it ends there: it becomes capital immediately in the executor's hands.¹⁰³⁷ This is even so, in the author's opinion, when there are no established onerous claims but there are FLA/Dependents' Relief applications being settled or contested since the fundamental element to be recognized is that the executrix is in complete ownership and control of the title of that income as such and she cannot shed it within the arena of estate administration norms. This has the effect of capturing all income in the estate's hands rather than the beneficiary's for possible lower marginal rates when the estate is **residuary, even when it is actually paid to a beneficiary since any payments made are actually capital.**¹⁰³⁸ The subsection 104(6)-(13) mechanics operate when "income" (Division B) of the estate is being paid **but at common-law that amount is taxed capital since no one else but the estate owns that income: it's not "income" that is being paid.**¹⁰³⁹

To be noted is that s. 104(13.1)-(13.2) allows for avoidance of recognition by the beneficiary under the ITA when payment has actually been made through elective, however, those mechanics are only available depending on residency.

Equally, given that a residuary estate cannot transfer income, recognizable as income, until the resulting capital is distributable upon net ascertainment, it stands to reason that even when the administration is completed that income still cannot be transferred out for recognition: the estate has had a year-end, as a tax creature not the same as a trust, and that prompts for recognition in its hands.

¹⁰³⁷ Imagine the instance where an executrix is retaining all income to cover on-going debts materializing: whose income is it, the beneficiaries or hers? Even well past the executor's year?

¹⁰³⁸ The fact that Finance has recognized explicitly the character of an estate as distinct from a trust arising out of it Sec. 164(6) via the handling of dispositions in the "executor's year" buttresses this: given this provision how can the common-law principles of who owns the income as such be ignored so lightly?

¹⁰³⁹ See *Burke v. Hudson's Bay Co.*, 2010 SCC 34, [2010] 2 S.C.R. 273 where the Court, recently evaluating the nature of a residuary beneficiary's interest until complete administration, held:

[58] Cory J. did not elaborate on the significance, or content, of that equitable interest in the surplus while the plan is ongoing. However, it seems to me that it might be somewhat analogous to a floating equity. A floating equity attaches to, for example, the residue in a will. **The residuary beneficiary does not immediately obtain an equitable interest in the residue of the estate, because the assets may be needed to pay debts. Even in the case of a solvent estate, it is still unclear what property constitutes residue until the administration of the estate is complete. The residuary beneficiary is therefore said to have a "floating equity", which may or may not crystallise.** A floating equity "protects the beneficiaries, not by giving them equitable interests, but by ensuring the due administration of assets by the personal representatives" (*Snell's Equity*, at para. 2-06).

This flies in the face of many Cdn. lower court cases that seem to have disregarded the nature of an unadministered-then administered residuary estate and the separate tax creatures recognized under the ITA and what the provisions actually provide for.

This is one area that should require Finance to act to make specific attendance of what is a "general" ITA provision attempting to apply to a slightly different situation.

In Case #G13¹⁰⁴⁰ the Taxation Board of Review had to ascertain whether a beneficiary was presently entitled to income of an estate that had been completely administered but that would be subject to the deceased's spouse's Testator Family Maintenance Act application for additional entitlement should she apply for it. Not 'enough' was left to her apparently and she was threatening to launch an action, **however she had not done so**, while the executor was in the process of negotiating with her in the relevant years of assessment. The income was not paid to the beneficiary in the relevant years but it was legally payable and the Board was of the opinion that the fact that the spouse was threatening to launch an action did not preclude the estate **from being fully administered thus allowing the income beneficiary's rights to its income to crystallize**. In the author's opinion, this Tax Review Board decision is poorly founded.

In George Alexander Hall, Mary Katherine Dobbin and James Douglas Hall and Her Majesty the Queen¹⁰⁴¹ the Tax Court had to consider an instance where an estate had been considerably administered and almost wound-up however there was argument over fees etc. and one of the beneficiaries had expressed contesting. The executor attempted to transfer liability for recognition of the income, as payable, to the beneficiaries while this was going on and the Tax Court held:

The Royal Trust Company of Canada was the sole executor and trustee of the Estate of Herbert L. Hall who was the uncle of the three Appellants, **the residuary beneficiaries. Royal Trust issued T5 Statements of Investment Income for the year 2000 to the Appellants in the amount of \$5,193 each which amount was not received by the Appellants until 2001.**

[2] The Appellants take the position that the administration of the Estate had not been completed and there had been no distribution to the taxpayers in the year 2000 and the amount should not be included in their income for that year. The Minister's position is that the interest became payable to the Appellants during the 2000 taxation year in accordance with subsections 104(13) and 104(24) of the *Income Tax Act*. The Minister submits that following the wind-up of the Estate, which he took as of January 2000, the Appellants were in a position to enforce distribution and thereby the interest earned became payable to them in the period following the wind-up.

...

And that is the crux of the question before us.

[4] For the most part, the facts are not in dispute. The issue boils down to whether the administration of the Estate had been completed in the year 2000 and whether the amounts became then payable and that the Appellants were entitled to enforce payment in that year. The *Act* treats income differently from different sources. Income from employment is included in the year it was received, income from business is included in the year the amount becomes an amount receivable. Yet, income from a trust differs in that the amount must be found to be payable to the beneficiary.

...

[5] Many cases have explored the difference between received and amounts receivable. This question was considered, whether payments received but yet not earned were to be included in a taxpayer's income in *Kenneth B.S. Robertson Ltd v. M.N.R.*, [1944] 3 D.L.R., Ex.Crt. 170, where Thorson J. found that an amount received was to be included in the income of the taxpayer, even if it was unearned, provided that it had the "quality of income". He stated:

1040 (1956) 7 T.B.R.D. 70 (Australia)
1041 2003TCC410

Did such amounts have, at the time of their receipt, or acquire, during the year of their receipt, the quality of income, to use the phrase of Justice Brandeis in *Brown v. Helvering*. In my judgment, the language used by him, to which I have already referred, lays down an important test as to whether an amount received by a taxpayer has the quality of income. **Is his right to it absolute and under no restriction, contractual or otherwise, as to its disposition, use or enjoyment?**

The Supreme Court of Canada considered quality of income in *Gagnon v. Canada*, [1986] 1 S.C.R. 264, and turned to other cases interpreting both *Robertson* and *Brown* in concluding that this referred to "restrictions on the right to dispose of an amount, not to restrictions on the way it was used". Mr. Justice Beetz quoted a rule in *Rutkin v. United States*, 343 U.S. 130 (1952), stating:

A gain constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it.

As regards the concept of quality income, trust income is not different.

[6] Therefore, in analyzing the issue in the present cases, we need to explore the question of whether the Appellants should have an absolute right to their distributions and "be under no restriction, contractual or otherwise, as to its disposition, use or enjoyment". Given the facts of this case, the amounts in question were payable but for the fact that Royal Trust refused to release the distribution until the settlement of a dispute with the Appellants.

[7] I find as a fact that Royal Trust had not completed the administration of the Estate; the beneficiaries were presented a Statement of Accounts for the Estate in January 2000 which included executor's compensation, to which the beneficiary, James, who is an attorney, vigorously opposed. He was not about to release Royal Trust from its duties of passing accounts. In addition, there were further funds to be collected, for example, a \$64,000 Revenue Canada refund. I refer to the Supreme Court of Canada decision in *Hall v. Québec Minister of Revenue*, [1998] 1 S.C.R. 200, where Gonthier, J. stated:

A contrary conclusion would have the unfair effect of making legatees pay tax on income from which they are not benefiting.

This quote was also included in the Appellants' Notices of Appeal.

[8] I find that Royal Trust caused the delay of the distribution until 2001 after the T5 slips had been prepared and issued. Royal Trust refused to amend them. It seems quite evident that for these reasons the Appellants did not have an absolute right to their distribution, nor could they, as a practical matter, readily realize economic value from them.

[9] Counsel for the Respondent argued that the delay in the distribution was due to the Appellants' own actions, or at least the actions of one of the three beneficiaries. I believe the testimony of James Hall who admitted that in this respect, he was the offending party. He laid out his reasons for persisting in the dispute with Royal Trust. Certainly, he could have given in and surrendered his position so that the Appellants would receive their funds when originally anticipated. I do not believe, however, that it was the intent of Parliament, in enacting subsections 104(13) and 104(24), that the beneficiaries of trusts relinquish the right to pursue funds which they believe belong to them for the sake of including a lesser amount in their income at the earliest possible opportunity. As Justice Gonthier said, this would be unfair.

[10] I therefore find the amounts in question were not payable to the Appellants in the year 2000 because the Appellants' distribution did not possess the requisite "quality of income". For these reasons, the appeals are allowed with costs.

In *Berry v. M.N.R.*¹⁰⁴² a non-resident was attempting to avoid withholding tax under Sec. 212(1)(c) on income that was not paid to him from a Canadian resident estate. The trust company commenced an action against the estate claiming damages arising from the actions of the testator and beneficiary when they were employed by the company and although it was not ascertainable at the time whether the property of the estate was

1042 1981 C.T.C. 2253 (TRB)

sufficient to satisfy the claims the trustee continued to pay the non-resident. The difference between the net income of the trust and the amount paid-out was concluded to have been credited to the beneficiary drawing Part XIII attention.¹⁰⁴³ Again, is this decision respectful of the higher law on residuary/specific devises?

The Trust as A Conduit.

Baker v. Archer-Shee¹⁰⁴⁴, Archer-Shee v. Garland¹⁰⁴⁵, Syme v. Commr.¹⁰⁴⁶, and Kemp v. M.N.R.¹⁰⁴⁷, Gilhooly v. M.N.R.¹⁰⁴⁸, Pan American Trust Co. v. M.N.R.¹⁰⁴⁹ and TransCanada Inv. Co. v. M.N.R.¹⁰⁵⁰ all provide that income paid as such to the beneficiary from the trust retains its source character on the payment and the beneficiary realizes it as from the underlying property.¹⁰⁵¹ Notwithstanding the common law the trust as a conduit of income in respect of its Part I¹⁰⁵² income no longer exists due to subsection 108(5) whereby, as per para. (a), any amount included in computing a beneficiary's income under Sec. 104(13)-(14) or section 105 will be **deemed** to be income from a property which is an interest in a trust as compared to the source of the income in the trust's hands.¹⁰⁵³ This causes considerable problems where the trust carries on active business and the beneficiaries are corporations since the small business deduction will not be available to the beneficiaries in respect of the income they recognize. If the corporate beneficiary was also the contributor of the income producing property, (or its substitute), then if it retained some sort of control over the property in the form of a veto against disposition, if the property could revert back to it, or if it was to be disposed of only through the beneficiary's direction then Sec. 75(2) could apply at least so as to cause the characteristics of the income to be retained in the beneficiary's hands as income from that particular property although this could be considerably expensive since Sec. 75(2) causes a double income inclusion effectively. However loss producing property could also be contributed which could also benefit from Sec. 75(2) so as to offset the inclusion and in the case of the S.B.D. is useless since Sec. 75(2) doesn't attribute business income.¹⁰⁵⁴

Subsection 108(5) does not apply to affect the income attribution rules as per the last phrase of the subsection.

Subsection 108(5) opens with "Except as otherwise provided in this Part..." and subdivision k has various provisions that allow a trust to designate in respect of a beneficiary, unilaterally, an income payment as having a particular source.

Subparagraph 108(5)(a) refers to amounts "included in computing the income for a taxation year of a beneficiary of a trust" but it doesn't refer to income payments upon which a withholding tax was applied. Part XIII doesn't compute income although subsection 212(1)(c) targets income payments that would have been included in computing the income of the recipient under Sec. 104(13) **only**, had he been resident in Canada. As the subparagraph presently reads, it cannot be applied for purposes of Part XIII, (especially when one recognizes the double targeting needed such as in subparagraph 53(2)(h)(i.1)(A)). In respect of payments made to non-residents by trusts or estates resident in Canada subsection 212(11) provides that, regardless of the source from which the trust or estate derived their substance, for purposes of Sec. 212(1)(c) they shall be **deemed** to be paid or credited as income from a trust or estate. There is thus reason to say that the conduit principle in respect of how it applies to non-residents under Part XIII has also been deactivated. As per Sec.

¹⁰⁴³ Part XIII, Sec. 212(1)(c) targets Sec. 104(13) income inclusions specifically. In *Boger v. M.N.R.*, 89 D.T.C. 15, an M.P.A. application prevented indefeasible vesting.

¹⁰⁴⁴ 1927 A.C. 844

¹⁰⁴⁵ 15 T.C. 693

¹⁰⁴⁶ 1914 A.C. 1013

¹⁰⁴⁷ 1947 C.T.C. 343

¹⁰⁴⁸ 2 D.T.C. 725

¹⁰⁴⁹ 49 D.T.C. 672

¹⁰⁵⁰ 53 D.T.C. 1227

¹⁰⁵¹ *Archer-Shee v. Garland* illustrates the importance of the proper law of the trust in this principle where it was held that under the particular U.S. law the beneficiary had only a right to have the trust administered, not to the property itself. See also *Kelly v. Rodgers*, 19 T.C. 692, and *I.R.C. v. Clarke's Trustees*, 1939 S.L.T. 2, "Tindal and all that...", J.R. Sharp, *Taxn. in Aust.*, 1984 pg. 1038.

¹⁰⁵² or in the case of foreign resident trusts any of its income

¹⁰⁵³ See *Minister of National Revenue v. Trans-Canada Investment Corporation Ltd.*, [1956] S.C.R. 49 for exactly this problem when source character did not flow through to the corporate receiptient of an in-substance trust dividend.

¹⁰⁵⁴ Can Sec. 75(2) be interpreted to attribute income from what is property in the trust's hands to a corporate beneficiary/contributor whereby it recognizes it as business income if it carries on a business in respect of similar property?

212(11) and the general undertone of I.T. 465R if the income is capitalized in the trust it can be distributable without incident under Sec. 212(11) and 212(1)(c).

Subparagraph 108(5)(b) provides certainty as to the deductibility of charges by heirs on both their personal account and on account of the trust that they may be identified with under Sec. 104(1). It provides that an amount deductible by the trust in computing its income, (other than under Sec. 104(6) and (12)), will not be deducted by a beneficiary in computing his income.

“Interpretation – Sec. 108(5)”

(5) Except as otherwise provided in this Part,

(a) an amount included in computing the income for a taxation year of a beneficiary of a trust under subsection 104(13) or (14) or section 105 shall be deemed to be income of the beneficiary for the year from a property that is an interest in the trust and not from any other source, and
(b) an amount deductible in computing the amount that would, but for subsections 104(6) and (12), be the income of a trust for a taxation year shall not be deducted by a beneficiary of the trust in computing the beneficiary's income for a taxation year,
but, for greater certainty, nothing in this subsection shall affect the application of subsection 56(4.1), sections 74.1 to 75 and 120.4 and subsection 160(1.2) of this Act and section 74 of the Income Tax Act, chapter 148 of the Revised Statutes of Canada, 1952.

Constructive Receipt.

There is not a single Canadian tax case that the author knows of where the issue of dispute was the applicability of the Sec. 104(13)-(6)-(24) mechanics to an **indirect constructive receipt** of income by the beneficiary of a trust where it was applied for the beneficiary's benefit without him having the power to receive it in person. In Interpretation Bulletin 305R3, para. 12, the Department is of the opinion that indirect constructive receipt of the income of a spousal trust will suffice as to qualify it as such providing the income was applied or applicable exclusively for the spouse's benefit. While the intentions of the Department are ennobling in this particular instance, in providing of such a lenient interpretation allowing the settlor of the trust to structure it in such a way as to protect the spouse's right to the benefit of the income, in the author's opinion the provisions of Sec. 70(6)(b) and 73(1)(c) provide otherwise (and advance tax rulings should be obtained before following the Departments "opinion"). Indirect applications may be suffice to allow the spousal trust to be regarded as such but this doesn't cause the payment to be precluded from being included in income under Sec. 105(1) without the trust recognizing the Sec. 104(6) deduction.

It's also to be noted that CRA has issued a TN opinion, commented on in the section regarding minor income entitlements, that provides that when income is applied for the indirect benefit of a minor it will be considered paid to her. Given that the Minister has felt slightly compelled to provide “an exception” in such a case, it can be concluded that such mechanics are not otherwise available in respect of adult/corporate beneficiaries.

In respect of other constructive receipts of income it would appear that the Act has only specifically dealt with their inclusion or qualification in few instances. Subsection 105(2) deals with them, where specific forms of constructive receipt/application of income are referred to while the definitions of income and capital interest in section 108 are phrased so as to capture rights to income or capital other than through its receipt ie; the right to have it applied for ones benefit. When one turns to the charging provisions in Sec. 104(13) and 104(24) it would appear that the concept of constructive receipt has been completely overlooked in that those provisions only deal with payments made **to the beneficiary** and one cannot argue respectfully that the provisions are wide enough to encompass indirect receipt when one reviews the other provisions where both have been explicitly referred to. These include of course the income attribution charging provisions in Sec. 74.1(1)-(2), 74.2(1), and 74.5(9), where both transfers or loans of property to or for the benefit of taxpayers are commented upon.

Subsection 105(1) applies to indirect applications of trust **capital** for the benefit of a beneficiary whereby the trust does not receive a Sec. 104(6) deduction and capital is reintroduced into the tax base. Where **income** is indirectly applied for the beneficiary's benefit, since it isn't payable to him in person, he'll also recognize a

Sec. 105(1) inclusion and the trust will not gain the Sec. 104(6) deduction again.¹⁰⁵⁵ Obviously a Canadian resident trust should have all of its income payable directly to the beneficiary himself if it is to be payable so as to avoid this double taxation but if this is the spirit and object of the Act; being that Sec. 105(1) is to apply to constructive applications of income or capital, then there is a paramount weakness in all of the other various targeting provisions in the Act concerning beneficiary receipt in that they usually refer to the ability of the beneficiary to **receive** income or capital in person. Since the application of Sec. 105(1) cannot be easily avoided in the case of indirect capital applications, even in the case of personal trusts, one has to tread lightly in arranging beneficial application of capital in order to avoid such provisions. Such provisions include Sec. 74.5(10) in respect of those persons beneficially interested in a trust which falls within the targeting provision of Sec. 74.3(1) for purposes of income attribution, more dangerously Sec. 94(7) which applies for the same purposes in respect of non-resident trusts and offshore investment funds, Sec. 212(11) in respect of deeming the character of payments made by a Canadian resident trust to a non-resident beneficiary, and Sec. 104(7) in respect of Sec. 104(6) deductions in respect of income paid or payable to a designated beneficiary however the avoidance of the targeting of these provisions doesn't necessarily result in beneficial results, (especially in the latter case). The constructive receipt concept, and the lack of provision for it, is also relevant when one considers to whom property is being distributed to in satisfaction of a capital interest under section 107 and the ascertaining of a preferred beneficiary's share of accumulating income under Sec. 104(15)(b) and elsewhere in respect of that tax device.

This being said, it is entirely possible to charge a payable to a beneficiary's hands with an obligation to use it for certain purposes and you're invited to consume the material in The Spousal Trust section, in the earlier part of this compendium, "The Spouse as Trustee" and the precedents (*Countess of Bective v. F.C.T.* and *Bouck v. M.N.R.*), and footnotes, for the principal issues. In this regard, while you cannot have a particular expense covered directly, it can be the focus of the end of the payable through the beneficiary's hands.

¹⁰⁵⁵. See however the T.I. provided in Dec. 1981 by the Non-Corporate Rulings Division where it was provided that income paid to a guardian and devoted to an offspring's benefit would gain Sec. 104(13) treatment while those pennies counted as expended on the guardian would cause him to recognize a Sec. 105(1) inclusion. This is obviously an example of administrative leniency when no provision provides for such specifically under the Act.

The Subsection 104(13.1) & (13.2) Income Payable Fine Tuning.

The Problem and Solution.

The manner in which income and capital appreciation recognition can be flowed out to its respective beneficiary by the trust has been fully provided for by the Act under Sec. 104(6), (12), (13), (21), etc. (whereby the tax liability in respect of the economic benefit is transferred) however upon a superficial review of the pre 1988 reform provision in light of the taxable income recognition process, including those deductions under Division C, would result in it being obvious that harmonization of "loss" tax benefits flowing through a trust was not provided for.

Division B income forms the basis upon which gross taxable income is computed, as per section 3, which includes subdivision k in the case of trusts and estates which generally operate to transfer tax liabilities from the trust to the beneficiaries who recognize benefits from the trust, however in arriving at the amount upon which the trust will be taxed, the Division C deductions will have to be deducted, in order to obtain true "taxable income". Division C contains the bulk of the provisions that allow for previous years' loss carry forwards such as non-capital, net capital, restricted farm, farm, and limited partnership losses sustained in previous years which may be limited in number, to be deducted from the Division B net income, **if any exists**, so as to obtain net taxable income upon which tax can be applied **however** if there isn't any Division B income recognizable by the trust in the year, then it cannot take the appropriate deduction with respect to booked losses.¹⁰⁵⁶ Since the losses usually have a limited carry forward period wherein they may be deducted and whereafter they "fall off the table", the obvious danger occurs in respect of a trust which must, as per its terms, distribute all of its Division B income to the beneficiaries currently which will result in it not being able to deduct the booked Division C losses. Since subdivision K operates only to cause trust income to be recognized by a beneficiary whereupon they will incur the tax liability without allowing them to recognize a loss realized by the trust in respect of them, the loss technically becomes locked up in the trust. What was even more inequitable was the fact that under the above situation, if the trust subsequently recognized Division B income, the provisions, (and their ordering of application), would not allow the beneficiary from being precluded from recognizing a tax liability in respect of it (when appropriate) in that subdivision K, Sec. 104(13), is a Division B income computation division that doesn't apply to income that has been removed from the particular entity's tax liability, the result; that income beneficiaries would have to continue to recognize Sec. 104(13) income, even though there were booked losses that could have been deductible.¹⁰⁵⁷

Thankfully with the 1988 reform subsections 104(13.1) and (13.2) were introduced the principal purpose of which is to alleviate the problems described above in a manner by which the income beneficiaries/trust are allowed to elect the amount of Sec. 104(13) income to be recognized whereby they may choose to allow the trust to recognize adequate net Division B income sufficient to absorb Division C loss (or exempt income etc) deductions. By doing so they will not have to recognize a Sec. 104(13) tax liability in respect of the amount elected upon **however** the amount elected upon, when actually distributed or paid to the beneficiary may draw unfavourable treatment under the Sec. 105(1)-53(2)(h) rules whereby either it may be fully includable in the income of the beneficiary under Sec. 105(1), cause an ACB adjustment in respect of the beneficiary's capital interest, (other than a capital interest in a personal trust that was acquired for no consideration), or cause absolutely no further tax consequences where it is paid in respect of a capital interest in a personal

¹⁰⁵⁶ Toshach v. M.N.R., 68 D.T.C. 315 (TAB), is an excellent case illustrating this phenomenon, while see also Doherty v. Commr., 48 C.L.R. 1, where a beneficiary was not allowed to deduct an estate's loss on account that the executors were not his legal representatives. See also Massey v. Commr., 1929 R. & McG. 1928-30 237, and White v. Commr. 1926 R. & McG. Ct. of Rev. 132.

See the Australian case of Raftland Pty Ltd as trustee of the Raftland Trust v Commissioner of Taxation [2008] HCA 21 (22 May 2008) where tax-loss shifting between trusts led to considerable legal problems when not executed properly with the wrong structure in the absence of Cdn.-like deferral provisions such as these.

¹⁰⁵⁷ See the Aust. cases of AX01C and AX01D and Commissioner of Taxation [2001] AATA 996; (2001) 48 ATR 1200; 2001 ATC 150 (5 December 2001), Zeta Force Pty Ltd v Federal Commissioner of Taxation 98 ATC 4681, Case Z35 92 ATC 326 and Case 6 2000 ATC 168 for examples of the problem, as well as Ian Richardson v Commissioner of Taxation [1997] FCA 1273 (25 November 1997) for instances where income is to be computed in different manners.

trust acquired for no consideration. Depending on the nature of the particular beneficiary's rights under the trust, the nature in which they were acquired, and the nature of the trust itself, distributions of the elected upon amount precluded from being recognized under Sec. 104(13), will attract differing tax treatment.

Subsections 104(13.1) and (13.2) operate mutually responsively in that where an election is made under one, it will affect the maximum amount electable under the other, and while their mechanics are extremely similar, the former concerns elections upon amounts of Sec. 104(13) or 105(2) income otherwise recognizable the substance of which is not a taxable capital gain, while the latter concerns elections upon amounts of Sec. 104(13) or 105(2) income otherwise recognized the substance of which has been designated under Sec. 104(21) to be a taxable capital gain and thus recognizable as such by the designated beneficiary. Both elections, which are done on a beneficiary by beneficiary basis, are available only to non-exempt trusts, (exempt as that in Sec. 149(1)), while the elections may be only unilaterally elected by the trust and not the beneficiaries when it was resident in Canada throughout its tax year. Since the provision operates exclusively in respect of amounts that "...would be included in computing the income of a beneficiary under the trust by reason of subsection (13) or 105(2)..." the provision cannot be applied favourably in respect of non-resident beneficiaries who recognize Sec. 104(13) amounts as amounts subject to withholding tax under Sec. 212(1)(c) and not as "income".¹⁰⁵⁸ The terminology is critical; see para. 53(2)(h)(i.1)(A) where amounts "included in the taxpayer's income by reason of subsection 104(13) or from which an amount of tax was deducted under Part XIII by reason of paragraph 212(1)(c)" indicate distinction of income inclusion and withholding tax application.

Capital Gain Recognition.

Subsection 104(13.2) provides the provision by which an amount designated out by the trust to be considered as a taxable capital gain realized by the beneficiary under Sec. 104(21) can be cut back so as to allow the trust to maintain the recognition of the net taxable capital gain so that it may then deduct the booked net capital losses it has under Division C.¹⁰⁵⁹ The amount designated under Sec. 104(13.2) shall be deemed not to have been paid or payable to the particular beneficiary in the year but only where that income would otherwise be recognized under Sec. 104(13) or 105(2), hence the designation has absolutely no application when the Sec. 104(14) preferred beneficiary election is the basis of recognition by the beneficiary. For purposes of subsection 104(21), the t.c.g. designation provision itself, the amount designated under Sec. 104(13.2) will be for purposes of the Sec. 104(21.1) & (21.2), (capital gains deduction provisions in respect of the Sec. 104(21) designation), deemed not to have been included in the beneficiary's income by reason of Sec. 104(21), so as to restrict the effect of the election upon the apportioning process defined in Sec. 104(21.1) & (21.2).

The amount that the trust may designate under Sec. 104(13.2) in respect of a beneficiary can be any amount not exceeding the amount determined as per the formula:

$\frac{A}{B} \times C$ where "A" is the amount otherwise designated in

B respect of the particular beneficiary under Sec. 104(21)), (as a t.c.g.), for the year, "B" is the aggregate of all such amounts designated in respect of any beneficiaries for the year, "C" is the amount determined by the trust, and used in designating amounts under this subsection for the year, equal to the amount of Sec. 104(13) or 105(2) income for the year otherwise recognizable by all of the appropriate beneficiaries, (before any Sec. 104(13.1) or (13.2) adjustments), that exceeds the amounts actually deducted by the trust under Sec. 104(6) for the year in computing its income. Thus normally the three variables in the formula are the individual and aggregate Sec. 104(21) designations and the aggregate amount deducted by the trust under Sec. 104(6) in respect of income payable under Sec. 104(13) or paid under Sec. 105(2), **but not** the amount deductible under Sec. 104(12) in respect of a Sec. 104(14) P.B.E.. The key variable will obviously be the amount of Sec.

¹⁰⁵⁸ If the non-resident carries on the business of dealing in income interests it may be possible to have a Sec. 104(13) inclusion recognized under Sec. 115(1)(a)(ii) as business income, thus allowing Sec. 104(13.1)-(13.2) to be available.

¹⁰⁵⁹ Subsection 104(21) allows a trust to designate as having been receivable by a beneficiary as part of its income recognizable under Sec. 104(13)-(14), or section 105 such part of the trust's net taxable capital gains in the period and thus allows the gain's character to be maintained through the distribution, regardless of Sec. 108(5).

104(6) deduction the trust takes being; the lesser the deduction the more Division B income the trust will recognize and the more designation base will be available in respect of all of the beneficiaries in respect of whom a Sec. 104(21) designation was made. By prorating that amount amongst the beneficiaries who recognize a Sec. 104(21) t.c.g. flow through, the effect of which is to reduce the Sec. 104(21) amount recognizable by each, the trust's Division B income attributable to taxable capital gains is inflated and it can then absorb and be negated with any Division C net capital loss carry forwards. The beneficiary will thus not be required to recognize the income designated.

The provision derives a great deal of its inflexibility, (ie; prorating of gross designatable amount), from the apportioning process in Sec. 104(21) which is fairly restrictive in that a Sec. 104(21) designation can be made in respect of an amount only if it can reasonably be found, having regard to all of the conditions including the trust terms and circumstances, to be part of an amount included in computing a beneficiary's income under Sec. 104(13), **(14), 105(1)**, (2), hence the beneficiary must have been entitled to enforce a distribution of the substance of that t.c.g., or it must have been paid to him, or for his benefit in order to qualify for Sec. 104(13.2) treatment. Even when not making a Sec. 104(21) designation in respect of a particular beneficiary, other beneficiaries' proportions of the t.c.g., under Sec. 104(21), and the designatable amount under Sec. 104(13.2) will still be limited by that excluded beneficiary's entitlement.

The subsection 104(13.2) designation operates on a beneficiary by beneficiary basis whereby designations need not be filed in respect of all the appropriate beneficiaries in order for the designation in respect of any one to be considered valid, while on the other hand, it could prove more beneficial to file the designation, even when there isn't a net capital loss deductible in that the tax credits available to the trust may be quite capable of negating the taxes on the taxable capital gain resultantly required to be recognized. It is only if the taxpayer has a capital interest that was not acquired for consideration payable **and** where the trust is personal that this will be favourable since in all other instances a distribution of the capital subsequently will cause a capital interest ACB adjustment, (which could eventually cause the recognition of a deemed capital gain), as per Sec. 53(2)(h), while since the effected beneficiary has a capital interest in respect of which the distribution is made Sec. 105(1) will never apply. If the beneficiary can receive the distribution tax free then it may be preferable to always use the Sec. 104(13.2), or (13.1), provision if the tax rates of the trust are less than that of the beneficiary.

Finally, the subsection 104(13.2) designation does not provide for any treatment of Sec. 104(21) taxable capital gains designated in respect of the Sec. 104(14) preferred beneficiary election and thus, if it is believed that a Sec. 104(13.2) designation will have to be made, don't waste a T.3, designate all Sec. 104(21) amounts in respect of the beneficiaries recognizing Sec. 104(13) or 105(2) inclusions **if possible**. If this isn't possible, then unfortunately, Sec. 104(13.2) offers no benefit to the preferred beneficiary or the trust in respect of him.

"Idem – Sec. 104(13.2)"

(13.2) Where a trust, in its return of income under this Part for a taxation year throughout which it was resident in Canada and not exempt from tax under Part I by reason of subsection 149(1), designates an amount in respect of a beneficiary under the trust, not exceeding the amount determined by the formula

$$A/B \times C$$

where

A is the amount designated by the trust for the year in respect of the beneficiary under subsection 104(21),

B is the total of all amounts each of which has been designated for the year in respect of a beneficiary of the trust under subsection 104(21), and

C is the amount determined by the trust and used in computing all amounts each of which is designated by the trust for the year under this subsection, not exceeding the amount by which

(i) the total of all amounts each of which is an amount that, but for this subsection or subsection 104(13.1), would be included in computing the income of a beneficiary under the trust by reason of subsection 104(13) or 105(2) for the year exceeds

(ii) the amount deducted under subsection 104(6) in computing the income of the trust for the year, the amount so designated shall

(a) for the purposes of subsections 104(13) and 105(2) (except in the application of subsection 104(13) for the purposes of subsection 104(21)), be deemed not to have been paid or to have become payable in the year to or for the benefit of the beneficiaries or out of income of the trust; and

(b) except for the purposes of subsection 104(21) as it applies for the purposes of subsections 104(21.1) and 104(21.2), reduce the amount of the taxable capital gains of the beneficiary otherwise included in computing the beneficiary's income for the year by reason of subsection 104(21).¹⁰⁶⁰

Income Recognition.

Subsection 104(13.1) offers a provision very similar in concept and purpose to that of Sec. 104(13.2) whereby the trust may designate an amount otherwise includable in a beneficiary's income under Sec. 104(13) or 105(2) as not being payable whereby the beneficiary will not recognize it, the trust will maintain recognition of it, and the trust will thereby use it to absorb any non-capital, or other loss carry forward deductible under Division C which will thereby reduce the effective taxation of the designated amount, **at the trust level**, to nil. The amount unilaterally designatable under Sec. 104(13.1) by a trust in respect of a particular beneficiary can be any amount not exceeding an amount determined by the formula; $A \times (C-D-E)$, where "A" is the particular beneficiary's

B

share of trust law income for the year **regardless of if he actually received it**, "B" is the aggregate of any appropriate beneficiaries' trust law income realizable in the year, "C" is the aggregate of all amounts required to be included in computing a beneficiary's Division B income under Sec. 104(13), or 105(2), (but not Sec. 104(14) or 105(1)), for the year, "D" is the amount deducted by the trust under Sec. 104(6) for the year and is one of the key variables, and "E" is the amount used in Sec. 104(13.2) as "C" for the year, which was equal to the excess of the Sec. 104(13) & 105(2) income recognized by beneficiaries over the Sec. 104(6) deduction taken by the trust. Before going any further it should be remembered that the Sec. 104(13.1) provision's purpose is to have the trust continue to recognize Division B income, even though it might have been payable to or in respect of a beneficiary, thus allowing it to absorb non-capital losses, hence it comes as no surprise when the amount determined from the formula above, (or any lesser amount elected), will, for purposes of

1060 1988 FINANCE TECHNICAL NOTES: Subsection 104(13.2) contemplates the situation where a trust has a non-capital loss carryforward from a prior taxation year and current taxable capital gains. In such circumstances, the trust may choose not to deduct the full amount to which it is entitled under subsection 104(6) in order to allow the non-capital loss carryforward to absorb the current taxable capital gain. The designation in subsection 104(13.2) allows the trust to designate to its capital beneficiaries their respective shares of the portion of the potential deduction under subsection 104(6) which has not actually been deducted under subsection 104(6) or used in the designation under subsection 104(13.1). Such amount designated under subsection 104(13.2) reduces the amount of taxable capital gains otherwise included in the beneficiary's income pursuant to subsection 104(21). However, such amounts will reduce the adjusted cost base to the beneficiaries of their capital interest in the trust unless that interest was acquired for no consideration where the trust was a personal trust.

The amount designated under subsection 104(13.2) will not affect the amount designated under subsection 104(21) for the purposes of subsection 104(21.1) or (21.2) or paragraph 53(2)(h). Notwithstanding the subsection 104(13.2) designation, the non-taxable portion of a capital gain will be able to be flowed through to a beneficiary without reducing the adjusted cost base of a trust interest in accordance with clause 53(2)(h)(i. l)(B).

Sec. 104(13) and 105(2) **only**, be considered not to be payable to the beneficiary or for his benefit.

The gross designation amount that is to be attributed amongst the beneficiaries is similarly calculated to that in Sec. 104(13.2) however it is understandably net of the gross designation base in Sec. 104(13.2) since that amount, **regardless** of whether or not in fact it was **wholly used**, is attributable to a taxable capital gain. With respect to the reduction of the Sec. 104(13.1) gross designation base it's important to recognize that the gross amount base of Sec. 104(13.2) is the amount which is being deducted, not the aggregate amount of cut back provided to the beneficiaries under Sec. 104(13.2) thus if a designation is not made in respect of a beneficiary under Sec. 104(13.2) when it could have been, the amount will still reduce the amount designatable under Sec. 104(13.1) in respect of other beneficiaries. Obviously the gross designation base under Sec. 104(13.1) is variable via the amount of Sec. 104(6) deduction the trust chooses to take in the year and thus through a reduction in the Sec. 104(6) deduction the trust recognizes more Division B income.

“Amounts deemed not paid – Sec. 104(13.1)”

(13.1) Where a trust, in its return of income under this Part for a taxation year throughout which it was resident in Canada and not exempt from tax under Part I by reason of subsection 149(1), designates an amount in respect of a beneficiary under the trust, not exceeding the amount determined by the formula

$$A/B \times (C - D - E)$$

where

A is the beneficiary's share of the income of the trust for the year computed without reference to this Act,

B is the total of all amounts each of which is a beneficiary's share of the income of the trust for the year computed without reference to this Act,

C is the total of all amounts each of which is an amount that, but for this subsection or subsection 104(13.2), would be included in computing the income of a beneficiary under the trust by reason of subsection 104(13) or 105(2) for the year,

D is the amount deducted under subsection 104(6) in computing the income of the trust for the year, and

E is equal to the amount determined by the trust for the year and used as the value of C for the purposes of the formula in subsection 104(13.2) or, if no amount is so determined, nil,

the amount so designated shall be deemed, for the purposes of subsections 104(13) and 105(2), not to have been paid or to have become payable in the year to or for the benefit of the beneficiary or out of income of the trust.¹⁰⁶¹

Questions About the Apportioning Base.

The gross designation base is then apportioned amongst the beneficiaries based on the amount of their

¹⁰⁶¹ 1988 FINANCE TECHNICAL NOTES: New subsections 104(13.1) and (13.2) are consequential on the change to subsection 104(6) which permits a trust to deduct less than the full amount of its income distributions. By reason of these new provisions, a Canadian resident trust (other than a trust exempt from tax under subsection 149(1)) may also choose to have distributed income taxed at the trust level rather than the beneficiary level.

Subsection 104(13.1) provides the 'mechanism for a trust to designate to its beneficiaries their respective shares of that portion of the trust's actual income distributions which has not been deducted in computing its income for the year. Such designated amounts are deemed not to have been paid or payable in the year by the trust for the purposes of subsections 104(13) and 105(2), with the result that such amounts will neither be deductible to the trust nor taxable in the hands of the beneficiaries. Under revised paragraph 53(2)(h), however, such amounts will reduce the adjusted cost base to the beneficiaries of their capital interest in the trust unless that interest was acquired for no consideration in a personal trust. (See comments on the amendments to paragraph 53(2)(h).)

respective "share of income of the trust for the year computed without reference to this Act" that is of the aggregate of all such amounts, (the beneficiaries shares, **not** the trust law income realized), and it is this amount that serves as the **maximum** that can be designated in respect of the particular beneficiary. Obviously there is a noticeable technical deficiency in the apportioning description since either the beneficiary's "share" of trust law income **payable** to him in the period, or the beneficiary's "share" of trust law income to be accumulated by the trust and distributed to him subsequently, may be used as apportioning base however from an overall view of the provision it would seem to be that the apportionment base is to be trust law income payable in the year, although until the Department "cleans up" this section of the Act the alternative could be successfully argued. If the base is to be trust law income payable then the entire computation may be materially affected by trust law loss carry forwards as previously discussed which in many cases could operate under equity to materially reduce the amount of trust law income realizable by an income beneficiary in the year. Such debt extinguishment/loss carry forwards could affect the income beneficiaries' entitlements differently on a beneficiary by beneficiary basis, depending on the construction of the trust agreement. Since this could allow the particular beneficiary to avoid the recognition of trust law income, a designation could not be made in respect of him until the accounting loss had been absorbed, and the entire Sec. 104(13.1) system would be thrown off until that time.¹⁰⁶² If the apportionment basis includes the amount of trust income that is accumulated for a beneficiary's benefit then the entire mechanism is defeated since the beneficiary isn't recognizing Sec. 104(13) or 105(2) income at that point. (The non-capital loss could be deductible depending on for whose behalf it was sustained.) If both payable and accumulated income shares are valid bases then some flexibility may exist if a trustee chooses to accumulate income for a period of time for the beneficiary, while allowing him to recognize some under Sec. 104(13) or 105(2). It could be possible to designate amounts, in certain circumstances, so as to negate an amount of Sec. 104(13) recognition by one beneficiary and then once it has been resultantly recognized by the trust, negate it with a Sec. 104(14)-(15)(b)(i) or (ii) preferred beneficiary election, and if the amounts are properly calculated, other beneficiaries unused personal tax credits could be indirectly accessed. (A power of appointment could correct any rights recognized under *Sachs v. The Queen* involving the P.B.E. election.)

The apportionment basis described is the beneficiary's share of the income of the trust for the year however it is not his share of the "net income" of the trust and the difference in the two terms has been debated judicially before as in the case of *Tindal v. F.C.T.*¹⁰⁶³ If trust law expenses are charged against revenue streams inconsistently, and the income beneficiaries "shares" of income are meticulously specified and referenced to individual revenue sources, their "share" of the gross income may not equal their "share" of the net income, (in tax or trust law), and the apportionment basis may be considerably warped. Such would be the instance where one particular revenue stream, the net amount of which is to be subject to a particular beneficiary's entitlement, is charged, as per the trust deed, with the extinguishment of expenses that inure, grossly, to other beneficiaries. Gross income shares may be substantially different from the shares of "net income" realized by the trust.

It can be easily determined how much flexibility with respect to the Sec. 104(13.1) & (13.2) designation may be obtained with various discretionary powers given to the trustees or other parties.

Uses and Abuses.

Depending upon the ability of the beneficiary to get the resulting capital out of the trust tax-free after the income has been taxed in its hands, at the tax rate applicable to the trust, the Sec. 104(13.1) and (13.2) provisions serve as an ideal vehicle with which to avoid an attribution circumstance described in section 74.3, in that by making the designation the particular beneficiary is precluded from recognizing either income under Sec. 104(13) or 105(2), or taxable capital gain under Sec. 104(21), which are three bases upon which the

¹⁰⁶² In the author's opinion, given this fact, it was the Department's intention to have the rules primarily apply to those instances where the trust deed arbitrarily called for the distribution of current income without absorption of booked losses. They have not misconceived the problem.

¹⁰⁶³ (1946) 8 A.T.D. 152, at pg. 157. See also *Corbett v. I.R.C.*, 21 T.C. 449 and *F.C.T. v. Totledge Pty. Ltd.*, 82 A.T.C. 4168 where income held to be beneficiary's at moment of realization subject to management etc charges. Compare also *E. Murray v. I.R.C.*, 11 T.C. 133, *MacFarlane v. I.R.C.*, 14 T.C. 532, with *Archer-Shee v. Baker*, 1927 A.C. 844, *Archer-Shee v. Garland*, 1931 A.C. 212. The nature and extent of the beneficiary's right depends on the construction of the deed/will.

Sec. 74.3(1) attribution provision operates. After-tax income (capital) may be distributed by a personal trust to a beneficiary in respect of his capital interest, tax free, if the capital interest was not acquired for consideration payable, as per the Sec. 53(2)(h)-105(1) benefit recognition mechanism. If the personal trust interest has been acquired for consideration paid by the holder then a distribution may have immediate or future tax consequences, (which can be alleviated by more arrangements than what can be described here). Understandably there would need to be some math and recognition of loss carry-forwards for which the provisions were enacted.

The subsection 104(13.1) mechanism can consist of an income splitting device handed to taxpayers on a silver platter since there is no qualification placed upon its use and thus even when a testamentary trust, which is enjoying a low marginal tax rate, doesn't have loss carry forwards it can choose to designate under Sec. 104(13.1) and achieve the perfect immediate income split between itself and the beneficiary. Only in the rarest of instances will the cut-back amount received by the beneficiary and not included in computing his income lead to the sustaining of tax consequences however this depends on whether the Department will choose to pursue such acrobatics with the possible application of Sec. 105(1) to the benefit. Such an approach is not precluded by the Act in that Sec. 104(13.1)-(13.2) precludes the beneficiary from recognizing the elected amount in his income through Sec. 104(13) & 105(2) but **does not** preclude him from recognizing a Sec. 105(1) benefit in respect of it.¹⁰⁶⁴ This would effectively double the taxation of the income if the entire cut back is exposed to a Sec. 105(1) recognition by the beneficiary: in the author's opinion this provision would be the Department's first weapon of choice in dealing with uses that were clearly not intended to be conferred and which are fully targeted with the habitual barrage of penalty provisions. As well it is arguable that the Sec. 105(1) value would not be limited to the **tax** saving only, that amount between the tax paid by the trust on the income and that expected to be paid if the beneficiary were to have recognized it, but instead it would be that amount **of income** that the beneficiary doesn't recognize under Sec. 104(13), net of any reimbursements made to the trust in respect of the tax debt it has caused. The real benefit the beneficiary initially realizes is the former but the value of the benefit that is taxable is the value of the additional income net of tax on it that is reimbursed to the trust: it is the latter that Sec. 105(1) stands dangerously capable of assessing.¹⁰⁶⁵

The subsection 104(13.1) provision can also be used to take the sting out of the Sec. 70(6)(b) requirement that the spouse under a spousal trust be required to be entitled to receive all of the trust's income that arises prior to her death. Income splitting can occur here as well. In the case of *inter vivos* trusts, which are usually hit with the highest possible tax rates the Sec. 104(13.1) election need not be made when loss producing property is stuffed into the trust in a tax free transfer in such a way that Sec. 75(2) applies to it so as to allow both the trust and the transferor to recognize the loss. This could be arranged through a variation of the trust after the Sec. 73(1) transfer provision has been accepted so that the contributor acquires some degree of control over the ownership of the loss producing property and this arrangement could only be properly constituted if the trust is resident at the time. In such an instance, when the losses are being recognized, Division B income would technically not be payable to the beneficiary since the book loss would eliminate it while it is also possible to book the losses then absorb them subsequently. Having losses of the trust available to offset the resulting increase in the trust's Division B income following the Sec. 104(13.1) application is of primary importance while if Sec. 75(2) can be made to apply the loss isn't wasted but benefits two taxpayers. The applicability of Sec. 75(2) isn't restricted by Sec. 74.5(11).

¹⁰⁶⁴ Although Sec. 105(1) does not form the basis of a Part XIII tax liability Sec. 104(13.1)-(13.2) isn't presently available in respect of non-residents.

¹⁰⁶⁵ This doesn't seem to be the opinion of the Financial Industries Division in an April 25th, 1990 memorandum forwarded to a District Office when it recognized that the subsections were being used to access a testamentary trust's tax rate and declined to think that anything could short of mending the provisions would allow them to restrict the beneficial designations. "They" don't have to restrict the designations: all they have to do is issue a few Sec. 105(1) assessments to put a stop to the abuse.

Amended Previously Filed Trust Returns and Can the "Abuse" be Condoned by the Court

In *Jeannette Lussier v. Her Majesty The Queen*¹⁰⁶⁶ the Tax court had to consider the instance where a trust had not filed for the s. 104(13.1) claw-back in recognition and asked to file an amended return: the CRA refused and the taxpayer appealed to the TCC. It held:

[2] Although Ms. Lussier herself included the amounts in her tax return for each of those taxation years, she now submits that they should be excluded because of designations made by the estate under subsection 104(13.1) of the *Income Tax Act (Act)* in a letter dated November 15, 1994. The purpose of the letter was to amend the tax returns previously filed by the estate. Under subsection 104(13.1) of the *Act*, an amount designated by a trust in respect of a beneficiary under the trust is deemed not to have been paid or payable to the beneficiary; it therefore does not have to be included in the beneficiary's income but is instead income of the trust.

[3] Because the designations were not made by the estate in the tax returns initially filed, the respondent argues that they were not made in accordance with subsection 104(13.1) of the *Act*.

...
[18] As noted above, the respondent argued that the designations made in the letter of November 15, 1994, were not made in accordance with subsection 104(13.1) of the *Act*. It is clear from the letter of January 12, 1995, that the Minister refused to give effect to the designations made in the letter of November 15, 1994, because they were made late.

...
[20] It must therefore be determined whether the Minister was justified in not considering the amendments made by the estate to its 1992 and 1993 tax returns. To make this determination, the first question that must be answered is whether the estate was entitled to amend its 1992 and 1993 returns. It must then be determined whether the letter of November 15, 1994, constitutes an amendment to its tax returns.

...
[22] In my opinion, the purpose of this subsection [s. 152(6)] is more to oblige the Minister to make a reassessment than to authorize the amendment of a previous return. It cannot be concluded from this provision that a taxpayer is not entitled to amend a tax return already filed except in the cases explicitly mentioned. Chief Judge Couture of this Court stated the following on this point in *Lee v. M.N.R.*, [1990] 2 C.T.C. 2262, at page 2268:

. . . Furthermore, I am not aware of any authority for the proposition that once a taxpayer has signed his tax return that [*sic*] he may not change his mind subsequently following the discovery of a mistake notwithstanding the certificate that he signed as part of his return. Certainly, when an honest mistake has been discovered by a taxpayer he must be permitted to correct it and the procedure to do so is provided in the *Income Tax Act* within certain prescribed requirements. The appeal process serves this purpose. . . .

...
[41] Are there any reasons in the instant case for not allowing the late filing of the designation provided for in subsection 104(13.1) of the *Act*? First of all, what reason could Parliament have had for wanting to prevent this? Contrary to what occurred in *Nassau, supra*, no reason was given to me during the parties' arguments, nor can I myself think of any.

[42] However, there is at least one serious reason to think that Parliament did not want to prevent a "late-filed designation". One of Parliament's objectives when it enacted subsection 104(13.1) of the *Act* in 1988 was to authorize loss carry-overs.[3] Prior to the amendment, a trust all of whose income was paid or payable to a beneficiary could not, in computing its taxable income, take advantage of the deduction for "non-capital losses" or "net capital losses" provided for in section 111 of the *Act*. Section 111 provides that such losses may be carried back to the three taxation years immediately preceding the year in which they were incurred.

[43] A concrete example will illustrate the scope of this rule. If the estate had incurred non-capital

losses in 1995 and had wanted to carry them back to 1992 and 1993, it would have been beneficial for it to deduct the 1995 loss in computing its 1992 taxable income. Prior to the enactment of subsection 104(13.1) of the *Act*, the deduction of the loss would have been pointless, since the estate did not generally have any income. Since all of the estate's income was paid to Ms. Lussier, it had no income to report. Under subsection 104(6) of the *Act*, any income paid or payable to the beneficiary is deductible from the estate's income and must be included in the beneficiary's income. [44] With the enactment of subsection 104(13.1) of the *Act*, it became possible to designate an amount equal to the amount of the loss carried back, with the result that, in our hypothetical example, the estate would have income from which the loss could be deducted. The estate could thus reduce its taxable income to zero and the beneficiary would be deemed not to have received the designated amount, thus benefiting indirectly from the carryback of the 1995 loss.

[45] It is easy to see that, in 1992, the estate could not have foreseen that it would incur a loss in 1995. If the question of income splitting is disregarded, the estate would have had no reason to make a designation. Thus, if we adopt the respondent's interpretation that the estate could not, in filing its 1995 return and the amended return for 1992, make a late-filed designation for 1992 so as to carry its loss back to 1992, the estate would not be able to take advantage of subsection 104(13.1) of the *Act*, which would be contrary to Parliament's objective as explicitly set out in the explanatory notes.[4] This result would be absurd and contrary to the purpose for which subsection 104(13.1) was enacted in 1988. It is therefore not only more logical to conclude that a designation may be filed late but, in my view, it is essential to do so to achieve the purpose of the *Act*.

[46] It is important to note that the Minister's administrative practice is to respond favourably to taxpayers' requests to make late designations in order to deduct losses carried back under section 111 of the *Act*. However, he denies such requests when the taxpayer's purpose is to achieve income splitting.

[47] In my opinion, there is no reason to draw a distinction between a late-filed designation made to take advantage of a loss carryback under section 111 and a late-filed designation that makes it possible to minimize the beneficiary's tax by means of income splitting. It should be noted that, in *Neuman v. M.N.R.*, [1998] 1 S.C.R. 770, at paragraph 35, the Supreme Court of Canada recognized the legitimacy of income splitting:

. . . In fact, "there is no general scheme to prevent income splitting" in the *ITA* (V. Krishna and J.A. VanDuzer, "Corporate Share Capital Structures and Income Splitting: *McClurg v. Canada*" (1992-93), 21 *Can. Bus. L.J.* 335, at p. 367).

[48] As well, in *Hall v. Quebec (Deputy Minister of Revenue)*, [1998] 1 S.C.R. 220, 1997 CanRepQue 1306, at paragraph 49, Gonthier J. acknowledged that income splitting has always been possible by means of a trust:

As for the fear expressed by the Court of Appeal that the appellant's position would open the door to all kinds of abuse, such as income splitting, I agree with the appellant that income splitting is integral to the scheme of taxation of estates and is not in any way reprehensible *per se*. Furthermore, income splitting has always been possible by means of a trust.

[49] It is even possible to conclude that income splitting was anticipated when the 1988 amendment was passed. I will again quote a passage from the explanatory notes I reproduced in footnote 3:

This change will enable trusts to utilize in a particular year losses from prior years without affecting the ability of the trust to distribute its income currently. Also, testamentary trusts will also be able to choose to be taxed at the trust level rather than at the beneficiary level by using subsection 104(13.1).

Why would a trust "also" decide that the income payable to its beneficiary will be taxed at the trust level if not to engage in income splitting?

[50] In conclusion, if subsection 104(13.1) must be read as providing for an implicit time limit, I would conclude, as Robertson J.A. did in *Nassau*, *supra*, that "the inference that Parliament

***did not intend to accord relief in these circumstances has been rebutted"* (p. 305).**

[51] Before closing, I would like to come back to the question of a taxpayer's right to amend a tax return and the Minister's obligation to reassess the taxpayer's tax. In my view, it is important to properly distinguish between the taxpayer's right and the Minister's obligation. The fact that a taxpayer is entitled to amend a return does not necessarily mean that the Minister must automatically give effect to the amendment. The Minister is free to choose whether or not to do so unless he is obliged to do so by the *Act*, as he is, for example, in the circumstances set out in subsection 152(6) of the *Act*. Another example is where a decision is rendered by this Court on a validly filed appeal against an assessment. Under subparagraph 171(1)(b)(iii) of the *Act*, this Court may dispose of an appeal by referring the assessment back to the Minister for reconsideration and reassessment.

[52] In the circumstances of this appeal, not only were the taxpayer and the estate entitled to amend their returns, but the Minister should also have given effect to the amendments. I consider what Robertson J.A. said in *Nassau*, *supra*, to be quite apt here: "*It cannot be doubted that the refusal of the Minister to accede to Nassau's request seems antithetical to elemental concepts of fairness*" (paragraph 29, p. 297).

[53] Accordingly, the Minister should have reassessed the estate in order to determine the tax to be paid on the amount designated under subsection 104(13.1) of the *Act*. For inappropriate reasons, he refused to do so. He will have to live with the consequences of his decision if it is too late to make a reassessment. Since the amount of tax assessed by the Minister was nil, the estate could not object to the assessment and appeal to this Court.

[54] As for Ms. Lussier, she also asked the Minister to vary his assessment to reduce the amount of her taxes because of the designation made by the estate. The Minister refused to do so. Fortunately for Ms. Lussier, she filed notices of objection in accordance with the *Act's* requirements and then filed notices of appeal with this Court.

[55] To be perfectly clear about this, it is obvious that Ms. Lussier could not have obliged the Minister to make a reassessment if she had not filed her notices of objection within the prescribed time. Since she filed notices of objection and then filed notices of appeal with this Court, she preserved her right to contest the assessments for 1992 and 1993. Before this Court, she was entitled to require that the amount of tax for which she was liable for those years be determined in accordance with the *Act's* provisions, *inter alia* subsection 104(13.1). Since all the conditions set out in that subsection have been met, she is entitled to benefit therefrom.

Trust Law Considerations and Tax Law Repercussions.

A designation in favour of a beneficiary will increase the trust's taxable income which will expose it to additional liability which, if unprovided for, may have to be extinguished out of the remainderman's resources.¹⁰⁶⁷ For this reason, unless agreements are properly arranged between the beneficiaries and the trustee, the capital beneficiaries could launch actions on uneven handed treatment to require the trustee to satisfy the liabilities personally, (though he could call for indemnification from the income beneficiaries subsequently). If the agreement calls for the income beneficiary to indemnify the trust directly the author is of the opinion that usually such could not constitute "a gift" or "a contribution" to the trust which could operate to tarnish its testamentary character: either of these descriptions entail an element of benefaction, and it is beyond comprehension how one could recognize the extinguishment **of a liability** as a gift; the liability being that in equity to realize the benefits of the income at the same time as sustaining its burdens. This is to be qualified however; if the trust deed specifies that such tax liabilities are to be attended to the detriment of another class of beneficiaries and the enfranchised beneficiary **gratuitously** agrees to furnish compensation to the trust such could be recognized as a gift, the difference being the lack of equitable obligation to provide

¹⁰⁶⁷ The particular terms of the trust deed/will will specify how the liabilities are to be satisfied.

it.¹⁰⁶⁸

In making the designations the trustee must continually act with an eye to the equal benefit of the parties involved: he cannot refuse to designate one beneficiary in a manner similar in magnitude of benefit to any others.

A trustee must also be mindful of favouring the capital beneficiaries to the demise of the income beneficiaries pursuant to the rule in *Upton v Brown* (1884) 26 Ch D 588 whereby the capital beneficiaries are not to suffer for the income beneficiaries' losses. In this context, when designations are made to recognize the income ensure that there are in fact losses recognized to off-set, otherwise capital beneficiaries' economics may be affected.

As a concluding comment it is not recommended that the provision be "played with fast and loose", if you'll pardon the expression, for the Department doesn't have to rely on section 245 to nail any offensive uses: subsection 105(1) is sufficient - and if it is applied the value of the after tax income recognized by the trust will be includable back into income. An unreasonable person would conclude that the splitting of income was the concern of the legislators while the reasonable one would conclude that the splitting of income in the context of loss carryforward utilization was of sole concern. The author is of the latter opinion... and to favourably utilize the rules to split income in an attribution sense paper losses must be created in the trust.

¹⁰⁶⁸ This was basically the opinion of the Financial Industries Division on Apr. 19th, 1990, when it recognized where a beneficiary has agreed to satisfy the taxes arising out of the Sec. 104(13.1)-(13.2) designation via reimbursing the trustee, giving a cheque payable to the R.G. to the trustee, or receiving an amount of income net after tax payments, the Sec. 70(6)(b), 104(4)(a) or 122(2)(d) tax character of the trust will not be affected. In T.I. 5-9084 of Dec. 1989 provided by the F.I.D. it was opined that the trust would not normally act as agent for the beneficiary in paying the taxes that arise on the designation and that it is a question of fact. It was also stated that it is a question of fact whether the payment of such taxes by the trust constitutes a proper charge against the trust income to be deducted in computing the income to be distributed to the designated beneficiary.

Trust Benefits.

The pre 1988 reform subsection 105(1) provided that "the value" of all benefits, other than those from the distribution or payment of capital of such by a trust, to any taxpayer "from or under" a trust, contract, arrangement or power of appointment, irrespective of when created, were to be included in the taxpayer's income unless they were included under Sec. 105(2) as benefits of up-keep on property. Obviously, this provision operated as a "catch-all" similar to a rudimentary Sec. 15(1) for all of the benefits realized by a party from or under a trust that did not fall within the parameters of the other beneficiary income inclusion provisions, however unfortunately, due to its exclusive references to only distributions or payments of capital and Sec. 105(2), it could be regarded as applying whenever a benefit was realized, including to those in the form of income payments under the Sec. 104(13) income inclusions themselves. The provision refers to benefits "from or under a trust": not only those benefits or advantages realized via the status of beneficiary as designated by the trust deed that do not fall for treatment under section 104-105-106-107 specifically are captured but those realized in relation to a trust, apparently no matter how remote a connection, give rise to an income inclusion. A trust may manage the control of a substantially owned corporation for the benefit of minority shareholders who are not the trust's principal beneficiaries while a trust guaranteeing an individual's debt extinguishment also confers a benefit otherwise outside of those upon which sections 104-105-106-107 can apply. These are situations in which Sec. 105(1) can apply.

"Benefits under trust – Sec. 105(1)"

(1) The value of all benefits to a taxpayer during a taxation year from or under a trust, irrespective of when created, shall, subject to subsection 105(2), be included in computing the taxpayer's income for the year except to the extent that the value

(a) is otherwise required to be included in computing the taxpayer's income for a taxation year; or

(b) has been deducted under paragraph 53(2)(h) in computing the adjusted cost base of the taxpayer's interest in the trust or would be so deducted if that paragraph

(i) applied in respect of the taxpayer's interest in the trust, and

(ii) were read without reference to clause 53(2)(h)(i.1)(B).¹⁰⁶⁹

The Now-Not-So-New Integration.

The scope of the post 1988 reform Sec. 105(1) provision, like that of the pre-reform, extends not just over benefits realized by trustees and beneficiaries but also those realized by any taxpayer. Substantial amendment has, however, changed the provision in that it now is fairly in line with other integration steps whereby now it precludes from possible income inclusion benefits of the amounts that were previously recognized in income such as under Sec. 104(13), (14) etc., for **any** tax year, or benefits that have led to certain adjustments in the adjusted cost base of a capital interest in the trust held by the taxpayer or that **would have caused ACB adjustments had Sec. 53(2)(h) applied to his capital interest.** Deleted with the reform were references to specific sources of "benefit" such as "contract", "power of appointment", however, such sources may still cause application of Sec. 105(1) to the benefit realized. The overall effect the amendments had on the provision was to clarify it and thus alleviate doubts that tax practitioners had with respect to its scope, and to fine tune its application so that it integrates the taxation of capital and income, as

¹⁰⁶⁹ 1988 FINANCE TECHNICAL NOTES: Subsection 105(1) provides that the value of all benefits received or enjoyed by a taxpayer from or under a trust — other than capital distributions — are to be included in the taxpayer's income. The subsection is amended to ensure that trust distributions which would ordinarily reduce the adjusted cost base of a beneficiary's capital interest in a trust in accordance with the amendments proposed to paragraph 53(2)(h) and discussed above are excluded from the scope of subsection 105(1).

well as benefits which **were not paid but conferred** upon the taxpayer from or in respect of the trust.

The new subsection 105(1) provision requires that the value of all benefits from or in respect of a trust, during a tax year, irrespective of when created, shall be included in computing the income of the taxpayer benefiting except where they are subject to Sec. 105(2), (up-keep benefits), or where they were required to be included in computing the **particular** taxpayer's income for a tax year, or where they led to a reduction in the ACB of a capital interest owned by **the particular taxpayer** under Sec. 53(2)(h), or where they would have led to a reduction under that provision had it applied to his interest. The "taxation year" in which the inclusion is to be recognized is not specified in the provision but under Sec. 104(23)(c), the income of a taxpayer from a testamentary trust shall be deemed to be that from under or from the trust for the tax year of the trust that **ended** in the taxpayer's tax year hence there can be some deferral of recognition and the basis isn't the taxpayer's tax year solely.

Double Taxation.

Subsection 104(6) doesn't, nor does any other provision in the Act, provide a deduction in respect of the Sec. 105(1) inclusion to the trust hence whenever the provision applies, if the substance of the benefit conferred (other than paid) arises from trust income double taxation will result. The income will be taxed in the hands of the trust while the beneficiary will recognize a Sec. 105(1) inclusion without the trust realizing a Sec. 104(6) deduction. It is due to this that a settlor would never want a trust to **apply** its income for the benefit of its **Canadian** resident beneficiary without its payment to him such as for the payment of tuition fees, maintenance etc., unless the amount was previously recognized by the beneficiary in his income, perhaps via Sec. 104(18) or (14) in respect of minor inclusions or preferred beneficiary elections.¹⁰⁷⁰ If the benefit arises from capital, it will form a introduction of that capital back into the tax base without equivalent deduction. If income is paid in error to a beneficiary who isn't entitled to it the properly phrased Sec. 104(6) will allow a deduction to the trust and the beneficiary will recognize a Sec. 104(13) inclusion¹⁰⁷¹.

Inapplicable to Non-residents.

The value of all benefits **in the year**, regardless of when created, will have to be recognized, however, if the trust terms are set up so that the particular taxpayer can realize the benefits only when he has been non-resident throughout the year then he will not be caught under Sec. 105(1) due to the fact that the Sec. 212(1)(c) withholding provision, applicable to trusts and estates, only refers to Sec. 104(13) income inclusions. Although Sec. 214(3)(a) refers to section 15 benefits conferred on non-residents so as to treat them as taxable dividends subject to withholding tax Sec. 105(1) isn't mentioned once in Part XIII.¹⁰⁷²

Value Inclusions.

The value of the benefit to be included, (or upon the value of which the provision may apply), is not

¹⁰⁷⁰ See *I.R.C. v. Lord Hamilton of Dalzell*, 10 T.C. 406, as well as *Curtis-Willson v. C.I.R.*, 31 T.C. 422, for interesting 'internal' application of funds creating a benefit. See *Sacks & Ors. v. Gridiger & Ors.*, 90 A.T.C. 4299, for list of cases involving application of income for ones benefit and recognition of beneficiary status.

¹⁰⁷¹ though perhaps not if the beneficiary is compelled to return it. See "Payments in Error" previous.

¹⁰⁷² This "deficiency" can be interpreted in two ways: either Part XIII isn't suppose to capture Sec. 105(1) benefits or "all the Department's horses and men" were thoroughly intoxicated on donuts and good wishes during the lead up to the 1988 reform. The former could be contended with legitimacy given that Sec. 214(3)(a) was amended materially, twice, in 1973-74 and 1977-78 with respect to Sec. 15(1) - 56 benefits without a **single** reference to Sec. 105(1) and Sec. 15(1) and the latter are essentially identical provisions in purpose and effect and any competent fiscal formulator worth his pay would think of both at the same time if all benefits were to be captured: the fact that Sec. 56(2) is mentioned, (and even Sec. 56(4) isn't) operates against the argument that only corporate benefits were to be captured **but** if express recognition was made of Sec. 56(2), a provision not at all related to the manner of the Sec. 15(1) target, and Sec. 105(1) isn't, there would be a strong argument that Sec. 105(1) is expressly not to be a basis of a Part XIII liability, otherwise given the breadth of the formulator's concern he would have definitely made it such. With respect to the latter interpretation, that the intention of Parliament was to capture all benefits flowing out of the country and the exclusion of Sec. 105(1) as a basis to be captured is an error, the author can only comment that the particular provision was amended **twice** and with all the huffing and puffing of "our" highly trained formulaters they still weren't able to, incidentally, notice that such a massive loop-hole existed. Canadian citizens in particular shouldn't be overly concerned with how much taxes are collected but instead far more concerned with how they are spent ... the inefficiency of the latter calls for excesses in the former... and are you aware of some of the salaries that CRA doles out...?

described, however, since the term "value" is usually qualified with the description "fair market", as it is in the vast majority of the Act, its absence must be interpreted as evidence of the draughtsman's intention that the basis of the inclusion be **other than** the fair market value of the benefit, and for an example of this intention, one can review Sec. 70(2) where "the value" of "rights or things" is to be included in a deceased's income. In I.T. 212R2, para. 4, with respect to the term "value" in Sec. 70(2), the Department has expressed the opinion that the "gross" **amount** of the right or thing may be reduced by those amounts that would have been deductible in respect of that right or thing if the taxpayer hadn't have died to determine "the value" thereof to be included. The "amount" of a right on thing, as defined in Sec. 248(1), equals its net fair market value generally, thus the above opinion can be extrapolated to mean that the "value" is equal to the fair market value net of the amounts deductible in computing income, and if this opinion is applied to Sec. 105(1), (as it should be), only the **net** income value will be recognized. If the taxpayer has incurred interest expense, acquisition cost, etc. to obtain that benefit then apparently only the amount by which the gross benefit exceeds such otherwise deductible amounts will be caught by Sec. 105(1) proper, even though the deductible amounts may or may not be deducted elsewhere in Division B so as to completely eliminate the net value recognized. Subsection 105(1) operates on **net** "value", not on **gross** "value" as per the reasoning in I.T. 212R2 para.4.¹⁰⁷³

The Two Forms of Benefit.

There are two distinct forms of benefit recognizable by a taxpayer from or under a trust; the first being an actual payment or change in title of property, be it cash or a dwelling etc., whereby title is transferred to the taxpayer while the latter may be a **conferment** of a benefit other than through a payment, such as when property may be borrowed/temporarily used by the taxpayer for no or low consideration payable, and it is with respect to these two forms of "benefit" that the Sec. 105(1) provision has been amended, (and integrated with Sec. 53(2)(h)), to cause different treatment to be applicable to each. All of the jurisprudence evolved in respect of Sec. 15(1) relating to corporate benefits also applies to Sec. 105(1). Under para. (a) only those benefits that have not been included in the taxpayer's income for any tax year may lead to the application of the provision causing inclusion thereof and thus those amounts that were included previously in the **particular** taxpayer's income under Sec. 104(13), or (14) (income payable or the preferred beneficiary election) will not attract direct inclusion when they are subsequently distributed. All other benefits **may** lead to a Sec. 105(1) inclusion but **only after not falling under the condition described in para. (b).**

If the benefit comes in the form of a payment or distribution of legal title to property **by the trust**, even if the substance of such a payment wasn't previously included in computing the particular taxpayer's income, it will fall under the conditions of para. (b) and will not be subject to the Sec. 105(1) provision, but only if the taxpayer had a capital interest (or income interest?) in the trust, (and it was paid in respect of that particular interest), since under para. (b), the Sec. 105(1) provision does not apply where an adjustment has been made, **or would have been made**, under Sec. 53(2)(h), to the ACB of the capital interest owned by the taxpayer in **the** trust. The subsection 53(2)(h) ACB adjustments occur only in respect of certain tax credits designated out to the trust beneficiary, or in respect of **payments** made in respect of the capital interest in the trust **by the trust** (of a certain character), thus it can be said that **all conferment** of benefits, other than the listed tax credit designations under Sec. 53(2)(h), will be treated by Sec. 105(1) proper, if at all.¹⁰⁷⁴

Benefits that are **conferred**, other than tax credits designated out by the trust that may be deducted by the beneficiaries, will always be captured by Sec. 105(1) as a last resort, if at all, while **payments** of capital or income **by the trust** may not be captured by Sec. 105(1) if their value has been deducted under Sec. 53(2)(h) in computing the ACB of a capital interest in the particular trust from which the benefit was realized or, that "**would be** so deducted **if** that paragraph applied in respect of the taxpayer's **interest** in the trust..." and if that subsection had been read with a certain adjustment. Subparagraph 53(2)(h) applies only to capital interests in trusts, other than interests in personal trusts that were acquired for no consideration or an interest in a commercial trust described in Sec. 108(1)(j)(ii) to (v), hence acting in concert with Sec. 105(1), where a

¹⁰⁷³ Also, can the first eight words of the provision be construed as meaning the value to the taxpayer of the benefit or is it the value on the open market that is to be measured?

¹⁰⁷⁴ Technically if the payment is made by a taxpayer other than the trust in respect of the trust Sec. 53(2)(h) cannot apply to it and Sec. 105(1) will fully include it in income.

payment is made by the trust in respect of a capital interest acquired for no consideration in a personal trust not only will there **not** be an ACB adjustment but, Sec. 105(1), read **as if** there was an ACB adjustment, **will also not apply**, resulting in the capital being distributed tax free. In order for the second exempting provision under Sec. 105(1) to apply the taxpayer recipient must in fact have an interest in the trust from which or in respect of which the benefit is being realized, **however**, it is questionable whether the interest must be a capital interest within the definition thereof in Sec. 108(1)(c) or whether it can be a discretionary capital "interest" or whether it can even be an income or discretionary income "interest" since there isn't any qualification placed on the description of "the taxpayer's interest" in respect of the hypothetical adjustment under Sec. 105(1)(b). In order to avoid application of Sec. 105(1), Sec. 53(2)(h) must have applied, or could have been applicable to the payment, hence it would seem that this limits the type of interest to being a capital interest, while subparagraph 53(2)(h) describes several types of payments that will be captured and cause an adjustment.

The Sec. 53(2)(h) Exemptions.

Under subparagraph 53(2)(h)(i), an amount paid **to the taxpayer** after 1971 **by the trust** as a distribution or payment of capital by the trust in respect of a **purchased capital interest in a personal trust, (except as proceeds of disposition of the interest)**, to the extent that it became payable before 1988 will cause an ACB adjustment and will not lead to an application of Sec. 105(1) while the substance of this provision is effectively the reciprocal of the pre-reform Sec. 105(1) which didn't apply to distributions or payments of capital.¹⁰⁷⁵

Proceeds of disposition received from a trust in respect of a capital interest in it are received in satisfaction of the right and are treated under section 107 however it is only a taxable capital gain realized on a satisfaction that is included in computing income, not the proceeds themselves hence on a terminal distribution that amount of consideration net of any recognizable taxable capital gain will be included in computing the recipient's income as a benefit under Sec. 105(1) proper. The exception in Sec. 105(1)(a) is the value of the benefit that is to be otherwise included in computing the particular recipient's income as described in section 3, not the amounts taken into consideration in deriving the inclusion amount. An interest granted to a taxpayer via a power of appointment and satisfied with a **section 107 distribution** may easily give rise to a massive inclusion under Sec. 105(1) of the value of the benefit. If the beneficiary is non-resident such is not the case and if such is the case understandably one would want to appoint to a non-resident trust a capital interest while a Canadian resident has a capital interest in the recipient. The Sec. 105(1) provision could still be applied here however: a benefit has been realized via the non-resident trust. A preferred option is to make distributions without satisfying the interest so that the Sec. 53(2)(h)-105(1) tax-free distribution mechanism can operate.

In order for the Sec. 53(2)(h)(i) adjustment to occur the payment could have been made at any time although it would have had to become payable prior to 1988, while it also must have been payable **as capital** before that time. The second major ACB adjustment consists of that in subparagraph 53(2)(h)(i.1) whereunder any amount that becomes payable **to the beneficiary by the trust** after 1987 **in respect of the capital interest**, otherwise than as proceeds of disposition upon a distribution, **except** for amounts having one of three possible characteristics, will lead to an ACB reduction by the amount when they **became payable**, and thus will not attract application of Sec. 105(1) when they are eventually paid. Payments made in respect of a capital interest, not satisfying it, to a third party will **not** gain Sec. 53(2)(h) treatment unless the beneficiary is the beneficial owner of the receipt and its payment is directed by him.

The three amounts that will **not cause** an ACB adjustment and thus cause **potential** application of Sec. 105(1) consist of; (1) an amount that was included in computing the particular taxpayer's income under Sec. 104(13)¹⁰⁷⁶ or from which withholding tax was held under Part XIII by reason of Sec. 212(1)(c)¹⁰⁷⁷ or, (2) amounts equal to 1/3 the amount designated by the trust in respect of the particular taxpayer under Sec.

¹⁰⁷⁵ If the interest isn't purchased but the trust is personal Sec. 53(2)(h) will not apply to any distribution but Sec. 105(1) will apply as if it did to prevent a Sec. 105(1) inclusion.

¹⁰⁷⁶ but apparently **not** Sec. 104(14), the preferred beneficiary election

¹⁰⁷⁷ income from trusts and estates otherwise described under Sec. 104(13)

104(21)¹⁰⁷⁸ or the full amount designated under Sec. 104(20) in respect of the particular taxpayer¹⁰⁷⁹. All of these amounts represent either amounts that the taxpayer has been previously taxed upon or amounts which should be exempt from tax due to other provisions of the Act such as the non-taxable portion of any capital gain or non-taxable capital dividends etcetera. Unfortunately, these amounts will not cause an adjustment in the ACB, (or cause a hypothetical adjustment), of the interest and thus fall back under the effect of Sec. 105(1), whereby if the amount wasn't previously included in computing the particular taxpayer's income, it will be under Sec. 105(1).

Amounts previously recognized under Sec. 104(13) will obviously not be included twice, amounts that were the subject of a preferred beneficiary election will not be includable under Sec. 105(1) **since they will actually cause an interest ACB adjustment when distributed**¹⁰⁸⁰. Amounts upon which Part XIII withholding tax has been applied will not be included in computing the beneficiary's income, (as per the wording in Sec. 105(1)(a)), since non-residents don't compute income per se however Sec. 105(1) doesn't cause withholding tax anyway. An amount designated out as a non-taxable dividend by a trust to its beneficiary under Sec. 104(20) will not cause an ACB adjustment when distributed and since it was not required to be included in computing the particular taxpayer's income previously it may cause the ludicrous but technical result whereby a non-taxable dividend is includable under Sec. 105(1) in income, while the same applies for the "1/3rd" amount of the Sec. 104(21) designation which equals 1/4 of the whole net capital gain designated. It will **not** always do this due to the technical adjustments in Sec. 105(1)(b) itself which cause only the **hypothetical** adjustments to exclude the two exceptions just cited, thus **causing hypothetical** ACB adjustments in respect of them. **Actual** applications of the Sec. 53(2)(h) provision will cause those two elements to be technically subject to the effect of Sec. 105(1)¹⁰⁸¹. **Hypothetical** adjustments will not cause the payments to be subject to inclusion under Sec. 105(1) by virtue of the fact that Sec. 105(1)(b) reads; "... **or would be so deducted if that paragraph applied in respect of the taxpayer's interest in the trust, and were read without reference to clause (i.1)(B) thereof**", which are the two exceptions just described.

Capital interests in personal trusts that were acquired for consideration payable will attract the entire barrage of Sec. 53(2)(h) ACB adjustments when appropriate and will also cause the beneficiary to be exposed to a Sec. 105(1) inclusion in respect of a non-taxable portion of a capital gain or a non-taxable dividend when those amounts are distributed, since the above applies only when the ACB adjustments are not applicable. Where the interests were not acquired for consideration payable the beneficiaries will not be exposed to ACB adjustments under Sec. 53(2)(h), while they **will** also not be exposed to Sec. 105(1) inclusions in respect of the amounts that would otherwise **cause** an ACB adjustment which **includes** for these purposes the two otherwise exempt amounts representing non-taxable portions of capital gains and non-taxable dividends. It thus is redundant to say that a capital interest in a personal trust which is based on the right to non-taxable dividend streams or capital gains to be realized should **not** be acquired for consideration payable since these amounts once paid, **unless in satisfaction of the interest, will lead to a full Sec. 105(1) income inclusion**.¹⁰⁸² The provision formerly referred to capital interests which were "purchased" however presently

1078 the taxable capital gains designation

1079 the non-taxable dividend designation

1080 which may cause P.B.E.'s to cause slightly less than double taxation when Sec. 53(2)(h) applies which occurs when the amount is paid to a beneficiary in respect of a capital interest in a personal trust acquired by him for consideration payable

1081 and this will occur only when the capital interest in the personal trust was acquired for consideration payable, or when the trust isn't personal but commercial. This is supported by Departmental Technical Notes accompanying the introduction of that provision.

1082 Subparagraphs 105(1)(b)(i) and more importantly (ii) apply only where the Sec. 53(2)(h) provision doesn't apply to the capital interest, **not where it actually does**. The provision reads: "deducted ... in computing the adjusted cost base of his interest in the trust **or would be so deducted if that paragraph applied in respect of the interest and were read without reference to clause (i.1)(B) thereof**." The non-taxable receipt is not required to be included in his income hence Sec. 105(1)(a) isn't satisfied, and where the capital interest is acquired for consideration Sec. 53(2)(h) applies and subpara. (i.1) prevents an a.c.b. adjustment in respect of the receipt that prevents Sec. 105(1)(b) from being satisfied: no a.c.b. adjustment occurs but the amount is fully taxable. Where the capital interest in the personal trust is acquired for consideration payable unless the distribution is satisfying the interest it must either already have led to one of the specific income inclusions or actually caused an a.c.b. adjustment otherwise Sec 105(10) will fully include the amount in the receipt's income. This is one of the primary restrictions placed on trading in personal trust capital interests in the 1988 reform. Again, if the beneficiary is non-resident Part XIII isn't activated by Sec. 105(1). The fact that one could argue that a capital dividend isn't trust law income but capital is irrelevant in this context in that regardless of its character it still isn't satisfying the interest and thus isn't exempt

it would appear that regardless of how the interest was acquired, if consideration was paid or payable for it in any form, Sec. 53(2)(h) will apply to it.

There are three ACB adjustments to capital interests described under Sec. 53(2)(h) which arise due to flow through designations of tax credits described in Sec. 127(5), the investment tax credit, 127.2(3), the share-purchase tax credit, and 127.3(3), the scientific research and experimental development tax credit, the substance of which could have otherwise been subject to the Sec. 105(1) inclusion in that they represent benefits to the beneficiaries in the form of a reduction in taxes payable by them, and not payments made to them in respect of the trust. The three tax credits just mentioned is **not an exhaustive list** of tax credits that can be flowed through to the benefit of beneficiaries. Under Sec. 104(22), a beneficiary under a trust is deemed, if so designated by the trust, to have paid a certain proportion of the foreign income taxes paid by the trust in respect of income recognized that was recognized by him under Sec. 104(13) or (14), and while these taxes deemed paid do not lead to a capital interest ACB adjustments under Sec. 53(2)(h), they do lead to the ultimate benefit to the beneficiary in the form of a possible tax credit under section 126. Subparagraph 105(1)(b) refers to all "benefits" described under Sec. 53(2)(h) hence one is being prudent in questioning if such indirect benefits such as those caused by Sec. 104(22) will be caught by Sec. 105(1) and included in income.¹⁰⁸³ ... Maybe the Department should comment.

The final capital interest ACB adjustment under Sec. 53(2)(h) consists of the amount of government assistance received by **a beneficiary** under a trust by way of grant, subsidy, forgivable loan, deduction from tax, investment allowance etc. from a federal, provincial, or municipal government or public authority that can reasonably be considered to relate to the acquisition of depreciable property by the trust which has caused the capital cost of the property to be reduced for purposes of the Act as per Sec. 13(7.1). If assistance was received but it did not lead to a capital cost adjustment due to the fact that it was an amount, described in Sec. 37(1)(d), deducted under section 65 as a resource allowance, or was included in income under Sec. 12(1)(u) or 56(1)(s), it will not cause an ACB adjustment in respect of the capital interest and may thus be potentially includable in the beneficiary's income under Sec. 105(1) as per the previously discussed criteria.

“Cost Integration of Capital Interest in Trust - Sec. 53(2)(h)“

(h) where the property is a capital interest of the taxpayer in a trust (other than an interest in a personal trust that has never been acquired for consideration or an interest of a taxpayer in a trust described in any of paragraphs (a) to (e.1) of the definition "trust" in subsection 108(1)),

(i) any amount paid to the taxpayer by the trust after 1971 and before that time as a distribution or payment of capital by the trust (otherwise than as proceeds of disposition of the interest or part thereof), to the extent that the amount became payable before 1988,

(i.1) any amount that has become payable to the taxpayer by the trust after 1987 and before that time in respect of the interest (otherwise than as proceeds of disposition of the interest or part thereof), except to the extent of the portion thereof

(A) that was included in the taxpayer's income by reason of subsection 104(13) or from which an amount of tax was deducted under Part XIII by reason of paragraph 212(1)(c),

from the Sec. 53(2)(h)-105(1) mechanics.

¹⁰⁸³ The exact same occurs in respect of the Sec. 104(19) dividend designation allowing the beneficiary to gain the section 121 D.T.C. and the taxable capital gain flow through designations. The substance of these designations has of course already led to an income inclusion or is ancillary thereto but the exclusion of these three designations from treatment under Sec. 53(2)(h) or the Sec. 105(1) exemptions allows them to be targeted by Sec. 105(1). The income they relate to may have already been recognized but the benefit in the reduction in taxes that income carries as a result of the designation hasn't been. A D.T.C. is of course a benefit to the beneficiary in the form of a reduction in taxes and the extent to which Finance has integrated the two subsections and placed reliance on their smooth functioning compels amendments to be made in respect of the three designations.

(A.1) that was deemed by subsection 104(16) to be a dividend received by the taxpayer, or

(B) where the trust was resident in Canada throughout its taxation year in which the amount became payable

(I) that is equal to the amount designated by the trust under subsection 104(21) in respect of the taxpayer,

(II) that was designated by the trust under subsection 104(20) in respect of the taxpayer, or

(III) that is an assessable distribution (as defined in subsection 218.3(1)) to the taxpayer,

(ii) an amount equal to that portion of all amounts deducted under subsection 127(5) in computing the tax otherwise payable by the taxpayer under this Part for the taxpayer's taxation years ending before that time that may reasonably be attributed to amounts added in computing the investment tax credit of the taxpayer by virtue of subsection 127(7),

(iii) any amount added pursuant to subsection 127.2(3) in computing the taxpayer's share-purchase tax credit for a taxation year ending before or after that time,

(iv) an amount equal to 50% of the amount deemed to be designated pursuant to subsection 127.3(3) before that time in respect of each share, debt obligation or right acquired by the trust and deemed to have been acquired by the taxpayer under that subsection, and

(v) an amount equal to the amount of all assistance received by the taxpayer before that time that has resulted in a reduction of the capital cost of a depreciable property to the trust by virtue of subsection 13(7.2);

(j) where the property is a capital interest in a trust (other than a unit trust) not resident in Canada that was purchased after 1971 and before that time by the taxpayer from a non-resident person at a time (in this paragraph referred to as the "purchase time") when the property was not taxable Canadian property and the fair market value of such of the trust property as was

(i) a Canadian resource property,

(iii) an income interest in a trust resident in Canada,

(iv) taxable Canadian property, or

(v) a timber resource property

was not less than 50% of the fair market value of all the trust property, that proportion of the amount, if any, by which

(vi) the fair market value at the purchase time of such of the trust properties as were properties described in any of subparagraphs (i) to (v) exceeds

(vii) the total of the cost amounts to the trust at the purchase time of such of the trust properties as were properties described in any of subparagraphs (i) to (v),

that the fair market value at the purchase time of the interest is of the fair market value at the purchase time of all capital interests in the trust;

Interest Free Loans and other Benefits.

In *S. Cooper v. M.N.R.*¹⁰⁸⁴ a taxpayer had received a substantial loan of money, interest free, in the role of a trustee, from a trust over an extended length of time and the Minister assessed him as having received a benefit, as described under Sec. 105(1), equal to the prescribed rate of interest, applied to corporate loans described under section 15 and 80.4, on the loan amount. The Tax Court of Canada found that the benefit was taxable under that subsection whereupon the taxpayer appealed to the Federal Court Trial Division¹⁰⁸⁵ whereby it was found that the prescribed rates of interest cited were applicable to corporate loans described in section 80.4 and not to trust loans while counsel, for the taxpayer, leaned on the argument that prior to the enactment of subsection 15(2), Sec. 15(1), the general benefit charging provision in respect of **corporations**, basically equivalent to Sec. 105(1), was seen by the authorities as not formidable enough to capture interest free loans thus the need to enact Sec. 80.4(1) and 15(2). Subsection 80.4(1) and 15(2) are the only provisions that are targeted properly to be a base for the application of the prescribed rates of interest, however, section 105 does not contain an equivalent and thus Sec. 105(1) stands (presently), in the same position as Sec. 15(1) did **before** the Sec. 80.4(1) or 15(2) enactments were made; incapable of capturing interest free loans from trusts as **taxable** benefits, even though their benefit is judicially recognizable.¹⁰⁸⁶ Unfortunately, this phenomenon exists only with respect to loans of money to taxpayers due to the existence of the Sec. 15(2), 80.4(1) and (2) provisions explicitly recognizing the inclusion of loan benefits in the income of the shareholder/employee debtor, while in respect of other types of property, one would expect Sec. 105(1) to apply as per the reasoning in *C.I.R. v. Lady Wolerton*¹⁰⁸⁷ where the annual value of the use of a dwelling was included in a taxpayer's income, even though she was also acting in the capacity of an executrix of the estate. See also *Lord Tollemache v. I.R.C.*¹⁰⁸⁸ *Lady Miller v. I.R.C.*¹⁰⁸⁹ and *Lady De Robeck v. I.R.C.*¹⁰⁹⁰ where only the actual benefit realized and not *available* was includable in income.¹⁰⁹¹ There are certain situations, however, where the use of a dwelling under a trust will not be treated as a benefit, even though the taxpayer has not given consideration for the arrangement nor has incurred an equitable charge in respect of it. In *Peardon Estate v. M.N.R.*¹⁰⁹² the Tax Court of Canada found that the use of a dwelling adjacent to land which a beneficiary rented for fair market value consideration from the trust was not a benefit in that the availability of the dwelling depended upon the renting of the land as spelt out in the trust terms. If the beneficiary chose not to rent the land, and not make rent payments in respect of "it", then the dwelling would not be available to him, and on this premise, *Brulé, T.C.J.* found that the dwelling was not separate from the renting agreement and thus when the taxpayer/beneficiary made rent payments he was also **renting** the house. While residing in the dwelling, the beneficiary was also responsible for its upkeep, which could include substantial expenses, and in accompany with the previous facts the Judge found quite appropriately that:

"The grandson if he is renting, (from the trust), is providing income to the trust. Perhaps as an added inducement he is permitted to occupy a dwelling but in so doing must keep it in good repair and condition. This is tantamount to rent, and if he were not there, the executors would have to rent the property and pay for any upkeep. The testator obviously through such an arrangement was a quid pro quo and Dean is not getting any benefit for nothing from the trust."

However, he did not go on to comment on whether the expenses (allocatable or direct) were equal to the fair market value rent chargeable on the dwelling. If they were less then the taxpayer could still be found to be

¹⁰⁸⁴ 1987 C.T.C. 2287

¹⁰⁸⁵ 88 D.T.C. 6525

¹⁰⁸⁶ This situation should be compared to *E.C. Dickman et al. v. C.I.R.*, 465 U.S. 330 (1984), and it illustrates the danger and benefit of statutory construction and convention. See *Metro Gas Co. v. F.C.T.*, 47 C.L.R. 621, for absolute powers used to extent interest free loans from discretionary trust and trust duties possibly appendant thereto.

¹⁰⁸⁷ 23 T.C. 48

¹⁰⁸⁸ 11 T.C. 277

¹⁰⁸⁹ 15 T.C. 25 (HL)

¹⁰⁹⁰ 13 T.C. 345 (HL)

¹⁰⁹¹ See also *C.I.R. v. Duncanson*, 31 T.C. 257.

¹⁰⁹² 86 D.T.C. 1045

realizing a benefit through "cheap" rent.¹⁰⁹³ By the mere fact that the Judge approached the arrangement as such clearly seems to indicate that the Courts will have no qualms in applying Sec. 105(1) to instances where a benefit is realized through a "cheap" use of any non-cash property.¹⁰⁹⁴ If property is purchased at a bargain price from the trust Sec. 105(1) should apply¹⁰⁹⁵ and the relationship between the purchaser and the trust may be irrelevant.

Personal Property Use.

Question 69 of the 1988 CRA Roundtable Question-Answer session dealt with the possible application of the Sec. 105(1) provision to situations where **personal** property, such as dwellings, were used rent free by beneficiaries under a trust which held legal title thereto, and the Department forwarded the opinion that Sec. 105(1) would not apply to such situations if the trust allowed the use of the property and if the individual had allowed the use to another individual a tax advantage or benefit would not otherwise result.¹⁰⁹⁶ Apparently, one means of measuring whether Sec. 105(1) should apply is to examine the type of benefit conferred and if it would have been a tax advantage or taxable benefit had it been arranged between two other individuals, however, as per the Department's opinion in the answer, this examination applies only to **personal use property**. If rental property benefits are conferred then the above criteria breaks down and Sec. 105(1) applicability follows. A capital interest is defined to be a right held by the taxpayer in the capacity of a beneficiary to or to receive capital and thus if the beneficiary is given the right to use a dwelling etc., the benefit is being conferred on the beneficiary and by virtue of the fact that there isn't a section 107 or 106 commutation or payment Sec. 105(1) will be applicable. This thus precludes arrangements from being tax efficient where income producing property, not personal property, is to be available for the use of the beneficiary so that he may realize income from it without receiving legal title. In such an instance however Sec. 105(1)(a) precludes the double inclusion in income of the value of the income realized from the use of the income producing property by the beneficiary. The beneficiary will either recognize an investment income, such as rent, royalties, etc. **or** a Sec. 105(1) inclusion but not both since para. (a) of the subsection precludes it. If income isn't recognized by the beneficiary then Sec. 105(1) may apply in full since the availability of the property may confer a benefit that is being realized.

"Benefits" to Settlers.

Dunn v. I.R.C.¹⁰⁹⁷ is an interesting case that has some illustrative value. In this case the taxpayer set up a trust *inter vivos* to provide for the maintenance of his spouse pursuant to a court order that was pending.¹⁰⁹⁸ When the award was duly made the trust provisions operated to the terms of the order eliminating the taxpayer's personal liability and the Tax Man contended that the settlor had realized a benefit from the trust in the form of the reduction in his liability and that its value should be included in his income. The Court didn't agree on the grounds that he wasn't a beneficiary under the trust¹⁰⁹⁹. In such a case Sec. 105(1) shouldn't apply since the settlor is not realizing a benefit from the trust; he's settled FMV consideration to provide for the elimination of the liability and merely structures the trust to satisfy it accordingly as a step in the process.

1093 This aspect was covered in the answer to a question tabled at the 1987 Roundtable where the Department provided: "To quantify the value of a subsection 105(1) benefit requires the valuation of the benefit using appropriate methods. If, for example, the benefit was for the use of real estate subject to the beneficiary's paying upkeep (and therefore no subsection 105(2) benefit), the benefit should be based on the fair market value - that is - the rent for a comparable property with adjustments for costs incurred."

This approach was endorsed in technical Interpretation 911687 of Aug. 1991 by the Business and General Section as well as T.I. 5-6790 of Nov. 1988 of the same. This opinion is qualified and not generally applicable in respect of personal use property as subsequently discussed.

1094 This case actually concerns whether the taxpayer could receive the use of trust capital under a spousal trust prior to the death of the spouse and the author disagrees that the basis of the disqualification is mere "benefit".

1095 See *New v. M.N.R.*, 71 D.T.C. 318.

1096 This was also the opinion in Q31 of the 1989 Roundtable which was endorsed in Technical Interpretation 5-9698 provided in March 1990 by the Financial Industries Division.

1097 1975 1 N.Z.L.R. 465

1098 The income was not assessable to the settlor under the particular legislation but in the author's opinion would be under the ITA pursuant to Sec. 75(2).

1099 though this is in fact questionable when one reviews the substance of the arrangement

In Relation to Upkeep Benefits.

Subsection 105(2) is expressly targeted at indirect benefits realized by beneficiaries in the form of maintenance/upkeep of property through the application of income of the trust, however, it should be pointed out that very much unlike the Sec. 105(1) inclusion, the Sec. 105(2) provision offers the integration of the tax liability for the **income** applied whereby the trust will obtain a deduction, appropriately. It's understandable why the draughtsman would want to segregate the two benefits in that if Sec. 105(2) did not exist a use of income to maintain/upkeep a property would be taxed twice; in the hands of the trust and beneficiary; truly an inequitable and harsh result.¹¹⁰⁰ Uses of capital to provide such maintenance do not gain Sec. 105(2) treatment, whereby the trust would not receive a deduction in respect of it, appropriately, however, they should be included, as a benefit, in the beneficiary's income on the basis of the reasoning underlying the purpose of Sec. 105(1). Capital will not be payable to the beneficiaries but to relieve the beneficiary's expenses hence Sec. 53(2)(h) is inapplicable. In the author's opinion, contrary to the opinion expressed in the S. Cooper appeal, the mere fact that the draughtsman introduced Sec. 105(2) in respect of maintenance/upkeep does not preclude from the recognition of taxable benefit under Sec. 105(1) other types of upkeep benefits financed through the **application** of trust capital.

Transfers of Income Rights.

In *L.M. Lyons v. M.N.R.*¹¹⁰¹ a question of either the application of Sec. 105(1) or 56(2) was of concern when a beneficiary under a trust had assigned a portion of her income interest in a trust created by a will, to another taxpayer the substance of which when realized was to extinguish a debt she had with the assignee. The Minister assessed the assignee as receiving income and included it in his income by virtue of subsection 105(1) while the assignee contended that the payments received were as a repayment of debt pursuant to an agreement between the beneficiary and himself while he further contended that the payment was made pursuant to the direction of the initial beneficiary and that by virtue of Sec. 56(2), since it otherwise would have been taxable in her hands and that they had been paid/transferred pursuant to her direction or with her concurrence, they should be taxed in her hands. The Minister chose not to pursue this argument and did not comment on whether or not the agreement existing between the beneficiary and the assignee was ineffective or whether she retained an enforceable income interest even after the apparently effective assignment thereof. The Tax Review Board, with M.J. Bonner presiding, found that Sec. 105(1) applied, and although this case occurred prior to the reform the post reform Sec. 105(1) could have been equally applicable given that it operates to exclude from inclusion of the subject's income, amounts that were previously included **only in his income**. The Tax Review Board considered that since the taxpayer no longer owned the interest in respect of which the income was paid she could not 'direct' the trustees to pay the income within the context of Sec. 56(2) however the Board did not consider the tax consequences of the assignment of the taxpayer under Sec. 106(2) nor did the Minister's counsel. If she assigned the right a Sec. 106(2) inclusion would have been in order due to the disposition while the assignee would become the beneficiary recognizing a Sec. 104(13) inclusion.¹¹⁰² If she didn't assign **the income right** to the income, but instead **only assigned the income in respect of the right**, if and as it came distributable, then she would not have satisfied the Sec. 56(4) exempting qualification and she could have been caught by that provision and recognized the income, while the recipient assignee would have also been caught under Sec. 105(1), since the two subsections are not mutually exclusive.

It is questionable how accurate the decision was in *Lyons v. M.N.R.* given the fact that the assignee was extinguishing a right to receive payment from the assignor and thus could clearly be seen not to have been receiving "something for nothing" from the trust. If one follows the basis of reasoning displayed in *Peardon Estate v. M.N.R.*¹¹⁰³ one would quickly doubt the soundness of the reasoning in *Lyons*. The assignee in *Lyons*

¹¹⁰⁰ Note the introduction of subpara. 105(1)(a) in the last reform.

¹¹⁰¹ 83 D.T.C. 113 (TRB)

¹¹⁰² See *Camp v. King*, 1887 14 V.L.R. 22, *Perp. Trustee Co. Ltd. v. Smith*, 1939 39 S.R. (N.S.W.) 19, *Re: Bond*, 1940 35 Tas.L.R. 96, & *Booth v. F.C.T.*, 76 A.L.R. 375, *Comp. of Stamps v. Howard Smith*, 54 C.L.R. 614.

¹¹⁰³ a judgment rendered at the Tax Court level

had given up a right that had value, as a lender, to receive payment from the trust thus the payment from the trust was not received "free". Even though the trust deducted such amounts paid to the assignee as "interest expense" etc. the real benefit was recognized by the assignor since it was she who was receiving, in effect, an extinguishment of her debt "for nothing". This brings to issue the fact that if an income amount isn't received by a beneficiary, nor is payable to her, the trust will not receive the benefit of the Sec. 104(6) deduction even though, in the authors opinion, the beneficiary is fully exposed to a Sec. 105(1) or 56(2) inclusion. In April 1988 the T2-T3 Assessing and Taxroll Programs Division provided an interesting opinion to the F.I.D, Rulings Directorate (HAV 9586-1) where it held that the wording of Sec. 105(1) was all inclusive but that the application of thereof should be based on two elements: the purpose for which the trust was created which includes establishing whether or not a benefit has been conferred and whether the benefit confers a tangible and financial advantage to the beneficiary. Key to establishing such involves the circumstances involving the transfer of the property to the trust, the settlor and the beneficiaries before the creation of the trust. It was held that "This view is substantiated if one considers the apparent intent of the subsection, namely to preclude the sheltering of assets and or benefits which, but for the trust, would be taxable or, to quote Raphael in Canadian Income Taxation of Trusts (page 264) "The purpose of subsection 105(1), like that of paragraph 15(1)(c), is to prevent income that would otherwise be taxable to the trust under the Act from being assigned or transferred to volunteers or other persons in the form of a non-taxable amount.""

In the author's opinion the present Sec. 105(1) has as its principal purpose the introduction into income of all of the benefits that are realized from or in respect of a trust that are not otherwise provided for in the other sections of the Act and this is fully substantiated by the extent to which the benefit is to be evaluated as having caused tax consequences under other sections. Subsection 104(13) inclusions are expressly exempted while distributions directly to the beneficiaries in satisfaction of their capital interests, as **specifically targeted under section 107**, are also exempted. If the benefit does not fall to be treated specifically by these provisions the application of which depends, not so co-incidentally, on very specific transactions it may be subject to income inclusion and this is also harmonious with the underlying thrust of Sec. 15(1) which targets those benefits that have not fallen to be attended to by other sections as described. In the case of Sec. 105(1), in the author's opinion, the income of the trust and its taxation has nothing to do with the application of the provision but what is exclusively concerned with is whether the benefit gives rise to a tangible and financial advantage **that is not attended to by some other section of the Act as listed**, which have narrow criteria for application. The trust as a fiscal entity, like the corporation, is to be maintained completely separate from its beneficiaries who have the benefits they realize therefrom taxed narrowly under sections 104, 106, 107 or broadly under section 105.

Extra Payments for Taxes.

In *Havelock v. Grant*¹¹⁰⁴ income from a Ceylon resident trust was paid to a U.K. resident plus an amount to cover the U.K. tax on the income. The tax reimbursement was erroneously distributed by the trustees as per the terms of the trust and they were entitled to recover it from her however the U.K. revenue authorities included the sum in her income. It was held that it did not represent income since she was required to return it having no legal or equitable right to retain it.¹¹⁰⁵ In the Canadian context, if such were to occur Sec. 105(1) would apply to the extra payment if it didn't have as its source the trust's income. This would not be the case if the beneficiary had a legal right to reimbursement, (and such a right could be considered a capital interest in the fund and the payment was received directly and not on her behalf). If the beneficiary has the right to have it applied **only** to extinguish his tax liability even if it's capital it will lead to a Sec. 105(1) inclusion, (unless he isn't resident in Canada).¹¹⁰⁶

Powers of Appointment.

Subsection 105(1) **formerly and explicitly** was structured so as to apply to benefits that arose by virtue

¹¹⁰⁴ 27 T.C. 363

¹¹⁰⁵ See also *C.I.R. v. Duncanson*, 31 T.C. 257.

¹¹⁰⁶ See *C.I.R. v. Watson*, 25 T.C. 25, for attempts to assess for deduction of tax. See also *Meeking v. I.R.C.*, 7 T.C. 603, & *Drummond v. Collins*, 6 T.C. 525, generally.

of a power of appointment¹¹⁰⁷ be it special or general be it exercisable in respect of beneficial or legal title.¹¹⁰⁸ If the power was exercised and was a special power of appointment, the trust could **not** be read as granting the interest to the beneficiary recipient **at a time of creation**, however, at issue is how disconnected the benefit realized can be from the exercise of the power in order for it not to be subject. If a discretionary interest has been granted through a power of appointment, and it has not been rewarded through a favourable exercise of discretion then the beneficiary hasn't realized a benefit, **unless** he has done something with the interest separate from the trust i.e.; sold it.¹¹⁰⁹ If the effect of the power of appointment is to distribute legal title to property directly to the appointee then obviously a benefit has been realized, however, does this include instances where the power is a special one¹¹¹⁰ and its effect can be taken to be derived from conditions set out in the original deed, (read back into the original settlement)? In such an instance would not the recipient be recognized as having an interest since the time of the creation created by the trust deed as provided by the settlor, **at common law**, hence be precluded from realizing a benefit, due to the machinery of common trust law, from the exercise? Under post-reform Sec. 105(1), in the author's opinion, it could be credible to argue the above point when a **special** power of appointment is exercised so as to give a taxpayer an interest in the trust or appoint legal title to him. Where a **general** power of appointment is exercised it derives its result, at common law, from the actions of the appointor and thus clearly any benefit realized from the exercise may be subject to Sec. 105(1). The right that a beneficiary acquires through the exercise of a general power of appointment derives its existence from the exercise of the power while those acquired through the exercise of a special power of appointment derive their existence from the trust deed itself.¹¹¹¹

While the pre-reform Sec. 105(1) provision did not specify the nature of any benefit causing power of appointment it can be argued that even though in common law upon an exercise of either the recipient would acquire property in the capacity of a beneficiary holding a right Parliament had the intention of wishing otherwise. By specifying such the draughtsman precluded the effect of section 107 to the subsequent distribution of property in respect of that granted right and especially when one considers that the provision formerly read, "irrespective of when made or created," it could be said that the intention was to capture uses of both general and special powers. Presently, however, the provision does not specify any source of the benefit but it does preclude from effect only those items that were included in computing the particular taxpayer's income, or, that led to an adjustment in the ACB of his capital interest, (or hypothetically could have). Dispositions of capital interests through distributions by the trust do not effect the ACB of the interest being extinguished but do cause some proceeds, net of the recognizable cost, to be included in computing income hence these deemed proceeds shouldn't be captured by Sec. 105(1) when terminating distributions are made. An interesting aspect about the use of powers of appointment to grant beneficial interests should be commented on here; if the power is exercised to grant a contingent/future equitable right then until that right becomes enforceable in respect of the trust (and if the condition of its creation include that it can't be sold/transferred or used as collateral), the recipient hasn't realized a benefit.¹¹¹² If property is distributed/paid in respect of such a capital interest granted **without** satisfying the interest, subsection 105(1) will not apply

¹¹⁰⁷ The mere existence of the power may not constitute a benefit.

¹¹⁰⁸ Would it include instances where a power of appointment has been exercised to grant a taxpayer a future, contingent, or "discretionary", interest in the trust that was either gifted and thus caused the availability of a gift tax credit to the trust or beneficiary, or was used to collateralize a loan that otherwise wouldn't be available?

¹¹⁰⁹ See *I.R.C. v. Macpherson*, 1988 2 W.L.R. 1261, where the House of Lords recognized a benefit conferred on an appointee under a general power of appointment over legal title. On a subsequent sale however, Sec. 105(1) may be partially offset with a capital gain realized on the sale which is "previously included in computing" the taxpayer's income. essentially the non-taxable portion of the gain and the value up to the interest's Sec. 108(1)(d) cost amount may cause a full Sec. 105(1) income inclusion.

¹¹¹⁰ restricted by the grantor to apply solely in respect of certain parties

¹¹¹¹ Would it be intolerable inequitable for the Act to include in income fully those benefits derived from a trust which one held in common law to be derived from the settlor's initial disposition (as is the case with special powers) but not include in income those same benefits if the settlor has directly specified them in the initial disposition?

¹¹¹² In T.I. 910214/910786 provided in Apr. 1991 by the Business and General Division it was essentially held that payment of funds into a trust fund for the training of employees by an employer does not give rise to a taxable benefit under subsections 149(1)(l), 105(1), or 6(1)(a). In T.I. 5-910981 provided in August 1991 by the F.I.D. it was held that the application of Sec. 75(2) to an arrangement doesn't prevent Sec. 15(1) from also applying. The Department seems vicarious enough to pursue an arrangement with both Sec. 75(2) and 105(1) depending on its characteristics.

by virtue of the applicability of para. (b) thereunder¹¹¹³. If the benefit is recognized at the time of the exercise of the power, such as the case where the taxpayer mortgages/lends/sells the interest, which as per the above would prove to be a more valid basis of inclusion, what would be "the value" of a discretionary capital interest created by the power which becomes enforceable only upon a further exercise of a discretionary power whereafter Sec. 53(2)(h) may then apply, or hypothetically apply to it, thus causing the negation of the applicability of Sec. 105(1)?¹¹¹⁴

Subsection 105(1) was amended to eliminate the explicit references to the four distinct ultimate sources of benefit, (the trust, a contract, an arrangement, or a power of appointment), however, it was amended in such a way as to not preclude application to those instances, but only those that were previously recognized in income or that led to an actual or hypothetical interest ACB adjustment¹¹¹⁵. The third ultimate source of a benefit, "an arrangement", is quite copious and can be taken to mean instances where a beneficiary structure has been altered so as to add a beneficiary under the appropriate statute law variation rules, **however**, similar to the nature of a power of appointment, a benefit will not be realized until, generally, the trust distributes income or capital to the new beneficiary and in this regard, Sec. 105(1) will not apply at all due to the applicability of Sec. 104(13) or 107(2) et cetera which will cause the amount to be included in computing the beneficiary's income. The key in this case is the fact that the benefit realized has drawn attention from other areas of the Act. Any variation results in a benefit to some beneficiary or another, otherwise it wouldn't be executed. Not all variations, however, result in benefits the exclusive nature of which is a distribution and thus Sec. 105(1) may apply where, for instance, an interest has been enlarged and sold for greater proceeds than otherwise attainable or where a distribution date has been extended so as to reduce the fair market value of the interest for purposes of Sec. 128.1(1). Since the Sec. 105(1) provision isn't restricted to applying only to beneficiaries or trustees, it could also apply to taxpayers where through the purchase of property of the trust for consideration less than the property's fair market value they have realized a bargain, causing it to be fully includable in their income.¹¹¹⁶ In the instance where a capital interest, received via the exercise of a power of appointment, is sold it would appear that Sec. 105(1) could again not apply since the proceeds would be required to be included in computing the beneficiary's income however is the non-taxable portion of the gain not required to be included and thus subject to possible Sec. 105(1) inclusion?¹¹¹⁷ In the author's opinion it may be, while the same holds true in respect of interests that produce losses for the beneficiary upon disposition in that the net capital loss is a benefit, isn't it? The interaction of Sec. 105(1) with sections 106 and 107 should definitely be a topic for a roundtable question.¹¹¹⁸

1113 and herein lies a way of avoiding the Sec. 105(1) problem on terminating distributions

1114 If an exercise of a power over the legal title rather than equitable interest operates to convey the property Sec. 105(1) would apply since Sec. 53(2)(h) can't, since the payment isn't made in respect of a capital interest. In T.I. 5-911387 provided in June 1991 by the F.I.D. it was held that Sec. 105(1) will not generally apply to a distribution of property in satisfaction of a capital interest if the beneficiary has directed or concurred with the distribution, in which case the beneficiary will have beneficial ownership of the proceeds.

1115 See C.I.R. v. Prince-Smith, 25 T.C. 84, Ewart v. Taylor, 57 T.C. 401, Copeman v. Coleman, 22 T.C. 594, Newton v. Tax Commr. of Aust., 1958 A.C. 450, Crossland v. Hawkins, 39 T.C. 493, for arrangements. See also Jenkins v. I.R.C., 26 T.C. 265, and Wachtel v. I.R.C., 46 T.C. 543, for benefits realized on the reduction of a settlor's guarantee as surety for a trust through application of the trust funds.

1116 Such is the case with options granted by the testator *inter vivos* or by the trustee but not in the case of options given by will by the testator; the latter is, in the author's opinion, a bequest.

1117 If Revenue takes the position that Sec. 105(1) otherwise applies to benefits realized on a disposition - mortgage - satisfaction of an interest gained on the exercise of a general or special power of appointment it could prove beneficial to have the trust make advances to the holder without satisfying his interest, via the appropriate powers to mortgage etc., so that the subparagraph 105(1)(b) exemption is operative preventing a Sec. 105(1) inclusion while such would not cause an a.c.b. adjustment itself. (If the interest was not acquired for consideration payable there will not be an actual reduction in its a.c.b. so as to create capital gain.) On a subsequent disposition/distribution the benefit realized by the holder would be actually reduced reducing an otherwise Sec. 105(1) inclusion. This would be a quite arbitrarily arrived at exclusion from taxation possibly exposed to section 245. (See Re: Wills, 1939 Ch. 705, Re: Hillas-Drake, 1944 Ch. 235, Re: Slee, 1962 1 W.L.R. 496, for advance accounting. If interest is applied retroactively to the date of the advancement to value the advance and reduce the commutating proceeds in trust law will this reduce the Sec. 105(1) benefit?)

1118 There has been at least one disturbing opinion expressed in respect of the applicability of Sec. 105(1) in the case of advances in respect of contingent interests not yet enforceable. In B-6366 of May 1986 the Deferred Income Plan and Trusts Section provided that when a beneficiary has a contingent right to income he has no right to have it paid to him within the context of former Sec. 104(24) for purposes of Sec. 104(6)-(13). Consequently amounts paid to him were to be captured under Sec. 105(1). This is not the case with new Sec. 104(24) which also recognizes amounts paid regardless of who they

Disclaimers.

The provision could be found to apply even when a beneficiary disclaims/renounces his interests in the trust so as to enrich another's entitlement. In such an instance the disclaiming/renouncing of the interest will expand the value of other beneficiaries' entitlements, and even though the disclaiming/renouncing party may have to recognize substantial tax consequences other beneficiaries would still be required to recognize Sec. 105(1) inclusions. In such an instance, should the Department of National Revenue be of this opinion upon being probed, would it not be more tax efficient, in the case of capital and income interests, to buy the interest from the party, adding on a marginal amount of consideration to cover tax consequences, rather than have it be disclaimed? At least, its cost could be deductible or recognized for purposes of subsequent dispositions/distributions while it would avoid any inequitable Sec. 105(1) inclusion.¹¹¹⁹

Problems with C.C.A..

Previous to tax years starting after 1987, an income beneficiary under a trust could recognize gross Division B trust income under Sec. 104(13), before C.C.A., terminal loss, etc. was claimed in respect of it by the trust, whereby the trust could then designate out to the beneficiary, under Sec. 104(16), who recognized the income, a portion of the C.C.A. otherwise available in respect of the gross income to the trust, whereafter the beneficiary could claim the C.C.A. himself. This provision was repealed with the 1988 reform and presently an income beneficiary can recognize under Sec. 104(13) from a trust that was resident in Canada throughout its tax year only income that is net of the C.C.A. otherwise available to the trust and thus in order to claim C.C.A. the trust must do so thereby reducing the amount of Division B income recognizable by the income beneficiaries. With respect to the Sec. 105(1)-53(2)(h) mechanism this **may** cause the income beneficiaries to be significantly exposed to a Sec. 105(1) inclusion due to the fact that their respective income rights cause income to be payable but this income is some sort of gross accounting income and is not usually income, net of applicable C.C.A., terminal loss, etc.. Since the amount of Division B income reduced by a C.C.A. deduction will not enter their income under Sec. 104(13), when that amount, (representing C.C.A. deductions), is distributed it will lead to an ACB adjustment under Sec. 53(2)(h)(i.1) in respect of the capital interest **only** where the distribution is made in respect of the taxpayer's **capital** interest, (as per the wording of para. (i.1)). If the beneficiary has only a pure trust law income interest, being a right enforceable only against income of a personal trust, then a distribution of C.C.A. deducted funds will not be considerable in respect of a capital interest the beneficiary clearly and technically doesn't possess and since he only holds an income interest the amount distributed can obviously be caught by the Sec. 105(1) provision and included in the beneficiary's income.¹¹²⁰ Understandably, if C.C.A. is to be deducted from the income stream accruing to the benefit of a

are paid to or whether they were un fact payable but in respect of the applicability of the above principle to contingent capital interests it must be noted that the section 107 provisions look to whether an amount has actually been distributed regardless of whether or not it was distributable. Consequently the section 107 provisions can not be said to be inapplicable where capital is distributed in satisfaction of a capital interest that has yet to become enforceable and Sec. 105(1) will not apply on these narrow grounds. It will apply in the author's opinion, however, where the amount distributed in satisfying the interest is unreasonably large in relation to the interest's actual value and while as a result of the interaction of sec. 108(1)(d) and 107(2) the beneficiary can recognize a capital gain in such an instance the non-taxable portion of that gain can be includeable in income via Sec. 105(1). This however wasn't the opinion of the Department as expressed in T.I. 5-0051 provided in March 1981 to the Technical Applications Section provided by the Non-Corporate Rulings Division when it held: "Where a distribution (or encroachment) of capital would come under subsection 107(2) it should be noted that the Income Tax Act does not confer any right to capital where it is not provided for in the trust deed. Therefore, a distribution in breach of trust would not come within subsection 107(2). subsection 105(1) would then apply to such a payment. Notwithstanding the above, we do not recommend the application of subsection 105(1) for the following reasons: a) It is our view that where an amount of accumulating income has been subject to tax in the hands of the trustee, subsection 105(1) should not be applied to subject this amount to tax again when it is distributed to a beneficiary at a subsequent time, regardless of whether it is called an amount of corpus or an amount of accumulated income pursuant to the term of the trust document." As per above the author disagrees fully with this opinion and to further point out the weaknesses it must be noted that the section 107 provisions were enacted in general accompaniment to the former Sec. 104(24)-(6)-(13) provisions. If Parliament had wanted them to apply only to those instances where capital is distributed to those who have an enforceable right to it it could have imply drafted in the requirement as it did in respect of the former income recognition mechanics.

1119 The recipient could create a trust out of the proceeds for the same beneficiaries while using powers of appointment the interest could be disposed of with less tax consequences.

1120 There are limited transitional provisions in respect of this phenomena but they lose their applicability by 1991.

pure income beneficiary, it would be beneficial to have the trust agreement drawn up so that the particular beneficiary is recognized explicitly to have a capital interest, for tax purposes, in the C.C.A. being deducted from the income stream since in that way the Sec. 105(1) full inclusion thereof will not occur although it may be exposed to three-quarter inclusion by causing excessive reduction in the ACB of the interest and causing a deemed capital gain¹¹²¹. If the trust is personal and the income beneficiary did not acquire the capital interest for consideration payable Sec. 53(2)(h) won't apply and he will be able to receive the C.C.A. deducted funds "tax-free".¹¹²²

Differences in Income Recognition.

Trust law income payable and tax law income payable may vary for a variety of reasons however, generally, unless the beneficiary has a capital interest enforceable in respect of it, any excess of trust law income payable over tax law income payable, may be captured by Sec. 105(1), and not Sec. 53(2)(h), and may be fully included in income under Sec. 105(1). This is due to the fact the Sec. 53(2)(h) adjustments apply in respect of "capital interests" only, and "income interests", as per Sec. 108(1)(e), are rights to or to receive trust law income, (as per Sec. 108(3)), hence "capital interests", as defined through Sec. 248(1) to 108(1)(c), in respect of personal trusts are rights to or to receive trust law capital, and only incidentally, tax law capital. The excess of the trust law income payable over the tax law income payable to a beneficiary will not be included in income under Sec. 104(13) nor will it cease to be trust law income unless it is accumulated. If it is immediately paid, it will not be payable in respect of a "capital interest" since the trust law right thereto is not a right to trust capital at that point of time hence when it is paid it will not attract an adjustment under Sec. 53(2)(h) and, having not been previously included in income, can be by virtue of Sec. 105(1) proper.¹¹²³ If the excess of the trust law income payable over the tax law income payable is accumulated, so that as per the trust terms it is payable to the same person in the following period, at the end of the earning period it will cease to be income and the rights held by the beneficiary will be recognized as "capital interests" being rights to receive trust law capital. If the excess is then distributed the section 107 provisions will apply. The advantage to be obtained is a tax free distribution by deferring the payment of the excess until the subsequent period and to do this the beneficiary's rights should consist of a right to receive the tax law income in respect of him in the period in which it was recognized by the trust, and the right to enforce a distribution of the excess of income earned for his benefit, in excess of the tax law payable, in the following period only, as capital. In the interim, the excess cannot be recognized to confer, directly, a benefit on the beneficiary and the trust would also not recognize any income. Would it be within the object and spirit of the Act to tax the excess of the trust law income payable over the tax law income payable simply because of the fact that it arises by virtue of the accounting methods followed by the trust? The economic benefits that are being taxed without the application of Sec. 105(1) are equal to the amount that would be taxed if the beneficiary carried on the activity directly but this could be irrelevant when one considers that there are numerous instances in the Act where taxed capital is introduced into the tax base simply due to the accounting methods followed, such as in Sec. 104(13)(c) in respect of non-resident trusts. This would be an excellent topic for the Minister to clear up in the next Roundtable Discussions.

Testamentary Forgiving of Debt and Commuting of Income Interests.

While the shift in the approach of Sec. 105(1) is to exclude from treatment those instances that either caused another income inclusion in respect of the particular taxpayer or which led to an actual or hypothetical adjustment in the ACB of the taxpayer's capital interest in the trust this causes problems when the particular transaction does not have either of these two results. The forgiving of debt by a testator under his will falls squarely into this character of transaction in that pursuant to Sec. 80(1)(h) such will not be included in the

¹¹²¹ but only if the interest was acquired for consideration payable

¹¹²² The trust deed may also be drawn up so that any C.C.A. deducted will be precluded from being distributable until the following period whereby its substance will transform into capital at the end of the period. If it's then distributed to a capital beneficiary, who also holds the income interest in the net amount, it will be distributed tax free under the Sec. 105(1)-53(h) rules if the trust is personal.

¹¹²³ See *Stanley v. I.R.C.*, 26 T.C. 12, *Cornell v. Barry*, 36 T.C. 268, and *I.R.C. v. Blackwell Minor's Trustee*, 10 T.C. 235.

debtor's income while it will not cause an ACB adjustment of any capital interest the debtor has in the estate. Arguably the forgiving of debt constitutes a gift and operates as an immediate transfer of capital (in substance) and in this perspective the treatment of the forgiving and benefit must be viewed very separately. Subsection 80(1)(h) prevents an income inclusion and Sec. 105(1) is prevented from applying by virtue of the fact that the substance of the debt is being transferred to the debtor. Technical Interpretation 5-7\9706 dated March 1990 by the F.I.D. provided that the Department recognizes the NO tax consequences result on the testamentary forgiving of debt though this argument is arguably correct regardless of the basis of their opinion.

The second more alarming event occurs when an income interest is commutated through the distribution of a lump sum of capital to the income beneficiary. Under subsections 106(2)-(3) this will not give rise to an income inclusion however this situation also doesn't satisfy either of the exemptions under Sec. 105(1) and the proceeds could be recognized as a "benefit". The distribution of capital immediately in satisfaction of the right to receive income in the future surely constitutes a benefit regardless of whether the future streams of income are discounted to reflect the present value of the right and consideration distributed. If the interest had been sold to realize that value there would have been a full income inclusion but the fact that Sec. 106(2)(a) prevents such when the trust "purchases" the interest doesn't negate the fact that a benefit is realized, regardless of how valued, that doesn't satisfy the exemptions under Sec. 105(1). Arguably there would be a considerable clash in policy where a Sec. 105(1) assessment is made in this situation given the intention of Sec. 106(2)-(3) due to essentially a deficient technicality in the former subsection and it is not expected that CRA would pursue this type of assessment regardless of how novel the point.¹¹²⁴

Loans through Trusts.

Subsection 15(2) provides the main anti-avoidance provision applicable to where certain parties in a shareholder capacity, or proximity thereto, have received a loan from a corporation but it only causes the entire value of the loan to be included in the recipient's income if the loan is not repaid within a calendar year following the end of the tax year of the lender or where it was repaid within that time period but it cannot be considered part of a series of loans and repayments. The parties which may be subject to the provision include any person other than a non-resident corporation or a partnership¹¹²⁵ that is a shareholder, of any degree, of a particular corporation, or is "connected" with such a shareholder or is a member of a partnership or beneficiary of a trust that is a shareholder of the particular corporation, while the loan is included if that person or partnership receives a loan or becomes indebted to, the particular corporation, to a corporation related thereto, or a partnership of which the corporation is a member. There is the standard exception to the inclusion contained in para. 15(2)(a) which can be read at will, however, if a beneficiary under a trust receives a loan from a corporation some or all of the shares of which are held by the trust, unless the loan is repaid within the specified period of time it will be included in the beneficiary's income under Sec. 15(2), and not 105(1). One should recognize that the beneficiary of the trust need not be a shareholder, nor need he have capital rights to the corporation's shares held by the trust and in this respect it is only by virtue that the lender is a corporation that the beneficiary isn't caught by Sec. 105(1). If the beneficiary can stretch the loan life over almost two years, as is possible, and satisfy the Sec. 15(2)(b) exemption then Sec. 105(1) may apply since the benefit is not otherwise required to be included in computing the income of the taxpayer, however following the reasoning in *S. Cooper v. M.N.R.* Sec. 105(1) may not apply.

The persons to whom Sec. 15(2) apply are very specifically defined and in this case they include the trust holding the corporation's shares, (as "the person"), or the beneficiary under the trust, ("or a beneficiary of a trust"), however, it does not cause second tier beneficiaries to be captured even when one looks to the fact that persons "connected" with the shareholder may be caught. Persons "connected" to the shareholder, as per Sec. 15(2.1), include those persons, other than foreign affiliates and other specified corporations, that do

¹¹²⁴ Subsection 105(1) would apply fully to that value of consideration received that is in excess of the value of the interest to the beneficiary but where such a commutation occurs it is also arguable that the beneficiary is not realizing any benefit in excess of the value of his interest which if sold would provide an equal amount of consideration. The benefit takes the form of the avoidance of the tax sting that would otherwise be sustained if the interest had in fact been sold rather than commutated.

¹¹²⁵ other than partnerships consisting exclusively of Canadian resident corporate partners

not deal at arm's length with **the specific shareholder**. If the shareholder of the corporation is a trust and the capital rights to the shares are held by a beneficiary thereunder which is another trust, and under the second trust the capital rights thereto are exclusively held by a certain individual beneficiary, and if that individual beneficiary deals at arm's length with the **initial trust's trustee** so that the initial trust and secondary individual beneficiary are at arm's length, then if the corporation makes a loan to the individual he will not be caught by Sec. 15(2) by virtue of the fact that he is not a beneficiary under the trust **which is the shareholder**, nor is he **"connected"** with the shareholder.¹¹²⁶ Subsection 251(1) provides for purposes of the Act that related persons do not deal with each other at arm's length and that it is a question of fact if at a particular time, two parties deal with each other at arm's length. If the top tier shareholder trust is managed by a trust company and its trust deed is irrevocable then how can it be said to be anything but at arm's length with a beneficiary of a trust which is a beneficiary thereunder. The trustee doesn't even have to be a trust company, all that is needed is that it be acting without influence from the beneficiary, directly or indirectly, and that there be no existence of a common mind between them.

With respect to the extent of "connectedness" a simpler example is where a family trust controls a corporation through the ownership of its shares, the beneficiaries thereunder are related to the trustees thus not at arm's length but a friend of a beneficiary receives a loan from the corporation. Since the beneficiary can only be proven to possibly be not at arm's length with the loan recipient, how can the trustee also be proven not to be at arm's length with the recipient of the loan? Once again, if the trustee in the case is a trust company and the trust deed expressly allows the corporation to make such loans on the director's discretion¹¹²⁷ how can the recipient of the loan be caught by Sec. 15(2)? If a beneficiary holds shares, and the trust is administered by a trust company and unrelated, will the trust recognize a Sec. 15(2) inclusion when it receives an interest free loan from the particular corporation? Are the trust and beneficiary dealing at arm's length? If the only other beneficiaries are other trusts, which have as beneficiaries parties that are related to the controlling beneficiary, the loan proceeds could cascade down to them without fear of attracting Sec. 15(2) application.¹¹²⁸

Property Upkeep Benefits.

Subsection 105(2) provides the only provision that allows a trust to take a Sec. 104(6) deduction in respect of income paid for the benefit of a beneficiary other than its payment directly to him. Income of the trust that is **paid** in the year for the upkeep, maintenance or taxes of and in respect of property that, **as per the terms of the trust**, is to be maintained for the use of a life tenant or a beneficiary will be includable in the particular beneficiary's/life tenant's income for the year, if it is reasonable in the circumstances.¹¹²⁹

In order to be includable in the beneficiary's income, the amount paid in respect of the upkeep must have as its immediate source the income, as computed under Division B, of the trust, while payments of capital will not qualify. Realized capital appreciations in the form of taxable capital gains that are included in computing income may be validly expended while amounts such as non-taxable dividends or other exempt income will not qualify by virtue of the fact that they are not includable in computing the trust's Division B income.¹¹³⁰ The amount paid must be in respect of upkeep, maintenance, taxes on the property but the property need not be

¹¹²⁶ See *Bates v. I.R.C.*, 1967 1 All E.R. 84 (HL). Can a second tier trust beneficiary be considered a beneficiary under a top tier trust the beneficiary of which is the second tier trust given that he in his personal capacity cannot sue for the execution of the top tier trust deed since he is not a described beneficiary therein? It would seem that he can be considered beneficially interested or indirectly beneficially entitled depending on the status of the rights the second tier trust has under the top tier trust.

¹¹²⁷ and the director is the settler of the trust or virtually any other party. In A-0759 of January 1985 by the Non-Corporate Rulings Division it was held that if the trustees are independent of the influence of the settlers or shareholders in the above situation Sec. 15(2) may not apply.

¹¹²⁸ On Oct. 18th, 1983, the Non-Corporate Rulings Division issued a technical interpretation addressing a situation where a taxpayer compelled a wholly owned corporation to lend money to a family trust the beneficiaries of which were his children. It provided that the trust would not be dealing at arm's length with the shareholder and would realize a Sec. 80.4(2) benefit.

¹¹²⁹ See *Waley Cohen v. I.R.C.*, 26 T.C. 471. If it is not reasonable, it will not be includable and though the trust will not gain a deduction under Sec. 105(2), (although it may gain one elsewhere in the Act), the beneficiary/life tenant may have to recognize the benefit under Sec. 105(1). What exactly or broadly speaking is reasonable in this context?

¹¹³⁰ Such payments will be captured by Sec. 105(1) since they are not being paid to a beneficiary.

a dwelling but could be land or equipment, however, the qualifying criteria is that it must be, as per the trust arrangement, required to be maintained for the use of the particular beneficiary.

It would seem appropriate to apportion expenses in respect of the above three types of expenditures where the property is to be maintained for the use of more than one beneficiary while the criteria is that the property be maintained **for the use** of "a beneficiary", or "a life tenant" regardless of whether in fact the beneficiary made use of it continuously or at all.

The property in respect of which the expenditures are made need not be property held by the trust but instead may be owned by the particular beneficiary.¹¹³¹ In *Alan W. Cockeram and E. Anne Cockeram, Trustee of the Cockeram Family Trust v. The Queen*¹¹³² the Fed. Ct. of Appeal, in the author's opinion, did not correct a Tax Court Judge who, per them, noted:

"[4] The Tax Court judge determined that the Appellants had the burden of establishing that the property is an asset of the trust and that the trust was entitled to deduct the payment of \$49,200 in 1996 from its income pursuant to the relevant sections."

In the author's opinion, the statute clearly does not state that in order for the income expended to be deductible the property upon it is spent must be owned by the trust.

Improvements in the original nature of the property, that are of an enduring nature, will not be considered as upkeep or maintenance and will thus be subject to the Sec. 105(1)-53(2)(h) system quite unlikely to be included in income under Sec. 105(1), however, if the trust agreement provides for both maintenance/upkeep and enlargement/permanent improvement of all the property then both Sec. 105(2) and (1) will apply.¹¹³³ If the beneficiary receives the capital in person, and he has a capital right thereto, the Sec. 105(1)-53(2)(h) mechanism may be circumvented to allow the tax free distribution however even though the beneficiary may have a right to have the capital so applied, as defined in Sec. 108(1)(c), unless **he** receives it Sec. 53(2)(h) will not be applicable to it on its payment with the obvious result. This also applies to excess trust law income. In this respect the trust deed should provide that if payments are to be made in respect of the expenses incurred in respect of the property, unless they are required to be included in the beneficiary's income under Sec. 105(2) and the trust obtains a Sec. 104(6) deduction in respect of it, they should be paid directly to the beneficiary so as to avoid the Sec. 105(1) inclusion.

In *Sarah Blackstien v. Her Majesty The Queen*¹¹³⁴ the Tax Court had to consider whether an estate had covered the expenses of a condominium for its life tenant and the court held appropriately:

[2] In June 1987, Max Blackstien and the Appellant entered into a marriage contract (the contract). Mr. Blackstien owned a condominium residence in Toronto, described as condominium corporation plan 167, level 10, unit 7 (the condominium unit). **The Appellant owned a residence in Florida. They provided, by paragraph 14 of their contract, that these residences would continue to be their separate property after their marriage, and that upon the death of the first of them, the other would enjoy a life estate in the residence of the deceased. Max Blackstien died in January 1990, leaving a will, of which his son and daughter-in-law are the executors. There is no mention of the condominium unit in the will, but since the death of her husband the Appellant has enjoyed her life estate, pursuant to the terms of the contract. During the year 1991, the estate paid to the condominium corporation the amount of \$3,932 which is in issue.**

¹¹³¹ See *Donaldson's Exors. v. I.R.C.*, 13 T.C. 461, *Sutton v. I.R.C.*, 14 T.C. 662 (CA), & *Shanks v. I.R.C.*, 14 T.C. 249 (CA). The use of the term "maintained" in the phrase as it relates to the receipt of property by the trust or the on-going maintenance of newly acquired property is of concern. In T.I. 5-1291 of May 1986 rendered by the F.I.D. it was held that when a testamentary spousal trust is to acquire a home for the personal use of the spouse out of capital Sec. 105(2) would not apply because "pursuant to the terms of the deceased's will, it was not property required to be maintained for the use of a beneficiary." This is obviously a narrow interpretation of the term "maintained" as applied in a testamentary situation and in the author's opinion is clearly off the mark as to the spirit of the provision. When a will directs that property be purchased and maintained for a beneficiary such should squarely fall within the terms of Sec. 105(2) and it would be administratively ignorant to hold that the provision applies exclusively to property that is left in a trust for the benefit of a beneficiary.

¹¹³² 2005 FCA 372

¹¹³³ Subsection 105(1) may apply where a trust agreement provides that capital is to be **paid directly** to a contractor/carpenter etc. rather than a beneficiary so as to cause improvements/enlargements to the beneficiary's property, regardless of whether it is or isn't paid in respect of a capital interest held by the beneficiary.

¹¹³⁴ 96-4257-IT-1

It is not disputed that this was the annual levy made by the condominium corporation in respect of the unit. What is disputed is that it falls to be taxed in the Appellant's hands pursuant to subsection 105(2) of the *Act*.

...

[6] There are a number of reasons why the Minister's assessment in this case cannot stand. The first is that there is no trust to be found under the terms of which the trustee is bound to maintain the condominium unit for the benefit of the Appellant. Ms. Espejo argued for the Crown that a trust arose out of the marriage contract. However, there are no words in that document which could be said to create a trust. Nor could she cite authority for the proposition that a trust arises, at common law or otherwise, simply out of the fact that the marriage contract provides for a life tenancy to pass to the Appellant upon the death of her husband. A trust is created under the will of the late Mr. Blackstien, but there are no words in that will, or elsewhere in the evidence before me, whereby the trustees are obliged to maintain the condominium unit for the use of the life tenant. There may be obligations which arise at common law, as was argued, but they are irrelevant to the issue before me. To satisfy the words of the subsection, the payment must be made to fulfil an obligation arising "under the terms of the trust arrangement". An examination of the will of the late Mr. Blackstien leaves no doubt that this requirement cannot be satisfied. Indeed, it would appear that the estate simply made the payment to satisfy the obligation imposed on it, as the owner of a freehold interest, by section 32 of the *Condominium Act*.^[2]

[7] Nor is the second requirement set out above satisfied in this case. There is no evidence before me as to whether or not the payment was made out of the income of the trust. Nor has the Minister, made any assumption in that regard in assessing the Appellant; certainly no such assumption on the Minister's part has been pleaded by the Deputy Attorney General. Absent either an unrebutted assumption, or some evidence, I cannot find that the payment has been made out of the income of the trust. The Minister has assumed that a T-3 Supplementary form was issued by the executors of the estate to the Appellant, indicating that she had received a taxable benefit in the amount of \$3,932 during the 1991 taxation year. However, I am not prepared to infer from the fact that such a form was sent to the Appellant that all the facts required to bring the payment within subsection 105(2) have been established.

[8] It has not been established, nor I think could it be, that it would be reasonable, if all of the other requirements were satisfied, to include the entire \$3,932 in the Appellant's income. The parties are in agreement that the amount of \$3,932 was the payment required to be made in respect of the condominium unit to the condominium corporation for the year 1991. However, the *Condominium Act* requires that some part of that amount, not less than 10%, must be contributed to a reserve fund which is established to provide for major repairs and replacement of common elements and assets of the condominium corporation.^[3] It is clear that neither the trustee in issuing the T-3 Supplementary form, nor the Minister in assessing, gave any thought whatsoever to what part of the annual payment it would be reasonable to include in the circumstances. No evidence was led as to how much of the payment was for the reserve fund, and how much for the current expenses of the corporation. In view of my conclusion that the other requirements of subsection 105(2) have not been met, I need not attempt to catalogue all of the relevant circumstances that would otherwise have had to be taken into account.

Similarly with respect to Sec. 105(1), benefits included in computing a beneficiary's income under Sec. 105(2) may attract attribution under Sec. 74.3(1) by virtue of the fact that that attribution provision operates upon amounts required to be included in computing a taxpayer's income under Sec. 12(1)(m) which includes all inclusions described in subdivision K (except capital gains).

Where a trust is to maintain property owned by it in good repair so as to preserve its value for the remaindermen insurance/maintenance expense etc. will not be deductible by the trust if, *dehors* the trust

agreement, a beneficiary is allowed to use the dwelling as an incidental arrangement provision for which has not been made in the trust agreement.¹¹³⁵ This is similar to the case in *Malkin v. M.N.R.*¹¹³⁶ where a settlor was not expressly allowed to use a dwelling contributed to the trust by him as per the terms of the trust but was allowed to by the trust's beneficiaries, resulting in the Minister's attempt to assess upkeep expenses paid by the trust as taxable in his hands as personal living expense payments. He was unsuccessful, but only under the then existing legislation whereunder Sec. 105(1) did not exist, however, under the present legislation, the arrangement would be captured by Sec. 105(1). If the property is to be maintained for a life tenant, regardless of whether or not he uses it, the trust will get a Sec. 104(6) deduction in respect of income utilized to maintain the property, **for the ultimate benefit of the remaindermen**, however the life tenant will have to recognize a Sec. 105(2) inclusion.

If the trust deed provides that the property is to be maintained for alternating minor beneficiaries their unused personal tax credits can be effectively applied to absorb the Sec. 105(2) inclusion however the trust deed will have to be structured so as to only allow the minor to use the dwelling if he allows his family to also use it. The dwelling is being maintained for the beneficiary but it is also saddled with an equitable charge. In the meantime the upkeep of the property is paid with before-tax bucks which will reduce the amount of income the trust-beneficiary group will have to recognize, after the use of the personal tax credits.

The subsection 105(2) inclusion, unlike the one caused by Sec. 105(1), can form the base for the income character flow-through provisions offered under subdivision K such as those concerning taxable capital gains and taxable dividends, however, not in the case of death benefits/pensions dealt with under Sec. 104(27) which can be designated only in respect of Sec. 104(13) income inclusions. In *Molson v. M.N.R.*¹¹³⁷ a taxpayer was recognizing Sec. 105(2) upkeep benefits and the substance of the payments made by the estate came out of current dividend receipts. When the Minister refused to allow the inclusion to be recognized as dividend income upon which a tax credit would be computed in respect of the beneficiary the matter had to be brought before the Income Tax Appeal Board. There it was found as a matter of simple ratio computation, as provided for by the terms of the trust, that the beneficiary was entitled to the dividend tax credit since she recognized the Sec. 105(2) inclusion as dividend income following the appropriate designation.

Part XIII does not capture Sec. 105(2) income inclusions however the trust does not obtain a deduction in respect of them, as per Sec. 104(6)(b), unless it "was included in computing the income of a beneficiary for the year by reason of subsection 105(2)." Part XIII doesn't cause a beneficiary to "compute income".

"Upkeep, etc. – Sec. 105(2)"

(2) Such part of an amount paid by a trust out of income of the trust for the upkeep, maintenance or taxes of or in respect of property that, under the terms of the trust arrangement, is required to be maintained for the use of a tenant for life or a beneficiary as is reasonable in the circumstances shall be included in computing the income of the tenant for life or other beneficiary from the trust for the taxation year for which it was paid.

¹¹³⁵ If the trust is spousal and the spouse is allowed to use the property, and allows the kids to use it by an agreement which is independent of the trust deed the trust will not be tainted and if the Department holds to its opinion viz-a-viz the inapplicability of Sec. 105(10) in respect of personal property, the kids also won't sustain Sec. 105(1) exposure.

¹¹³⁶ 1 D.T.C. 456

¹¹³⁷ 58 D.T.C. 476 (ITAB)

Trust Law Income Payable v. Tax Law Income Payable: A degree of reconciliation.

Under subsection 104(13) a beneficiary shall recognize in computing his Division B income for the year "such part of the amount that, but for subsections (6) and (12), would be the **trust's income** for the particular year as **became payable** in the particular year to the beneficiary" but this applies only in respect of trusts (or estates) that were throughout their tax year resident in Canada. Although a definition of "income of a trust" is provided in Sec. 108(3) it applies only for purposes of subsections 108(1)(e), 70(6)(b)(i), 73(1)(c)(i), and 104(4)(a)(iii) which are irrelevant for purposes of Sec. 104(13)(a). "Income" of a trust thus, failing to be the topic of Sec. 108(3) which provides that "income" is to have the meaning of that derived without the use of the Act, must then be computed as per the operational definition in section 3, being the Division B tax income. Section 3 "income" includes the recognition of realizations of increases in capital in the form of capital gain, losses etc. and it is at this point that a considerable divergence occurs with respect to trust law income payable and tax law income payable by a trust/estate since such may not be payable to a trust law income beneficiary.

Tax law Division B income of a trust is easily computed by a simple application of the Division B rules to the sources of revenue that a trust/estate has however it also allows deductions, both of a recurring income related nature and of a capital nature and these deductions also cause a divergence of tax law income payable from trust law income payable.

Trust law income, regardless of whether or not it is actually payable in the period in which it is recognized or realized, is to be computed as per the terms of the trust/estate instrument and where such operational descriptions are lacking in the instrument itself the trustee/executor may be duty bound by the even hand rule to make every possible effort to ascertain what would be the most equitable manner of computing income. The manner in which income is computed will have a direct effect upon the amount of funds that the income beneficiaries will realize, and where adequate description is lacking in the trust instrument the trustee may have to apply to the Courts for advice in order to fulfil his obligations of dealing with the capital and income beneficiaries in an even handed manner. Excessive income depreciation charges against income realized from wasting assets for instance may reduce the benefits of the income beneficiaries too much and benefit the capital beneficiaries while they may also be not enough depending on the rate at which the capital asset is wasting.

On the tax law side of the subject the trust law income payable will only by fluke be equivalent to the tax law payable by a trust amongst all of its beneficiaries and this is due to the fact that depreciation rates charged by the trustees, if they have the authority to do so, will rarely equal capital cost allowance, eligible capital expenditure allowance, etc., that are deductible by the trust. As per the new reformed rules C.C.A. and E.C.E.A. are deductible only by the trust at its level. There may also be significant inclusions in Division B tax income of a trust of amounts entirely arising out of or related to the disposition of capital property that should accrue to the benefit of the capital beneficiaries only. Perhaps most burdensome to the income beneficiaries is the instance where the trust law income payable to them in a year is, due to differences in depreciation/C.C.A., income recognition methods, etc, greater than what could be considered as the Division B tax law income payable to them in a year, thus resulting in an excess payment that would obviously qualify as a "benefit" under Sec. 105(1) and thus be introduced into their income for taxation, (especially where this excess was caused by excessive C.C.A. deductions at the trust level which could cause recapture when the property is ultimately sold by the trust, the recapture of course recognized by the trust to the detriment of the capital beneficiaries). Will CRA tax such benefits when the substance of the economic activity is being taxed at the appropriate rate anyway? It can be thus clearly seen how the manner in which the trust law income is computed may have considerable tax consequences to all parties, both income and capital beneficiaries, and trust.

Capital Cost Allowance and Depreciation.

The trust deed or will is the source document upon which all rights and peculiarities concerning a trust/estate are based and thus it should contain a fairly detailed description of how "income" should be computed. There are two basic methods of computing income, being the cash method and the accrual method, and there are infinite combinations in which both of these methods may be applied to recognize

"income" however rather than attempt to describe the pros and cons of a sample of them the discussion will comment on only the major factors in any recognition system that cause considerable divergence of the method for tax accounting, the primary one being the base upon which the income rights will be applied: "net income". In trust law it has been traditionally held that expenses incurred of a nature that are recurring, and are needed to produce revenue should be chargeable against the revenue realized in order to arrive at some figure that represents the net realization of economic wealth upon which the beneficiary's income right can act.¹¹³⁸ There is a material difference in the use of the term "net income" and simply "income" to describe the revenue realized to which the income beneficiaries become entitled. In re: Zive¹¹³⁹ the testator a business man provided in his will that the "net annual income" from income producing properties has to be made payable to the income beneficiaries and although the will granted the executors the discretionary power to determine the allocation of the revenue as capital or income it did not give them an adequate definition of the term "net annual income" and thus there came to question how to measure the income payable and whether a depreciation charge could be accumulated from the revenue realized. Hart, J. of the Nova Scotia Supreme Court held that:

"In my opinion it was necessary for the testator to vest this discretion in his executors since the determination of what is meant by the expression "net annual income" requires a decision on business principles based upon the facts known at the time the decision is made... An ordinary businessman would be bound only by business considerations in making such a decision. Executors, on the other hand, **have an additional responsibility** to consider the effect of their decision on the income from the corpus of the estate and those who succeed them and take the capital."

The Judge then went on to comment on a series of cases dealing with the question of depreciation charges: Chartered Trust Co. v. Robertson Estate¹¹⁴⁰, Re: Bridgewater Navigation Co.¹¹⁴¹, Re: Stekl¹¹⁴² and then provided:

"It seems to me that the true test of whether or not **executors** should take depreciation allowances should not be based upon whether they are operating a business but on whether the assets composing the estate **are in fact depreciating to the point where the remainderman is suffering an actual disadvantage over the income beneficiary**. There is, of course, no problem when the executors are in fact carrying on a business and there is a direction for the executors to pay only the net income or net profit from the business to the life tenants, because such a reserve is an integral part of the ordinary accounting of the business operation. The authorities all hold that an amount must be retained out of income to offset the estimated decline in the value of the depreciable assets before determining the net profit of the business."

The application to the Court in Re: Zive was a result of the concern of the executors in exercising their discretionary power in an even-handed way and if the will had stated what rate to apply depreciation and on what property they would have no choice but to withhold a depreciation charge. The critical factor brought up in Re: Zive was that when given a "clean slate" and a direction that "net income" is to be paid from the estate that realizes business revenue, the executors are not only allowed to deduct depreciation on the basis that it is normal business practice but that they are also almost compelled to do so under the even hand rules if it can be recognized that not to do so would cause considerable disadvantage to the capital beneficiaries when the property is realized and a reduction in value of the property has materialized. Understandably if there isn't actual reduction in value due to wear or tear etc. then a deduction of depreciation will work to the benefit of the capital beneficiary and to the disadvantage of the life tenant, (income beneficiary)¹¹⁴³.

¹¹³⁸ See Halsbury's Laws of England "Settlements" 4th Ed. Vol.42, para. 967. & Perp. Trustee Co. v. Kelly & Johnson, 1963 N.S.W.R. 904.

¹¹³⁹ [1977] 77 D.L.R. (3d) 669 (NSSC)

¹¹⁴⁰ [1953] 4 D.L.R. 225

¹¹⁴¹ [1891] 2 Ch. 317

¹¹⁴² [1974] 40 D.L.R. (3d) 407

¹¹⁴³ See also Trustees of The Mrs P L Travers Will Trust v Revenue & Customs [2013] UKFTT 436 (TC) for an interesting instance of recoupment of capital value on an intangible that led to substantially different tax consequences. This case also studies various other precedents on when a settlor can bid or otherwise compel a trustee to treat what

In *Re: Zive* the testator was a business man having a practical understanding of the term "net income" and its depreciation aspect however in *Re: Katz*¹¹⁴⁴ a testator left rental property subject to the terms of a trust under which its "net income" was to be payable to the income beneficiaries. Although the trust deed gave powers to the trustees allowing them to effect the repairs of the property when warranted it did not provide that they should carry on the renting of the property as a business and thus they could only receive the revenue therefrom as an investment. Maloney J of the High Court of Justice of Ontario commented upon authorities allowing deductions where the executors carried on a business or activities similar to a business and then concluded:

"The executors argue that "net" as employed in a will by a businessman who names his accountant an executor can only mean net of the deduction of depreciation and if that be correct, there is no discretion in the executors. As discussed above, the testator was not a "businessman" **with respect to his real property income**. Although he was presumably familiar with the accounting term, it would be contrived to conclude he meant anything but "net of the usual expenses". Also given the implied conversion clause, the logical conclusion in the absence of good reason to postpone conversion, the testator must have been concerned that his wife, as opposed to his nieces and nephews (capital beneficiaries), have access to the greatest income possible. If one bases the argument on the fact that the testator was a business man who knowingly employed the jargon of the business world, one might ask why he did not include a clause specifically directing the executors to deduct a depreciation allowance. It appears that he knowingly omitted the clause, especially since he did include the standard power to repair clause."

Since the testator/settlor of property is in the position to legally make the gift of the property it is also he who should impose the terms upon how it is to be given and thus it is entirely possible for a settlor to indicate that certain streams of revenue should have a certain degree of depreciation charged against them. Discretionary powers may also be granted to the trustees, with parameters imposed, whereby they may decide what degree and when depreciation will be chargeable, while purely arbitrarily derived formulae may also be expressed.

The deduction of depreciation to realize trust law income will result in the accumulation of funds that may be used as operating cash, funds upon which an advancement may be drawn or funds that can be used to acquire income producing property.

In tax law, capital cost allowance, in order to be deducted from the stream of economic benefits being realized, will have to be done so at the trust/estate level before the income is paid/payable out to the life tenants, (income beneficiaries).¹¹⁴⁵ Since C.C.A. is habitually deductible upon a declining balance basis, the absolute amount deductible against the tax income will dwindle over the life of the trust and taken into consideration the fact that some of the C.C.A. rates do not even begin to be realistic depreciation rates with respect to the property one can ascertain that arbitrarily applied, or even discretionary derived, depreciation rates will rarely equal C.C.A.. Allowances for the cost of the capital property are not meant to be equated with depreciation. C.C.A. taken at the trust level reduces the amount of tax law income that the income beneficiary would otherwise have recognized under Sec. 104(13) and although once taken they induce a benefit to the income beneficiary via a reduction in Sec. 104(13) taxable income inclusion only, **(and not Sec. 105(1))**, they also may work against the benefit of the capital beneficiaries in that when the trust converts the property it may have to recognize recapture of C.C.A. taken, thus increasing income and taxes payable by them or the trust on their account. If C.C.A. had not been taken, there could be no recapture of C.C.A. and while the income beneficiaries would have, in the meantime, recognized greater income payable under Sec. 104(13) the capital beneficiaries would not have sustained the inherent potential liability of capital cost allowance recapture upon an ultimate disposition.¹¹⁴⁶ Since the Sec. 104(13)(a) inclusion provides that the base amount

would otherwise be income receipts as capital instead.

¹¹⁴⁴ [1980] 29 O.L.R. (2d) 81

¹¹⁴⁵ Prior to the 1988 reform, under Sec. 104(16), (17), (17.1), (17.2), it was possible to designate "out" to an income beneficiary who had recognized income under Sec. 104(13), a portion of the trust's C.C.A. deductible that would allow the beneficiary to reduce his net Sec. 104(13) income inclusion when deducted by him.

¹¹⁴⁶ In determining the amount of C.C.A. to be deducted year by year the trustees would have to review the depreciation

of income to be recognized by the income beneficiary is to be net of C.C.A. it is irrelevant whether or not the income beneficiary is entitled to the capital upon which the C.C.A. is being taken. The problem with the inconsistent treatment arises where the trust deed provides that no depreciation¹¹⁴⁷ is to be deducted in computing the amount of trust law income to which a beneficiary is entitled, thus if C.C.A. is deducted the amount of trust income that the beneficiary receives will be in excess of the amount of taxable income recognized by him under Sec. 104(13). Understandably the trustee would wish to retain some portion of the excess to extinguish any recapture tax liabilities that would otherwise be extinguishable only by the remainderman, and thus act in an even handed way however the excess paid out to the income beneficiary as trust law income could be includable the recipient's income under Sec. 105(1) thus reintroducing the C.C.A. deduction into the income.¹¹⁴⁸ If the C.C.A. can be retained by the trust, as per its terms, until the following year, while the amount can be recognized to be earned for the benefit of the income beneficiary, then when the income amount is paid out on account of capital in the following period, as per the Sec. 105(1)-53(2)(h) mechanics it will be received tax free only if the trust is personal.¹¹⁴⁹

The Sec. 105(1) capital interest inclusion problem will only occur if the C.C.A. taken in a year is greater than the trust law depreciation deduction taken, (since it reduces the Sec. 104(13) inclusion), while if trust law depreciation amounts equal C.C.A. deductions the tax liability possibly ultimately recognizable on the disposition of the property may be eliminated by the accumulated funds however those pooled funds will not have been distributed for the benefit of the income beneficiaries hence treatment of the two classes of beneficiaries will be equal. If the trust deed provides that the capital beneficiaries are to receive an amount in the future less than the present FMV of the property, and the deed grants a capital interest to the income beneficiary, referenced in respect of the accumulated depreciation funds then trust C.C.A. deductions have a beneficial use. By deducting C.C.A. in excess of depreciation and distributing the pooled funds a year later as capital to the income-capital beneficiary the C.C.A. deduction has produced a tax-free distribution. The cost of the property which forms the basis of the other capital beneficiary's entitlement can be written down to the absolute amount of the entitlement and C.C.A. can be deducted accordingly so as to allow the pure capital beneficiary to be able to receive the fair market value of the property net of potential tax liabilities in the form of recapture, when the property is disposed of. If the proper amount of funds are maintained in the trust to extinguish a tax liability with respect to recapture¹¹⁵⁰ the balance of the accumulating depreciating deductions can be distributed as capital, tax free.

It has historically been held that, in the absence of expression to the contrary in the trust deed, expenses and costs incurred in a recurring nature with respect to property are to be charged against revenue being realized from the property¹¹⁵¹ while costs incurred in the administration of the estate/trust may be made good out of the corpus itself. The implicit rule is that if the cost/expense was incurred for the benefit of a beneficiary then that beneficiary's entitlement should be accordingly diminished and in this regard expenditures incurred for the purpose of producing revenue will obviously be charged upon revenue realized. This concept in itself deviates considerably from the underlying tax income computation criteria hereunder capital expenditures may be deductible against revenue realized and some income related expenses may not be deductible against the income it produces at all.¹¹⁵² In T.I. 5-9694 provided in Apr. 1990 by the F.I.D. it was held that expenses which relate to more than one source of income should be apportioned on a reasonable basis to the applicable sources of the income of the trust in determining the taxable income from each source.

amounts that are in order and the expected tax liabilities that would result from taking the C.C.A. over the period until conversion, in order to ascertain what C.C.A. to take in the year.

1147 or lesser rates of depreciation than those of C.C.A.

1148 If recapture occurs the amount will be taxed twice. Subsection 105(1) isn't applicable in respect of non-resident's

1149 If the capital interest, specifically referenced to this phenomenon has been purchased then a.c.b. adjustments will occur.

1150 taking into consideration the absolute amount of the pure capital beneficiary's entitlement and the gross realizable proceeds on the disposition of the property

1151 see Halsbury's Laws of England 4th Ed. vol. 42 para. 967.

1152 See Widdifield on Executor's Accounts, 5th ed. p. 228.

Accounting Losses.

Nowhere does the treatment of income items differ more in respect of ascertaining the Sec. 104(13) income payable amount than with respect to the treatment of losses incurred by a trust/estate that carries on business activities, (and those not incurred in business). In *Upton v. Brown*¹¹⁵³ a trust carrying on a business suffered a loss during the life of a life tenant while after that life tenant had died and a contingent life tenant thereby became entitled to the income the trustees attempted to recoup out of income the loss previously sustained. Pearson, J. held:

"The question is whether the loss which was incurred by the receiver in carrying on the business during the life of the first tenant for life who received no profit, is to be made good out of capital, or out of the profit which has arisen during the second and now existing tenancy for life. I think it ought to be made good out of that profit, and for this reason. If the receiver had contracted debts in carrying on the business during the life of the first tenant for life, they would have been treated as contracted on behalf of the business generally and must have been paid out of future profits, if there had been any. I think therefore that this loss must be treated as if it had been a debt incurred by the receiver, and must be paid in the same way."

In *Upton v. Brown* there was a business carried on as directed by the trust deed, although there was no expression on how to treat the loss that could occur from it.¹¹⁵⁴ In *Re: Hengler, Frowde, v. Hengler*¹¹⁵⁵ a business was carried on by the executors of a settlement, however authorization to do so was not granted in the instrument and the executors were doing so only so as to allow it to be sold profitably.¹¹⁵⁶ On the basis that the proceeds from the sale of the business were to be used to acquire investments, the income of which was to be paid to life tenants Kekewich J. felt that the losses being realized should be apportioned between both the life tenants and the remainderman.

Where the trustees **are directed** to charge business losses against the corpus of the trust then they cannot do otherwise and the revenue that is realized will flow unhindered to the life tenants. This was the case in *Gow v. Forrester*¹¹⁵⁷ where the previous practice of the testator with respect to the asset (a partnership interest) was to disregard capital in ascertaining what income was realized. Capital was depleted in a previous period and was not allowed to be increased through subsequent recoupment to the detriment of the life tenant. In *Re: Millichamp*¹¹⁵⁸ in respect of business losses the capital was to absorb the losses and not income when there was an implied direction in the will.¹¹⁵⁹ Understandably where an accounting loss is carried forward and applied against subsequently realized trust income the life tenant may not be in the position at trust law to receive anything in the way of income and thus he may not be entitled to enforce a distribution. Under Sec. 104(13) the division B income payable to a beneficiary is included in the life tenant's income, however, it is only under **Division C** that losses, (capital or non-capital) are deductible by the taxpayer and thus the income recognized under Sec. 104(13) is to be income before loss carry forward deductions.¹¹⁶⁰ It then comes as no surprise that due to trust accounting loss carry forwards Sec. 104(13) income recognizable may well be nil since income will not be payable hence even the Sec. 104(13.1)-(13.2) cut back mechanism will be irrelevant.¹¹⁶¹ There may be instances however where losses are not to be deducted from subsequent income in which case booked non-capital losses will not reduce the Sec. 104(13) income recognizable and the Sec.

¹¹⁵³ [1884], 26 Ch. D. 588

¹¹⁵⁴ See also *Massey v. F.C.T.*, 1929 R. & McG. 237 (Aust.), for an example of a reduction in tax income recognized by a beneficiary due to a loss carry-forward of the trust.

¹¹⁵⁵ [1893] 1 Ch. 586

¹¹⁵⁶ If they had sold the business (a circus) a loss would have been sustained to the demise of all of the parties; life tenants and remainderman.

¹¹⁵⁷ [1884] 26 Ch. 12 672

¹¹⁵⁸ 1885 52 L.T. 758

¹¹⁵⁹ See also *In re: Lees*, 1909 28 N.Z.L.R. 126, where the intention of the testator was ascertained to be that losses were to be absorbed by capital when income from the business was to be ascertained and distributed "annually". See also *In re: Mountain*, 1934 N.Z.L.R. 399, *In re: Naim*, 1935 N.Z.L.R. 134Sup, *In re: Jex-Blake*, 1939 N.Z.L.R. 256. *Rutherford v. C.I.R.*, 1965 N.Z.L.R. 444, discusses all of these and engages in an examination of various expressions of intention; it should be reviewed in detail.

¹¹⁶⁰ This can be seen incidentally just from the structure of the T.3 and the ordering of deductions.

¹¹⁶¹ This was exactly the case in *Rutherford v. C.I.R.*, 1965 N.Z.L.R. 444. See also *Case W95*, 89 A.T.C. 795, and *Davies v. Commr. of Taxn.*, 89 A.T.C. 4377.

104(13.1) mechanism must be relied upon to allow the loss to be used for the benefit of the taxpayer-trust.

This problem was brought up in *Toshach v. M.N.R.*¹¹⁶². In that case the Minister was successful, appropriately, in holding that business losses that were deductible solely by the trust in the computation of its **taxable income**¹¹⁶³ **could not be deducted by a beneficiary against Division B income that he recognized under what was effectively Division B.** That case had nothing to do with the potential reduction of the possible **trust income payable** due to accounting loss carry forward/application due to the fact that "The net annual profits arising...are to be paid at each year end to the beneficiaries..." and that "net annual profit", as per the Minister, were to be computed annually without recognition of accounting loss carry forwards. If the *Toshach* will could be read as allowing for carry forward of accounting losses, then the estate income in a period could thus be reduced, reducing the amount of trust income payable to a beneficiary which would also cause the reduction of Division B income payable, since it shadows the trust law income.

If the Sec. 104(13.1)-(13.2) provisions are not employed or employable (as in respect of non-residents), the income beneficiary **may** still not have to recognize Sec. 104(13) income inclusion when due to trust law loss carry forwards, trust law income is not payable to him and the reason lies in the Sec. 104(24) definition "amounts payable".

Subsection 104(24) provides that for the purposes of amongst others, Sec. 104(13), an amount will be deemed not to have become payable in the year to a beneficiary unless it was actually paid to him in the year or "he was entitled in the year to enforce payment thereof", and since the Sec. 104(13) provision refers only to Division B income there can obviously be a considerable problem in determining just what amount of tax income is payable, or capable of even being paid. At this point one has to not only recognize the level of losses that are chargeable against income recognized by the trust, but also how the income is recognized and if it is actually "payable" or can be "paid" to the beneficiary. If accounting losses are applied to reduce current revenue, or simply the trustee/executor recoups from revenue the amount of capital that was distributed under a power of encroachment etc, then the revenue/net trust income that is payable to an income beneficiary is reduced. Since less trust law income is payable to the particular beneficiary he should also recognize less Division B income under Sec. 104(13). The latter consists of components of the former.¹¹⁶⁴

Liquidity and Payment in Specie.

A trust recognizing income under the full cash method records income as cash or near cash revenues net of cash disbursements incurred with relation thereto, and thus it stands quite capable of distributing cash to its life tenants. A trust recognizing income under a full accrual method will obviously not be in the same position since its book income may be tied up in inventory, receivables etc. and thus unless properly prepared for considerable conversion or unanimous beneficiary agreements would have to occur in order for such non-cash property to be distributed or retained in respect of the life tenants rights.¹¹⁶⁵ In *Taylor v. Clark*¹¹⁶⁶ where a trust was to pay a certain level of income to the life tenant and could not simply because it did not have the funds (the income was not realized) the judge held:

"My opinion therefore, is that, for the purpose of determining the amount of income to which the plaintiff is entitled from a year after the testator's death the property in Portugal must be considered as converted and placed in a proper state of investment at that time. **I must be understood, however, as speaking only of a measure of the income to which the tenant for life is entitled, and not as declaring that she can necessarily demand payment of an income to that amount until the property in respect of which it is payable shall be gotten in.**"¹¹⁶⁷

If the trust deed provides that only income realized in cash form under an accrual recognition method can

¹¹⁶² 68 D.T.C. 315 while see also *Doherty v. Commr.*, 48 C.L.R. 1

¹¹⁶³ similarly to that provided for in Division C presently

¹¹⁶⁴ See *Davies v. Commr. of Taxn.*, 89 A.T.C. 4377, and *Case W95*, 89 A.T.C. 795, for some issues.

¹¹⁶⁵ The topic is discussed on page 386 of *Jacob's Law of Trusts in Australia 4th Ed.*

¹¹⁶⁶ 1 Hare. 162, 66 E.R. 990, (at 994)

¹¹⁶⁷ This statement must not be read out of context however in that it relates to income distributable during the initial year of an estate, the "executor's year", wherein any beneficiary's right to enforce a distribution, be he capital or income, is restricted. See also *Re: Owen*, 1912 1 Ch. 519, *Re: Rutherford*, 1913 S.R. (N.S.W.) 729, *Union Trustees Co. of Aust. Ltd. v. Graham*, 1931 S.R. (N.S.W.) 528, & *Re: Tindal*, 34 S.R. (N.S.W.) 8.

be distributed then the trustees would be required to accumulate cash receipts, however if for some reason they did not, then the beneficiary would not be entitled to enforce the distribution, even though he could be described as having had income accrue for his benefit.

Kitto, J. in *F.C.T. v. Taylor*¹¹⁶⁸ held that for a Sec. 97(1) income inclusion under the Australian Income Tax Assessment Act to occur the beneficiary must be able to enforce a distribution of income which is legally available to be distributed:

"... the preferable construction of s. 97(1) is to treat the requirement of present entitlement to a share of the income of the trust estate as not being concerned with distinctions between gross income as derived and 'surplus income' after payment of costs, expenses and outgoings but as referring to a present vested right to demand and receive payment of the whole or part of what has been received by the trustee as income and, retaining that character in his hands, is legally available to be distributed to those entitled to it as beneficiaries under the trusts of the relevant trust estate."

The concept was of issue in *Re: Richards*¹¹⁶⁹ where the will allowed the executors to carry on a farming business under which a life tenant was entitled to "the income". Judge Cooke provided with respect to the life tenant's rights to actual and notional income in a business situation:

"On the whole matter one must search, I think, for the intention reasonably to be imputed to a testator who empowers his trustees to carry on his farming business and gives his widow or some other beneficiary the income for life. If no developmental policy is embarked upon by the trustees I think that the principles applicable between life tenant and remainderman must normally be standard value accounting for stock held, distribution of **net cash income only**, but sale of surplus stock as soon as prudent—a decision naturally governed by market prices and other relevant factors such as the state of the stock and the land. But there are cases - perhaps many cases - where circumstances such as the potentialities of the property and general economic trends may properly lead the trustees to pursue a policy of improvement and building up. **A discretion to decide whether this is wise is ordinarily inherent in the power to carry on the farming business.** ... When such a policy is properly followed I think that the surplus stock becomes part of the corpus and that it would be unreal and unreasonable to suppose that the testator meant the life tenant to be able to insist on a sale of the surplus stock or the life tenant's personal representatives to be able to require an actual or notional sale at market values to the remainderman. But the essential condition of following such a policy must normally be, I think, adoption of the accounting principles recognized in such cases as *McBride v. Hudson*, *Union Trustee Co. of Aust. Ltd. v. Bartlam*, and *Re: Hemi Matenga*. That is to say, the income ultimately to be credited to the life tenant should take into account each year opening and closing stock numbers at standard values. Part of the net income so arrived at annually can be held in a suspense account...provided that the trustee has ensured, after having regard to all relevant considerations, that a reasonable **cash** income is paid or credited to the life tenant: **the testator, as a reasonable farmer, cannot be supposed to have meant to make obligatory an annual payment out or crediting to the life tenant of book profit. It is only the sum which the trustee in prudent management of the business determines to be distributable in cash to which the life tenant is immediately entitled: cf. Marshall v. C.I.R., 1960 N.Z.L.R. 972, 981, per Gresson P.**¹¹⁷⁰ When the book profit is to be released from the suspense account to the life tenant's account is ordinarily a question for the trustee; but clearly, if the discretion has not previously been exercised in favour of the life tenant either as to all or part of the amount from time to time held in the suspense account, the balance becomes due to the estate of the life tenant on the latter's death."¹¹⁷¹

In *Littlejohn v. Davies*¹¹⁷² it was held that the trustee of a testamentary trust should retain out of income

1168 119 C.L.R. 444

1169 1974 2 N.Z.L.R. 60 (SC)

1170 See also *McIntyre v. McIntyre*, 1914 15 S.R.N.S.W. 45. See also *FCT v. Totledge Pty Ltd* (1982) 12 A.T.R. 830, 82 A.T.C. 4168 where it was held that when the income of a trust is not in distributable form it cannot be sude for payment.

1171 See also *Ritchie v. Trustees, Exors. and Agency Co.*, 84 C.L.R. 553, *In re: Havill*, 1953 N.Z.L.R. 443.

1172 1916 S.R. (N.S.W.) 183

amounts necessary to promote/acquire stock in a business.¹¹⁷³ *Marshall v. I.R.C.*¹¹⁷⁴ is illustrative of the effect of the common law principle. In this case a life tenant was entitled to the income from an estate carrying on a wool production business however the will provided that should she marry she'd lose her entitlement. This she did in February **after** the sheering of the wool and before her March statutory tax year end. The wool was not sold until the following September and the court recognized that prior to the liquidation of the wool she had no rights to it in specie (no proprietary rights) but that she was entitled only to the cash income and on these grounds she was not assessable in the particular year ending in March, (though they recognized her entitlement in the subsequent period). Unfortunately the proceeds were paid to her in September just prior to the end of the trust's accounting and tax year and pursuant to provisions that read with effective exact opposition to those in Sec. 104(23)(c) of the ITA¹¹⁷⁵ the income was carried back and recognized prior to the end of the March tax year **as deemed**. Of importance is the fact that without the effect of the particular provisions the beneficiary would recognize income only when payable in the form of cash to her: in her following tax year.

Debt and Indemnification.

If the trustees are given the discretion of charging income of the trust with the payment of recurring or long term debt then again there may be instances where the notional income may not be distributable for lack of funds.

In *Octavo Investments Pty. Ltd. v. Knight*¹¹⁷⁶ concerning the indemnity of trustees the Court held:

"It is common ground that a trustee who in discharge of his trust enters into business transactions is personally liable for any debts that are incurred in the course of those transactions: *Vacuum Oil Co. Pty. Ltd. v. Wiltshire*, (1945) 72 C.L.R. 319. However he is entitled to be indemnified against those liabilities from the trust assets held by him and for the purpose of enforcing the indemnity the trustee possesses a charge or right of lien over those assets: *Vacuum Oil Co. Pty. Ltd. v. Wiltshire* supra... In such a case there are then two classes of persons having a beneficial interest in the trust assets: first the cestuis que trustent, those for whose benefit the business was being carried on; and secondly, the trustee in respect of his right to be indemnified out of the trust assets against personal liabilities incurred in the performance of the trust. The latter interest will be preferred to the former, so that the cestuis que trustent are not entitled to call for a distribution of trust assets which are subject to a charge in favour of the trustee until the charge has been satisfied."

Thus there are at least two instances in which although the trust recognizes notional income, none is payable to the life tenants; where the trust deed authorizes only the discretionary or non-discretionary accumulation of cash receipts, (of which none may exist), and where the deed allows for the extinguishment of debt, obligations etc, out of cash which would otherwise be distributable to the life tenant. In both instances, since the life tenant (income beneficiary) is not in a position to enforce a distribution, even though notional income has been recognized, (the amount of which he may subsequently receive), subsection 104(13)(a) would not be applicable since if he can't enforce a payment of trust law income he certainly can't enforce one of tax law income.¹¹⁷⁷

When Amounts are not Actually Payable.

An even more interesting aspect arises where the tax law income recognized in respect of the income beneficiary exceeds the trust law income that he is in fact entitled to enforce payment of. Surely since he

¹¹⁷³ Re: Walker, 1901 1 S.R. (N.S.W.) 237, Re: Weir, 1910 28 W.N. (N.S.W.) 4, *Littlejohn v. Davies*, Re: Richards, and *Porter v. Porter*, 1930 31 S.R. (N.S.W.) 115, all support the concept that a life tenant **failing the expression to the contrary in the will/deed** should be entitled to only what prudent management would hold distributable in the period of income.

¹¹⁷⁴ 1960 N.Z.L.R. 972 (CA)

¹¹⁷⁵ which provides that income realized from a testamentary trust will be recognized in the tax year of the beneficiary in which **the trust's tax year ends**. The New Zealand Act required the opposite: the beneficiary recognize the income from the trust paid within its tax year in which her tax year ended.

¹¹⁷⁶ (1979), 54 A.L.J.R. 87

¹¹⁷⁷ This was precisely the case in *Case T63*, 86 A.T.C. 456, citing *Whiting*, 68 C.L.R. 199, *Taylor v. F.C.T.*, 70 A.T.C. 4026, and *Allhusen v. Whittell*, 1867 L.R. 4 Eq. 296.

cannot enforce payment of that extra amount, and it isn't paid to him, Sec. 104(13) cannot be applied to it and it becomes taxable in the hands of the trust.¹¹⁷⁸

In *F.C.T. v. Belford*¹¹⁷⁹ the Federal Commissioner of Taxation of Australia contended that an income beneficiary was to recognize, under section 97 of Income Tax Assessment Act his share of the trust's assessable income regardless of whether or not he had received it. The charging provision provided:

"97(1) Where a beneficiary of a trust estate who is not under any legal disability is presently entitled to **a share of the income** of the trust estate -
(a) the assessable income of the beneficiary shall include -
(i) so much of **trust share** of the **net income** of the trust estate as is attributable to a period when the beneficiary was a resident
..."

while due to trust law deductions the amount to which the sole income beneficiary was entitled was less than the trust's assessable income. Taylor, J. held:

"The ascertainment of the total assessable income of the trust estate for any year is, of course, not concerned with payments by way of distribution to beneficiaries and the total assessable income of the trust estate will, in any particular case, be precisely the same whether the whole or some part only, or none of the estate income has, during the relevant year, been distributed to beneficiaries presently entitled to show thereof. Yet in such cases, s. 97 requires that the **appropriate share** of the total assessable income of the trust estate shall be included in the assessable income of each beneficiary, **and this is so whether any beneficiary has actually received the whole or some part only, or none of such income.** To my mind this is a clear indication that the Act intends, in such cases, that there shall be included in a beneficiary's assessable income, **not the amount of his actual receipts of the estate income, but a proportion of the total assessable income of the trust estate which, for obvious reasons, may be quite a different amount and, generally at least, a greater amount.**"

Subsection 97(1) of **that Act**¹¹⁸⁰ to which Taylor J referred refers to "**a share**" of the trust's tax income being included in the beneficiary's taxable income. The ITA, in particular Sec. 104(13), **does not refer to shares of income, only amounts payable.**¹¹⁸¹ In *Pichosky v. M.N.R.*¹¹⁸² the Exchequer Court had to decide whether an income beneficiary was to recognize under Division B as per section 63, (the equivalent of Sec. 104(13)), a portion of the **deemed** income of the trust. Jaccett, P provided in respect of the deemed amount:

"In fact, however, the trust **received** no income in 1959 and **no income** would therefore be "payable" to a beneficiary in 1959 so as to be taxable in the hands of that beneficiary in 1959."

In *I.R.C. v. LeBus*¹¹⁸³ the U.K. Court of Appeal had to decide whether a widow was assessable in respect of partnership income that, as per the terms of the deceased's will, was to be payable to trustees and then payable to her. She didn't have beneficial ownership of the partnership interest and the partnership income was not withdrawn by the trustees and was not in substance payable to the widow in the particular year. The Commissioner's assessment was not upheld, with Lord Greene M.R. providing quite accurately:

"Now says the Crown: 'That is really what has happened here. The three partners have made profits and they are taxable even though they did not draw those profits out of the business.' Similarly, the Crown says: 'Mrs. Lebus has made some profits and it makes no difference whether she draws the profits out of the business or does not.' But there is all the difference in the world between the two cases, because Mrs. Lebus is not a partner, and the assets of the partnership do not belong to her. It is therefore, impossible to say as against her what can be said against the partners-that she has in the accretion to the value of the partnership assets realized a profit in the income tax sense. She has not realized a profit unless and until the profit is paid to her. It is a complete confusion, with

¹¹⁷⁸ See *Mereweather Trustees v. F.C.T.*, 1922 R. & Mcg. Ct. of Review 77, where non-deductible interest incurred by the estate reduced the income recognizable by the life tenant.

¹¹⁷⁹ [1953] 88 C.L.R. 589

¹¹⁸⁰ Australian income Tax Assessment Act

¹¹⁸¹ See *Davis and Anor. v. F.C.T.*, 86 A.L.R. 195 at 230 for comparison of inclusion bases and the Australian I.T.A.A..

¹¹⁸² 64 D.T.C. 5105, while see also *Caldwell Trust v. M.N.R.* for similar situation.

¹¹⁸³ [1946] 1 All E. R. 476

great respect to the argument to put her in the same position as if she had been a partner."¹¹⁸⁴

From the above commentary it should be beyond doubt that if an income beneficiary doesn't have a right to receive the excess of the Division B income over the trust law income to which he is entitled, as income, then it will not be assessable in his hands under Sec. 104(13).

Beneficiary by Beneficiary Allocation.

Subsection 104(13)(a) income payable that is included in the beneficiary's taxable income consists only of Division B "income" operationally defined in section 3 and since it potentially includes significant components relating only to capital gains etc.¹¹⁸⁵ it would be fundamentally incorrect to simply prorate the amount of Division B tax income of the trust on the basis of the trust law income payable to one life tenant that is of the total trust law income payable in the period to them all to determine the amount of Sec. 104(13) income the life tenant must recognize.¹¹⁸⁶

A far more equitable designation process would be to simply trace the streams of revenue and expenditures recognizable for tax purposes through to the beneficiaries to whom the corresponding trust law benefits inure. This would result in a recognition of a more appropriate taxable income figure in respect the particular beneficiary. Understandably one may have to prorate the C.C.A. available in respect of certain properties over the beneficiaries who are entitled to the income from those properties.¹¹⁸⁷ Unfortunately the equitable bookkeeping is but a general rule that can be overridden with the slightest of indication to the contrary in the trust deed/will. The terms of the specific deed would have to be scrutinized to ascertain how much discretion exists as to how expenses are to be charged.¹¹⁸⁸

If this method were followed then those elements found in Division B income in respect of capital gains, business investment losses, etc. that ultimately accrue to the benefit or detriment of the capital beneficiaries would remain taxable in the hands of the trust, taxes upon which would properly reduce or increase the economic benefits ultimately realized by the remainderman. If this method were followed however, and the trust law income payable to a particular income beneficiary was less than the tax law traced as being in respect of that revenue stream, the beneficiary should only have to recognize income payable under Sec. 104(13) up to the trust law amount since the excess could not be paid or payable to him as income. Understandably a trust deed should specifically attend to these instances so as to disallow an income

1184 See also *Von Wald v. F.C.T.*, 1968 15 A.T.D. 160, for similar situation where due to significant partnership capital expenditure partnership earnings not drawn upon though see Case E39, 73 A.T.C. 339, where partnership income wasn't deemed to be payable to minor beneficiary under an equivalent of Sec. 104(18) due to provision out of income for retiring partner. See also *F.C.T. v. Walsh & Anor.*, 83 A.T.C. 4415 (Aust. F.C.), where partnership wound up and receipts not income. See however *Vandepitte v. Pre. Acc. Insurance Corp.*, 1933 A.C. 70, at 79, where beneficiaries implied to be partners under partnership contract while see also *Clarke v. Earl of Dunraven*, 1897 A.C. 59, and "Trustee-Partnerships: An old Remedy for a New Need", G. Nash, W.A. Uni. Annual Law Review, 1965/6 Vol 7, p.158.

1185 which accrue for the benefit of capital beneficiaries usually

1186 See problems to be caused by proportional assessment of trust income, regardless of character in *Davies & Anor. v. F.C.T.*, 89 A.T.C. 4377 at 4403-4.

1187 There is no statutory provision that precludes the trustees from streaming C.C.A. in respect of one beneficiary's income recognizable or another's hence it could be possible to have one income beneficiary's Sec. 104(13) inclusion reduced by the entire amount of C.C.A. deducted by the trust while allowing others to recognize gross Sec. 104(13) inclusions. Equitable accounting would have to take place, understandably, but such streaming could allow for indirect personal tax credit-loss utilizations etc.. Is there any trust law principle that disallows a tax benefit, in the form of C.C.A. deductions, from being realized by a life tenant in respect of property held for the benefit of a remainderman when any terminal loss otherwise recognizable by the trust on the disposition of the property would not inure to the benefit of the remainderman due to the lack of property etc.? There may not be in instances of trusts for sale only however where in specie distributions are compelled, in the author's opinion, C.C.A. should be restricted since a benefit of any terminal loss potential would be shifted to the life tenant, while also increasing any recapture exposure that would penalize the remainderman. The terms of the trust deed/will would be relevant of course as well as the participation of all beneficiaries in subsequent realizations.

1188 In T.I. 5-9694 provided in March 1990 the F.I.D. stated essentially that it is a question of fact whether expenses relate to a particular source of income and in the case of general expenses unrelated to any particular source there is no requirement to allocate them to a particular source. If they are streamed off against a particular beneficiary's entitlement or another's there will be reductions in Sec. 104(13) inclusions for some beneficiaries with increased Sec. 105(1) inclusions for others consequently. Though in tax law there is no equitable or statutory requirement to trace expenditures to revenue to establish the quantum of the Sec. 104(13) inclusion, not basing it on the trust law allocations may result in a tax cost in the form of a Sec. 105(1) inclusion, without any tax benefit (since if not causing a Sec. 104(13)-(6) flow-through the trust will recognize the taxable element). The applicability of Sec. 105(1) to benefits of accounting income in excess of those recognized under Sec. 104(13) obviously causes problems.

beneficiary the opportunity of avoidance of income tax on undistributable income by providing that the income accumulated to the next period will be reduced by taxes payable by the trustee, possibly adjusted for additional effective taxation that it has caused due to a shift in tax brackets etc.¹¹⁸⁹ Legal and actuarial advice fees incurred to vest a beneficiary's interest have been held deductible in computing a trust's capital gain on a deemed disposition¹¹⁹⁰ and would, in the author's opinion, be deductible when section 107 caused any deemed disposition on a roll out of property. The same can be said about fees incurred to liquefy the estate for wind-up.¹¹⁹¹

¹¹⁸⁹ See Australian case #K87, 1960 10 T.B.R.D. 459, in respect of the reduction of the income recognizable by a life tenant due to insurance, interest costs of the estate was well as *Murray v. I.R.C.*, 11 T.C. 133, & *MacFarlane v. I.R.C.*, 14 T.C. 532. In *Piratin v. C.I.R.*, 54 T.C. 730, life insurance premiums paid on insurance policies on the settlers' lives were held not to reduce the income distributable to the beneficiaries **in the absence of express instructions to the contrary**. See also *Carver v. Duncan*, 1985 2 W.L.R. 1010 (HL), where the trust deed allowed the life insurance premiums to be paid from income but the House of Lords held that such didn't make them deductible for income tax purposes. They would still reduce distributable tax income. Income tax payments in immediately following years may reduce the distributable income of the trust for tax purposes: Case C36, 71 A.T.C. 156.

¹¹⁹⁰ C.I.R. v. Chubb's Trustees, 47 T.C. 353

¹¹⁹¹ C.I.R. v. Richard's Exors., 46 T.C. 626 (HL)

The Preferred Beneficiary Election.

While the Income Tax Act generally requires that specific conditions must exist in order to allow the tax liabilities of an economic benefit to be imposed upon the beneficiary rather than the trust, it does allow assignment of certain liabilities where the conditions are not met, through the operation of a tax device; the preferred beneficiary election (P.B.E.).

Recalling the commentary on the subsection 104(13) and 105(1) income inclusions it was observed that the basis of trust Division B income inclusion in the beneficiary's taxable income was that the income had either been actually paid to the beneficiary or the beneficiary had a right which allowed him to be entitled at that time to enforce its distribution. Under Sec. 105(2) the right held by the beneficiary was not of the nature that could allow entitlement to enforce a direct distribution but instead allowed an indirect benefit to be obtained from the income of the trust while under Sec. 105(1) the value of all benefits recognized by any taxpayer that were not required to be otherwise included in his income or that did not lead to a real or hypothetical adjustment in the ACB of a certain capital interest in the trust were to be included in the taxpayer's income. Common to **all** of the inclusions is their basis of inclusion whereby either the benefit/income was actually realized through a payment or conferment or the right to receive the income was enforceable in the year without impairment¹¹⁹².

The Problem.

A trust agreement is known for its usefulness in transferring title to property to persons in an orderly systematic manner where initially the recipient may not have been in the capacity to possess the title, (maturity, temperament, intelligence factors), while another common use is the accumulation of income derived from property held in trust which will be distributed to a particular beneficiary upon his fulfilling of a certain condition such as age, marriage, etc.. There may be a multitude of legitimate reasons why the settlor of the property may not wish to have the absolute title to the income, (or the income generating property and thus the income itself), granted to the person until the condition has been fulfilled or a lapse of a stated time period hence in order to deny that person a course in action that would, through an application to the courts if need be, legally cause the income to be payable to the person the settlor instead would explicitly state in the trust deed that the person would have no right to the income until the condition exists or the time period has lapsed. By granting only a contingent or future right to the person a settlor has ascertained that the specific conditions must exist before the right can be enforceable.

Subsection 104(18) has some application in the instance of minors in specific instances here but through the preferred beneficiary election there is another route though of limited nature compared to what the preferred beneficiary election used to be.

This being the case it can be seen that although the beneficiary does not have a right to enforce a distribution due to the deferral of the timing of the enforceability of his right it can reasonably be concluded that the economic benefits of the property (income) will accrue, as per the terms of the trust, for his ultimate benefit, in the interim, even though he has no immediately enforceable right thereto. With respect to how income tax liabilities are assigned between trusts and their beneficiaries the inability to enforce a distribution obviously causes the income to be precluded from inclusion in the beneficiary's income, (unless it was actually paid to him in the period), and instead it is taxed in the hands of the trust. Distributing income in the period to a contingent or future income beneficiary is fundamentally offensive to current trust law if the trust deed doesn't allow it. The Act generally requires inclusion in income of amounts actually distributed or distributable yet the preferred beneficiary election (P.B.E.) is a tax device operative where income is not paid, **nor is payable** to the beneficiary due to the absence of an immediately enforceable right. Since certain streams of trust income as per the trust deed may be said to be accumulating in respect of certain beneficiaries who will receive them upon fulfilling stated conditions, such income **should** be taxed at **their** applicable tax rates rather than the trust's, even though the provisions in the ITA do not explicitly require that the subject beneficiary obtain an indefeasibly vested right to such income accumulating in the trust and elected upon under Sec. 104(14).

¹¹⁹² after the exercise of discretionary powers

“Deduction of amounts included in preferred beneficiaries’ incomes – Sec. 104(12)”

(12) There may be deducted in computing the income of a trust for a taxation year the lesser of

(a) the total of all amounts designated under subsection 104(14) by the trust in respect of the year, and

(b) the accumulating income of the trust for the year.¹¹⁹³

“Election by trust and preferred beneficiary – Sec. 104(14)”

(14) Where a trust and a preferred beneficiary under the trust for a particular taxation year of the trust jointly so elect in respect of the particular year in prescribed manner, such part of the accumulating income of the trust for the particular year as is designated in the election, not exceeding the allocable amount for the preferred beneficiary in respect of the trust for the particular year, shall be included in computing the income of the preferred beneficiary for the beneficiary’s taxation year in which the particular year ended and shall not be included in computing the income of any beneficiary of the trust for a subsequent taxation year.¹¹⁹⁴

1193 Dec. 1995 FINANCE TECHNICAL NOTES: Subsection 104(12) allows a trust to deduct in computing its income amounts of such income allocated under subsection 104(14) to its preferred beneficiaries. Subsection 104(12) is amended to ensure that the amount that may be deducted in computing the trust's income for a taxation year under this subsection does not exceed its accumulating income for the year. This amendment is consequential on amendments to subsections 104(14) and (15) which are described below.

1194 1997 FINANCE NOTICE OF WAYS AND MEANS MOTION, 1997 BUDGET SUPPLEMENTARY INFORMATION: See under 108(1) "preferred beneficiary".

Dec. 1995 FINANCE TECHNICAL NOTES: Subsections 104(12), (14) and (15) provides that a trust and a preferred beneficiary under the trust may elect that an amount not exceeding the preferred beneficiary's share in the accumulating income of the trust be deducted in computing the trust's income and be included in computing the beneficiary's income. Subsection 108(1) defines the expressions "preferred beneficiary" and "accumulating income". Under the existing definition, a "preferred beneficiary" under a trust is the trust settlor, the settlor's spouse or former spouse, as well as the settlor's children, grandchildren, great-grandchildren, and their respective spouses.

Existing subsection 104(15) sets out the rules governing the computation of a preferred beneficiary's share in accumulating income. Special rules are provided under existing paragraph 104(15)(a) for spousal trusts where the beneficiary spouse is still alive, in which case, the beneficiary spouse's share in accumulating income is equal to the full amount of the accumulating income, and the share of any other beneficiary is considered to be nil. Rules are also provided for non-discretionary and discretionary trusts under existing paragraphs 104(15)(b) and (c), as well as Part XXVIII of the Income Tax Regulations. Where none of these rules apply, a preferred beneficiary's share in accumulating income is considered to be nil under paragraph 104(15)(d).

The definition of "preferred beneficiary" [in 108(1) - ed.] is amended to provide that a beneficiary under a trust no longer qualifies as a preferred beneficiary unless the beneficiary is entitled to a tax credit for mental or physical impairment under subsection 118.3(1) (or would be so entitled if there were no deductions claimed for an attendant or care in a nursing home in respect of the beneficiary).

Subsections 104(14) and (15) are amended so that a preferred beneficiary's share in the accumulating income of a trust is now referred to as the "allocable amount" for the preferred beneficiary, to take into account the possibility that there may be more than one preferred beneficiary under a trust, and that the total allocable amounts for those preferred beneficiaries will typically exceed the accumulating income of the trust. (However, because of amended subsection 104(12), there will be no advantage to a trust to make elections for a taxation year under subsection 104(14) in excess of the trust's accumulating income for the year.)

Subsection 104(15) has been amended to simplify the calculation of the allocable amount for a preferred beneficiary. Except where existing paragraph 104(15)(a), described above, applies, the allocable amount for a preferred beneficiary under a trust for a taxation year is

- the accumulating income of the trust for the year, provided the beneficiary has a right of any type to any portion of that income and such right is not entirely contingent on the death of another beneficiary who has a capital interest in the trust and who does not have an income interest in the trust, and
- in any other case, nil.

1995 FINANCE NOTICE OF WAYS AND MEANS MOTION: (11) That preferred beneficiary elections be eliminated for trusts' taxation years that begin after 1995, except with respect to beneficiaries entitled under subsection 118.3(1) of the Act to the tax credit for mental or physical impairment.

1995 BUDGET SUPPLEMENTARY INFORMATION: The Taxation of Family Trusts

Family, trust arrangements allow property to be held by a trust for the benefit of beneficiaries under the trust. Trusts are used for many purposes, including succession planning for businesses and dealing with the needs of beneficiaries in

“Allocable amount for preferred beneficiary – Sec. 104(15)”

(15) For the purpose of subsection 104(14), the allocable amount for a preferred beneficiary under a trust in respect of the trust for a taxation year is

(a) where the trust is an alter ego trust, a joint spousal or common-law partner trust, a post-1971 spousal or common-law partner trust or a trust described in the definition “pre-1972 spousal trust” in subsection 108(1) at the end of the year and a beneficiary, referred to in paragraph (4)(a) or in that definition, is alive at the end of the year, an amount equal to

(i) if the preferred beneficiary is a beneficiary so referred to, the trust’s accumulating income for the year, and

(ii) in any other case, nil;¹¹⁹⁵

(b) where paragraph (a) does not apply and the preferred beneficiary’s interest in the trust is not solely contingent on the death of another beneficiary who has a capital interest in the trust and who does not have an income interest in the trust, the trust’s accumulating income for the year; and

(b) in any other case, nil.¹¹⁹⁶

special circumstances, such as age and disability. The budget proposes two changes to the taxation of family trusts to ensure that they do not provide any undue tax advantages.

Preferred Beneficiary Election

Before its allocation to beneficiaries, trust income is determined in the same manner as it is determined for other taxpayers. Interest, dividends and realized taxable capital gains are all included in computing a trust’s income for this purpose. The taxable income of testamentary trusts (and certain pre-1972 trusts) is subject to the same graduated income tax rate structure as applies to individuals. The taxable income of other trusts is subject to income tax at the top personal income tax rate.

The preferred beneficiary election currently, allows trust income to be allocated to “preferred” beneficiaries (defined to include the spouse, children and grandchildren of the settlor of the trust) and taxed in their hands rather than at the trust level. This allows trust income to accumulate, without the need to pay the income to beneficiaries. There is no requirement that the income allocated to a beneficiary ultimately be paid to that beneficiary.

The preferred beneficiary election is an exception to a general rule which provides that income earned on trust property is subject to tax in the hands of the trustee, except to the extent that such income is payable to, and consequently, taxed in the hands of the trust’s beneficiaries.

The flexibility of the preferred beneficiary election and the potential to split income among large numbers of preferred beneficiaries make it a significant tax planning tool. The preferred beneficiary election allows trust income to be split among family members for income tax purposes without regard to the amount that the beneficiary will ultimately receive. Thus, for example, where trust income in the form of dividends is allocated to a beneficiary such as a young child with little other income, substantial amounts can be accumulated on a tax-free basis because of the dividend tax credit. In addition, the entitlement to the \$500,000 lifetime capital gains exemption can be multiplied because of the preferred beneficiary election. The budget proposes to eliminate the preferred beneficiary election, except as it applies to those beneficiaries who are entitled to a tax credit for mental or physical impairment or who would be so entitled if amounts paid for the remuneration of an attendant or for care in a nursing home were ignored. This measure will eliminate a tax planning technique and seeks to ensure a level playing field between a property held in a trust and property held directly.

This measure is to apply to taxation years of trusts that commence after 1995.

¹¹⁹⁵ June 1992 FINANCE TECHNICAL NOTES: Subsections 104(12) and (14) provide that a trust and a preferred beneficiary under the trust may elect that an amount not exceeding the preferred beneficiary’s “share” in “accumulating income” of the trust be deducted in computing the trust’s income and be included in computing the beneficiary’s income. Subsection 108(1) defines the expressions “preferred beneficiary” and “accumulating income”: A preferred beneficiary’s “Share” in the accumulating income of a trust is determined under subsection 104(15). Paragraph 104(15)(9) provides that, in the case of a post-1971 spousal trust referred to in paragraph 104(4)(a) in which the beneficiary spouse is alive at the end of the year, only the spouse is a beneficiary to whom the trust’s accumulating income for the year may be allocated. Paragraph 104(15)(a) is amended so that a preferred beneficiary’s share of accumulating income for a year under a trust that is at the end of the year, a pre-1972 spousal trust is determined on the same basis. The expression “pre-1972 spousal trust” is defined in new paragraph 108(1)(f.2).

¹¹⁹⁶ March 2001 FINANCE TECHNICAL NOTES: Subsection 104(14) provides a mechanism under which a preferred beneficiary of a trust and the trust can elect to have a designated amount taxed in the hands of the beneficiary rather than

The Election and Who May Make it.

Subsection 104(14) provides that where a trust and a "preferred beneficiary" jointly elect in a prescribed manner within the prescribed time, such part of the "accumulating income" of the trust for the specific year, as was designated by the election, that does not exceed "**the allocable amount for the preferred beneficiary**", will be included in the preferred beneficiary's income for that year and not included in computing the income of **any** beneficiary when it is subsequently distributed. Subsection 104(12) provides a deduction to the trust in computing its Division B income equal to the amount of accumulating income inclusion recognized by the beneficiary under Sec. 104(14).

The Sec. 104(14) provision does not explicitly require that the preferred beneficiary obtain an eventually enforceable right to the accumulating income however in *H.J. Sachs v. The Queen*¹¹⁹⁷ Thurlow C.J. provided that:

"In my view by making elections under this provision to avoid taxation of the income as that of the trust the trustee acknowledged the right of the children (P.B.) to the income and invited the Minister to assess them accordingly. That in my view could only be done on the basis that there had been an exercise of the trustee's authority **to pay** the whole of the income for the taxation years in question to the children and to irrevocably confer on them the right to it. The authority to pay income to beneficiaries, in my opinion, includes the authority to declare or designate income as held for them to the exclusion of the continuance of the trustee's authority to deprive them of it and to the exclusion of the possibility of their being deprived of it upon the happening of events referred to in the trust deed."

In the author's opinion this statement, though routinely referred to, is not valid with respect to the purpose or the mechanics of the Sec. 104(14) election.¹¹⁹⁸ Indefeasibly vesting of the income elected upon by a preferred beneficiary in the beneficiary isn't referred to at all in the Sec. 104(14)-(15) provisions and when one recognizes that Sec. 104(15) offers provisions in respect of contingent interests in the accumulating income it becomes questionable whether the beneficiary must ever gain an absolute right to the amount elected upon. There is a substantial difference between the reporting of events that occur and their actual occurrence and *Hashman Trustees v. M.N.R.* indicated this however in respect of the P.B.E. the preferred beneficiary could always refuse to elect to recognize a certain amount and perhaps this is one of the draftsman's reasons for requiring a joint election by both beneficiary and trustee, which is unlike a majority of the various flow-through elections available. Subsection 104(15) also prescribes rules in respect of contingent or discretionary interests in the accumulating income hence obviously Parliament recognized the potential of electors to never be in a position to receive the elected amount however with respect to the above quoted case the trust allowed the trustees to determine in their discretion whether accumulating income would become payable to any beneficiary.¹¹⁹⁹

Finally, the PBE has been severely restricted to be available effectively to only certain categories of dependants whose income is within certain levels described in the definition of "preferred beneficiary".

at the trust level. Under the definition "preferred beneficiary" in subsection 108(1), a preferred beneficiary of a trust is generally a disabled person resident in Canada who is, or is closely related to, the settlor of the trust. Under paragraph 104(15)(a), if the preferred beneficiary is the living spouse or common-law partner beneficiary under a trust for the benefit of a spouse or common-law partner, an "allocable amount" in respect of the beneficiary, for a taxation year is the trust's "accumulating income" for the year (which, in general terms, is defined in subsection 108(1) as undistributed trust income). Subsection 104(15) is amended so that the preferred beneficiary election in connection with allocations of income from an alter ego trust, a joint spousal or common-law partner trust, a post-1971 spousal or common-law partner trust or a trust described in the definition "pre-1972 spousal trust" in subsection. 108(l) is available to the spouse, common-law partner or other beneficiary, (i.e., the settlor) identified in paragraph 104(4)(a), only while the spouse, common-law partner or other beneficiary is alive.

This amendment also reflects changes effected by the Modernization of Benefits and Obligations Act.

¹¹⁹⁷ 80 C.T.C. 358 (FCA) at 362

¹¹⁹⁸ See *C.I.R. v. Simpson*, 1989 2 N.Z.L.R. 704 (CA).

¹¹⁹⁹ The case actually concerned the vesting of title to the accumulating income upon which the former Sec. 75(1) attribution provision would apply where the preferred beneficiaries had jointly filed elections but they were under 18 years of age however with the implementation of Sec. 74.3(1) vesting of title to the income is no longer a criterion for trust income attribution.

Definition: "preferred beneficiary" – Sec. 108(1)

"preferred beneficiary" under a trust for a particular taxation year of the trust means a beneficiary under the trust at the end of the particular year who is resident in Canada at that time if

(a) the beneficiary is

(i) an individual in respect of whom paragraphs 118.3(1)(a) to (b) apply for the individual's taxation year (in this definition referred to as the "beneficiary's year") that ends in the particular year, or

(ii) an individual

(A) who attained the age of 18 years before the end of the beneficiary's year, was a dependant (within the meaning assigned by subsection 118(6)) of another individual for the beneficiary's year and was dependent on the other individual because of mental or physical infirmity, and

(B) whose income (computed without reference to subsection 104(14)) for the beneficiary's year does not exceed the amount used under paragraph (c) of the description of B in subsection 118(1) for the year, and

(b) the beneficiary is

(i) the settlor of the trust,

(ii) the spouse or common-law partner or former spouse or common-law partner of the settlor of the trust, or

(iii) a child, grandchild or great grandchild of the settlor of the trust or the spouse or common-law partner of any such person;¹²⁰⁰

1200 Sept. 1999 FINANCE TECHNICAL NOTES: Section 108 sets out certain definitions and rules concerning the taxation of trusts and their beneficiaries.

Subsection 108(1) defines the expression "preferred beneficiary". Under the preferred beneficiary election in subsection 104(14), certain amounts of income otherwise taxable at the trust level can be allocated to a preferred beneficiary. In general, individuals must qualify for the disability tax credit in order to be a preferred beneficiary. However, adults not qualifying for the disability tax credit who are nevertheless dependent on another person because of mental or physical infirmity can qualify as preferred beneficiaries if their income (determined before allocations under the preferred beneficiary election) is below \$6,456.

The \$6,456 threshold is increased to \$6,956 for the 1998 taxation year to reflect the \$500 supplementary amount that was introduced as part of the 1998 budget.

The definition "preferred beneficiary" is further amended to increase the \$6,956 threshold to \$7,044 for the 1999 taxation year and to \$7,131 (partially indexed) for the 2000 and subsequent taxation years. These amendments to the definition are consequential on the increase of the basic personal amount from \$6,456 to \$6,794 for 1999 and to \$7,131 (partially indexed) starting in 2000, and on the two-year phase-out of the \$500 supplementary amount provided under paragraph (b.1) of the description of B in subsection 118(1).

For information on the changes to the personal amounts, see the commentary on subsection 118(1).

Dec. 1997 FINANCE TECHNICAL NOTES (budget): Subsection 108(1) defines the expression "preferred beneficiary", which is relevant for the purpose of the preferred beneficiary election in subsection 104(14). A preferred beneficiary for a trust's taxation year is essentially an individual who

- is resident in Canada,
- is a beneficiary under the trust at the end of the trust's taxation year who is entitled to a disability tax credit under subsection 118.3(1) for the individual's taxation year in which the trust's taxation year ends, and
- is the trust settlor, the settlor's spouse or former spouse, a child, grandchild or great-grandchild of the settlor or a spouse of such a person.

The definition "preferred beneficiary" is amended so that the requirement that the beneficiary under a trust be entitled to a tax credit under subsection 118.3(1) is satisfied for a trust taxation year where the beneficiary is entitled to the tax credit for the beneficiary's taxation year that ends in the trust year. This amendment affects only testamentary trusts with non-

Definition: "settlor"

(a) in relation to a testamentary trust, means the individual referred to in the definition "testamentary trust" in this subsection, and

(b) in relation to an *inter vivos* trust,

(i) if the trust was created by the transfer, assignment or other disposition of property thereto (in this definition referred to as property "contributed") by not more than one individual and the fair market value of such of the property of the trust as was contributed by the individual at the time of the creation of the trust or at any subsequent time exceeds the fair market value of such of the property of the trust as was contributed by any other person or persons at any subsequent time (such fair market values being determined at the time of the making of any such contribution), means that individual, and

(ii) if the trust was created by the contribution of property thereto jointly by an individual and the individual's spouse or common-law partner and by no other person and the fair market value of such of the property of the trust as was contributed by them at the time of the creation of the trust or at any subsequent time exceeds the fair market value of such of the property of the trust as was contributed by any other person or persons at any subsequent time (such fair market values being determined at the time of the making of any such contribution), means that individual and the

calendar year ends. It ensures that trustees of a testamentary trust will know, with greater certainty, the status of a beneficiary by the time a preferred beneficiary election is made in respect of the beneficiary. This definition is also amended to provide that an adult is not excluded as a "preferred beneficiary" for a trust taxation year because the adult is not entitled to the tax credit under subsection 118.3(1), where the adult is a dependant (within the meaning assigned by subsection 118(6)) of another individual for the adult's taxation year that ends in the trust year because of mental or physical infirmity and an income test is satisfied. The income test is satisfied where the adult's income (computed without reference to any amount designated under a preferred beneficiary election and allocated to the adult) for the adult's year that ends in the trust year does not exceed \$6,456. The \$6,456 limit is the same as the income limit used for the purposes of the dependant tax credit under subsection 118(1). Amended subsection 117.1(1) provides for the indexing of this new limit.

1997 FINANCE NOTICE OF WAYS AND MEANS MOTION: Preferred beneficiary election

(15) That a beneficiary under a trust not be excluded as a "preferred beneficiary" under the trust for any trust taxation year that ends after 1996 because the beneficiary does not claim a disability tax credit where another person is entitled to claim a dependant tax credit under Paragraph (d) of the description of variable B in the formula used in subsection 118(1) of the Act in respect of the beneficiary.

1997 BUDGET SUPPLEMENTARY INFORMATION: Trusts and people with disabilities

Trusts allow individuals (known as trust "settlers") to transfer property to a trust for the benefit of other individuals or "beneficiaries" of a trust. Trusts may be used for many different purposes including meeting the needs of beneficiaries with disabilities.

The undistributed income earned by a trust is normally taxed at the trust level. An exception to this general rule is currently made in the case of beneficiaries qualifying for the disability tax credit. The existing preferred beneficiary election allows the income earned by a trust to be taxed as if it had been paid out to a preferred beneficiary. A preferred beneficiary is a beneficiary under a trust who is entitled to the disability tax credit and is in a close family relationship with the settlor of the trust. Although the funds stay in the trust, the election allows the income of the trust to be taxed in the hands of a preferred beneficiary, who may be subject to tax at a lower tax rate than the trust.

The budget proposes to broaden the definition of a preferred beneficiary to include adults who are dependent on others by reason of mental or physical infirmity. This measure will apply to individuals for whom an infirm dependant credit can be claimed.

Dec. 1995 FINANCE TECHNICAL NOTES: The amendment to this definition is discussed in the commentary on the amendments to subsections 104(14) and (15).

spouse or common-law partner;¹²⁰¹

Definition: "accumulating income"

"accumulating income" of a trust for a taxation year means the amount that would be the income of the trust for the year if that amount were computed

(a) without reference to paragraphs 104(4)(a) and (a.1) and subsections 104(5.1), (5.2) and (12) and 107(4),

(b) as if the greatest amount that the trust was entitled to claim under subsection 104(6) in computing its income for the year were so claimed, and

(c) without reference to subsection 12(10.2), except to the extent that that subsection applies to amounts paid to a trust to which paragraph 70(6.1)(b) applies and before the death of the spouse or common-law partner referred to in that paragraph;¹²⁰²

¹²⁰¹ It is possible to settle a trust without capital transfer, in a Canadian example see *Dunkelman v. MNR* while a recent example also includes *CIR v. Dick*, [2002] 2 N.Z.L.R. 560 HCNZ, where "a settlor" included an individual who performed services for a trust he settled which brought in income for it.

¹²⁰² "accumulating income"

March 2001 FINANCE TECHNICAL NOTES: The amount that may be allocated under subsection 104(15) to a disabled beneficiary for a trust taxation year is limited to the trust's accumulating income for the year. The trust's accumulating income is designed, in part, to ensure that the preferred beneficiary election cannot be used to allocate income and gains under a trust for the benefit of a spouse or common-law partner to non-spouse or non-common-law partner beneficiaries. Under the existing definition, trust income arising from a deemed disposition of trust assets under subsection 104(4), (5) or (5.2) is not included in computing "accumulating income" and cannot be allocated to beneficiaries in the event that the trust is a trust for the benefit of a spouse or common-law partner.

The definition "accumulating income" is amended so that the above restriction only applies in connection with the deemed disposition of trust assets that occurs on the death of the spouse or common-law partner beneficiary under a trust for the benefit of the spouse or common-law partner. As a consequence of amendments to paragraph 104(4)(a), a similar restriction applies to alter ego trusts and joint spousal or common-law partner trusts, as defined in subsection 248(1). This amendment also reflects changes effected by the Modernization of Benefits and Obligations Act.

Dec. 1995. FINANCE TECHNICAL NOTES: Subsection 108(1) defines the expression "accumulating income", which is relevant for the purposes of determining amounts that can be allocated to preferred beneficiaries under the preferred beneficiary election in subsection 104(14). Subject to a number of adjustments, it is essentially the undistributed income of a trust for a taxation year.

The definition of "accumulating income" is amended to ensure that, if a trust fails to claim a deduction to the maximum extent possible under subsection 104(6), "accumulating income" is computed as if the maximum claim had been made. (It may be advantageous for a trust not to claim the maximum deduction under subsection 104(6) in order to allow for a tax-free distribution to a beneficiary under subsection 104(13.1) or (13.2).).

The definition is also amended to provide that, where a trust is a post-1971 spousal trust and the beneficiary spouse died on a day in a trust's taxation year, the trust's accumulating income for the year is computed as if any disposition by the trust before the end of that day of capital property, land described in an inventory of the trust, Canadian resource property or foreign resource property had not occurred. The purpose of this amendment is to ensure that the capital gains recognition for spousal trusts under subsections 104(4) to (5.1) cannot be avoided by actual dispositions by the trust before the beneficiary spouse dies.

June 1992 FINANCE TECHNICAL NOTES: Paragraph 108(1)(a) [now 108(1)"accumulating income"-- ed.] defines the expression "accumulating income" for the purposes of the rules in subsections 104(12), (14) and (15) relating to the preferred beneficiary election. The preferred beneficiary election allows a trust and a specified beneficiary under the trust to jointly make an election which results in an amount of the trust's accumulating income being taxed in the beneficiary's hands and not at the trust level. Amounts subsequently paid out of such income are not taxable in the recipient's hands. Paragraph 108(1)(a) is amended so that pre-1972 spousal trusts at the end of a taxation year are treated in the same way as post-1971 spousal trusts for the purposes of the preferred beneficiary election for the year. Thus, accrued gains with respect to trust property may not be "sprinkled" to trust beneficiaries under a pre-1972 spousal trust to the extent such gains are realized under subsection 104(4), (5) or (5.2). The expression "pre-1972 spousal trust" is defined in new paragraph 108(1)(f.2).

Paragraph 108(1)(a) is also amended so that a trust making an election to defer its deemed realization day under subsection 104(5.3) must also disregard any income arising under subsections 104(4), (5) and (5.2) in determining its

“Regulations 2800 of the Income Tax Regulations”

2800.(1) Any election under subsection 104(14) of the Act in respect of a taxation year shall be made by filing with the Minister the following documents:

(a) a statement

- (i) making the election in respect of the year,**
- (ii) designating the part of the accumulating income in respect of which the election is being made, and**
- (iii) signed by the preferred beneficiary and a trustee having the authority to make the election; and**

(b) a statement signed by the trustee showing the computation of the amount of the preferred beneficiary's share in the accumulating income of the trust for the year in accordance with paragraph 104(15)(a), (b) or (c) of the Act, as the case may be, together with such information concerning the provisions of the trust and its administration as is necessary for this purpose.

“Late, amended or revoked election – Sec. 104(14.01)”

(14.01) A trust and a preferred beneficiary under the trust may jointly make an election, or amend or revoke an election made, under subsection 104(14) where the election, amendment or revocation

- (a) is made solely because of an election or revocation to which subsection 110.6(25), 110.6(26) or 110.6(27) applies; and**

accumulating income for the purpose of the preferred beneficiary election. This amendment also prevents the "sprinkling" of gains arising under subsection 104(4), (5) or (5.2) to trust beneficiaries.

Paragraph 108(l)(a) is further amended to exclude from "accumulating income" amounts that are paid to a trust from a net income stabilization account (as defined in subsection 248(1)) unless paid to a spouse trust described in paragraph 70(6.1)(b) and before the death of the beneficiary spouse.

1988 FINANCE TECHNICAL NOTES: The definition of "accumulating income" is relevant for the purposes of the preferred beneficiary election provided in subsection 104(14). The amendment adds a reference to subsection 104(5.2), which is strictly consequential on the addition in 1985 of that subsection.

Nov. 1985 FINANCE TECHNICAL NOTES: Paragraph 108(l)(a) defines the "accumulating income" of a trust as its income before certain deductions but after certain exclusions, including an exclusion of any taxable capital gains or other income of a spousal trust resulting from a deemed disposition of property under subsection 104(4), (5), (5.1) or 107(4). This paragraph is amended to remove the reference to subsection 104(5.1) which has been removed as a consequence of the repeal of the provisions relating to indexed security investment plans.

1983 FINANCE TECHNICAL NOTES: Paragraph 108(l)(a) defines the term "accumulating income" of a trust as its income before making any deduction as a result of a preferred beneficiary election and after excluding any taxable capital gains or other income of a spousal trust which arose from a deemed disposition of property under subsection 104(4), (5) or 107(4). This paragraph is amended by adding the reference to subsection 104(8) to provide for an ordering in the application of subsections 104(6), (8) and (12).

1982 FINANCE TECHNICAL NOTES Paragraph 108(l)(a) defines the term "accumulating income" of a trust as its income before making any deduction as a result of a preferred beneficiary election. A preferred beneficiary election enables income of a trust which is not payable to a beneficiary to nonetheless be included in a preferred beneficiary's income and deducted by the trust. This amendment will exclude from accumulating income any taxable capital gains or other income of a spousal trust which arose from a deemed disposition of property under subsection 104(4) or (5) or under subsection 107(4) as a result of the distribution of trust property to a person other than the spouse. This amendment ensures that after November 12, 1981 such income is taxed in the trust and is not eligible for the preferred beneficiary election.

(b) is filed in prescribed manner with the Minister when the election or revocation referred to in paragraph 104(14.01)(a) is filed.

“Late, amended or revoked election – Sec. 104(14.02)”

(14.02) Where a trust and a preferred beneficiary under the trust have made an election or amended or revoked an election in accordance with subsection 104(14.01),

(a) the election or the amended election, as the case may be, is deemed to have been made on time for the purpose of subsection 104(14); and

(b) the election that was revoked is deemed, otherwise than for the purposes of this subsection and subsection 104(14.01), never to have been made.

Subsequent Adjusted Cost Base Reductions.

Although Sec. 104(14) explicitly states that the amount of income elected upon that is subsequently distributed in a later tax year will "not be included in computing the income of any beneficiary" it makes no comment about the possible effect such a distribution may have upon the ACB of certain capital interests as described in Sec. 53(2)(h)(i.1). Under the Sec. 53(2)(h) provision any amount that has become payable after 1987 by the trust, will reduce the ACB of the capital interest, except to the extent that it was proceeds of disposition of any part of the capital interest in the trust, or was included previously in **that particular recipient's** income under Sec. 104(13) **only**, or upon which withholding tax was applied under Sec. 212(1)(c). This applies **only** to capital interests that were not interests in personal trusts which were acquired for no consideration payable nor interests in commercial trusts described in Sec. 108(1)(j)(ii) to (v).

Apparently with tax reform the Department forgot to make an exempting reference to an amount of distribution that was previously recognized in income of the beneficiary under the P.B.E. hence presently as per a strict reading of the relevant provisions it is very obvious that the amount subsequently distributed will not be included in computing income but instead may lead to an adjustment in the ACB of a capital interest. This may occur, under a non-personal trust or where the interest in the personal trust of the recipient was acquired for consideration payable, where a beneficiary recognizes a P.B.E. inclusion and the amount, capitalized, subsequently is distributed to another **or the same beneficiary**. A resulting capital gain, possibly due to a deemed disposition under Sec. 40(3) when the ACB of a capital becomes negative will be income from **the disposition of** a property which is a capital interest in the trust, which is not equivalent to the income realized from a property which is a trust interest as described under Sec. 108(5). Clearly then subsequent distributions of amounts that were previously recognized under Sec. 104(14) may indeed give rise to indirect income inclusions. Maybe someone should amend Sec. 53(2)(h) to correct this oversight.

In the case of personal trusts the interests in which were not purchased for consideration payable it appears possible to systematically have certain beneficiaries recognize P.B. inclusions while having the substance of the election distributed to another taxpayer subsequently tax free. When the income amount is distributed to a taxpayer who didn't elect for a Sec. 104(14) inclusion in respect of it it could lead to a **hypothetical** ACB adjustment of his interest under Sec. 53(2)(h)(i.1) since subpara. (A) would not apply to it. This automatically excludes it from full income inclusion under Sec. 105(1) by virtue of para. (b) therein.¹²⁰³

The OLD Preferred Beneficiary Election

The following are some notes on the Old Preferred Beneficiary Election that may be relevant in certain instances. I researched them in '87-93 and they still can bbe adapted to the present regime.

1203. There are limitations on this however given the "preferred beneficiary's share" that will be discussed.

Subject: Preferred Beneficiary Election.

IT-394R Date: July 14, 1989

Application

This bulletin cancels and replaces Interpretation Bulletin IT-394 dated September 26, 1977 and Special Release dated May 25, 1984. Current revisions are designated by vertical lines.

Summary

This bulletin deals with an election that may be made by a trust and a preferred beneficiary to have a portion of the trust's income taxable in the hands of the preferred beneficiary rather than in the trust. The bulletin defines a preferred beneficiary and outlines what portion of the trust's income may be subject to the election by each of the preferred beneficiaries and the trust.

Discussion and Interpretation

1. Subsection 104(14) provides that a trust and a preferred beneficiary thereof may elect jointly to have part or all of the preferred beneficiary's share in the trust's accumulating income for a taxation year included in computing the income of the preferred beneficiary for the year of election and excluded from the income of any beneficiary of the trust (not necessarily the beneficiary making the election) for a subsequent year in which it is paid.

2. The amount of a preferred beneficiary's share in the accumulating income of a trust for a taxation year that is designated in an election pursuant to subsection 104(14) may be deducted in computing the income of the trust for the taxation year by virtue of subsection 104(12).

Election

3. To be valid, the election under subsection 104(14) must be filed within 90 days from the end of the trust's taxation year and consist of the documents referred to in paragraph 2800(1)(a) and (b) of the Regulations. Where a preferred beneficiary does not have the capacity to sign the statement required under paragraph 2800(1)(a) of the Regulations (e.g., an infant, a mentally incompetent person, or a person who died after the end of the year but before making the election), the heirs, executors, administrators, or other legal representative may do so on behalf of the preferred beneficiary.

4. It is not necessary that all of the preferred beneficiaries of a trust elect, nor is there any need for a preferred beneficiary to be consistent in electing or not electing from one year to the next. **Neither is it necessary that the income elected upon be payable ultimately to the preferred beneficiary who elected nor that it be paid to any preferred beneficiary.** Furthermore, it is not necessary that such income ultimate be payable to a beneficiary who has an income interest in the trust.

Restricted Meaning of Trust

5. The exclusions contained in paragraph 108(1)(j) preclude certain trusts, such as unit trusts and trusts for deferred and other special income arrangements and preferred beneficiaries thereof, from making preferred beneficiary elections in respect of any portion of the accumulating income of such a trust.

Preferred beneficiary

6. A preferred beneficiary of a trust is an individual resident in Canada who is a beneficiary under the trust and is one of the following persons:

- (a) the settlor of the trust,
- (b) the spouse or former spouse of the settlor of the trust,
- (c) a child, grandchild, or great grandchild of the settlor of the trust, or
- (d) the spouse (but not the former spouse) of a child, grandchild, or great grandchild of the settlor of the trust.

7. A "beneficiary under the trust" includes a person who has a capital or an income interest in the trust, whether this interest is immediate or future, absolute or contingent.

8. A "child of the settlor" includes:

- (a) a person of whom the settlor is the natural parent whether the child was born within or outside marriage,
- (b) a person wholly dependent upon the settlor for support and who is presently, or was immediately before attaining the age of 21 years, under the custody and control of the settlor (for 1988 and subsequent taxation years, before attaining the age of 19 years),
- (c) a child of the settlor's spouse,
- (d) an adopted child, and

(e) the spouse of a person described in (a) to (d) above.

9. While a trust is deemed to be, in respect of trust property, an individual for purposes of the Act, a trust cannot be a preferred beneficiary under the meaning given in paragraph 108(1)(g).

10. IT-374 deals with the restricted meaning given to the term "settlor" in paragraph 108(1)(h) of the Act. Under this definition, an *inter vivos* trust may

(a) have no settlor,

(b) have a settlor for certain periods of time only, or

(c) have a settlor throughout its duration.

While a trust has no settlor, there can be no preferred beneficiary and hence no preferred beneficiary election. A testamentary trust, however, does have a settlor throughout its duration.

Accumulating Income

11. Accumulating income of a trust for a taxation year means the net income of the trust for tax purposes after the deduction of all amounts allowable in computing its income including deductions under subsection 104(6) but without regard to amounts designated under preferred beneficiary elections. Accordingly, taxable capital gains are included and allowable capital losses are deducted to the extent of such taxable capital gains. In case of a spouse trust described in paragraph 104(4)(a), the income (taxable capital gains less allowable capital losses, and other income) arising as a result of the deemed disposition of property under subsections 104(4), 104(5), 104(5.2) and 107(4) is excluded from accumulating income. (The income from a deemed disposition of property under subsection 104(5.2) is excluded from accumulating income only for taxation years commencing after 1987.) Since income held by a trust for a minor beneficiary is deemed to be "payable" under subsection 104(18) if the beneficiary's right to it has vested and if it is being held for the sole reason that the beneficiary is an infant or minor, it is deductible by the trust under subsection 104(6) and thus reduces its accumulating income.

12. A preferred beneficiary's share in the accumulating income of a trust is nil unless it is determined that the beneficiary has such a share in accordance with the rules in 13 to 21 below.

13. The shares of a preferred beneficiary who is the spouse referred to in an exclusive spouse trust (as described in paragraph 104(4)(a)) and is alive at the end of the trust's taxation year is all of the accumulating income of the trust for the year. In this situation, no other preferred beneficiary may designate any share of the trust's accumulating income.

14. The method of establishing the share of a preferred beneficiary in the accumulating income of a trust, other than a spouse trust described in 13 above, depends upon whether the exercise of any discretionary power (or the failure to exercise such power) determines the shares in which the accumulating income of the trust would be payable to the beneficiaries. A discretionary power to encroach on capital may result in a preferred beneficiary with only a capital interest in a trust also having, for income tax purposes, an interest in accumulating income. For example, there could be such an interest in a taxation year where the trust realizes a taxable capital gains that is capital for purposes of the trust and the right to the capital of the trust has vested in the preferred beneficiary as of the end of the particular taxation year of the trust or there exists a power of encroachment on the capital of the trust in favour of the preferred beneficiary. Discretionary power relating only to the timing of payment of a beneficiary's share that is fixed under the trust arrangement is not relevant.

No Discretionary Power to Determine Shares

15. The share of a preferred beneficiary who is a member of a class of beneficiaries each of whom shares equally in any source of income of a trust is computed as follows:

(a) determine the portion of the accumulating income of the trust for the taxation year that may reasonably be regarded as having been earned for the beneficiaries of that class, and

(b) divide the portion determined in (a) by the number of beneficiaries (other than registered charities) of the class in existence at the end of the year.

16. The share of a preferred beneficiary who is not a member of a class of beneficiaries described in 15 above is the portion of the trust's accumulating income for the taxation year that may reasonably be regarded as having been earned for the preferred beneficiary's benefit.

17. When the shares of the accumulating income of one or more beneficiaries of a trust do not depend upon the exercise of, or the failure to exercise, a discretionary power, the Department considers that the rules in 15

and 16 above apply to such of those beneficiaries as are preferred beneficiaries, even though the shares of other beneficiaries in the accumulating income of the trust are subject to discretionary determination.

Discretionary Power to Determine Shares

18. Subsection 2800(3) of the Regulations prescribes the manner of computing the share of a preferred beneficiary in the accumulating income of a trust under which all beneficiaries whose shares are discretionary are:

- (a) preferred beneficiaries,
- (b) non-residents who would otherwise qualify as preferred beneficiaries, or
- (c) registered charities.

Thus, this regulation will apply to the discretionary preferred beneficiaries of a trust which satisfies the above conditions, even though other beneficiaries of the trust, whose shares in the accumulating income are **not** discretionary, are **not** preferred beneficiaries.

19. To have a discretionary share of a trust's accumulating income, the preferred beneficiary must be "entitled to share in the accumulating income of the trust". The meaning of this phrase is restricted by subsection 2800(4) of the Regulations when used in paragraphs 2800(3)(a) to (e) of the Regulations but this restricted meaning does not apply to paragraph 2800(3)(f) of the Regulations. The effect of subsection 2800(4) of the Regulations is that the entitlement of a settlor or the settlor's spouse (or the entitlement of an individual and/or the individual's spouse who have jointly settled a trust) cannot be contingent upon the death of an individual who would otherwise be so entitled. Conversely, the entitlement of any other preferred beneficiary may be contingent upon the death of another individual otherwise entitled to share. For example, an *inter vivos* trust settled by an individual and the individual's spouse may give the trustee the discretionary authority to make payments out of the trust's accumulating income to the individual while alive and contingently to the spouse for any subsequent period that the spouse survives. In this case, the spouse is a preferred beneficiary but is not "entitled to share in the accumulating income of the trust" within its restricted meaning. As a result, the rules described in paragraph 2800(3)(a) of the Regulations (rather than those of paragraph 2800(3)(a)) apply while both are alive and paragraph 2800(3)(f) of the Regulations (rather than paragraph 2800(3)(c)) applies for any period during which the spouse survives.

20. Under paragraph 2800(3)(a) to (e) of the Regulations only a settlor or the settlor's spouse may have a discretionary share of the accumulating income of a trust and these rules must be applied in the situations described. All other situations are governed by paragraph 2800(3)(f) of the Regulations and consist of the following:

- (a) *inter vivos* trusts settled by individuals where
 - (i) neither the settlor nor the settlor's spouse is entitled to share,
 - (ii) the settlor is entitled to share, the settlor's spouse is not so entitled and the settlor is not alive at the end of the trust's taxation year, or
 - (iii) the settlor's spouse is entitled to share, the settlor is not so entitled, and the spouse is not alive at the end of the trust's taxation year,
- (b) *inter vivos* trusts jointly settled by married couples, where
 - (i) neither the individual nor the individual's spouse is entitled to share,
 - (ii) both the individual and the individual's spouse are entitled to share but neither is alive at the end of the trust's taxation year,
 - (iii) the individual is entitled to share, the individual's spouse is not so entitled, and the individual is not alive at the end of the trust's taxation year, or
 - (iv) the spouse is entitled to share, the individual is not so entitled and the spouse is not alive at the end of the trust's taxation year, and
- (c) testamentary trusts where
 - (i) the settlor's spouse is not entitled to share, or
 - (ii) the settlor's spouse is entitled to share (including an exclusive spouse trust) and the spouse is not alive at the end of the trust's taxation year.

21. As described in 14 above, a preferred beneficiary with a capital interest in a trust may also have an income interest. However, a preferred beneficiary whose right to the capital of such a trust is contingent on the death

of another capital beneficiary will have a nil share in the accumulating income of the trust where the latter beneficiary is alive at the end of the year. Nevertheless, the divisor in paragraph 2800(3)(f) of the Regulations will include such contingent preferred beneficiary.

Attribution (*inter vivos* Trusts Only)

22. If the preferred beneficiary is the spouse of the settlor or a child under 18, application of the attribution rules (sections 74.1 to 74.5) may result in some or all of the designated part of the accumulating income being deemed to be income of the settlor or some other person who transferred or loaned property to the trust. Refer to IT-510 and IT-511, on this subject. Also, in situations where subsection 75(2) applies (see IT-369), accumulating income of the trust is attributed to the settlor or some other person who transferred property to the trust, regardless of any preferred beneficiary election made in respect of such income.

The Preferred Beneficiary.

For purposes of subdivision k "preferred beneficiary" is defined in Sec. 108(1)(g) to be an individual resident in Canada who is a beneficiary under the trust and is; the settlor of the trust, the spouse or former spouse of the settlor of the trust, or, a child, grandchild or great grandchild of the settlor of the trust, or the spouse of any such person. Most important is that the P.B. be an individual and resident in Canada although the provision does not state at what time this residency must be satisfied. In I.T. 374 the Department is of the opinion that trust income will be recognizable on the last day of the trust's tax year hence it could be arguable that this is the time at which the beneficiary must be resident in order to qualify for preferred beneficiary treatment since it is at this time that the recognition of the assigned economic benefit occurs.¹²⁰⁴ One could be equally justified to argue that the time at which the beneficiary must be resident must be the time at which the accumulating income is actually being realized by the trust since the Sec. 104(14) provision recognizes only the "preferred beneficiary's share" of accumulating income and not the "share of the beneficiary whom later turned out to be a preferred beneficiary". Thus the beneficiary may have to have the "preferred" status at the time the accumulating income is being realized by the trust. If the settlor is a beneficiary under the trust Sec. 75(2) **may** apply to attribute income to him in respect of its income producing property and cause double taxation.

Since the entire P.B.E. operates in respect of income that isn't legally payable to any beneficiary it would seem implicit in the definition that the beneficiary's interest in respect of that accumulating income only must be other than an interest that would allow for an entitlement to enforce a distribution. With this in mind the beneficiary may be either contingent, discretionary, or futurally entitled but not immediately however his interest must allow him to stand as a beneficiary under the trust. Where the beneficiary's right to enforce a distribution is contingent upon the occurrence of an event as spelled out in the trust deed he is still capable of being a preferred beneficiary although his "share" may be affected by the rules in Sec. 104(15). If the beneficiary has only a discretionary interest which allows him to be considered as **potentially** entitled to the income subject to the exercise of a discretionary power then he is none-the-less a beneficiary in that the Sec. 108(1)(g) reference to "beneficiary" encompasses a taxpayer who holds one more type of interest than that described in Sec. 108(1)(e) which does not refer to discretionary "rights". Where the beneficiary has an absolute right to the accumulating income that is enforceable only in the future then he qualifies fully. In the author's opinion the preferred beneficiary can be either an income or capital beneficiary, income in the sense that he has the right to the income that accumulates and capital in the sense that he has a right to the capital that is generated by the accumulating income.

The preferred beneficiary must firstly be a beneficiary of the trust and secondly must be of one of the characters described previously. A settlor as defined in Sec. 108(1)(h) may be a P.B. while a spouse or former spouse of the settlor whom is a beneficiary may also be a P.B.. If the settlor of the trust has reserved himself a reversionary right to income producing property that becomes operative after the initial stated beneficiaries are unable to receive the benefits of the trust the income from the property to which the reversionary right relates will, as per Sec. 75(2), be attributed to him, while still being recognized by the trust thus causing double

¹²⁰⁴. This should be compared however to the case law applicable to deeds of certain construction that recognize the beneficiary to have a right to income the moment it is realized by the trust subject to the charge of expenses etc.

recognition.

Under Sec. 252(3) the definition of "spouse" or "former spouse" for the purposes of certain paragraphs **none** of them being the "preferred beneficiary" definition in Sec. 108(1)(g) includes a party to a voidable or void marriage hence in the absence of a specific statutory restriction, where meticulous statutory restrictiveness is the norm, a spouse under common law would, in the author's opinion, qualify. If the Department wanted the Sec. 252(3) meaning of "spouse" and "former spouse" to applied to the Sec. 108(1)(g) definition then another reference could have been made.

A "child", grandchild, a great grandchild of the settlor who is a beneficiary of the trust, as well as spouses but not former spouses thereof, will qualify while for purposes of sections 40, 44, 73 and 146, but not for 108(1)(g), a "child" defined under Sec. 70(10)(a) includes a child of the taxpayer's child, a child of his child's child etc. or a person who, at any time before he attained the age of 19 years of age was **wholly** dependent on the taxpayer for support and of whom the taxpayer had, at that time, in law or in fact, the custody and control. The Act gives extended meanings to "child" in four different areas, Sec. 70(10), 75.1(2), A.R. 20(1.11), and A.R. 26(20) and in all four of those provisions there isn't a single reference to the Sec. 108(1)(g) definition of "preferred beneficiary" hence it is quite arguable, due simply to the lack of statutory referencing, that an illegitimate offspring of the settlor's spouse who isn't nor hasn't ever been under the custody or control of the settlor may be a "child" of the settlor for purposes of Sec. 108(1)(g). By virtue of the fact that the statutory definitions that do exist do not distinguish between legitimate and biological children there would seem to exist, opposite to above, the ability of an offspring of the settlor, that isn't legally his child, (nor over whom he has never had custody or control), to be a preferred beneficiary. Biological children 'out' of wedlock would certainly thus be considerable as a "child of the settlor" for purposes of Sec. 108(1)(g). The lack of statutory clarity and resulting broadness multiplies as the "child chain" is extended downwards to his "great grandchild" as described under Sec. 108(1)(g)(iii). Unfortunately, provided the rules of remoteness and perpetuity are not previously violated, the chain stops at the third generation and the respective preferred beneficiary **cannot** set up a sub-settlement to extend it further in that once his interest is transferred to an *inter vivos* or testamentary trust the recipient trust **cannot** be a preferred beneficiary thus the initiating P.B.E. in the second chain can not be made. **Actual** income distributions can be arranged however. It is not essential that the beneficiary of the previous generation retain an interest in the trust in order for the child thereof to be considered a preferred beneficiary thus provided the rules in respect of perpetuities are not violated accumulating income can be elected upon over a substantial period of time as one particular interest is passed down from settlor to spouse to settlor's child to spouse of the settlor's child and all the way down to the spouse of the settlor's great grandchild.

Sec. 108(1)(g)

(g) "Preferred beneficiary". - "preferred beneficiary" under any trust means an individual resident in Canada who is a beneficiary under the trust and is

- (i) the settlor of the trust,
- (ii) the spouse or former spouse of the settlor of the trust, or
- (iii) a child, grandchild or great grandchild of settlor of the trust, or the spouse of any such person;

The "Settlor".

The key person in respect of the definition of the preferred beneficiary isn't the preferred beneficiary himself but instead is the "settlor" of the trust for if a "settlor", having a specific statutory meaning, doesn't exist then a preferred beneficiary can't exist. The "settlor" of a trust is given specific statutory definition other than its trust law definition under Sec. 108(1)(h) and it is defined in relation to either a testamentary or an *inter vivos* trust.

Sec. 108(1)(h)

(h) "Settlor". - "settlor",

- (i) in relation to a testamentary trust, means the individual referred to in paragraph (i), and
 - (ii) in relation to an *inter vivos* trust,
- (A) if the trust was created by the transfer, assignment or other disposition of property thereto (in this

paragraph referred to as property "contributed") by not more than one individual and the fair market value of such of the property of the trust as was contributed by him at the time of the creation of the trust or at any subsequent time exceeds the fair market value of such of the property of the trust as was contributed by any other person or persons at any subsequent time (such fair market values being determined at the time of the making of any such contribution), means that individual, and

(B) if the trust was created by the contribution of property thereto jointly by an individual and his spouse and by no other person and the fair market value of such of the property of the trust as was contributed by them at the time of the creation of the trust or at any subsequent time exceeds the fair market value of such of the property of the trust as was contributed by any other person or persons at any subsequent time (such fair market values being determined at the time of the making of any such contribution), means that individual and his spouse;

Of Testamentary Trusts.

In the case of a "testamentary trust", as defined in Sec. 108(1)(i), the settlor of the trust is the person described upon whose death and in consequence of the trust arose. This definition also applies to trusts created by an operation of a court order as described in Sec. 70(6.1) however in both cases one must recognize that this definition of settlor is only as good as the standing of the trust as testamentary under the Sec. 108(1)(i) definition. One of the main transactions that will cause an otherwise testamentary trust to lose its testamentary status is where property was contributed to the trust that was created after Nov. 12th, 1981, otherwise than by **an** individual on or after his death and as a consequence thereof. If additional contributions are made within the specified conditions just described the trust will not be tainted but that second contributor will not be classified as a settlor in that it was not upon and in consequence his death that the trust **arose**. There are several ways that a testamentary trust, being both the trust agreement and the estate, can lose its status however the Sec. 108(1)(i) provision provides two ways where this can occur by reason of an event and one which is an automatic exclusion from status, all of which refer to **trusts** (being the legal agreement).¹²⁰⁵

Of Inter Vivos Trusts.

Under Sec. 108(1)(h)(ii) where a trust is an *inter vivos* trust which was **created** by the transfer, assignment, or **other disposition** of property thereto, (referred to as a "contribution"), by not more than one individual and the fair market value of the property contributed by him at the time of the creation or any other subsequent time exceeds the fair market value of the property which was contributed to the trust by any other persons the "settlor" will be that individual while the fair market values of the properties are to be measured at the time of their contribution. Where a taxpayer and her spouse jointly create the trust through the joint contribution of property and the fair market value of all property contributed at the time of creation and subsequently by them, individually or jointly, exceeds the fair market value of the property contributed to the trust by any other persons the individual and her spouse will be the settlers. In both cases, **although the provision does not even suggest it**, the Department considers only those contributions of the **net gratuitous nature** in ascertaining the status of the initial contributor. Where the fair market value of property contributed is taken back in cash/property the by transferor, as per the Department, the contribution will not be considerable. If only part of the fair market value of the property is taken back as cash or other property then the net gratuitous contribution will be considered.

No need for Property to be Retained.

What is extremely instrumental is that the property **need not remain** in the trust after it has been "contributed" but instead the Sec. 108(1)(h)(ii) mechanics operate only on the basis of contributions.¹²⁰⁶ It

¹²⁰⁵. Without going into them in detail it should be recognized that even if the trust loses its testamentary status it will only become an *inter vivos* trust as per the definition under Sec. 108(1)(f), which, due to the referencing of the terms "trust" and "estate" in Sec. 104(1), cause a estate to be an *inter vivos* trust. "*inter vivos* trust" and "testamentary trust" are mutually exclusive and exhaustive definitions.

¹²⁰⁶. This should be compared to the requirement under Sec. 108(1)(i)(iii)(B) where the property **owned** by the trust at a particular time is relevant.

would thus be possible for the settlor to contribute property to the trust, receive it back possibly through a distribution through a second trust and then recontribute it again and thus further secure his settlor status.¹²⁰⁷ Property terminally distributed from the trust would not disqualify the particular contributor from being a settlor until another party makes contributions the aggregate fair market value of which exceeds the original contributions of the settlor. Since only property which has been assigned, transferred, or otherwise **disposed of** to the trust causes disqualification property **loaned** to the trust would seem to avoid it. Lending property to the trust serves as an interesting method of bolstering the substance of the income beneficiary entitlements without jeopardizing the settlor status.¹²⁰⁸ In the same way, since a retention of beneficial ownership on a legal title conveyance to a trust isn't a disposition, pursuant to Sec. 54(c)(v), it's doubted if it would be a "contribution".

Joint Spousal Settlers.

Where the trust is **created** by the joint contribution of property by an individual and his spouse the contributed property need not be jointly owned by them in order that the singular contribution be a "joint" contribution. Apparently after the trust has been constituted they may each make contributions of property which are owned entirely by themselves individually which will secure their **joint** settlor status. The settlor of a trust which was created by a joint contribution of property by an individual and his spouse is the individual **and** his spouse hence where they are divorced and both take on their own spouses they will **not** be two "settlers". If the individual and his spouse divorce there is a danger that the settlor status will be lost, (even though in I.T. 374 the Department's primary "opinion" is otherwise), **since the relationship between the two will not be spousal**. The provision refers to "individual and his spouse" **not** "individual and his spouse or former spouse", and the status rests with them as long as they maintain that relationship.

Losing and Gaining the Settlor Status.

In order to be the settlor the individual must have both created the trust and made contributions the aggregate fair market value of which at the time of their respective contribution, exceeds those made by any and **all** other parties **combined**, measured on the same basis hence the settlor may lose his tax status upon the subsequent contributions of property by another person(s) but once lost it is not obtained by that other contributor in that he did not create the trust. The loss of the status may not be permanent in that a subsequent contribution by the creator will increase the aggregate fair market value of all contributions made by him and possibly restore the status.¹²⁰⁹ The definition of settlor in respect of an *inter vivos* trust imports a requirement of subjecting the ownership of the property to the fiduciary obligation: property must be transferred thereto the trust - it cannot merely be transferred for its benefit. A trust interest newly created on the constitution of another trust can be "contributed" to the trust, and this serves as an interesting method of "creating FMV" - which can be annihilated subsequently with the exercise of a power of appointment instilled from the second trust. Funds expended on the creation of the trust to bring about the drafting of its documents, or any other expenses incurred by outside parties **that did not increase the wealth of the trust in a direct way per se**, should not be considered as contributions to the trust if paid on behalf of the payer/settlor and not paid quo trustee. Constructive contributions, "indirect" in nature, may be considered, but in order to be such they must add to the wealth which is subject to the trust, not merely bring about its imposition on other property.

Residency.

There is apparently no requirement that the trust, the property, or the contributor be resident when the

¹²⁰⁷ Property without any accrued tax liabilities in its cost should be used for such purposes unless the beneficiary subsequent to receipt would be willing to mortgage it to acquire tax neutral funds to contribute. Mortgaging the property in the trust and distributing the proceeds serves as an interesting method of avoiding tax consequences on a distribution.

¹²⁰⁸ If the trust is **created** through the lending of property so that a transfer, assignment or disposition has not taken place, technically, the trust cannot have a settlor even if property is subsequently transferred, assigned or disposed of to it.

¹²⁰⁹ In this latter instance the ability to receive the property back, which was previously contributed, in order to make additional "contributions", is quite instrumental. If after the settlor status is lost due to contributions from another taxpayer that taxpayer can cause himself to be recognized as the settlor where the original trust deed is varied so as to give him a power of appointment over the property and he subsequently exercises it to create a distinctive sub-trust. If the power is general the creator of the sub-trust, through the exercise of the power, will be the power holder.

contribution is made. Where a contribution, of supposedly a gratuitous nature, is to be made to the trust (or estate) by a party other than the settlor the trustee/executor would have to evaluate its impact with respect to the above factors and thereafter may disclaim the acceptance of the contribution. If the property **must** be held by the trust for some legal or legitimate reason then it may prove, from the point of view of the trust, more beneficial to grant an interest in the trust as consideration payable or possibly give as consideration a note receivable so as to reduce the gratuitous receipt. In both instances the fair market value of the property would not interfere with the existing "settlor" status but the contributor would realize a taxable disposition, (most likely under Sec. 69(1)), and in the former case the obtaining of the interest in an *inter vivos* trust would taint its personal status. If a contribution was to be made, for no proceeds receivable, then the contributor would likely recognize a taxable disposition of property under Sec. 54(d)(iii), and if the circumstance proved unfavorable, would have to recognize proceeds of disposition equal to the fair market value of the property as per Sec. 69(1). He would still be considered to have "contributed", gratuitously, the property to the trust for purposes of Sec. 108(1)(h) hence if he took back a note receivable etc. he would not only be obtaining proceeds from the trust that wasn't an interest herein, but would also be allowing the status quo, in respect of the settlor's status, to be maintained.¹²¹⁰

Subject: Meaning of "Settlor".

IT-374 Date: May 16, 1977

1. Paragraph 108(1)(h) provides the meaning of the word "settlor" as used in the definition of "preferred beneficiary" in paragraph 108(1)(g). "Settlor", for purposes of the subdivision of the Act dealing with trusts and their beneficiaries, is given a much more restrictive meaning than is found under trust law.
2. The settlor of a testamentary trust is the individual upon whose death and as a consequence of which the estate or trust is created.
3. An *inter vivos* trust has a settlor only if it is created by one individual (a "sole settlor") or one individual and his spouse at that time (a "joint settlor"). Thus, an *inter vivos* trust created by more than one individual (other than a married couple) or by a corporation does not have a settlor for the purposes of paragraph 108(1)(g).
4. To qualify as a joint settlor of an *inter vivos* trust, the initial contribution must be made "jointly" by the individual and his spouse. However, it is not necessary that the spouses' contributions be of equal value, nor is it necessary that the contributions consist of property owned jointly by the couple. **The simultaneous contribution of separately owned properties to create the trust is considered sufficient to satisfy this condition.**
5. For the purposes of paragraph 108(1)(h), a contribution of property is any transfer, assignment or other disposition of property to a trust whereby title vests in the trustee without any value being given to the contributor. Thus, a loan to a trust, or a purchase for full value by a trust does not constitute a contribution. When a trust acquires property for less than its fair market value, the transferor is considered to have made a contribution equal to the excess of the fair market value of the property over the fair market value of the consideration given by the trust.
6. An individual (or a married couple) becomes disqualified as settlor of a trust at any time when the aggregate of the fair market value of contributions made to the trust by others (**that are necessarily subsequent to the initial contribution**) exceeds the aggregate of the fair market value of all contributions made by the individual (or the married couple). In making this comparison of values, the fair market value of each contribution at the time it was made is used. As long as the value of contributions by others continues to exceed the value of the contributions by the individual (or the married couple), the trust has no settlor for the purposes of paragraph 108(1)(g).
7. A disqualified settlor, as described in 6 above, may regain his former status by making further contributions to the trust sufficient to rectify the imbalance in contributions that caused the disqualification.
8. In applying the disqualification provisions described in 6 above to the sole settlor of an *inter vivos* trust, the

¹²¹⁰. If the note is forgiven as a bequest there are no tax consequences to the trust pursuant to Sec. 80(1)(h) while the note could be forgiven "bits by bits" allowing the trust to absorb the tax consequences smoothly with also an eye to the proportionality of the contributors. Unfortunately appreciations in contributions while owned by the trust are not considered which is very inequitable.

value of contributions made by his spouse is properly included in the value of contributions by "others". When this inclusion would cause the disqualification of the sole settlor, the Department will consider the trust as having a joint settlor at that time, if the couple were married when the trust was created and notwithstanding the comments in 4 above.

Accumulating Income.

The amount that can be elected upon under Sec. 104(14) jointly by the trust and the preferred beneficiary, which is equal to the maximum amount of deduction the trust may take under Sec. 104(12) in the year, is equal to the "accumulating income" of the trust for that particular tax year, that does not exceed the particular "preferred beneficiary's share" therein.

"Accumulating income" of the trust for a tax year, as defined in Sec. 108(1)(a), means the amount of net Division B income that it had before any Sec. 104(12) P.B.E. deduction only, but where the trust was or is a spousal trust or a pre-1972 spousal trust described under Sec. 104(4)(a) or (a.1), (or **any** trust which has made a Sec. 104(5.3) disposition deferral election in a previous tax year), that tax income generated by the deemed dispositions under Sec. 104(4), (5), (5.2), and 107(4), (both capital gains and losses and recapture), will not be considered accumulating income.¹²¹¹ As such it represents the Division B income as operationally defined in section 3 after all possible other deductions were taken under the relevant subdivisions including subdivision K, except that it is not affected by the income, **or loss** recognitions caused by the deemed dispositions under the provisions previously listed.¹²¹²

It is not now enough to say that accumulating income is the trust tax income that isn't payable to a beneficiary for the income might have actually been payable but the trust might not have taken its appropriate deduction under Sec. 104(6). Where the trust has elected for the Sec. 104(13.1) or (13.2) provisions to apply, thereby reducing the amount of income payable that the beneficiary will recognize and thus its corresponding Sec. 104(6) deduction, its accumulating income will increase and thus strictly **from a tax point of view** more accumulating income may be subject to a P.B.E.. In some instances due to the wording of the provisions this "extra" accumulating income will not affect the amount that particular beneficiaries may wish or be able to recognize while in the case of discretionary entitlements as they will be described in Regulation 2800, the particular beneficiary's entitlement is not drawn into question, only the actual amount of the accumulating income.¹²¹³

The accumulating income of the trust is computed prior to any Division C deductions hence where all of the income is either payable in the year and/or is elected upon under a P.B.E., (in both cases allowing the trust to take the appropriate deductions), there will not be any net Division B income against which Division C deductions may be claimed. It would seem secondary to state that P.B.E. should rarely be elected upon "accumulating income" which will be negated by a Division C deduction but beneficiary entitlement to the benefits of those losses must be evaluated.

Accumulating income is income of the trust prior to certain Division B deductions and inclusions however it could be argued that it doesn't exist only in respect of trusts which were resident throughout their tax years but also applies to that recognized during part of the year in which the trust was resident. Section 114 may apply in those instances where the trust wasn't resident throughout the tax year, to allow Sec. 104(12) deductions in

¹²¹¹ As per *McLeod v. M.N.R.*, 1 D.T.C. 227:

"The word accumulating is here used gerundially, that it as a verbal noun rather than as a verb; it is used just to earmark it as the fund for unascertained persons or persons with contingent interest and which is taxable in the hands of the trustee. The expression 'income accumulating' is used only as a means of describing that part of the income from the total and upon which the trustee is liable to be taxed."

¹²¹² This latter aspect causes all taxable gains etc. to be taxed in the hands of the trust however produces warped results where instead substantial losses are realized through the application of those provisions. Losses recognized due to Sec. 104(4), (5), (5.2), or 107(4) will reduce the Division B income of the trust upon which it computes its taxable income and Part I tax payable, possibly to nil in a particular year, however for purposes of the P.B.E. the trust will still have "accumulating income". If a P.B.E. is made under Sec. 104(14) and the trust obtains the resulting deduction under Sec. 104(12), then automatically it will have sustained or increased its loss, (non-capital loss), but the preferred beneficiary will recognize the income.

¹²¹³ Through the Sec. 104(13.1)-(13.2) elections unused tax credits/losses of other preferred beneficiaries can be accessed through the P.B.E. being made after the trust has to recognize the subject income.

respect of accumulating income recognized when it was resident. If the trust was non-resident throughout its tax year then it cannot take any deduction in respect of income payable to Canadian residents or otherwise and its taxable income earned in Canada will be that computed as per section 115 without major effect from paragraphs (d), (e), and (f) thereunder.

Sec. 108(1)(a)

(a) "Accumulating income". - "accumulating income" of a trust for a taxation year means the amount that would, but for subsection 104(12) and, where the trust is a trust described in paragraph 104(4)(a), subsections 104(4), (5), (5.2) and 107(4), be its income for the year.

and The Preferred Beneficiary's Share.

Subsection 104(15) and Regulation 2800 determine the amount of a particular preferred beneficiary's share of accumulating income of the trust that may be elected upon however both are two of the more vaguely worded provisions in the Act and Regs. that have been the topic of considerable debate as to their scope and proper application in the last few years.

Sec. 104(15)

(15) Preferred beneficiary's share. The share of a particular preferred beneficiary under a trust in the accumulating income of the trust for a taxation year is,

- (a) where the trust is a trust described in paragraph (4)(a) and the taxpayer's spouse referred to therein is alive at the end of the year, an amount equal to,
 - (i) if the particular preferred beneficiary is the taxpayer's spouse, the trust's accumulating income for the year, and
 - (ii) in any other case, nil.
- (b) in any case not referred to in paragraph (a), where the shares in which the accumulating income of the trust would be payable to the beneficiaries thereunder do not depend upon the exercise by any person of, or the failure by any person to exercise, any discretionary power.
 - (i) if at the end of the year the particular beneficiary was a member of a class of beneficiaries under the trust each of whom was entitled, as a member of that class, to share equally in any income of the trust, the portion of the trust's accumulating income for the year that may reasonably be regarded as having been earned for the benefit of beneficiaries of that class, divided by the number of beneficiaries (other than registered charities) of that class in existence at the end of the year, and
 - (ii) in any other case, the portion of the trust's accumulating income for the year that may reasonably be regarded as having been earned for the benefit of the particular preferred beneficiary;
- (c) in any case not referred to in paragraph (a) or (b), where each beneficiary under the trust whose share of the accumulating income of the trust depends upon the exercise by any person of, or the failure by any person to exercise, any discretionary power, is a preferred beneficiary, or would be a preferred beneficiary if he were resident in Canada, or is a registered charity, the portion of the trust's accumulating income for the year equal to the amount determined in prescribed manner to be his discretionary share of the trust's accumulating income for the year; and
- (d) in any case not referred to in paragraph (a), (b) or (c), nil.

Spousal Trusts.

Under subparagraph 104(15)(a), where the trust is in the tax year a trust which is described under Sec. 104(4)(a) as having the characteristics of a "spousal trust" at some time or a pre-1972 spousal trust at the end of the trust's tax year, then the only preferred beneficiary's share will be that of the spouse thereunder **if alive at the trust year end**, whose share shall be equal to **all** of the accumulating income for the year. Any other preferred beneficiaries' shares will be nil. The trusts described under Sec. 104(4)(a) are primarily spousal trusts created as such and *inter vivos* trusts which were **at any time** after 1971 spousal trusts, regardless of their present character, hence it may be possible for numerous levels of preferred beneficiaries to exist under a trust, shares of which will be nil simply due to the fact that at sometime previous the trust had the characteristics

described under Sec. 104(4)(a). This will only occur if the spouse described in respect of the former or present spousal trust is alive however as per the wording of para. (a) there is no need for the spouse to actually be a beneficiary under the trust in order for para. (a) to apply thus if she is alive, and isn't a preferred beneficiary being firstly a capital or income beneficiary, but not resident, or not a beneficiary, then technically an election cannot be made in respect of any other preferred beneficiary that may exist at that time. This is not the case with the new Sec. 108(1)(f.1) pre-1972 spousal trust definition which targets those trusts that have the spousal character up to the end of its particular tax year. Understandably the timing of being a trust described under Sec. 104(4)(a) is of paramount importance but it should also be noted that this is worthy of consideration only where the trust is an *inter vivos* trust. If the trust is testamentary and was not a spousal trust as created then it will not be of the character described in Sec. 104(4)(a) but will also not fall under para. (b) for purposes of determining the preferred beneficiary's share. An *inter vivos* trust which was **at any time** a spousal trust will, however, fall under the Sec. 104(4) deemed disposition rules and be the subject of para. (a) however as per the implicit substance of para. (a) if the *inter vivos* trust is at any time spousal before the end of its year then all of the accumulating income will be considered the spouse's share. Applying to all situations causing the exempting of the provision in para. (a) is the circumstance where the spouse was not resident at year end thereby disqualifying her from being a preferred beneficiary. This would result effectively in no one being allowed to benefit from the election.

A spousal trust's income to which the spouse must be entitled is the trust law income as described by virtue of Sec. 108(3) hence the trust, through the recognition of capital gains to which the spouse may not be entitled, may have "accumulating income" in a particular year depending on the trust's accounting methods. This accumulating income which represents a capital gain may be elected upon by the spouse however even if she wasn't, as per the terms of the trust, entitled to receive **capital**, gain or otherwise, from the trust as **capital**, (being that she only as an income interest), the Sec. 104(21) taxable gain designation can be made in respect of that amount, resulting in the capital gain character not being locked in the trust.¹²¹⁴ If she was a capital beneficiary as well then the designation could be made in respect of the elected amount, allowing her to utilize any booked net capital losses or unabsorbed capital gains exemption. In order for the spouse to elect to recognize the accumulating income she need **not ever be entitled to receive it**.¹²¹⁵

If the spouse under the spousal trust isn't alive at year end then either para. (b), (c), or (d) will apply and it is with respect to these provisions that there has been substantial interpretational confusion in the past.

Subject: Preferred Beneficiary's Election

ATR-34

Date: October 28, 1988

Facts

1. Mr. X died on February 15, 1966.
2. Mr. X was survived by Mrs. X who died in 1968.
3. Mrs. X was survived by Mrs. Y, the daughter of Mr. and Mrs. X.
4. Mrs. Y is still alive.
5. Mrs. Y has four living children all over the age of 21.
 - a) . No. 1 son
 - b) . No. 2 son
 - c) No. 3 son
 - d) No. 4 son

¹²¹⁴ The subsection 104(21) designation does not require the designatee be entitled to receive the capital gain or capital: all that is required is that the amount reasonably be considered to have been included in his income, via, amongst others, Sec. 104(14). the spouse can elect upon all of the capital gain even though she may not be interested in the income. This is reinforced by a technical interpretation provided by the Bilingual Services and Resource Industries Division on July 25th, 1990.

¹²¹⁵ The designation is arbitrary and has **absolutely nothing** to do with the spouse's entitlements and their scope which is substantially dissimilar to the balance of the share designation ascertainment mechanics which focus on, generally, for whom the income is accumulated. This allows a trust to gain the spouse's tax rates without ever paying her the income (though reimbursing her for the tax) and distributing the after tax capital to another beneficiary who has not acquired his interest for consideration payable.

6. The trustees of the Trust are Mr. X Jr. (the brother of Mrs. Y) and Trustco.
7. All of the above-noted individuals are resident in Canada with the exception of No. 4 son who is a non-resident.
8. The taxation year of the Trust ends February 15th.
9. Under the terms of Mr. X's Will:
 - (a) . Mrs. X received a life interest in the income from his estate.
 - (b) . Mrs. Y received a life interest in the income from one-half of the residue remaining at the death of Mrs. X.
 - (c) . The trustee have the discretionary power to encroach upon the capital of the Trust in favour of Mrs. Y during her lifetime.
 - (d) . Upon the death of Mrs. Y, her interest in the capital of the Trust will be divided equally amongst her sons (the grandsons of Mr. X) who are then alive and over the age of twenty-one years. If any grandson is under the age of twenty-one upon the death of Mrs. Y, his share will be held in trust until he attains the age of twenty-one when he shall be paid all remaining capital. Until the grandson attains the age of twenty-one, the trustees have absolute discretion as to capital or income distributions for his benefit. Should a grandson die before attaining the age of twenty-one years, his remaining share of capital will be divided equally amongst the grandson then living, to be held in trust for such grandsons until they attain the age of twenty-one years.
 - (e) . The trustees have the discretionary power to encroach upon the capital of the Trust in favour of the sons of Mrs. Y during her lifetime.
 - (f) The Trust owns securities, some of which contain an accrued capital gain the taxable portion of which, if realized, would be an eligible taxable capital gain as described pursuant to paragraph 108(1)(d.2) of the Income Tax Act ("Act").
10. The Will does not define capital gains to be income for trust purposes.

Proposed Transactions

11. The trustees wish to make changes in the investment portfolio of the residue of the Trust in which Mrs. Y received a life interest on the death of Mrs. X. The trustees will sell securities during the taxation year of the Trust ending February 15th, 1988, thereby realizing an eligible taxable capital gain as defined pursuant to paragraph 108(1)(d.2) of the Act.
12. No capital encroachments will be made during the Trust's taxation year ending February 15, 1988.

Rulings Given

Provided that the above descriptions of the facts and proposed transactions are accurate and constitute complete disclosure of all the relevant facts and proposed transactions and provided that the proposed transactions are carried out as set forth herein and provided that Mrs. Y and her No. 1, No. 2 and No. 3 sons will be alive at the end of the Trust's taxation year ending February 15, 1988 and that these children will be the only living children of Mrs. Y at that time who are resident of Canada, we rule as follows:

A. The taxation portion of the capital gain will constitute accumulating income of the Trust for its taxation year ending February 15, 1988 within the definition of that term, pursuant to paragraph 108(1)(a) of the Act.

B. Each preferred beneficiary's share of the accumulating income of the Trust upon which an election may be made pursuant to subsection 104(14) of the Act and paragraph 2800(3)(f) of the Income Tax Regulations will be:

(a) . Mrs. Y	$\frac{1}{4}$
(b) . No. 1 son	$\frac{1}{4}$
(c) . No. 2 son	$\frac{1}{4}$
(d) . No. 3 son	$\frac{1}{4}$

C. Provided that Mrs. Y and her No. 1, No. 2 and No. 3 sons each elect, in the prescribed manner and within the prescribed time, on the full amount of their share of accumulating income of the Trust for its taxation year ending February 15, 1988 pursuant to subsection 104(14) of the Act.

(a) all amounts so elected upon may be deducted in computing the income of the Trust for its taxation year ending February 15, 1988 pursuant to subsection 104(12) of the Act, and

(b) . any amount so elected upon will be included in computing income for the 1988 taxation year of each preferred beneficiary.

D. Provided that a designation is made pursuant to subsection 104(21) of the Act, Mrs. Y and her No. 1, No. 2 and No. 3 sons will each be deemed, for the purposes of sections 3 and 111 of the Act (except as applied for the purposes of section 110.6 of the Act), to have received from the disposition of capital property in their 1988 taxation years $\frac{1}{4}$ of the net taxation capital gains realized by the Trust for its taxation year ending February 15, 1988.

E. Provided the designations described in subsection 104(21.2) of the Act are made, each beneficiary shall, for purposes of sections 3, 74.3 and 111 of the Act as they apply for purposes of section 110.6 of the Act, be deemed to have a taxable capital gain for the year from the disposition by him in the year of capital property equal to the amount calculated by the formula in subsection 104(21.2) of the Act.

Editor's Note

Because of the beneficiary power of the trustee to encroach upon the capital of the trust in favour of the beneficiaries, paragraph 104(15)(c) of the Act together with paragraph 2800(3)(f) of the Regulations have application in determining each preferred beneficiaries' share of the accumulating income of the trust referred to in ruling (B) above.

Son No. 4 is not a preferred beneficiary because he is not a resident of Canada and therefore does not figure in the calculation.

This ruling was given in March 1987.

Income Tax rulings are issued for the general information of taxpayers, but are considered to be binding on the Department only in respect of the taxpayer to whom the ruling was given.

Non-Spousal Non-Discretionary Trusts.

"Where the **shares** in which the accumulating income of the trust would be payable to the beneficiaries thereunder do not depend upon the exercise by any person of, or the failure by any person to exercise, **any** discretionary power" paragraph 104(15)(b) applies to determine the particular preferred beneficiary's share of accumulating income. Past accumulating income may in substance have intermingled with the capital of the trust, however this does not diminish the fact that its original character was accumulating income hence a discretionary power which can be used to determine the share of **capital** payable to the beneficiaries **other than** that which arose in the form of accumulating income will not cause the trust to be disqualified from treatment under para. (b), (which is more favorable than those remaining). Accumulating income does however have a relation to the amount of Division B income that the trust recognizes, net of the income which was payable to the beneficiaries, and in this regard a discretionary power which may affect the amount of income payable **may** also inversely affect the amount of accumulating income the trust recognizes. This being said only if the discretionary power affects the **shares in which the accumulating income would be payable** will the trust be treated elsewhere under another paragraph being that if a discretionary power causes an increase or decrease in the gross accumulating income, but not in the manner in which it is **shared**, it will have no effect.¹²¹⁶ If the discretionary power affects only the **timing** of the payment of the share of the accumulating income it will not affect the application of the paragraph, however if the discretionary power affects **any** beneficiary's share of entitlement, be he preferred **or otherwise**, paragraph (b) will not apply.¹²¹⁷

The General Loose Wording.

Subparagraphs (i) and (ii) of Sec. 104(15)(b) apply mutually exclusively to determine a particular beneficiary's share of accumulating income and due to the loose wording of subpara. (i) there has been considerable confusion in the past few years as to its scope and intended application. If at the **end** of the trust's tax year the particular preferred beneficiary is a member of a class of beneficiaries, (who may not all be preferred beneficiaries), each of which was entitled, **as a member of that class, to share equally in any income of the trust** the particular preferred beneficiary's share will be equal to the portion of accumulating

¹²¹⁶ This may be the case where the entitlements to the accumulating income are based on absolute amounts and where the exercise of the discretionary power has reduced the accumulating income to an amount that isn't sufficient to cover those absolute amounts.

¹²¹⁷ One has to question whether Parliament was concerned with those distribution powers that do not involve an exercise of discretion such as powers in trust. Is a discretion in respect of which the draftsmen were sensitive involved here?

income for that year that may be reasonably regarded as having being earned for the benefit **of beneficiaries** of that class, divided by the number of non-registered charity beneficiaries of that class in existence at that year end. If that particular beneficiary is a member of a class the members of which are entitled to share equally in **any** income, though not necessarily all income, then the **entire** amount of accumulating income that can be reasonably considered as earned for the benefit **of beneficiaries** of that class will be shared equally for purposes of the P.B.E.. The non specification of for whose benefit the earning of the accumulating income is for, vis-a-vis the proportionality of the entitlements thereto, would seem to suggest that all that is needed to have the accumulating income qualify in respect of that class is that it be earned for the benefit of a particular beneficiary or group of beneficiaries of the class.¹²¹⁸ As long as they are all entitled to "share equally" in **any** stream of income the gross amount of accumulating income will be divided equally for purposes of the P.B.E., even though they may not be entitled to share equally in the accumulating income that is being recognized. This is true even where they are entitled to share equally in income that becomes payable in the year which doesn't (normally) enter into accumulating income.¹²¹⁹

As a Class.

At the end of the year each of the beneficiaries in the class must be entitled to share, possibly in the future, **as a member of that class** in any income of the trust, in order to be treated as a beneficiary in respect of which the income is accumulating. By the fact that the provision makes **specific reference** to the need for the beneficiary to be entitled, as a member of the class, to the income, accumulating or otherwise, it would seem to follow that if the trust deed doesn't specify a particular party as being, in accompany with other beneficiaries, entitled to a share of a certain stream of income, but instead specifies him as being one of many who has a certain percentage entitlement with other non-related parties then his entitlement, though equal to those held individually by all of the other parties will still not make him entitled, **as a member of that class**.

Not only must the beneficiaries of a class share equally in some source of income but they must also do so independently as a class being that their class status under the terms of the trust must be in existence regardless of whether they share equally in any source of income.

A class is a specific trust law term that indicates a group of persons beneficially interested in the trust/estate under some general description in the will/deed that bear a certain relationship to the testator/settlor.¹²²⁰ In *Re: Munro Estate*¹²²¹ a class was found not to exist in a certain instance and the judge quoting from Halsbury provided:

"Gifts to persons described only by relationship are sometimes construed as class gifts to individuals. A gift may be none the less a gift to a class because some of its members were referred to by name, or because a person who would otherwise fall within the class is excluded by name. On the other hand, a gift to an individual and the children of another individual is not regarded as a class gift, unless there is something in the context to show that the testator intended to form a class; and gifts to several persons designated by name or number or by reference are not class gifts, and are liable to lapse unless a joint tenancy is created, or words are added implying a contingency."¹²²²

A beneficiary can be both a member of a class and "persona designata" or entitled individually to accumulating

¹²¹⁸ Persona designata income is included in the class's income; the provision states 'earned for the benefit of members of that class' not 'earned for the benefit of the class'.

¹²¹⁹ If Donald, Huey, Duey, and Louie are income beneficiaries under a trust and all are entitled to share, as a class, equally in 1,000\$ worth of interest income generated per year, that accumulates, and if Donald is entitled to income from property that accumulates at a rate of a zillion dollars per year on Donald's behalf only, then the Sec. 104(15)(b) provision can be favorably applied. Technically all "ducks" could elect in respect of the accumulating zillion, (providing they were preferred beneficiaries), and the trust or Donald could make payments to "the boys" to cover their tax bill and thus benefit from their lower effective tax rates.

¹²²⁰ See *Re: Stewart*, 1964 47 W.W.R. 500, *Re: Conner Estate*, 1970 72 W.W.R. 388, *Re: Cowan Estate*, 1950 1 W.W.R. 417, *Re: Creighton Estate*, 1950 2 W.W.R. 529, *Re: Brush*, 1943 1 D.L.R. 74, *Re: Driver Estate*, 39 W.W.R. 612, *Nat. Trust Co. Ltd. v. Fleury*, 1965 53 D.L.R. (2d) 750, *Brownsfield v. Earle*, 17 C.L.R. 615, *Harris v. Ashdown*, 1985 3 N.S.W.L.R. 193, *A.N.Z. Banking v. Nat. Mutual Life*, 137 C.L.R. 252, *Re: Shield's Will Trusts*, 1974 2 All E.R. 274, *Re: Griffith*, 1951 1 D.L.R. 551, *Re: Collshaw*, 1953 3 D.L.R. 829, *Re: Telfel*, 1964 1 O.R. 373.

¹²²¹ 1951 2 W.W.R. 295

¹²²² See *Theobald on Wills*, 10th Ed., p.562, and *Halsbury's Laws of England*, 4th ed., Vol. 50, Para. 486-7-8, 90, 92.

income¹²²³ in which case the accumulating income subject to the beneficiary's persona designata entitlement could also be elected upon by members of the class.

Entitled to What Income?

The "income" in which the beneficiaries of the class must be entitled to share equally is of slightly mystical character. Firstly it may not be limited to mean only current income but instead may include income that has not yet been recognized, which will be realized in the future. In this sense the class of beneficiaries may be fully entitled to share in "any income" of the trust, **that has not yet materialized**, and thus accumulating income that has been earned in respect of one of the class, may as per the mechanics of the provision, be spread over in respect of other beneficiaries.

"Income" under Sec. 104(15) refers to the tax definition of income, for purposes of Part I, operationally defined in section 3 thus it includes capital gain/loss elements as well as income from the use of property. With this in mind it is clearly obvious that the entitlement to "accumulating income" need not rest just with income beneficiaries in order to qualify but instead pure capital beneficiaries may avail themselves of the P.B.E. even when they don't realize tax **or** trust law income but only tax and/or trust law capital.

The beneficiary of the class must be **entitled** to share equally at the end of the trust's tax year, however it would indeed be reading too much into the provision to interpret this as meaning that the right to income must be indefeasibly vested in the beneficiary at that time. All that the provision states effectively is that the beneficiary must be entitled to share in any income at the year end and it does not specify when or how this "income" is to qualify or when or how the entitlement is to be enforceable.¹²²⁴ It would appear that the subject income may be recognized in the future without being disqualified from consideration. The nature of the "entitlement" to share in that income may cause disqualification. If the particular beneficiary is only a condition precedent beneficiary, being that until he performs a transaction, (or possibly until an event transpires), he has no right to the accumulating income then he is not entitled **at that time** to share in it. This should not be confused with an "immediate" contingent beneficiary the right of whom is recognized as giving him entitlement in the present subject to a divestment thereof upon the occurrence of a subsequent event. The latter is presently entitled, the former's entitlement arises only in the future and thus he could not qualify under the Sec. 104(15)(b)(i) as part of the class, even though he was, as per the trust terms, a full member of the class.

"Earned for the Benefit of"

The gross amount of the accumulating income that is to be divided by the number of beneficiaries of the class that will result in the amount electable in respect of each beneficiary is "the portion of the trust's accumulating income for the year that may reasonably be regarded as having been earned for the benefit of beneficiaries of that class", and it should be obvious from the latter part of that phrase, (taken from subpara. i), that the income need not have been earned for the equal benefit of all of the beneficiaries of the class. In fact, since the "any income" to which the beneficiaries of the class must share equally is not specified¹²²⁵ it would seem to imply that this is what was intended when the provisions were enacted. Accumulating income being earned for the benefit of beneficiaries in the class may be income that is set aside to satisfy possible contingently arising entitlements in excess of those which have been recognized to exist presently or possibly used to buy property which will be used by particular beneficiaries of that class thus "benefitting" them.¹²²⁶ The fact that the provision states "for the benefit of beneficiaries" rather than "which will be distributed to beneficiaries of..." would seem to imply that Parliament recognized, when enacting the provision, that such income may not be actually distributed to benefit the beneficiaries however it must be recognized that it must be reasonably regarded as having being earned to achieve such a benefit. It would be truly reading too much

¹²²³ See Re: McDonald, 1928 S.A.S.R. 437.

¹²²⁴ Although they must share equally at year end, during part of the year they may have been entitled to unequally share.

¹²²⁵ and due to the fact that Parliament used particularly broad terms without apparent attempts to give them specific restriction

¹²²⁶ This may not be valid in the face of Burns v. M.N.R., 2 D.T.C. 893 (SCC), where "accumulating income for the benefit of" unascertained persons was interpreted to mean accumulation, when completed, passes in its entirety to the persons entitled: and that transmission is the benefit contemplated. Constructive application was not commented upon.

into the paragraph to interpret a requirement that the sole **purpose** of the earning of the accumulating income was to benefit the beneficiaries but instead what is required was that it was **earned** (past tense) for the benefit of those beneficiaries thus once the income has terminally become the subject of a subject beneficiary's entitlement it will qualify. It may be, in the author's opinion, subject to other entitlements which may arise contingently upon the occurrence of current events before it becomes subject to the particular beneficiary's entitlement where it will be considered under subpara. (i).¹²²⁷

In *Dale v. Mitcalfe*¹²²⁸ "income accumulated for the benefit of" beneficiaries under a trust would gain beneficial tax treatment and the U.K. Court of Appeal held with respect to the terms of the provision:

"It seems to me that I must assume that the Legislature have here deliberately used words which are very much wider than they might have used. Instead of saying "accumulated for any person", they have gone out of their way to say "accumulated for the benefit of any person". I think that anybody applying ordinary language to well known social phenomena would say that when a man provides for income to be accumulated in this way he is doing it for the benefit of the daughter."

This case concerned whether income on income accumulated which was itself accumulated until the beneficiary's age of majority could gain beneficial treatment and recovery of tax paid when the beneficiary hadn't an absolute right to it during the accumulation period.¹²²⁹ Lord Hanworth held with respect to Judge Rowlett's opinion above:

"He calls marked attention to the fact that the words used in this section are not "accumulated for any person" but "accumulated for the benefit of any person" contingently on his attaining some specified age or remarrying. It would seem clear that in ordinary parlance it would be said that these accumulations which were being held to the ultimate advantage of the daughters which were accumulations which were being made for the benefit of those daughters. It is true that they would not receive the corpus of the accumulations, they would only receive the income; but they would be benefitted to the extent of the increased income arising from the addition to corpus of those accumulations without any deduction for income tax. In other words, it appears that this fund has been accumulated "for the benefit" of a daughter even if the corpus of the accumulations is not to be handed over to her, but only the income arising from it."¹²³⁰

In *Lynch v. Davies*¹²³¹ the application of income "accumulated for the benefit of" beneficiaries was examined in a very different context though with respect to exactly the same provision. Income was to be accumulated and held under a different trust (protective discretionary) for the benefit of a life tenant if she were to sell her income interest. It was found that the provision applied for the benefit of the taxpayer.

Unfortunately the gross amount of the accumulating income earned for the benefit of beneficiaries in the class is to be divided by the number of beneficiaries in the class at the trust's year end to obtain the amount of accumulating income equal to each beneficiary's share even though in trust law they may not have the right to share equally in a particular stream of accumulating income considered. The beneficiaries can be parties other than registered charities, (which is defined in Sec. 248(1)), hence R.R.S.P.'s, and non-resident parties will qualify but in this regard it must be remembered that the P.B.E. applies only to "preferred beneficiaries"

¹²²⁷ See *Burns Exors. v. M.N.R.*, 50 D.T.C. 748 PC:

"The expression for the benefit of appears to them to be wide enough in its ordinary significance to cover the case where unascertained persons will receive an interest in **the income to be derived from the fund built up from the accumulating income.**"

¹²²⁸ 13 T.C. 41

¹²²⁹ The purpose of the particular section can be said to be equivalent to the P.B.E.: to reduce the rate of taxation on income that can reasonably be expected to be eventually payable to particular beneficiaries with lower tax brackets.

¹²³⁰ In *Burns Exors. and Royal Trust Co. v. M.N.R.*, 1946 2 D.T.C. 893 SCC, it was held:

"Are they income accumulating for the benefit of unascertained persons or of persons with contingent interests within section 11(2)? The plain meaning of that language is, I think, that the accumulation, when completed, passes in its entirety to the persons entitled: and that transmission is the benefit contemplated. **Here in a sense the accumulations are for the benefit of the charities in the future increased income from increased capital. But the word cannot, in my opinion, be extended to that indirect and remote advantage.**"

¹²³¹ 40 T.C. 511 (Ch)

which were resident thus by including the above two parties in a class with other qualifying preferred beneficiaries the amount that will be determined as their "share" will be reduced and the two parties themselves will be unable to take the election. It would be thus somewhat prudent to draft the trust deed in such a manner that excludes from a class of beneficiaries for whom accumulating income is being realized beneficiaries who cannot qualify as preferred beneficiaries and also provide that where an otherwise qualifying preferred beneficiary becomes non-resident he will lose the status of being of that particular class but instead stand alone as to his share of any accumulating income. This would allow the *inter vivos* trust's tax rate to apply to a lesser amount of accumulating income.

The fact that the gross income is divided by the number of beneficiaries of the class in existence at the year end indicates that Parliament did not intend that income accumulating for future members of the class, (that had not yet been born etc), could be elected upon by those non-existence parties, obviously, but where accumulating income is being realized for their benefit, as members of the class, then it may be elected upon by other existing preferred beneficiaries of the class. To determine each existing beneficiary's "share" the gross accumulating income realized for the benefit of beneficiaries in the class is divided by the number of existing beneficiaries but to determine the amount of accumulating income that is earned in respect of the class, one cannot include that which is earned for the benefit of beneficiaries of the class that have not yet come into existence. Where a discretionary power has the ability to include a beneficiary in, or exclude from, a class then it may not affect the shares in which the accumulating income would be **payable**. If through the exercise of a discretionary power a beneficiary's entitlement to accumulating income is futurally contingent upon the occurrence of an event, such as the death of a present member of the class, then the exercise of that discretionary power has not altered the "sharing" proportionality of the class by adding a new member thereto, but has merely arranged for a continuation of that proportionality. If the death does occur, and the new beneficiary becomes entitled it is indeed a question of substance whether at that time the exercise of the discretionary power has caused an alteration in the shares of income payable to the beneficiaries, or whether the death did.

A Multitude of Classes

Any particular beneficiary may be a member of more than one class, the members of which are all entitled to share equally in a particular stream of income ("any income") thus his aggregate share of the accumulating income of the trust would be arrived at by more than one set of calculations. Again due to the vagueness of the phrasing it may be possible for accumulating income "earned for the benefit of beneficiaries" in one class to be also considered as "earned for the benefit of beneficiaries" in another class by the simple fact that the beneficiary for whom it was earned was a member of more than one class. When this occurs substantiating alternate qualifying accumulating income amounts in respect of particular beneficiaries becomes an art rather than a science.

Discretionary Powers over Indirect Application.

As a very final note on subparagraph 104(15)(b) the provision applies only where "the shares in which the accumulating income of the trust **would be payable to the beneficiaries** thereunder do not depend on the exercise by any person...of a discretionary power." The subsection 74.1(1), 74.2, 74.5(9) attribution provisions fully target transfers or loans of property not just "to" but also "**for the benefit of**" specific taxpayers while in respect of subdivision k there is implied notice of the distinctiveness of such conferment however with respect to Sec. 104(15)(b) only **payments to** beneficiaries are targeted, **not payments on their behalf**. If a discretionary power exists that would affect unequally the beneficiaries rights to have the accumulating income **applied** for their benefit through debt extinguishment etc. the application of the paragraph would not be jeopardized. Such applications indirectly for their benefit would attract full income inclusion under Sec. 105(1), (only when the beneficiary was resident when the amount was paid), but such a power could be altered through variation after the elections have been made so as to allow the accumulated income to be received directly by the beneficiaries.

Non-Class Members Entitlements

The importance of being a member of a class which shares equally in some source of income, as a function of the class, is recognizable only when compared to what will result if the entitlement to some portion of the accumulating income is not a function of a class status held by the particular beneficiary. Under subparagraph (ii) where subpara. (i) isn't applicable **"the portion of the trust's accumulating income for the year that may reasonably be regarded as having been earned for the benefit of the particular preferred beneficiary"** will be his amount of accumulating income upon which he may elect but only where the share in which it is payable is not affected by a discretionary power.¹²³² Once again similar to subpara. (i) the exclusive purpose for having been earned need not be restricted solely to benefiting the particular beneficiary but only that the residual amount was earned for the benefit of the particular beneficiary. The distinction is fine but material being that particular income, which turns into accumulating income if not paid/payable to a beneficiary under subdivision K rules, may be used, as per the trust terms, to be set aside to extinguish such things as commercial obligations or satisfy sinking fund requirements for future payment etc. Such pooling of non-payable funds will result in its being recognized as accumulating income, (in that under tax law a deduction wasn't allowed for its segregation since it wasn't payable to a beneficiary), however once the pooling requirements have been satisfied the remaining balance may fall under a particular beneficiary's entitlement. If the pooling requirements are terminated all of the accumulating income may be distributed to beneficiary, in both cases the amounts can be regarded as been earned for the benefit of the particular preferred beneficiary.¹²³³

Where the particular beneficiary isn't entitled as a member of the class to share equally in any income in order to elect upon an amount of accumulating income the particular preferred beneficiary must be able to substantiate that the amount elected upon was earned for his particular ultimate benefit. This is quite different from the subpara. (i) provision whereunder accumulating income earned for the benefit of particular beneficiaries in the class can be elected upon, (via the mechanics of the division etc.), by beneficiaries who will never obtain title to it, provided they are part of the class. Effectively, under subpara.(ii) the particular preferred beneficiary must be recognized as the singular ultimate recipient of the benefit of the accumulating income, however, once again the provisions do not preclude him from being also a member of a class for which a different allocation computation must be made. There would appear to be no requirement that the particular preferred beneficiary remain a preferred beneficiary after the amount has been elected upon.

Unlike the subpara. (i) provision the particular preferred beneficiary need not be "entitled" to the accumulated income but all that is required is that it be regarded as having been earned for his benefit. There are two dimensions to this lack of entitlement to the accumulating income itself being, the particular preferred beneficiary may not ever be able to realize the substance of the income, the cash/capital itself, but instead may benefit from what it was used for by the trust while the particular beneficiary's entitlement, or right to the cash or capital **or** the benefit may not become enforceable until some subsequent time or occurrence of event. As long as it was "earned for the benefit of the particular beneficiary" and within the "grand scheme of things", it can be reasonably expected that he will become entitled to it, (possibly through a death of a third party or upon reaching a certain age), then it should be able to qualify.

The effect of the exercise of a discretionary power on the amount of **current income payable** thus reducing the amount of accumulating income that is recognized in respect of the particular preferred beneficiary is of no result since it does not, in any manner, alter the "share" of the **accumulating income** that was earned in respect of the particular preferred beneficiary. It may affect, considerably, the percentage of the trust's current income that the particular beneficiary will realize **as** accumulating income but such an upstream exercise of power cannot, technically, affect his **share** of the amount that in fact results after the exercise, (if in fact it is payable to him).

¹²³². A discretionary power affecting the timing of its payment will not affect the share.

¹²³³ The provisions do not state that **as per the trust's terms** the income must have been earned for the benefit of **any particular beneficiary**. If a preferred beneficiary has purchased the relevant interest he will satisfy the test by merely holding it in a beneficiary capacity and will not be prevented from qualified merely because the trust deed doesn't refer to him by name. This is also the case where an interest of a class beneficiary is purchased.

Latent and Previous Exercises of Powers.

Discretionary powers can be drafted so as to allow the holder to alter practically every characteristic of a particular trust vis-a-vis its beneficiaries, its income recognition methods, the distribution of benefits and its continuing existence however paragraph (b) applies only where "the shares in which the accumulating income of the trust would be payable to the beneficiaries thereunder do not **[as opposed to did not]** depend upon the exercise by any person of, or the failure by any person to exercise any discretionary power". The definition of "accumulating income" under Sec. 108(1)(a) refers only to current year income while the Act does not provide a provision that relates to, in any degree or form, **accumulated** income. With this statutory environment in mind it could be quite successfully argued that Parliament concerned itself only with the shares in which current year accumulating income would be ultimately payable thus the other criteria under para. (b) must be evaluated at that time as well. If a discretionary power **could have** affected the shares in which **accumulating income** would have been payable, as it was earned in previous years, that discretionary power must be evaluated **in the current year** to ascertain if it is capable of producing the same results. A discretionary power that has **ceased to be operative in a previous period cannot**, ever, affect the shares in which the accumulating income of a **later period** can be paid. It can alter, for a subsequent period, the proportionality in which the accumulating income of that period will be shared but if it loses its ability to do so **before** that period being the shares in which the accumulating income of that period are payable do not depend upon the exercise of a discretionary power but instead **did, at one time in the past**, depend upon such a power the power is irrelevant. Thus the reference to discretionary powers is limited to their effect on the sharing of the **current** year's accumulating income. A trust discretionary power, which must be exercised within a specific period of time, does not have effect upon sharing of accumulating income in the periods following that time period, but instead only creates the proportionality before the period in which the income will be shared. Once the time period ends, the subsequent period's proportionality cannot be altered, and unless some other discretionary power exists, the shares in the current year's accumulating income cannot be altered by the discretionary power. The power has ceased to exist.

If the power is exercisable only in the future in respect of accumulating income, and cannot directly affect the current year's proportionality of entitlements, it may not affect the Sec. 104(15)(b) application in that the Sec. 104(15) provision, in the first two lines, refers to the shares of accumulating income of a particular year, not in respect of all of the years of the life of the trust, though by the way the provision is phrased could the opposite be argued?¹²³⁴

Applicable to both subpara. (i) and (ii) is the fact that there appears to be no time limit within which the particular beneficiary must realize the benefit from the accumulating income. Understandably the rules concerning perpetuities may pose some limitation however the comment appropriate with respect to this lack of specification is that it would appear that the accumulating income may be used to achieve any number of infinitesimal ends **until** the particular beneficiaries are to realize its benefit. The provisions provide that the accumulating income must have been earned for the ultimate benefit of the beneficiaries but it does not prohibit it from benefitting other parties in the interim.

"Discretionary" Trusts.

Paragraph (b) applies only when the shares in which the accumulating income of the trust, in its entirety, which would be payable to all beneficiaries, are not affected by a discretionary power while the applicability of paragraph (c) depends on the exact opposite being that **each preferred beneficiary's** share of the accumulating income under the trust must be dependent upon such a discretionary power. Paragraph (c) provides¹²³⁵ that where each beneficiary under a trust, whose share of the accumulating income depends upon the exercise or failure to exercise a discretionary power, is a preferred beneficiary or would be a preferred

¹²³⁴. A power that may cause difficulty in the P.B.E. mechanics can be disclaimed/renounced if it isn't in the nature of a trust power that must be exercised, while even if it is, the trust may be varied to remove it without, in the author's opinion, upsetting the interest structure and leading to interest dispositions. If it can be removed without the holder's consent he won't recognize a consensual disposition. If the power is contracted to be terminally unexercisable by its holders will it continue to have relevance for purposes of the P.B.E.? It would appear not. See Re: Evered, 1910 2 Ch. 147 (CA).

¹²³⁵. only where para. (a) and (b) do not apply

beneficiary if he were resident in Canada, (or is a registered charity), his portion of the trust's accumulating income equal to his discretionary share will be determined in the prescribed manner set out in Regulation 2800(3). Under Regulation 2800(3) there are six different scenarios described, each resulting in particular preferred beneficiary's shares of accumulating income being ascertained in a different manner.

The scope of the discretionary power and the manner in which it applies to different beneficiaries must be scrutinized. Where a beneficiary's share of the accumulating income of the trust depends upon a discretionary power that beneficiary must be either a preferred beneficiary or a beneficiary who would be a preferred beneficiary if he were resident in Canada, (or is a registered charity), in order for para. (c) to apply. Where one beneficiary's share of accumulating income is dependent upon a discretionary power and the beneficiary is not, nor can be, a preferred beneficiary then the entire paragraph isn't applicable and since it applies only where paragraphs (a) and (b) do not apply, paragraph (d) will apply. Under paragraph (d), where paragraph (a),(b) or (c) do not apply, automatically **any** preferred beneficiary's share of accumulating income is nil and the trust must recognize all of the income.

Various Powers

The application of para. (c) is not only narrow in the above sense but it is far more narrowly applied when one recognizes that each share of accumulating income which is affected by a discretionary power must be done so with **one particular** discretionary power and not various discretionary powers held by various parties which may be exercisable within different restraints. This point manifests itself by virtue of the fact that the effect thereof must depend "upon the exercise by any **person** (singular), of, or the failure by any person to exercise, **any** discretionary power (singular)". It does not depend "upon the exercise by any person or persons of, or the failure by any person or persons to exercise, any discretionary **powers**" (all plural).¹²³⁶

Various Ways Powers can Have Effect

The exercise of a discretionary power in respect of current income payable may indirectly affect the subject shares of the accumulating income where such shares are measured in absolute dollar amounts and not on a percentage basis. Where the exercise of a discretionary power lowers the amount of gross accumulating income which can be computed as per Sec. 108(1)(a), then if each beneficiary's share thereof is based on a percentage of the amount recognized their **share** will not be affected although the amount in respect of that share will be. Where the beneficiaries' shares are structured on an absolute dollar basis being that one beneficiary's share will be all or a certain percent of the first X number of dollars of accumulating income recognized while another beneficiary's share will be all or a certain percentage of Y number of dollars that exceed X number of dollars obviously the lowering of the amount of accumulating income may affect the second beneficiary's "share" of accumulating income. In this case, if the respective beneficiaries are preferred beneficiaries, (or would be...), since the exercise of an upstream discretionary power has affected one share and not the others, para. (c) will not apply.

The term "share" is particularly vague and one has to take a considerable leap of faith in ascertaining what "the share" pertains to under para. (c). Under paragraph (b) the opening preamble causes "the share" of accumulating income which is payable to be critical while under paragraph (a) the shares of accumulating income is not a factor to consider at all. Under subpara. (b)(i) the ability of the beneficiaries to "share" (verb) in the accumulating income is the factor to recognize. Although the Regulations operate to prescribe the discretionary share which can be subject to the P.B.E., in order to apply the Regs. each relevant "share" must depend upon a discretionary power. There are at least two different processes where a "share" may be important being either the share in which the accumulating income is payable¹²³⁷ and the share which was earned for the particular beneficiary's **benefit**¹²³⁸. It is here where a permanent deficiency exists in the P.B.E. because it is this "share" of the accumulating income that determines whether para. (c) is applicable or not. Either basis just described could be argued to apply in this case.

1236. See subsections 74.5(10) and 94(7) for examples of references to **powers** and Sec. 256(1.2)(f)(ii) for a reference to a singular power. Is there a convention here that must be attended to?

1237. which is the criteria for the application of para. (b) though not its measurement

1238 the benefit not being limited to payment of the accumulating income

"Discretionary Shares" under the Regulations.

Regulation 2800(3) provides the provision by which the discretionary share of a particular preferred beneficiary of the accumulating income of the trust can be determined however five of the six described are subject to a qualifying test described in Reg. 2800(4). All six scenarios described operate upon one common aspect being the entitlement of the particular preferred beneficiary to share in the accumulating income of the trust however under the first five of them such an entitlement to share in the accumulating income of the trust could not have arose by reason of the death of **any** individual who would himself be otherwise entitled to share in the accumulating income of the trust. The regulations do not describe how this entitlement to share is to be ascertained hence it may be quite possible that the particular beneficiary need only be entitled to share in the benefit of the accumulating income which may not include its distribution but instead be restricted to being benefits obtained through its use, or, it may again be possible that it is to be narrowly construed and taken to mean entitlement to share in the accumulating income through its actual distribution and receipt.¹²³⁹

Entitlements "Arising" Upon Death.

Regulation 2800(4) provides that for purposes of para. (a) the phrase "entitled to share in the accumulating income of the trust" does not include any entitlement that **arises** by reason of the death of any individual who would otherwise be entitled to share in accumulating income hence where the entitlement of the spouse or the individual or both arose due to the death of one of their offspring it would be ineffective and a P.B.E. could not be made in respect of any amount since Sec. 104(15)(d) would apply. Tax law has as a basis of application words that either; carry their general meaning in the context in which they are read, or that are given special meaning either by supporting auxiliary provisions or by the subject matter which they are being used in respect of. The term "arises" is just such an instance where these two fundamental norms may prevail. The subject matter of Reg 2800(4) is an entitlement, under a trust agreement, to a particular amount of income and it is generally accepted that the proper terminology in describing how these rights (entitlements) are created is to describe them as **"arising out of the trust agreement"** due to the fact that unless the trust agreement recognizes them they will not exist. The Reg. 2800(4) provision expressly concerns itself with "any entitlement that **arises** by reason of the death" and in this regard it refers exclusively to entitlements that **as an operation of the trust deed** arose upon the death of a previous holder of such an entitlement. A right "arises" to an beneficiary from the trust deed. It does not "arise" to the beneficiary from another beneficiary. In this respect only those entitlements that are based upon the life of the holder, being life interests only, will be affected in that if the entitlement is transferred via Sec. 70(5) or (6)¹²⁴⁰ without being extinguished then it could not be "any entitlement that **arises** by reason of the death". The term used is "arises", which is not at all equivalent to the much broader description of "obtained" thus it would seem that not at all contemplated by the draughtsman was the instance where the entitlement is not subject to consequential trust deed provisions but instead may be transferred as a property of the deceased. In this later case the entitlement could not "arise".¹²⁴¹

An even more interesting noteworthy technicality in the provision is that it deals with entitlements which arise by reason of the death of any individual who would **"otherwise be entitled"** to share in the accumulating income and in this regard there would appear to be a misuse of words. The provision concerns the death of an individual who "would otherwise **be entitled**" to share in the income, not the death of an individual who otherwise **"may have been"** entitled to the income and thus it refers only to former beneficiaries whose entitlements were enforceable at some particular time and not affected by a discretionary power. Where the

¹²³⁹ There is extensive use of the term "settlor" in the Regulations to describe how discretionary shares are to be determined but does the Sec. 108(1)(d) definition of "settlor" apply for these purposes? There is no "bridging" provision.

¹²⁴⁰ or 70(3) depending on if one considers it a capital property or a "right or thing"

¹²⁴¹ See *Adamson v. A.G.*, 1933 A.C. 257, *Queensland Trustees Ltd. v. Commr. of S.D.*, 88 C.L.R. 54, *Parker v. Lord Advocate*, 1960 1 All E.R. 20 (HL), *Morgan v. I.R.C.*, 1963 1 All E.R. 481 (CA), *Burrell v. A.G.*, 1936 3 All E.R. 758 (HL), *Re: Parkes Settlement*, 1956 1 All E.R. 833, *Re: Cusell's Will Trusts*, 1946 1 All E.R. 32, *Royal Trust Co. et al. v. The Queen*, 10 E.T.R. 220. In *M.N.R. v. Worsley*, 67 D.T.C. 5011, the Exchequer Court held:

"The words accruing or arising are used in contradistinction to passing. They indicate, not the transfer upon death to another or something which the deceased or some other person had before or at the time of death, but the springing up, upon the death, and the vesting in another, of property which previously had not been existing in anyone."

former individual **may** have been entitled to share in the accumulating income before his death, but was not at the time of his death due to the exercise of a discretionary power, then an entitlement arising from the operation of the trust agreement to another individual, will not be captured under Reg. 2800(4).

The Scenarios.

Under paragraph (a) of Reg. 2800(3) where the settlor of the trust is an individual and his spouse and both are alive at the year end of the trust and both of whom may be "entitled to share in the accumulating income of the trust" their discretionary shares are equal to the accumulating income of the trust that is proportionate to the fair market value of the contributions they individually made to the trust that is of the aggregate fair market value of the contributions made (only) by them to the trust¹²⁴². One has to assume that the Department regards, like that in the case of ascertainment of "settlor" status, gratuitous contributions in this instance. Where there is another preferred beneficiary under the trust his share will automatically be nil. Before analyzing this provision it must be kept in mind that the settlor of the trust may be both an individual and his spouse as provided for under Sec. 108(1), (h), (b), however both must be beneficiaries of the trust as per the requirements of the preferred beneficiary definition. Obviously this is applicable only when the trust is *inter vivos*.

The paragraph operates so as to determine a discretionary share of both individual and spouse even though they both may be non-resident however the opening preamble to Reg. 2800(3) concerns only the discretionary share of particular **preferred beneficiaries**, while the Sec. 104(15)(c)¹²⁴³ concerns itself not only with preferred beneficiaries but also those beneficiaries if they were resident in Canada. Even if the settlers are¹²⁴⁴ or one of them is, non-resident thus technically not being a preferred beneficiary, para. (a) of Reg. 2800(3) will still be applicable otherwise it would be possible to lose the benefit of its application by having one, or both, of the settlor's non-resident. If it could be avoided in this manner the choice of beneficiary whom could elect under the P.B.E. could be altered, however since it cannot be avoided if the settlers become non-resident they will only be forfeiting the ability to have an amount taxed as if in their hands and not in the trust's.

The amount of accumulating income which is determined to be the particular beneficiary's discretionary share is derived as a function of the aggregate fair market value of contributions made to the trust by the individual or his spouse in proportion to the aggregate of such of contributions made by both of them and in this regard one can clearly see that by simply having one or the other make additional contributions the proportion of the accumulating income that can be elected upon can be altered. The subparagraphs do not specify that such contributions must remain within the trust being that in fact they might have already been distributed out to the beneficiaries.¹²⁴⁵

Paragraph (a) of Reg. 2800(3) provides the determination of discretionary shares of accumulating income when both the individual and spouse settlers are alive at year end however it does not comment or seem to apply where the individual and his **former** spouse are alive at year end. Some would believe that such an interpretation is too narrowly read from the provision simply because "former spouses" are not mentioned and that Parliament sensed that the preferred beneficiary status should not be restricted from being available in respect of former spouses and thus provided that the definition of "preferred beneficiary" apply to both spouses and former spouses, as provided in Sec. 108(1)(g)(ii). They **did not** extend this policy into the definition of "settlor" defined under Sec. 108(1)(h), quite likely due to the fact that it would take substantially voluminous

1242. the fair market value being measured at the time the contribution is made

1243 from which the application of the Regulation results

1244 in this case the individual and his spouse

1245 Cash could always be used to fine tune the proportionality, especially if cash is generated through mortgaging the trust property and distributing the proceeds. In this regard it is **fortunate** for the Department that the distributive triangle between an individual, the *inter vivos* trust set up for the spouse and his spouse is not available in that the particular trust to which the provisions in para. (a) apply cannot be a spousal *inter vivos* trust by virtue of restrictive definition in Sec. 73(1) and the fact that the settlor of the trust must be both the individual and his spouse for purposes of para. (a). Regardless, since the trust will most likely be personal a distribution under Sec. 107(2) will still reduce tax consequences where property is distributed to one spouse from the trust who transfers it via Sec. 73(1) to the other spouse who then "contributes" it to the trust thus altering the proportionality of the elected amounts. Over a lengthy and infrequent period of time with a "legitimate purpose other than to obtain a tax benefit" such transactions can be instrumental in fine tuning the P.B.E. once the trust has been created however the proportioning of the P.B.E. election amounts between the two could be more "securely" arranged if the property was transferred between the spouses to achieve the proper proportionality **before** the trust was created with its contribution of properties from them.

provision and adjustments to do so. It would seem debatable whether para. (a) of Reg. 2800(3) extends beyond individual and spouse settlers, existing in that particular relationship, to individuals which existed in that particular relationship previously.

Once again due to the non specification of how the parties are to be "entitled to share" in the accumulating income it would seem quite possible that they need not "share" in it equally, nor that their entitlement to share be based upon the same criteria. The fact that the provision contains the phrase "may be entitled to share" would seem to indicate that the beneficiaries need not have enforceable entitlements at all at the particular time but may satisfy the criteria by being **potentially** entitled to share in the accumulating income. Such potential entitlements need not exist exclusively due to a discretionary power but may be contingent upon the occurrence of an event.

Under paragraph (b) where the settlor of the trust is an individual and his spouse, both of whom are alive at the trust's year end but only one of whom **may** be entitled to share in the accumulating income then the individual's or spouse's share, as the case may be, of the accumulating income will be equal to all of it. If any other preferred beneficiary exists his discretionary share is nil.

The same aspects inherent in para. (a) are to be considered here as well, eg; manner of entitlement and share, spouse and individual capacity, however under para. (b) only the individual or the spouse **may** ever be entitled to share in the accumulating income. In this case if the spouse is contingently entitled to share in the accumulating income, for instance, upon the ceasing of residency by the individual or upon the termination of the marriage to the individual para. (b) will not apply while if she is included in a group of beneficiaries which may share in the accumulating income upon the exercise of a discretionary power the potential to participate will surely taint the arrangement. If she does obtain the potential or enforceable entitlement to share in the accumulating income upon the death of the individual, **as per the operation of the trust agreement or as a direct transfer from the individual**, then paragraph (b) won't apply in that the individual and the spouse are not both alive at year end.

Paragraph (b) concerns only the ability of either party to be entitled to share in the accumulating income however where both are entitled the para. (a) provision will apply. Where para. (a) applies the shares of accumulating income upon which the P.B.E. may be made are determined quite arbitrarily thereby restricting the ability of one particular beneficiary (spouse or individual) from electing upon all of the accumulating income, (in that she may be presently entitled to it), due to the fact that the other spouse **may** be also entitled to share in it. The ability of a discretionary power to affect the entitlement to share in **accumulating income** of the second party results in the loss of the ability of one party to elect for P.B.E. treatment of a larger amount. If a discretionary power was exercisable in respect of the amount of Division B income that would be immediately payable to one or the other parties then it could **not** be said to affect the manner in which the particular party is "entitled to share in accumulating income" since that party would not have any entitlement to share in the accumulating income. Through the exercise of the discretionary power he would have the entitlement to share in the current income, not the net accumulating income. Once such a discretionary power was exercised the resulting accumulating income would be less and since, if the trust deed was properly drafted, only one party, the other spouse, may have been entitled to share in that accumulating income para. (b) would apply with the result being the negation of an arbitrary allocation. Once the discretionary power is exercised the Division B income would have to be payable to the spouse in order for her to recognize it under Sec. 104(13), with the object being that the trust would avail itself of the Sec. 104(6) deduction, (thus reducing its accumulating income). **She need not receive it at all in the form of a distribution at that time**, thus it could remain in the trust whereby she would gain a capital interest in it. Without going into it any further than that two discretionary powers, one affecting the ability of one spouse to share in the current income, (and its amount), and the other affecting the ability of the other spouse to be entitled to share in the accumulating income can, in unison, avoid the application of Reg. 2800(3) para. (a) and ensure that para. (b) can be benefitted from.¹²⁴⁶

Under paragraph (c) where the settlers are an individual and his spouse and only one is alive at the trust's

¹²⁴⁶ The amount made payable to the spouse would equal the amount that she would otherwise have contemplated making a P.B.E. in respect of, if she could.

year end and the one who is alive **may** be entitled to share in the accumulating income then that party's discretionary share will be all of the accumulating income of the trust while any other preferred beneficiary's share will equal nil. If the party that is alive cannot be entitled to share in the accumulating income then obviously her/his share must be equal to nil. Where any other preferred beneficiary exists his "share" is equal to nil even though he may be entitled to substantially all of it. Under paragraph (d) where para. (a), (b), and (c) don't apply and the settlor (singular) of the trust **may** be entitled to share in the accumulating income and he is alive at year end then all of the accumulating income will be his "share" while if any other preferred beneficiary exists, her share will be nil. Under paragraph (e) where paragraph (a), (b), and (c), are not applicable and the spouse of the settlor of the trust may be entitled to share in the accumulating income but the settlor may not, and the spouse is alive at the year end, her share of the accumulating income will be equal to all of it while if any other preferred beneficiary exists his share will equal nil.

Under para. (d) where the settlor may be entitled to share in the accumulating income, regardless of whether other preferred beneficiaries, including his spouse, are also entitled, his share will equal all of it hence a discretionary power operating with respect to the payment of current income under Sec. 104(13) to the spouse etc. could effectively diffuse the tax cost of the income over two or more beneficiaries as was previously described.

Subsection 75(2)(a) explicitly deals with property or property substituted therefor that **may** revert to the person from whom it or the substitute property was directly or indirectly received, or, pass to persons to be determined by him at a time subsequent to the "creation" of the trust, and causes the income or loss, taxable capital gain or allowable capital loss from the disposition or use of the property or substituted property to be attributed to the particular contributor of the property described. The source of the inclusions are different: the trust interest and the property in specie and it could be argued that a Sec. 75(2) and 104(14) inclusion in the same taxpayer's income in respect of the same economic source is contrary to Sec. 75(2). Technically, if the contributor recognizes accumulating income which is recognized by the trust **and** attributed to him he may only be doubling his income recognition.¹²⁴⁷

Under paragraphs (a) to (e) of Reg. 2800(3) where the settlor, as the individual and his spouse, or where the settlor or the spouse of the settlor may be entitled to share in the accumulating income, (regardless of whether other preferred beneficiaries may also be entitled to share in the accumulating income), with certain exceptions, their share, or shares will always equal **all** of the accumulating income hence by allowing the settlor, or the spouse of the settlor, or the joint settlors to, through a discretionary power, be entitled to share in the accumulating income, (no matter how small the share), the flexibility of the P.B.E. has been substantially reduced. By allowing either or both to share directly in the **current** income rather than the accumulating income, through an exercise of a discretionary power, the flexibility has been maintained.¹²⁴⁸

Under paragraph (f) of Reg. 2800(3), (to which Reg. 2800(4) doesn't apply), where para.(a), (b), (c), (d) and (e) don't apply by virtue of their situational criteria described therein, the discretionary share of a preferred beneficiary alive at the trust's year end will be equal to the amount of accumulating income divided by the number of preferred beneficiaries under the trust alive at year end who may be entitled to share in it, regardless of whether or not, even with the exercise of the discretionary power, they may share in it equally. Since this paragraph is not affected by Reg. 2800(4) which causes the invalidity of an "entitlement to share arising by reason of death" the entitlements under para. (f) may have arisen upon the death of beneficiaries who were otherwise entitled to share in the accumulating income.

One obvious point should be made about the manner in which the discretionary power may affect the beneficiary's entitlement to share in the accumulating income. Paragraph (c) of Sec. 104(5) applies where each beneficiary under the trust, whose share depends upon the exercise of a discretionary power is, or would be a preferred beneficiary, if resident in Canada while Reg. 2800(3) determines the discretionary share where the subject preferred beneficiary "**may** be entitled to share in the accumulating income" however a

¹²⁴⁷ Compare the exclusion of the recognition of any attributed gain or income under Sec. 74.1(1) and (2), (closing phrases), and 74.2(1)(e), with the lack of such exclusion under Sec. 75(2).

¹²⁴⁸ If a non-discretionary right to share in the accumulating income has been granted to one preferred beneficiary and any other preferred beneficiary's entitlement is subject to a discretionary power para. (c) of Sec. 104(15) will not apply but instead para. (d) thereof will have effect causing **any** preferred beneficiary's share to be equal to nil.

discretionary power may affect only **part** of the beneficiary's **entitlement** to the accumulating income, **but not necessarily all of it**. Read in the context of both para. (c) of Sec. 104(15) and Reg. 2800(3) the discretionary power must affect the **share** of the accumulating income the beneficiary may be entitled to, **not** the absolute amount of it. In this case the subject beneficiaries may all have very specified and absolutely vested entitlements to the accumulating income, being expressed in absolute dollars or percentages however if, **in addition** to these **base** absolute amounts, they may be entitled to obtain additional rights to the accumulating income, through the exercise of the discretionary power their **share** of the accumulating income, being their **entire entitlement** to the accumulating income, will depend upon the exercise of discretionary power. If the discretionary power is operative only in such a manner as to cause **all** of the preferred beneficiary entitlements to increase with the exercise, (on an all or none basis), with the result that less "income is accumulated" for the benefit of non-preferred beneficiaries then Sec. 104(15)(c) may not apply in that by increasing the entitlement of the p. beneficiary a non preferred beneficiary's share will be decreased due to the effect of a discretionary power. If however the shares of the preferred beneficiaries, as per the trust terms, can be only those affected, being that the increase in one share causes a corresponding decrease in another, then para. (c) will continue to apply.

Subject: Preferred Beneficiary Election on Accumulating Income of Estate.

ATR-30

Date: May 9, 1988

Facts

1. Mr. X (the "Deceased") died in July 1985, and was survived by his wife, (the "Widow"), his son, (the "Son"), and his daughter (the "Daughter"). The Daughter has four children.
2. Trust Company Limited was appointed co-executor of the estate of the Deceased (the "Estate") together with the Widow, Son and Daughter (the "Executors"). The Widow has since died.
3. Under the terms of the Will (a copy of which you submitted with your request for the ruling), upon the death of the Widow 70% of the income of the Estate is payable to the Son and 30% to the Daughter. No direction has been given by the Will as to the treatment of any capital gain realized by the Estate.
4. Pursuant to clause 12 of the Will there is a limited power of encroachment on capital in favour of the Son and Daughter to pay for certain medical expenses. No capital encroachments have been made to date.
5. The Will provides that the residue of the Estate is distributable upon the death of the Son at which time the residue will pass to the Daughter if she is then alive. In the event that the Daughter predeceases the Son her surviving children (the "Grandchildren") have the right to receive the residue. Should the Daughter and the Grandchildren predecease the Son, the sisters of the Deceased (the "Sisters"), if then alive, would take the residue, failing which the residue would pass to a specified charity.
6. The charity is a registered charity.
7. The Estate realized a capital gain for its taxation year ending July 17, 1986, the taxable portion of which represents "Accumulating Income" of the Estate for its 1986 taxation year.
8. The Son, Daughter and Grandchildren are all residents of Canada.

Proposed Transaction

9. The Executors with the Daughter propose to make a preferred beneficiary election pursuant to the provisions of subsection 104(14) of the Income Tax Act (Canada) (the "Act") with respect to all or substantially all the accumulating income of the Estate for the 1986 taxation year.

Rulings Given

10. Provided the above descriptions of the facts and the proposed transaction are accurate and constitute a complete disclosure of the relevant facts and proposed transaction and the proposed transaction is carried out as set forth herein, our rulings are as follows:

- A. If a trust contains a power to encroach on capital for the benefit of any beneficiary, the trust is regarded as a discretionary trust for the purposes of determining a preferred beneficiary's share of the accumulating income of the trust. Consequently, the provisions of paragraph 104(15)(c) of the Act and not paragraph 104(15)(b) of the Act are applicable for the purpose of determining a preferred beneficiary's share in the accumulating income of the trust.
- B. Because of clause 12 of the Will of the Deceased, for the purposes of making preferred beneficiary elections

pursuant to subsection 104(14) of the Act, the Estate will be governed by the provisions of paragraph 104(15)(c) of the Act and paragraph 2800(3)(f) of the Income Tax Regulations (the "Regulations").

C. Pursuant to paragraph 104(15)(c) of the Act, the Son and Daughter can make preferred beneficiary elections with respect to the accumulating income of the Estate for the 1986 taxation year. The right of the contingent preferred beneficiaries, that is, the Grandchildren, to share in the accumulating income of the trust for the 1986 taxation year is not dependent upon the exercise or non-exercise of a discretionary power but rather upon the potential happening of a future event. Consequently, for the 1986 taxation year, because the Daughter is still alive at the end of that year, the Grandchildren are subject to the provisions of paragraph 104(15)(d) of the Act. Therefore, although they may make preferred beneficiary elections because they are preferred beneficiaries, their share of the trust's accumulating income for 1986 is nil and this is the maximum amount upon which they can elect pursuant to subsection 104(14) of the Act. However, for the purposes of calculation pursuant to paragraph 2800(3)(f) of the Regulations, all preferred beneficiaries, including contingent preferred beneficiaries must be included in the advisor. Therefore, the Daughter and the Son will each be entitled to make preferred beneficiary elections on an amount not exceeding 1/6 of the accumulating income of the Estate for the 1986 taxation year.

Please note that the fact that some of the contingent beneficiaries, namely the Sisters of the Deceased, are not preferred beneficiaries does not affect the applicability of the provisions of paragraph 104(15)(c) of the Act to the Daughter and the Son for 1986 since these contingent beneficiaries' share of accumulating income for that year does not depend upon the exercise or the non-exercise of a discretionary power.

This ruling was given in October 1986.

Income Tax rulings are issued for the general information of taxpayers, but are considered to be binding on the Department only in respect of the taxpayer to whom the ruling was given.

The Worst and Last Case Scenario.

Paragraph (d) of Sec. 104(15) provides effectively that where paragraphs (a), (b), and (c) don't apply, for any reason, the share of any particular preferred beneficiary under the trust will be nil. Given the four main qualifying situations in para. (a), (b), (i), and (ii), and (c) it may be quite possible for the trust not to allow for qualifications for the P.B.E. simply due to its terms, especially where it is complex and there exist a substantial amount of beneficiaries who satisfy the definition of "preferred beneficiary" with differing categories of interests under the trust. Clearly, in respect of para. (a), where the trust was, at any particular time, a trust described under Sec. 104(4)(a) to have the spousal characteristics and its subject spouse is alive, but may not be a beneficiary, then the share of any other preferred beneficiary will be nil, only by virtue of the character of the trust as described in the opening preamble of that paragraph and not by virtue of para. (d). If the spouse dies automatically paragraph (b) **may** be applied. If one singular discretionary power affects the shares in which the accumulating income would be payable to any one or more beneficiaries, preferred or otherwise, then automatically para. (c) will apply, and para. (b) won't. Given that a discretionary power may affect directly and **indirectly** the share of accumulating income any beneficiary may recognize disqualification from the application of para. (b) may occur fairly easily. With nothing left but para. (c) to apply to do so every beneficiary, whose share of the accumulating income may be affected by a discretionary power, must be a preferred beneficiary, a registered charity or would have been a preferred beneficiary if resident in Canada. If there is a single non preferred beneficiary's share which may be affected by the discretionary power, (or if there is more than one discretionary power that affects such shares), para. (c) will not apply. Given that this may occur due to the direct and **indirect effect** of a power in retrospect, it is fairly easy to disqualify the entire trust from being eligible to take the P.B.E. simply by not being careful on the drafting of its terms.

In this regard, if the trust deed, and in this sense the testamentary trust, is drawn up so as to allow for **several** trusts to arise from the singular testamentary document each giving life to different methods of enforceability of interests thereunder the flexibility and the availability of the P.B.E. will be improved. Care should be taken to ensure that Sec. 104(2) will not apply so as to cause the trusts to be grouped together which will result where the income therefrom may accrue or ultimately accrue to the same class of beneficiaries, regardless of the proportionality of their composition of the beneficiaries under any one trust. Of course a power of appointment drafted so as to allow new beneficiaries to be added as entitled to income may reduce

the possibility of not being eligible for para. 104(15)(b) or (c) treatment since until the exercise the recipients are not beneficiaries.¹²⁴⁹

Implicit in the closing phrase of Sec. 104(14) is the lack of requirement that accumulating income elected upon be actually distributed to the elector and although at the 1981 Tax Conference CRA opined that it would not accept a P.B.E. if the accumulating income doesn't vest in the particular beneficiary in the 1987 Conference it corrected itself when it concluded that the right to income elected upon will be determined by the trust's terms. The trust's terms could require the election to be made in order to have the beneficiary's right enforceable while it could do so without giving the beneficiary an indefeasibly right to such amounts.

Filing.

Regulation 2800(1) provides the description of how the documents electing for the P.B.E. must be filed. The "taxpayer" must file with the Minister a statement explicitly making the election for the year and designating the **part** of the accumulating income in respect of which the election is made. The designation of the **part** of the accumulating income which is being elected upon is critical for it is this **part** that may allow for favorable treatment in the hands of the beneficiary as due to its ultimate source and "flow-through" designations which the trust may then make in respect of it.

The statement must be signed by both the preferred beneficiary and a trustee having the authority to make the election. The trustee who has control over the accumulating income and its payment via discretionary powers may differ from the one who "has the authority to make the election", if the trust deed is drafted in a particular manner. Generally a trustee who controls the accumulating income, the proportions in which it is paid, and/or the property which gives rise to it, will implicitly have the authority to make the election. A particular trustee may be given the expressed exclusive authority to make the election, as per the terms of the deed, even though she need not control the income or its payment etc, and this segregation of powers could seriously impair the ability of the reasoning in *Sachs v. M.N.R.*, commented on previously, to apply. In this respect, a spouse, who is a beneficiary but also a token trustee of the trust may be granted such an authority through the expressed terms of the trust so as to allow **her**, rather than any other trustee, to decide what part of the accumulating income will be recognized by any particular preferred beneficiary.

The trustee may obtain his power to make the election from the trust deed, the applicable provincial trustee acts, or the Quebec Civil Code where applicable. While he may be reducing effective taxation on the accumulating income he elects, he may also be acting discriminately if he allows elections to be made in respect of some beneficiaries only, in the absence of specific direction to do as expressed in the deed. The partiality may be increased when one considers that the non-elected upon accumulating income **may** be taxed at higher rates. As a precaution against potential subsequent conflict, a testamentary trust, as a planning aspect, should express in respect of whom and to what amount a P.B.E. can be made, even though all of the beneficiaries may be entitled to the accumulating income. The power and the effect of the P.B.E. should not be equated with the granting of indefeasibly vested rights to the elected amount.

Regulation 2800 Elections in Respect of Accumulating Incomes of Trusts

2800. (1) Any election under subsection 104(14) of the Act in respect of a taxation year shall be made by filing with the Minister the following documents:

- (a) a statement
 - (i) making the election in respect of the year,
 - (ii) designating the part of the accumulating income in respect of which the election is being made, and
 - (iii) signed by the preferred beneficiary and a trustee having the authority to make the election; and
- (b) a statement signed by the trustee showing the computation of the amount of the preferred beneficiary's share in the accumulating income of the trust for the year in accordance with paragraph 104(15)(a), (B) or (c) of the Act, as the case may be, together with such information concerning the provisions of the trust and its administration as is necessary for this purpose.

1249. The preferred beneficiary must also be such in his personal capacity and not hold the interest as trust property.

Electing as a Condition Precedent

It would seem possible, through the fact that Sec. 104(14) explicitly provides that amounts elected upon will not be included in **any** beneficiary's income when distributed, for tax liabilities in respect of certain amounts to be incurred by beneficiaries other than by those who will ultimately enjoy the income. Understandably a preferred beneficiary who will not receive the portion of accumulating that he may elect upon will lack the incentive to do so in that he will be incurring a tax liability that will have to be extinguished. If he has non-capital losses that may be lost he may consider recognizing the income however he has no obligation to do so, (even when he is indefeasibly entitled to it), unless the making of the election is a condition placed upon the entitlement. The latter point, whereby the settlor expresses in the deed that the P.B.E. must be made by a particular beneficiary who is entitled to the income, as a condition of that entitlement, will provide greater certainty in assuring that the tax liability for the income is carried by the recipient of the income and not by potentially other beneficiaries. If vesting doesn't occur until the election is made it will not be available. Entitlement must exist for the election to be made though divesting thereafter may be structured to occur if the election isn't made. Such powers can also be instilled in the trustees.

Distribution of Funds

If the preferred beneficiary's entitlement is subject to the exercise of a discretionary power and on this basis he chooses initially not to enter into an election due to the fact that he will be incurring a tax liability on property that may never be realized, he may be able to be persuaded to do so if the trustee has the power to distribute funds out to him so as to extinguish the liability.¹²⁵⁰ This method of effective tax reduction on accumulating income is more complex than what appears in that by actually distributing the cash, be it as income or capital, the recipient will usually recognize additional taxable income under Sec. 104(13) or **possibly** 105(1), thus more than one simple calculation is needed to determine what amount may be distributed. Such an arrangement should only be entered into only when the preferred beneficiary's marginal rate of tax is less than the trust's and that of the party who will realize the income, (though this depends on whether he can actually take the P.B.E. himself).

In the 1984 Roundtable Discussions the Department expressed its view that the election can be filed by any party who is legally competent hence where the preferred beneficiary is, due to his infancy, unable to legally speak for himself, another person may make the election on his behalf. In the Department's opinion the other person should be the legal guardian thereof or in the absence of such an appointment, the person described in Sec. 150(1)(d) of the Act who will file his tax return. The signature of that person should carry the validity so as to bind the child. As provided in Question 32 of that discussion, in respect of Quebec trusts, CRA will accept the filing of an election by the trustee where he is so empowered to bind the minor as provided in the trust deed, but only when the minor hasn't been appointed a tutor and only where the trustee obtains the power by virtue of the Civil Code or the trust deed itself.

Regulation 2800(1)(b) provides that a statement signed by the trustee showing the computation of the amount of the preferred beneficiary's share, computed in accordance with the provisions of Sec. 104(15)(a), (b), or (c) as well as "information concerning the provisions of the trust and its administration as is necessary for this purpose" must accompany the statement making the election. Under paragraph (2) both documents must be filed within 90 days from the end of the trust's tax year.

Income Attribution.

A preferred beneficiary election results in the beneficiary recognizing income from the trust through subdivision K by virtue of Sec. 12(1)(m). If the amount represents a taxable capital gain that is deemed by subdivision K to be that of the taxpayer then Sec. 12(1)(m) will not apply to it.

Section 74.3 provides the main attribution provision in respect of trusts and it will apply where an individual has transferred property to the trust the income of which generally flows out to the beneficiaries. The provision

¹²⁵⁰. By recognizing income under Sec. 104(14), as income from property as per Sec. 108(5), the taxpayer's investment income is increased which can reduce their cumulative net investment loss which increases their capital gains exemption as per the section 110.6 rules.

applies only in respect of "designated persons" who realize the income, "designated person" being described in Sec. 74.5(5) to be the spouse, but not a former spouse of the individual and those who are under 18 years old and do not deal at arm's length with the individual or were his niece or nephew. Understandably most preferred beneficiaries of an *inter vivos* trust may satisfy this definition however this alone does not cause attribution to occur.

Paragraph (a) of Sec. 74.3(1) provides effectively that **generally** the amount of income that may be attributed back to the individual who contributed the property to the trust will be the amount of income recognized by the beneficiary under Sec. 12(1)(m) which clearly includes the preferred beneficiary's share of accumulating income that was elected upon. This attributable amount is limited to the amount of income from the particular property which was contributed, or its substitute. No attribution will result if the designated person does not recognize income, including preferred beneficiary elected amounts, from under the trust.

Under paragraph (b) the amount of income that represents a taxable capital gain that may be attributed back to the individual through section 74.2 is equal to the lesser of the amount that was designated in respect of the beneficiary under Sec. 104(21), (the flow through provision), and the amount of net taxable capital gains from the disposition of property in the year, that was contributed by the individual, by the trust. The property need not be situated in Canada. Like para. (a), paragraph (b) relies upon a main attribution provision, in respect of capital gains being that in section 74.2, rather than attribute automatically. Section 74.2 attributes gain only in respect of spouses thus all other preferred beneficiaries will not be caught by Sec. 74.2(1), where a P.B.E. is made in respect of a non-spousal preferred beneficiary, and the amount elected upon can also be designated under Sec. 104(21) as being a taxable capital gain. Where the spouse draws the income she needs to survive from the trust, excluding the capital gain realized therein, that gain will become accumulating income. If the trust terms are properly structured, attribution of it can be avoided when it is elected upon so as to access the beneficiary's lower tax rates.

Where the trust is a testamentary trust rarely will any of this be relevant in that attribution will not be possible **but** the attribution provision in Sec. 74.3(1) doesn't operate exclusively upon settlers who contribute property but any individual who contributes property to the trust.

Income Payable to Non-Residents and Part XII.2 Tax.

The Old Rules.

Under pre 1988 reform subsection 104(8) a trust or estate was restricted in taking the Sec. 104(6) deduction when its income of a certain character was payable to a "non-resident person, a non-resident-owned investment corporation, or a trust resident in Canada other than those described in Sec. 149(1) or a trust all of the beneficiaries under which, throughout the period beginning on May 6th, 1974 and ending at the time the amount became so payable, were resident in Canada". This applied to all trusts and estates and it did not restrict their ability to take the Sec. 104(6) deduction in respect of income payable altogether but it only limited the amount that could be deducted which was derived by the Sec. 104(8) provision. The amount that wasn't allowed to be deducted under Sec. 104(6) as per Sec. 104(8) would not attract withholding tax under Sec. 212(1)(c) as per former Sec. 212(11.1)-(11.2) when paid to a non-resident however the amount that was allowed deduction under Sec. 104(6) would when paid or credited to the specified person. Simply stated, since the deduction available to the trust was reduced, the tax payable recognized by the trust would be higher since it would recognize more Part I income. Unfortunately the trustees and executors had severe problems finding in trust law a precedent which would allow them to withhold an amount from the income payable to such specified "designated beneficiaries" that would extinguish the extra tax payable that resulted from the reduced Sec. 104(6) deduction and the tax burden in respect of income realized by the trust was spread evenly between "non designated" and "designated beneficiaries". In *Re: Liberal Petroleum Trust*¹²⁵¹ the Alberta Court of Queen's Bench held that the trustees of a trust had no power to withhold from a non-resident beneficiary an amount in respect of the additional tax liability caused by the non-resident beneficiary and the mechanics of the Sec. 104(8) limitation.

The purpose of former Sec. 104(8) was to ensure that the marginal rate of tax normally applicable to resident taxpayers also applied to certain income streams when they were passed through the trust to the non-resident rather than the 25% withholding rate. The type of income which was subject to this policy was "designated income" which was formerly defined in Sec. 108(1)(d.1) and included income from timber resource properties, income from Canadian resource property, income from business carried on in Canada, and net taxable capital gains from dispositions, deemed or otherwise, of taxable Canadian property. In arriving at "designated income" losses from real properties in Canada, timber resource properties, and from business carried on in Canada, were deductible.

The Not-So-New Rules.

The subsection 104(8) deduction limitation and the Sec. 108(1)(d.1) definition of designated income were repealed for 1988 and all subsequent tax years of the trust/estate in response to a miraculous recognition by the Department that they were very burdensome to some and in their place Part XII.2 was implemented at the same time. Unlike former Sec. 104(8), Part XII.2 is designed to ensure that the tax liability of the exempt "non-designated beneficiaries" of the trust is adjusted accordingly so as to alleviate the previous problem of the inconsistent imposing of liability for economic benefit realized. Income is taxed at higher rates and only resident or certain non-resident "designated beneficiaries" obtain an apportioned tax credit applicable against their Part I taxes.

The Trust Target.

Subsection 210.2(1) provides "where an amount in respect of the income of **a trust** for a taxation year is or would, if all beneficiaries under **the trust** were persons resident in Canada to whom Part I was applicable, be included in computing the income under Part I of a person by reason of subsection 104(13) or 105(2), **the trust** shall pay a tax under this Part in respect of the year equal to 36% of the least of "three amounts". Section 210.1 provides that Part XII.2 does not apply to a trust that was **throughout the year**, a testamentary **trust**, a mutual fund **trust**, a **trust** described in Sec. 149(1) that resulted in it being exempt from Part I tax, **trusts** described in Sec. 108(1)(j)(ii) or (iv), or a non-resident **trust**. Before going any further it must be pointed out that the essence of Part XII.2 in the form of Sec. 104(8) was formerly under subdivision K wherein as per Sec.

1251. (1985) 39 Alta. L.R. (2d) 357,

104(1) the terms "estate" and "trust" were synonymous. Since outside subdivision K the two cease to be synonymous, and must be each expressly referred to, it is easy to recognize that Sec. 210.2(1) does not apply to estates. Since it already doesn't apply to "testamentary trusts" which by definition through Sec. 248(1) to Sec. 108(1)(i) include certain types of estates that have not received property from a taxpayer other than from a deceased taxpayer as a consequence of and upon his death the obvious advantage occurs whereby property could be contributed to a resident estate that would disallow it from having the testamentary trust status but since the estate isn't captured by Sec. 210.2(1) the income from the property, (and the estate regardless), would not be subject to the tax rates imposed.

Subsection 210.2(1) applies, subject to section 210.3, where an amount in respect of **"the income"** of the trust would be included in computing the income of a beneficiary under Part I by reason of Sec. 104(13) or 105(2) and one has to recognize that Sec. 210.2(1) is part of Part XII.2, a separate distinct section of the Act other than Part I. This is significant in that if the income mentioned **isn't** included in the trust's income as per section 3, and isn't includable under Sec. 104(13) or 105(2), which only refers to Division B "income" it will not qualify the trust. Income that is recognizable under Sec. 105(1) is just such type of income, however given that the Sec. 104(13) provision includes in income that which was subject to a beneficiary's enforceable right as well as that which was **actually paid to the taxpayer** the only way this can be of any value is when the income was paid to another person to extinguish some debt of or provide a service to the taxpayer, or to otherwise be applied for an indirect benefit. Since the trust/estate would not be able to take a deduction under Sec. 104(6) in respect of a Sec. 105(1) inclusion, even when the non-resident person doesn't recognize the benefit under Sec. 212(1)(c), (due to that provision's singular reference to Sec. 104(13) inclusions), that income would be taxed at the same tax rates that would have been imposed on it if it had been accumulated and distributed by the trust as capital.

The subsection 210.2(1) provision does not refer to income that would have been included by virtue of the Sec. 104(14) preferred beneficiary election for a very good reason being that that election cannot be taken when the taxpayer (potential preferred beneficiary), is non-resident. The subsection does not refer to trust income that became payable to a taxpayer who is incidentally a beneficiary due to a relationship other than the trust-beneficiary one. If the foreign resident beneficiary has loaned property (money) to the trust the rent or interest paid, which may be deductible by the trust and subject to regular Part XIII withholding rates when received by the non-resident, will reduce the trust's tax exposure as same as the beneficiary income payable would have. Obviously "designated income" can be used to make the rent/interest payments and thus gain 25% withholding tax treatment under Sec. 212(1)(b) or (d) etc.. (Perhaps even more entertaining is the fact that in the case of debt or "obligations to pay" favorable tax consequences may result when property is distributed in satisfaction of capital interests and the trust is personal.)¹²⁵²

The subsection 210.2(1) charging provision operates on an annual basis whereby in the particular year if income is includable under Sec. 104(13) or 105(2) in **any** beneficiary's income, Part XII.2 tax will be chargeable. Under Sec. 104(13.1) and (13.2) there are two provisions that allow for the negation of income recognition by the beneficiary under Sec. 104(13) in order that the trust may absorb its non-capital and net capital losses by taking less Sec. 104(6) deductions. The income inclusion under Sec. 104(13) that is negated by the effect of Sec. 104(13.1) and (13.2) allows the income to be distributed tax-free, even to non-resident beneficiaries and in this respect since the person isn't recognizing Sec. 104(13) or 105(2) income it may be possible to avoid the application of Sec. 210.2(1) and the Part XII.2 tax, through its use. The subsection 104(13.1) and (13.2) adjustments are not presently technically applicable in respect of non-resident beneficiaries who don't recognize Part I income and most non-resident beneficiaries realize income net of Sec. 212(1)(c) withholding tax. The Sec. 104(13.1) and (13.2) cutback provisions are, however, applicable in respect of all of the other designated beneficiaries such as Canadian resident partnerships, trusts, etc.. The avoidance of the recognition of Sec. 104(13) or 105(2) income isn't of concern **only** in respect of designated beneficiaries. Subsection 210.2(1) charges tax whenever **any person** recognizes Sec. 104(13) or 105(2) income. If a single

1252. The subsection 18(4) thin capitalization rules apply only to Canadian resident corporations, not trusts.

Canadian resident beneficiary recognizes 1 Canadian dollar of Sec. 104(13) income it is only by virtue of section 210.3 that tax may be avoided on the designated income.¹²⁵³

The Exceptions.

Subsection 210.2(1) opens with "subject to section 210.3, ..." and it is within this section that one will find two broad exceptions to the imposition of the Part XII.2 tax, which will otherwise result, except for the above exceptions and the ones to follow, whenever the trust recognizes certain streams of income.

Trusts not Contaminated with Designated Beneficiaries

Under subsection 210.3(1) no taxes will be payable under Part XII.2 by a trust in respect of which the trustee has certified in the trust's return in respect of Part XII.2¹²⁵⁴ that no beneficiary under the trust was a "designated beneficiary" at any time in the trust's tax year. Under former Sec. 104(8) there were four different types of "designated beneficiary" described however they were improperly described in the statutes and thus it was fairly easy to insure that Sec. 104(8) did not apply by having the interest held in a certain manner by certain parties.

Section 210 provides that a "designated beneficiary" under **a trust** at any time means a beneficiary under **the trust** that was at the time one of five different characters of persons while the definition applies only in respect of trust and not estates.

The primary two types of "designated beneficiaries" that were not changed with the reform include a "non-resident person" and a "non-resident-owned investment corporation" and it is these two primary characters that the Part XII.2 tax provisions are targeted at. The third type of "designated beneficiary" is a person exempt from tax under Part I by reason of Sec. 149(1) but only where, with exception, such a person acquired an interest in the trust after Oct. 1, 1987 directly or indirectly from any beneficiary under the subject trust. There are two exceptions the first being where the interest was owned continuously since Oct. 1st, 1987 or the date the interest was created, whichever is later. If it owned the interest and did not acquire an addition "portion of interest" since that date it would not be caught. The second exception is where the exempt person was a trust that was governed by either an RRSP or RRIF that had acquired the interest in the trust directly or indirectly from an individual or spouse or former spouse of the individual who, immediately after such an acquisition, was a beneficiary under the trusts governed by the plan or fund. Under the second exception it is possible for a taxpayer to transfer the interest in the subject trust to a trust governed by a RRSP or RRIF but only where immediately after such an acquisition the former beneficiary, or his spouse or former spouse is a beneficiary under the RRSP/RRIF trust.

Subparagraph 210(c) refers to the acquisition of "an interest" by the exempt person, however it doesn't specify that this "interest" must be a "capital" or "income interest" in the technical sense of the word as defined in Sec. 108(1)(c) or (e). Since the only other statutory requirement in order for the provision to apply is that the person be a "beneficiary under the trust" it would seem entirely possible that discretionary interests, which are not income or capital interests, will cause the person to qualify as a designated beneficiary if he acquires them and in this respect the provision may apply very broadly. Until a power of appointment is exercised so as to grant an interest in the trust that interest will be considered not to have been created however if the power is general the interest that results from its exercise will not be acquired from a beneficiary but will have as its source the power. If the power is special the interest that results from its exercises will be recognized as being a beneficiary right from the moment the trust was constituted. The importance of this is that while the interest acquired through the exercise of a general power can rarely, if ever be recognized as having been acquired from a beneficiary, that resulting from a special power causes the beneficiary to be recognized as being the original beneficiary under the trust deed. On the other hand the provision refers to interests acquired from beneficiaries **explicitly** as compared to interests acquired from the trust deed itself hence in the author's opinion **any** type of power of appointment will be incapable of satisfying the criteria where its exercise instills

¹²⁵³ The tax if it is applied in such a hypothetical case would basically flow back to be the beneficiary in the form of credits to be mentioned which would result in little tax consequences, if at all any.

¹²⁵⁴ that must be filed within 90 days after the end of the trust's tax year

an interest in a specified taxpayer. The acquisition of the interest is from a specified taxpayer. The acquisition of the interest is broadly referenced and can include any manner by which the interest is **acquired**. It does not include instances where the interest was **loaned** to the specified taxpayer.

The fourth type of "designated beneficiary" recognized by section 210 is **a trust**, (which does not include an estate), other than a testamentary trust or trust exempt from tax under Part I by reason of Sec. 149(1), that is resident in Canada whereunder one of the beneficiaries, income or capital, has a certain character. If under the trust there is any beneficiary which/who is either a non-resident person, a N.R.O.I.C., or a person exempt from tax under Part I by virtue of Sec. 149(1) that was just described that trust shall be considered a designated beneficiary. If there is a beneficiary under that trust which is another trust, (but not an estate), that is **other** than a testamentary trust that is resident in Canada, the Canadian resident subject trust will be a designated beneficiary. *Inter vivos* trusts, regardless of residence are clearly caught in this case when they are beneficiaries. If there is a three level trust/beneficiary/trust relationship where one trust is a beneficiary of another trust, which is resident in Canada, which is itself a beneficiary of the subject trust, Part XII.2 will apply to the subject trust only when the second level trust is not testamentary but not when it doesn't reside in Canada. If the second level trust is testamentary then Part XII.2 will never apply to it as long as it remains so **throughout** its tax year, hence even when one of its beneficiaries is another trust that would have otherwise caused the top most trust to be exposed to Part XII.2, (by virtue of the third level beneficiary's character), as long as the second level trust remains testamentary, Part XII.2 will not be applicable to the whole arrangement. The varying of an existing testamentary trust so as to add a source of income and an income beneficiary can offer not only recognition deferral advantages but also Part XII.2 tax avoidance opportunities.

The provision does not incorporate into effect instances where there is an unadministered or unsettled estate anywhere as a beneficiary under the subject trust hence if an estate which could otherwise not qualify as a testamentary trust, is a beneficiary under the subject trust it will cause the trust to be subject to Part XII.2 if it's a non-resident person or other designated beneficiary.

The final type of beneficiary under the Canadian resident trust, (which is not a testamentary trust or tax exempt trust), that causes it to be a designated beneficiary is a certain type of partnership which is also the fifth type of possible designated beneficiary, (if it were a direct beneficiary of the subject trust). If a partnership, as described under Sec. 210(e), has as "a member" a non-resident person, a N.R.O.I.C., a Sec. 149(1) tax exempt person as described in para. (c) to be a designated beneficiary, **any type of partnership**, or a trust just previously described then the partnership, if a beneficiary under the subject trust, will be considered a designated beneficiary and thus cause Part XII.2 to apply to the trust. If it is a beneficiary of the second level trust just described, which isn't testamentary or resident in Canada at the time, but isn't a direct beneficiary of the subject trust, it will still cause the second level trust in para. (d) to be considered a designated beneficiary and thus cause the implementation of Part XII.2 to the top level trust. If the partnership has as "a member" another partnership then **automatically** it will be considered a designated beneficiary if it is a direct beneficiary of the subject trust, regardless of that second partnership's members or residence. The partnership can thus only be used once to defer the recognition of income being flowed through a trust however by having a partnership which has as a member a testamentary trust which has as an income beneficiary another partnership the application of the rules are avoided and the partnerships and trust are not designated beneficiaries and the recognition of income by a final taxpayer emanating from the primary trust can be substantially deferred by "lining up" their tax years.¹²⁵⁵ If the trusts are Canadian resident testamentary trusts this structuring can continue into infinite.

Where the partnership has as "a member" one of the described parties itself it will be considered a designated beneficiary ;"being a member" includes both general and limited partners. Prior to the reform the operational definition of "designated beneficiary" in Sec. 104(8) did not include references to partnerships which had designated beneficiaries as partners hence it was possible to hold the interest in the trust through a partnership in order to avoid the application of the provision. With the reform that loophole was substantially closed but not absolutely.

The subsection 210.3(1) exempting provision applies on a year by year basis wherein each year the trustee

¹²⁵⁵ A multitude of testamentary trusts may be created under one will.

certifies that no beneficiary under the trust during its tax year was a designated beneficiary **at any time**.

“Application of Part – Section 210.1”

210.1 This Part does not apply in a taxation year to a trust that was throughout the year

(a) a testamentary trust;

(b) a mutual fund trust;

(c) a trust that was exempt from tax under Part I by reason of subsection 149(1);

(d) a trust described in paragraph (a), (a.1) or (c) of the definition “trust” in subsection 108(1);
or

(e) a non-resident trust.

“Where no designated beneficiaries – Sec. 210.3(1)”

(1) No tax is payable under this Part by a trust for a taxation year in respect of which the trustee has certified in the trust’s return under this Part for the year that no beneficiary under the trust was a designated beneficiary in the year.

Designated Beneficiaries with Part I Liability

Since the whole purpose of Part XII.2 is to ensure that certain streams of income are taxed at effective rates when earned or paid to otherwise non-taxable parties that are equivalent to the rates that would have applied if the non-resident person had earned them directly it is understandable that the exception will be made when the designated beneficiary has to recognize the trust income as income and will pay the higher effective rate of tax on it. When a non-resident realizes income from a Canadian resident trust under any subdivision K provision, (other than when the income interest is disposed of), it will **normally** not be recognized under Division D in computing the non-resident's taxable income earned in Canada but instead will be subject to withholding tax under Sec. 212(1)(c) under Part XIII, which doesn't compute income but instead taxes certain payments. The one instance where a non-resident person will be required to pay the usual marginal tax on income realizations from a trust under Sec. 104(13), 105(1), or (2) is where that person carries on the **business** of realizing income from property which is in this case, as described in Sec. 108(5)(a), an interest in a trust. Under Sec. 115(1)(a)(ii) income from business carried on in Canada by the non-resident will be exposed to the higher usual rate of tax where it is included in computing his "taxable income earned in Canada" but it is important to recognize that the activity through which the income from the trust is realized must be **a business** and not an **investment activity**. The former, an adventure in the nature of **trade**, can be distinguished from the latter, the holding of property for the purpose of realizing income from it, by the common law principles established such as primary intention for holding the property, the manner in which the property is acquired and disposed of and the volume and number of transactions involving the property etc.

Under subsection 210.3(2) if the subject trust would have paid tax under Part XII.2 and would have been able to designate an income amount in respect of that **non-resident beneficiary** that is included in computing the income of the beneficiary under Part I **by reason of Sec. 2(3)** and is not exempt from tax under Part I by reason of a provision contained in a tax treaty, convention etc. that has the force of law in Canada for purposes of Sec. 210.3(1) that non-resident beneficiary shall be deemed not to be a designated beneficiary at any time in the year. In essence the Sec. 210.3(2) provision provides that where the non-resident beneficiary is required to include the substance of Sec. 104(13) or 105(2) in computing his income under Sec. 2(3), which means, Division D and more specifically Sec. 115(1)(a)(ii), then the beneficiary shall not be considered a designated beneficiary and will not cause the subject trust to be exposed to Part XII.2 tax on its account. If the income is exempt from Part I tax by virtue of a tax treaty the beneficiary will be considered a designated beneficiary; for an example of this see Article XX (2) of the Canada U.K. Tax Convention (1978) wherein income received from

a trust or estate will not be exempt from Canadian tax if the taxpayer carries on business in Canada through a permanent establishment situated therein, or performs in Canada professional services from a fixed base therein and the right or interest under the trust or estate is "connected" with the permanent establishment or fixed base, while for an example of where income is exempt review Article XXII of the Canada-US Tax Convention (1980). In paragraph (2) of that Article income arising to the resident trust/estate that is distributed to the non-resident beneficiary shall be exempt from tax if it arose outside of the country in which the trust/estate is resident.

The Tax and Its Bases.

Subsection 210.2(1) applies whereunder the trust there is a designated beneficiary at any time in the year **regardless of whether that particular beneficiary would have recognized an income inclusion** under Sec. 104(13) or 105(2) had he been resident.

Under Sec. 210.2(1), the trust shall pay a tax in respect of the year equal to 36% of the least of three amounts being; the "designated income of the trust for the year", the amount that but for Sec. 104(6) and (30) would be the "income of the trust for the year", and 100/64's of the total aggregate amount **deducted** under Sec. 104(6)(b), (in respect of all of the beneficiaries), in computing the trust income under Part I for the year. Since the provision operates to apply tax on the least of three amounts one of which, (c), is clearly discretionary the Part XII.2 tax may again be avoided. The payment can be very substantial.

"Designated beneficiary – Section 210"

210. In this Part, a "designated beneficiary" under a trust at any time means a beneficiary under the trust that was, at that time,

(a) a non-resident person;

(b) a non-resident-owned investment corporation;

(c) a person exempt from tax under Part I by reason of subsection 149(1), where that person acquired an interest in the trust after October 1, 1987 directly or indirectly from a beneficiary under the trust except

(i) where the interest was owned continuously since October 1, 1987 or the date on which the interest was created, whichever is later, by persons exempt from tax under Part I by reason of subsection 149(1), or

(ii) where the person was a trust governed by

(A) a registered retirement savings plan, or

(B) a registered retirement income fund,

and acquired the interest, directly or indirectly, from an individual or the spouse or common-law partner or former spouse or common-law partner of the individual who was, immediately after the interest was acquired, a beneficiary under the trust governed by the fund or plan;

(d) a trust resident in Canada (other than a testamentary trust, a mutual fund trust or a trust exempt, because of subsection 149(1), from tax under Part I on all or part of its taxable income), if

(i) a person described in paragraph 210(a), 210(b) or 210(c),

(ii) a partnership described in paragraph 210(e), or

(iii) a trust (other than a trust resident in Canada that is a testamentary trust) is, at that time, a beneficiary thereunder; or

(e) a partnership, if a person described in paragraph 210(a), 210(b) or 210(d), a partnership or a person exempt from tax under Part I by reason of subsection 149(1) is, at that time, a member thereof.

Designated Income: First Base.

"Designated income", defined in Sec. 210.2(2) for purposes of Sec. 210.2(1), is very similar to the former definition of such in Sec. 108(1)(d.1) and its taxation is the very purpose of Part XII.2 tax being that if this type of income were earned by a trust resident in Canada which then distributed it to the non-resident or tax exempt party due to Sec. 212(1)(c), the effective tax rate on it would be substantially lower.

"Designated income" means the amount of income recognizable by the trust under section 3, excluding the Sec. 104(6), (12), and (30) deductions available in respect of income payable, P.B.E.'s, and the Part XII.2 tax paid deduction, to be determined **as if** such income were derived solely from specific sources. Designated income is income of the trust determined under section 3 as if the trust had no income other than income from real property in Canada (other than resource properties), timber resource properties, Canadian resource properties, (other than those acquired by the trust before 1972), and businesses carried on in Canada, and the only taxable capital gains and allowable capital losses it had were from dispositions, (deemed or actual), of property that would have been taxable Canadian property if it had not been resident at any time in its tax year and as if the only losses deductible by the trust were from the four primary sources of income (other than gains and losses) just mentioned. Income from property which isn't real property situated in Canada will not be caught under the definition nor will losses from the same be deductible. If the business of the trust is carried on in another country then the income from that business is not caught and thus where the business consists of the realization of income from real property situated in Canada the obvious advantageous arrangement results.¹²⁵⁶

The taxable net gains realized upon the disposition of listed personal property by the trust appear not to be includable in designated income. In arriving at section 3 income from real property, timber resource properties, Canadian resource properties, and business carried on in Canada, all of the applicable deductions available in Division B may be taken including C.C.A. and the appropriate resource allowances however the only non-capital loss deduction available will be those that arose in respect of those from sources of income.

Only taxable capital gains and allowable capital losses from dispositions of what would be taxable Canadian property of the trust if it had not been resident at any time in its tax year will be relevant in computing designated income.¹²⁵⁷ Losses that are realized in respect of one of the described sources may negate income realized from another described source in the same year or they may be carried forward under the Division C rules however since the designated income is to be computed as per the structure of section 3 non-capital losses sustained in one year cannot be applied in a subsequent year to reduce a Part XII.2 tax exposure. Obviously if the trust is carrying on activities that cause the recognition of the above type of income/gain, it would be advantageous, if it had designated beneficiaries, to incorporate those activities and thus realize the economic benefits as dividend income which isn't designated income. Understandably it would either have to realize and become ultimately liable for the tax liability of other income, so as to absorb the section 121 dividend tax credit and thus alleviate possible double taxation, or capitalize the income, through non-payment until the following period, whereby the dividend tax credit would alleviate the tax on the dividend whereafter the capital could be distributed tax free to the non-resident.¹²⁵⁸

¹²⁵⁶ A business is carried on where it has a permanent establishment which may be quite different from the residence of the trust.

¹²⁵⁷ Taxable Canadian property is defined cooperatively through Sec. 115(1)(b) and 248(1).

¹²⁵⁸ Shares of a corporation holding massive amounts of Canadian resource property are not considered Canadian

"Designated income – Sec. 210.2(2)"

(2) For the purposes of subsection 210.2(1), the designated income of a trust for a taxation year means the amount that, but for subsections 104(6), 104(12) and 104(30), would be the income of the trust for the year determined under section 3 if

(a) it had no income other than taxable capital gains from dispositions described in paragraph 210.2(2)(b) and incomes from

(i) real properties in Canada (other than Canadian resource properties),

(ii) timber resource properties,

(iii) Canadian resource properties (other than properties acquired by the trust before 1972), and

(iv) businesses carried on in Canada;

(b) the only taxable capital gains and allowable capital losses referred to in paragraph 3(b) were from dispositions of taxable Canadian property; and

(c) the only losses referred to in paragraph 3(d) were losses from sources described in subparagraphs 210.2(2)(a)(i) to 210.2(2)(a)(iv).

The Income of the Trust: Second Base.

The second potential tax base consists of **"the amount that, but for subsections 104(6) and (30), would be the income of the trust for the year;"** and one must take a leap of faith in assuming that the "income" being referred to is Division B income since the section 3 operational definition of "income" in Part I cannot, unless specified as in the definition of designated income, extend to Part XII.2. Needless to say since two of Part I's deduction provisions are identified it can be assumed that the provision refers to Division B tax law income and not trust law income, (however the provision is still written awkwardly). The amount that is to serve as one of the possible tax bases is the amount of Division B income of the trust before it is reduced by any Sec. 104(6) income payable or 104(30) Part XII.2 tax paid deductions however **after all of the other available deductions** have been taken under Division B such as C.C.A., Sec. 104(12) deductions, and losses from alternate sources. Through the Sec. 104(14) preferred beneficiary election the trust's Division B income can be substantially reduced while non-capital losses, net capital losses, and all of the special deductions in Division C may not be deducted. Since the trust has control over the amount of voluntary deductions it takes it has the ability to control at least one of the potential tax bases; the amount of Division B income it recognizes however potential double taxation may follow when the Sec. 104(6) deductions are not taken.¹²⁵⁹ If under the trust there is a designated beneficiary the trust will be exposed to Part XII.2 tax however it can still adjust its income recognition. If the least of the three possible tax bases in Sec. 210.2(1) is the amount of Division B income recognized by the trust before any Sec. 104(6) deductions then the Part XII.2 tax will be applied on that amount however the entirety of that income may have been payable to Canadian resident beneficiaries whereby it would attract tax liabilities in the hands of the beneficiary under Sec. 104(13). Under subsection 210.2(3) that tax paid under Part XII.2 will be credited towards the resident beneficiaries Part I tax payables, (and will be included in the beneficiaries' income under Sec. 104(31)), however the trust will still have to make the payment of Part XII.2 tax within 90 days of its year end.¹²⁶⁰ If the amount is payable under Sec. 104(13) to

resource property themselves as per the definition thereof through Sec. 248(1) to 66(15)(c).

¹²⁵⁹ Subsection 104(13.1) technically isn't available to non-residents.

¹²⁶⁰ One way to avoid Part XII.2 tax on the start up of a Canadian resident trust by non-residents is to have a Canadian resident trust loss-loaded taxpayer trust become the sole income beneficiary until his losses are absorbed. Subsection

a non-resident beneficiary withholding tax will be applied and that amount will still attract additional tax under Sec. 210.2(1) and (3).¹²⁶¹ In this way the minimum tax rate that the designated income will have when paid to a non-resident or other designated beneficiary will be 45.6 - 52 percent.

The interesting aspect about the second possible tax base is that it allows income to be reduced by losses that would not be deductible in computing the initial possible tax base; the designated income. In other words if the trust has substantial designated income but also substantial current losses from other excluded activities, through their deduction the possible tax base will be reduced if not negated. Subsection 75(2) can be beneficially applied here.¹²⁶² Also, if the non-resident rents or loans property to the trust and extinguishes (renunciation) his interest, he will recognize income subject to withholding tax under Sec. 212(1)(b) or 212(1)(d) and thus also allow the trust to make the appropriate Division B deductions (if available) so as to reduce the second tax base. The designated beneficiary need not renounce his interest in the trust but in doing so he may be able to allow the trust to be recognized to have no designated beneficiaries at any time in the tax year thus causing Part XII.2 in its entirety to be inapplicable.

"Tax on income of trust – Sec. 210.2(1)"

(1) Subject to section 210.3, where an amount in respect of the income of a trust for a taxation year is or would, if all beneficiaries under the trust were persons resident in Canada to whom Part I was applicable, be included in computing the income under Part I of a person by reason of subsection 104(13) or 105(2), the trust shall pay a tax under this Part in respect of the year equal to 36% of the least of

(a) the designated income of the trust for the year,

(b) the amount that, but for subsections 104(6) and 104(30), would be the income of the trust for the year, and

(c) 100/64 of the amount deducted under paragraph 104(6)(b) in computing the trust's income under Part I for the year.

The Third Base.

The third possible tax base is 100/64ths of "the amount **deducted** under paragraph 104(6)(b) in computing the trust's income under Part I for the year" hence the larger the deduction taken by the trust under Sec. 104(6) in respect of income that became payable to **any** beneficiary, (under Sec. 104(13) via 104(24)), or was included in any beneficiary's income under Sec. 105(2) the larger the third possible Part XII.2 tax base will be. This applies regardless of the nature of the beneficiary in respect of which the deduction was made. If the income is not payable to any beneficiary under Sec. 104(13), (possibly due to a discretionary power), the Sec. 104(6) deduction will not be used or needed and the tax base may be reduced to nil, while the preferred beneficiary election may be made under 104(14) with the trust deduction under 104(12), thus reducing the Part I income.¹²⁶³ A considerable number of factors must be considered in evaluating the usefulness of the above arrangement some of which include availability of preferred beneficiaries, non-capital losses they may have that are stale dating, the terms of the trust deed, etc.

104(13) inclusions will be negated and the income can be capitalized in the trust and distributed to the non-resident as capital.

¹²⁶¹ The trust should always finance its own acquisitions etc. rather than having the non-resident arrange financing since the interest thereupon will reduce the Part XII.2 tax base and withholding tax. If the beneficiary financed the trust's acquisition and paid the interest it would not gain a reduction in Part XII.2 or XIII tax.

¹²⁶² A Canadian resident contributor could contribute loss creating property and reserve a reversionary interest or dispositive veto and thus cause the losses to be recognized by both the trust and the contributor.

¹²⁶³ The P.B.E. will still cause the designated income to be subject to Part I rates though personal tax credits/losses of the beneficiary may be utilized to eliminate a substantial tax base if the settlor of the trust and the income entitlements properly planned for.

If the trust has non-capital or net capital losses it will be possible to use the Sec. 104(13.1) or (13.2) income payable adjustments to reduce the amount of income that is considered payable to the beneficiaries in order that it will be recognized by the trust and used to absorb the losses. Since the beneficiaries are not recognizing income under Sec. 104(13) or 105(2) as a product of the Sec. 104(13.1) or (13.2) provisions the trust need not take the Sec. 104(6) deduction in order to maintain any equity but only the third Part XII.2 tax base will be reduced. Since subsection 210.2(1) is only applicable if the beneficiaries of the trust would have recognized any income under Sec. 104(13) or 105(2), if the mechanics of the Sec. 104(13.1) or (13.2) adjustment reduce such a recognition to nil the entire subsection will be avoided and no Part XII.2 tax payable will result. Obviously if the trust pays income as interest or rental expense to a designated beneficiary in a debtor-creditor/lessor-lessee relationship it will not deduct the payable under Sec. 104(6)(b). Again the Sec. 75(2) provision could be relied on when loss producing property was held by the trust.

In any event, in respect of any of the tax bases, if income is capitalized and taxed in the hands of the trust it can be subsequently distributed tax free as a capital distribution, to the designated beneficiary only where he has a capital interest that was not purchased and when the trust is personal. Since Sec. 105(1) does not apply under Sec. 212(1)(c) to cause withholding he need not actually have a capital interest, but will quite likely gain one once the subject of his income entitlement is capitalized. In any case, the amount will be exposed to taxation in the trust's hands unless its recognition or tax liability can be negated.

Filing and Payment.

Under subsection 210.2(5) the trust shall within 90 days after the end of each of its tax years file with the Minister a return "in prescribed form" and containing "prescribed information" however there is as yet no prescribing regulation concerning this form or its content. The return at the least must **estimate** the amount of tax payable by the trust and accompanying it must be the payment, made to the Receiver General.¹²⁶⁴ Under subsection 210.2(6) a trustee is personally liable to pay on behalf of the trust the full amount of any tax payable and the trustee is recognized to be entitled to recover from the trust any such amount paid by him.¹²⁶⁵ The enforcement provisions under the Act in Sec. 150(2), (3), 161(1), (11), sections 152, 158, 162, and 167 as well as Division J are applicable to Part XII.2 with modifications as the circumstances require, as per Sec. 210.2(7).

"Returns – Sec. 210.2(5)"

(5) A trust shall, within 90 days after the end of each taxation year,

(a) file with the Minister a return for the year under this Part in prescribed form and containing prescribed information, without notice or demand therefor;

(b) estimate in the return the amount of tax, if any, payable by it under this Part for the year; and

(c) pay to the Receiver General the tax, if any, payable by it under this Part for the year.

"Liability of trustee – Sec.. 210.5(6)"

(6) A trustee of a trust is personally liable to pay to the Receiver General on behalf of the trust the full amount of any tax payable by the trust under this Part to the extent that the amount is not paid to the Receiver General within the time specified in subsection 210.2(5), and the trustee is entitled to recover from the trust any such amount paid by the trustee.

¹²⁶⁴ Though the payment may be substantial it does not linger in the Government's coffers very long owing to that fact that the *inter vivos* trust beneficiary will be able to claim a credit equal to its amount, to be described, in the same calendar year return.

¹²⁶⁵ Does that necessarily indicate that such a recovery shall be tax free in respect of the possible application of Sec. 105(1)?

The Final Integration: Resident Beneficiary Tax Credits.

The final step the Part takes in ensuring that the Part XII.2 tax is imposed only on the income that is recognized by the tax exempt party is that it allows tax credits to be obtained by the **taxable** beneficiaries in respect of the tax paid by the trust, so as to reduce the effective tax rate on the trust income realized by them.

Under subsection 210.2(3) where income is included by reason of Sec. 104(13) or 105(2), **(only)**, in computing the income of a undesignated beneficiary under the trust under Part I, or in computing the income of the non-resident person that is subject to tax under Part I by reason of Sec. 2(3) and is not exempt from such tax by reason of a tax treaty, (and the beneficiary is not a designated beneficiary described in section 210, other than a non-resident person), then an amount in respect of the trust's Part XII.2 tax shall be deemed paid in respect of that person's Part I tax for the year. The beneficiaries to which this apportioning applies include only the beneficiaries under the trust that will pay Part I tax on the Sec. 104(13) or 105(2) income inclusions that will be able to recognize the possible tax credit. This obviously includes any Canadian resident beneficiary that is **not a designated beneficiary** while in the case of non-resident beneficiaries it is effectively only those who must recognize the income under Sec. 115(1)(a)(ii) as income from businesses carried on in Canada that will be able to obtain a tax credit.¹²⁶⁶

The credit available to any given beneficiary who is eligible is determined by a formula equal to the Part XII.2 tax paid by the trust for the year multiplied by the amount which is the income amount recognized by the beneficiary under the trust under Sec. 104(13) and 105(2) for the year that is of the aggregate of such amounts recognized by **all** of the beneficiaries under the trust had they been resident in Canada. Such amount determined in respect of each eligible beneficiary shall, if designated by the trust, be deemed to be an amount paid on account of the person's Part I tax payable for the year in which the trust's tax year ends but only so paid 90 days after the end of the trust's tax year.¹²⁶⁷

Under subsection 104(31) the amount designated shall for purposes of Sec. 104(13) be deemed to be an amount in respect of the income of the trust for the year that has become payable to the beneficiary under the trust. This is understandable since under Sec. 104(30) there shall be deducted, mandatorily, from the trust's Division B income such tax paid by the trust under Part XII.2, however this is only for purposes of Part I.¹²⁶⁸ The Sec. 104(30) deduction will cause a reduced Sec. 104(13) inclusion. Since the Part XII.2 tax paid by the trust reduces the taxable beneficiary's Part I tax payable the only beneficiary which incurs a higher marginal tax rate in respect of the income paid to him is the designated beneficiary.¹²⁶⁹

"Tax deemed paid by beneficiary – Sec. 210.2(3)"

(3) Where an amount (in this subsection and subsection 210.3(2) referred to as the "income amount") in respect of the income of a trust for a taxation year is, by reason of subsection 104(13) or 105(2), included in computing

(a) the income under Part I of a person who was not at any time in the year a designated beneficiary under the trust, or

(b) the income of a non-resident person (other than a person who, at any time in the year, would be a designated beneficiary under the trust if section 210 were read without reference to paragraph 210(a)) that is subject to tax under Part I by reason of subsection 2(3) and is not exempt from tax under Part I by reason of a provision contained in a tax convention or

¹²⁶⁶ A tax credit is not available in respect of an N.R.O.I.C. since such a person is not non-resident and is a designated beneficiary.

¹²⁶⁷ Is it possible to have the credit amount earn interest if the respective beneficiary's tax year doesn't end until 360 days after the end of the trust's tax year?

Under subsection 210.2(4) the designation made by the trust is further broken down, in the case of partnerships, resulting in a designation being made in respect of each partner thereunder. One should notice and question the reason for the difference in the way the apportioning mechanics operate under Part XII.2 and Sec. 104(13.1) - (13.2) of Part I. Under the latter the basis is not the amount of Part I income recognized by the beneficiaries under Sec. 104(13) or (105(2) while in respect of Part XII.2 tax it is. **Both** mechanisms were introduced in the 1988 reform.

¹²⁶⁸ It also prevents it from being included in the beneficiary's income under Sec. 105(1).

¹²⁶⁹ The timing of the cessation in residency of the trust becomes important.

agreement with another country that has the force of law in Canada, an amount determined by the formula

$A \times B/C$ where

A is the tax paid under this Part by the trust for the year,

B is the income amount in respect of the person, and

C is the total of all amounts each of which is an amount that is or would be, if all beneficiaries under the trust were persons resident in Canada to whom Part I was applicable, included in computing the income under Part I of a beneficiary under the trust by reason of subsection 104(13) or 105(2) in respect of the year,

shall, if designated by the trust in respect of the person in its return for the year under this Part, be deemed to be an amount paid on account of the person's tax payable under Part I for the person's taxation year in which the taxation year of the trust ends, on the day that is 90 days after the end of the taxation year of the trust.

"Where beneficiary deemed not designated – Sec. 210.3(2)"

(2) Where a trust would, if the trust paid tax under this Part for a taxation year, be entitled to designate an amount under subsection 210.2(3) in respect of a non-resident beneficiary and the income amount in respect of the beneficiary is included in computing the income of the beneficiary which is subject to tax under Part I by reason of subsection 2(3) and is not exempt from tax under Part I by reason of a provision contained in a tax convention or agreement with another country that has the force of law in Canada, for the purposes of subsection 210.3(1), the beneficiary shall be deemed not to be a designated beneficiary of the trust at any time in the year.

"Designations in respect of partnerships – Sec. 210.2(4)"

(4) Where a taxpayer is a member of a partnership in respect of which an amount is designated by a trust for a taxation year of the trust (in this subsection referred to as the "particular year") under subsection 210.2(3),

(a) no amount shall be deemed to be paid on account of the partnership's tax payable under Part I by reason of subsection 210.2(3) except in the application of that subsection for the purposes of subsection 104(31), and

(b) an amount determined by the formula

$A \times B/C$ where

A is the amount so designated,

B is the amount that may reasonably be regarded as the share of the taxpayer in the designated income of the trust received by the partnership in the fiscal period of the partnership in which the particular year ends (that fiscal period being referred to in this subsection as the "partnership's period"), and

C is the designated income received by the partnership from the trust in the partnership's period,

shall be deemed to be an amount paid on account of the taxpayer's tax payable under Part I for the person's taxation year in which the partnership's period ends, on the last day of that year.

"Provisions applicable to Part – Sec. 210.2(7)"

(7) Subsections 150(2) and 150(3), sections 152 and 158, subsections 161(1) and 161(11), sections 162 to 167 and Division J of Part I are applicable to this Part with such modifications as the circumstances require.

"Tax under Part XII.2 – Sec. 104(30)"

(30) For the purposes of this Part, there shall be deducted in computing the income of a trust for a taxation year the tax paid by the trust for the year under Part XII.2.

"Idem – Sec. 104(31)"

(31) The amount in respect of a taxation year of a trust that is deemed under subsection 210.2(3) to have been paid by a beneficiary under the trust on account of the beneficiary's tax under this Part shall, for the purposes of subsection 104(13), be deemed to be an amount in respect of the income of the trust for the year that has become payable by the trust to the beneficiary at the end of the year.

Part Year Resident Trusts & Beneficiaries.

As per section 210.1 Part XII.2 does not apply to trusts that were **throughout** their tax years testamentary non-resident trusts, (amongst others), while under Sec. 104(7) a Sec. 104(6) deduction is denied to a trust in respect of income amounts that became payable to a designated beneficiary, unless the trust was resident in Canada **throughout** its tax year. Thus if the *inter vivos* trust becomes non-resident in a particular year it can be exposed to Part XII.2 tax, by virtue of the fact that it was not, throughout its tax year, non-resident, while at the same time it will recognize a Sec. 104(7) cutback in the Sec. 104(6) deduction, if the circumstances exist. If the trust makes Sec. 104(6) deductions in the year in respect of other beneficiaries then it will definitely have a tax base that Sec. 210.2(1) can be applied upon, (assuming that it has designated income). Under the pre 1988 reform Act, as per Sec. 212(11.1) and (11.2) the amount of Sec. 104(6) cutback caused by Sec. 104(8) would not attract Part XIII withholding tax when it was distributed to the non-resident hence under the former Act there would either be taxation in the hands of the trust or in the hands of the beneficiary, but not both. Presently, income payable may thus not be deducted by the trust as per Sec. 104(7) in the year it became non-resident, thus causing them to be taxed in its hands under Part I, will form a basis upon which Part XII.2 tax may be applied as per Sec. 210.2(1)(a),(b) or (c), **and** the payment net of Part XII.2 tax will be subject to withholding as per Sec. 212(1)(c) when it became payable to the non-resident beneficiary when the trust was resident. The subsection 210.2(3) designation mechanics do not operate in respect of a beneficiary who was, at any time in the tax year of the trust, a designated beneficiary and thus if a resident beneficiary ceases to reside in Canada during that time a Part XII.2 credit cannot be allocated to him. This will cause significant additional taxation of the income that beneficiary recognizes though such can be alleviated with Sec. 104(13.1) elections or withholding or exercise of discretionary distributive powers. The income beneficiary may also sell his income interest to a resident so as to recognize Part I income at the appropriate rates while the income interest can be subjected to a trust which has as its beneficiaries residents though which instills in the departing taxpayer an absolute power of appointment over all of the income which is to be exclusively capitalized in which case the income would continue to benefit from Part I rates only and the capital can subsequently be distributed without consequence under Sec. 107(5).

Benefits to Non-Residents and N.R.O.I.C's.

Subsection 104(10) provides that where all of the property owned by the trust "for the benefit of non-resident persons or their unborn issue" there may be deducted from the trust's income the amount of interest and dividends actually received by the trust in the year from a non-resident owned investment corporation

(N.R.O.I.C.), as were not deductible under Sec. 104(6), in computing the trust's income, (as payable to a beneficiary or included in computing the recipient's income under Sec. 105(2)).

Subsection 104(11) provides that where any of the just mentioned **dividends** are **deductible** by the trust under Sec. 104(10), for purposes of **Part XIII only** the trust shall be deemed to have paid them to the non-resident person as income of the non-resident person from the trust, on the last day of the trust's tax year thus the trust will have to remit withholding tax applied upon them.¹²⁷⁰

Under Sec. 104(10) all of the **owned** property must be held for the benefit of non-resident parties but it need not apparently be owned exclusively for their benefit hence interest from N.R.O.I.C.'s could be accumulated and shielded from taxation in the hands of the trust, while at the same time not cause withholding tax to be applied as is the case with dividends under Sec. 104(11). If the interest wasn't immediately payable as income then Sec. 104(13) would not cause Sec. 212(1)(c) to cause withholding when the beneficiary is non-resident. Effectively the interest would be received by the trust tax free while the N.R.O.I.C. would not receive a deduction in computing its income in respect of its payment by virtue of Sec. 133(1)(a) and 133(2)(a), and while this would cause the taxation of the amounts to occur in the N.R.O.I.C.'s hands the distribution of those amounts will not attract further taxation as is the case with dividends, (other than capital dividends), as provided in Sec. 212(2). Subsection 133(3) causes a tax rate of 25% to be applied to N.R.O.I.C.'s taxable income, and where the interest can be distributed tax free by the trust, (as capital), to any beneficiary then this will be the effective rate on that amount of income realized by the N.R.O.I.C. and passed on to the beneficiary. Even when the capital interest in the personal trust has been acquired for consideration payable effective tax free distributions can be arranged.

The above does not apply equally with respect to dividends however the essential factor to recognize is that all of the property of the trust must be owned for the benefit of a non-resident person (beneficiary?) at the time while in the future this condition may not be maintained. Since the Sec. 104(10) provision refers only to "...all of the property of a trust is owned..." rented/loaned property for the benefit of a resident person (in the form of income realizations), would disqualify the application of Sec. 104(10) since the provision does not refer to "...where all of the property owned by the trustee..."

Subsection 104(10) allows a deduction completely separate from that in Sec. 104(6) to the trust however the amount thereof cannot exceed the amount of N.R.O.I.C. interest and dividends net of that part thereof that was recognized as payable to a non-resident person and that caused a Sec. 104(6) deduction.

One of the tax bases for the application of Part XII.2 tax (as per Sec. 210.2(1)(c)), is the amount of Sec. 104(6) deduction the trust took in the year regardless of the beneficiary in respect of whom it was taken hence if the trust is to incur Part XII.2 tax, (due to the recognition of designated income), it could be beneficial to have the dividends/interest capitalized in the trust, if they are to be payable to a non-resident, rather than be payable immediately as income, since the former will allow the trust to benefit from the **Sec. 104(10) deduction** instead of the Sec. 104(6) deduction required to alleviate double taxation if the amounts are payable as income. The Sec. 104(10) deduction is not commented on in Sec. 210.2(1) as a possible off-setting deduction for income base recapture for Part XII.2 tax thereon, hence by altering the deduction from one of Sec. 104(6) character to that of Sec. 104(10) the Part XII.2 base is reduced since the income is reduced. This will only be of benefit if Part XII.2 tax was to be incurred in the first place, while interest and dividends from N.R.O.I.C.s do not constitute designated income.

Since the provision applies where property is owned for the benefit of the non-residents or their unborn issue tax free capitalization of interest in the trust can be carried on over long periods of time whereafter it can be distributed tax free by the personal trust as capital. **The provisions speak nothing as to whether this income must be payable as income.**

Where any amount of **dividends** were received by the trust from a N.R.O.I.C. were **deductible** under Sec. 104(10), for purposes of Part XIII withholding they will be deemed to have been paid to a non-resident person on the last day of the trust's tax year thus the trust will have to retain and remit the 25% tax on the gross amount called for by Sec. 212(1)(c), unless it wouldn't be included in the trust's income. The application of the

¹²⁷⁰ See *Williams v Singer* [1920] UKHL 2 (17 May 1920) for an ancillary UK case on certain issues.

Sec. 104(10)-(11) mechanics changes the character of the payment from dividend income to income from a trust interest, and the provision recognizes that the ultimate recipient of the amount need not be identifiable. Since the taxable dividend will be exposed to withholding of 25% under Sec. 212(1)(c), and the amount of dividend was taxed at the 25% rate in the hands of the N.R.O.I.C. when it was realized as income, manipulated interest payments have their advantages over dividend payments if a trust is to be used as an intermediary property (share) holder.

Since the subsection 104(7) restriction operates only in respect of Sec. 104(6) deduction, it will not affect the application of Sec. 104(10)-(11) if the trust becomes non-resident within its tax year and Sec. 104(10) is available to non-resident trusts.

“Where property owned for non-residents – Sec. 104(10)”

(10) Where all the property of a trust is owned by the trustee for the benefit of non-resident persons or their unborn issue, in addition to the amount that may be deducted under subsection 104(6), there may be deducted in computing the income of the trust for a taxation year for the purposes of this Part, such part of the dividends and interest received by the trust in a year from a non-resident-owned investment corporation as are not deductible under that subsection in computing the income of the trust for the year.

“Dividend received from non-resident owned investment corporation – Sec. 104(11)”

(11) Where any part of the dividends received in a taxation year by a trust described in subsection 104(10) from a non-resident-owned investment corporation are deductible under that subsection in computing the income of the trust for the year, for the purposes of Part XIII the trust shall be deemed to have paid to a non-resident person on the last day of the year an amount equal to that part, as income of the non-resident person from the trust.

Income Attribution – Non Reversionary Trusts.

An Overview of the General Rules.

Whenever income tax rates are progressively applied on differing levels of income recognized by taxpayers it will be advantageous for a taxpayer who is recognizing higher levels of income, and thus being exposed to higher rates of tax, to transfer income producing property to a taxpayer recognizing lower levels of income and thus paying lower effective rates of tax since the absolute amount of tax paid will be resultantly less. Understandably good income tax laws will attempt to hinder such relocating of income bases to lower effective tax rates through provisions that will attribute back to the transferor of the property the taxable income therefrom.

The attribution provisions that exist in the Canadian Income Tax Act that apply most directly to income splitting through the use of trusts and estates, are spread out primarily over four different sections and differ only minimally, but significantly, from each other. Subsections 74(1), (2) and 75(1), applicable with respect to transfers (and not loans) to spouses and minors made prior to May 22, 1985 have been repealed and replaced by subsections 74.1(1), (2), 74.2(1), and 74.3(1) which apply to both loans and transfers of property to spouses, persons under 18 that do not deal at arm's length with the transferor/lender or nieces or nephews thereof and to trusts (though not estates) under which one of the three above "designated persons" was "beneficially interested...". Subsection 56(4.1) applies solely to loans of property by an individual to a non-arm's length individual, the purpose of which was to reduce or avoid tax on the income realized on the property. Subsection 75(2) is such a "wonderful" provision it deserves extensive comment in a chapter all by itself.

The attribution provisions have evolved considerably since they were first introduced however there is considerable relevance in historic judicial commentary provided in respect of their predecessors starting with *Fasken Estate v. M.N.R.*¹²⁷¹ whereunder a substantial debt carrying interest that was owed to the taxpayer was vested in a trust set up by him whereunder the interest from the debt would be payable to the spouse and son of the taxpayer. The interest payments were made directly to the beneficiaries by the debtor and the Minister assessed the taxpayer as recognizing the income under the 1924 Act being that the charging provision read as follows:

"4(b) Where a husband transfers property to his wife, or vice versa, the husband or the wife, as the case may be, shall nevertheless be liable to be taxed on the income derived from such property or from property substituted therefore as if such transfer had not been made."

The Exchequer Court, while on commenting on the word "property" provided that:

"The Courts have also recognized the wide extent of the word. For example, in *Jones v. Skinner*, (1836), 5 C.J. Ch. 87 (N.S.), at 90 Lord Langdale M.R. said:

"It is well-known, that the word "property" is the most comprehensive of all the terms which can be used, in as much as it is indicative and descriptive of every possible interest which the party can have."

...Vide also *Re Lunness*, (1919) 46 O.L.R. 320 at 322, per Riddell J. what Mrs. Fasken became entitled to is manifest from clause (5) of the declaration of trust, namely **the right** to receive from the trustees one half of the interest on the indebtedness that should come to their hands from time to time after the interest on Andrew Fasken's claim had been paid. In my view, the word "property" as used in the Act is clearly wide enough in meaning to include such a right."

With respect to the phrase "husband transfers property", although not certifying that the provision only applies if the action was voluntarily initiated by the husband, the Court held:

"In *Gathercole v. Smith*, (1880-81) 17 Ch. 1 at 7, James L.J. spoke of the word "transfer" as "one of the widest terms that can be used", and Lush L.J. said, at page 9, "The word "transferrable", I agree with Lord Justice James, is a word of the widest import and includes every means by which the property may be passed from one person to another."

The word 'transfer' is not a term of art and has not a technical meaning. It is not necessary to a transfer of property from a husband to his wife that it should be made in any particular form or that it should be made directly. All that is required is that **the husband should so deal with the property as to divest himself from it and vest it in his wife**, that is to say, pass the property from himself to her. The means

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by which **he** accomplishes this result, whether direct or circuitous, may properly be called a transfer. The plain fact in the present case is that the property to which Mrs. Fasken became entitled under the declaration of trust, namely, the right to receive a portion of the interest on the indebtedness, passed to her from her husband who had previously owned the whole of the indebtedness out of which the right to receive a specified portion of the interest on it was carved. If David Fasken had conveyed this piece of property directly to his wife by a deed such conveyance would clearly have been a transfer. The fact that **he brought about** the same result by indirect or circuitous means, such as the novation referred to by counsel involving the intervention of trustees, cannot change the property which had previously belonged to him to pass to his wife. In my opinion, there was a transfer of property from David Fasken to his wife within the meaning of the Act."

"...But it was not the interest itself that was transferred. There was not a fresh transfer of property from David Fasken to his wife in each of the years 1925 to 1926 when she received payments of interest, what was transferred was the right to receive the interest not the interest itself, and the right could be and was transferred only once. The amounts of interest received by Mrs. Fasken were the fruits of such right and could properly be regarded as income derived from it. The right was, therefore, property from which income was derived."

(It is particularly interesting to note that even in the 1924 Act the attribution provisions were based upon the husband (or taxpayer) making the transfer to the spouse as it was highlighted in the Judge's comments, and it is particularly important to recognize that as per Fasken Estate, a case upon which substantial jurisprudence followed, the attribution provisions, **and** the judicial commentary were exclusively phrased to attend to the fact that it was the taxpayer who accomplished the transfer **by his own actions** and not that the "transfer" was initiated by a third party having control over his property.)

The Court in Fasken Estate v. M.N.R. also provided that although the legal title to the property formerly owned by the taxpayer had not been transferred to the spouse, the equitable title had been, and since this property subsisted in the legal title formerly held by the taxpayer, and since it was the property which caused the income to accrue to the wife, there had been a transfer of property.¹²⁷² The fact that the Sec. 4(b) provision of the 1924 Act as well as today's provisions apply both to property transferred and property "substituted" therefor renders irrelevant the argue that the property which caused the taxpayer to recognize the income; the legal title, was not transferred to the spouse; who only realized the equitable title.

The subsection 74.1(1) and 74.2(1) provisions contain several qualifying technicalities one of the most important of which is that the loan or transfer of property must have been made to a spouse of the transferor or a person who has since become his spouse however as per Sec. 74.5(3)(a) income, or loss will not be attributable where it relates to a period throughout which the transferor and transferee are living apart and separate but only by reason of a break down in the marriage while in respect of the attribution of capital gain or loss under Sec. 74.2(1), attribution will not result where the disposition of the property, (and not the recognition of the gain), occurs during the period just mentioned and the transferor filed with his return for the period **in which they started to live apart** etc an election **jointly** completed by the two parties stating the Sec. 74.1(1) provision should not apply.

The subsection 74.1(1) provision contemplates transfers or loans made directly or indirectly, by means of a trust or by any means whatsoever, **"to or for the benefit of"** the spouse and thus it is not important that the spouse ever receive legal title to the property, or equitable title to it, but only that she benefit from the transfer or loan. The more important qualification of this benefit is that by virtue of the phrase "...shall be deemed to be income or a loss, as the case may be, of the individual for the year and not that person" it will only be the income (or loss) which the spouse realizes from the property, (or its substitute) that will be attributable, (and in this regard it's important to recognize that this income need not be subject to tax). In Pichosky v. M.N.R.¹²⁷³ the Exchequer Court held that although the appellant had transferred cash to a trust which was used to purchase dividend producing shares, (substitute property), since the trust did not, in fact, receive any dividends

¹²⁷² Presently, in Sec. 108(5), it is deemed that when a taxpayer recognizes income from a trust/estate under the subdivision K rules the income will be considered that of a property which an interest in a trust is.

¹²⁷³ 64 D.T.C. 5105

in a certain year, the beneficiaries under the trust to whom its income was payable also wouldn't have to recognize the income that was deemed to have been earned, (they being spouse and sons of the contributor), thus attribution could not occur:

"In my view, subsection (1) of section 21 and subsection (1) of section 22 (the attribution provisions) clearly provide only for income that otherwise would be taxable in the hands of the transferee being taxable in the hands of the transferor. I think this view is clenched by the enacting words at the end of subsection (1) of section 21, which provide that the income from the property or the property substituted therefore shall be deemed to be income of a transferor "and not of the transferee". Similar words are to be found in subsection (1) of section 22. Assuming that Albert Pichosky Limited was a personal corporation, and the \$60,000 dividend is **deemed** to have been received by its shareholders in 1959, that would make it income deemed to have been received by Albert Pichosky trust for purposes of the Income Tax Act (see section 67(1)). In fact, however, the trust received no income in 1959 and no income would therefore be "**payable**" to a beneficiary in 1959 **so as to be taxable in the hands of that beneficiary** in 1959. (See section 63, subsection (6) and subsection (7) and (24)). The \$60,000 dividend would not therefore have been otherwise taxable in the hands of Mrs. Pichosky or the sons and it follows therefore, on the view of section 21 and section 22 that I have already indicated, that the \$60,000 dividend is not taxable in the hands of the appellant."¹²⁷⁴

If the trust above had current property losses then income payable to the spouse/issue would have been reduced (as based on Division B income) and thus less attribution could have resulted. If the spouse realizes income from the property as per the Division B rules then although her non-capital loss carry forwards may be able to negate its recognition for the imposition of tax it will still be income from property and thus attributed back. If the revenue she realizes from the property doesn't enter income under the Division B rules then it isn't income for the purposes of the attribution rules and thus will not be attributable.

Most of the attribution rules apply to income, loss, or gain, that was realized when the transferor was resident in Canada however they do not operate to preclude from effect transfers or loans of property that were made when one, the other, or both transferor or transferee were non-resident and subsequently became resident. Since the Act is administered in respect of income from all places and sources, (being global income), not precluded from effect are transfers or loans of property to a person who is non-resident at the time, or any time thereafter.

Subsection 74.1(2) provides a provision that, for all intents and purposes, is identical to Sec. 74.1(1) except that it applies where the transferee or debtor is under 18 years old and does not deal at arm's length with the taxpayer or is a niece or nephew of the taxpayer, however it does not apply to any income or loss realized in the whole taxation year **if before the end of the taxation year** the transferee/debtor attained the age of 18 years. It is applicable for loans outstanding on or after May 22nd, 1985 that have not been repaid before 1988, and transfers made after May 22nd, 1985 and attempts to replace Sec. 75(1) which provides basically the same thing except in respect of transfers only made before May 22, 1985.

Subsection 74.2(1) applies to cause attribution of taxable capital gains and allowable capital losses and net taxable gains from the disposition of property transferred or loaned directly or indirectly, through a trust, to a **spouse only**, and thus capital gains and gains from the disposition of property by a minor will not be attributable back to the transferor, at least not under Sec. 74.2(1).¹²⁷⁵ Subsection 74.2(2) operates to allow the gain or loss attributed to the transferor to be recognized for purposes of the capital gains deductions and the loss carry forward provisions as that from a disposition of property by the transferor.

Subsection 74.2(1) is split into broad parts applying to dispositions by the spouse during which the transferor was resident in Canada of property other than listed personal property, (as defined in Sec. 54(e)). The net

¹²⁷⁴ This is an excellent example of the present inadequacy of Sec. 104(24). See also *Houry v. C.I.R.*, 1959 3 All E.R. 781 (PC) for another example of notional distribution not being actually distributable. The Pichosky problem still exists: Sec. 12(1)(m) forms the basis for attribution under Sec. 74.3(1), as well be seen, but Sec. 104(13) inclusions making up that basis occur only when in trust law income is legally distributable or distributed.

¹²⁷⁵ Subsection 75.1(1) applies to attribute gains from transfers of property made by a transferor to his child where the property was farm property that was transferred *inter vivos* and benefitted from the Sec. 73(3) roll-over provision, and the transfer was made at less than the fair market value of the property and the child disposed of it in a tax year in which he had not turned or been 18 years old before the end of.

taxable capital gain or allowable capital loss and the net gain or loss from the disposition of the respective types of property, separately determined, that were property loaned or transferred or substitute property therefore, will be attributable back to the transferor/lender.

“Transfers and loans to spouse or common-law partner – Sec. 74.1(1)”

(1) Where an individual has transferred or lent property (otherwise than by an assignment of any portion of a retirement pension pursuant to section 65.1 of the *Canada Pension Plan* or a comparable provision of a provincial pension plan as defined in section 3 of that Act or of a prescribed provincial pension plan), either directly or indirectly, by means of a trust or by any other means whatever, to or for the benefit of a person who is the individual’s spouse or common-law partner or who has since become the individual’s spouse or common-law partner, any income or loss, as the case may be, of that person for a taxation year from the property or from property substituted therefor, that relates to the period in the year throughout which the individual is resident in Canada and that person is the individual’s spouse or common-law partner, shall be deemed to be income or a loss, as the case may be, of the individual for the year and not of that person.

“Transfers and loans to minors – Sec. 74.1(2)”

(2) If an individual has transferred or lent property, either directly or indirectly, by means of a trust or by any other means whatever, to or for the benefit of a person who was under 18 years of age (other than an amount received in respect of that person either as a consequence of the operation of subsection 122.61(1) or under section 4 of the *Universal Child Care Benefit Act*) and who

(a) does not deal with the individual at arm’s length, or

(b) is the niece or nephew of the individual, any income or loss, as the case may be, of that person for a taxation year from the property or from property substituted for that property, that relates to the period in the taxation year throughout which the individual is resident in Canada, is deemed to be income or a loss, as the case may be, of the individual and not of that person unless that person has, before the end of the taxation year, attained the age of 18 years.

“Repayment of existing indebtedness – Sec. 74.1(3)”

(3) For the purposes of subsections 74.1(1) and (2), where, at any time, an individual has lent or transferred property (in this subsection referred to as the “lent or transferred property”) either directly or indirectly, by means of a trust or by any other means whatever, to or for the benefit of a person, and the lent or transferred property or property substituted therefor is used

(a) to repay, in whole or in part, borrowed money with which other property was acquired, or

(b) to reduce an amount payable for other property, there shall be included in computing the income from the lent or transferred property, or from property substituted therefor, that is so used, that proportion of the income or loss, as the case may be, derived after that time from the other property or from property substituted therefor that the fair market value at that time of the lent or transferred property, or property substituted therefor, that is so used is of the cost to that person of the other property at the time of its acquisition, but for greater certainty nothing in this subsection shall affect the application of subsections 74.1(1) and (2) to any income or loss derived from the other property or from property substituted therefor.

“Gain or loss deemed that of lender or transferor 74.2 – Sec. 74.2(1)”

(1) Where an individual has lent or transferred property (in this section referred to as “lent or transferred property”), either directly or indirectly, by means of a trust or by any other means whatever, to or for the benefit of a person (in this subsection referred to as the “recipient”) who is the individual’s spouse or common-law partner or who has since become the individual’s spouse or common-law partner, the following rules apply for the purposes of computing the income of the individual and the recipient for a taxation year:

(a) the amount, if any, by which

(i) the total of the recipient’s taxable capital gains for the year from dispositions of property (other than listed personal property) that is lent or transferred property or property substituted therefor occurring in the period (in this subsection referred to as the “attribution period”) throughout which the individual is resident in Canada and the recipient is the individual’s spouse or common-law partner exceeds

(ii) the total of the recipient’s allowable capital losses for the year from dispositions occurring in the attribution period of property (other than listed personal property) that is lent or transferred property or property substituted therefor shall be deemed to be a taxable capital gain of the individual for the year from the disposition of property other than listed personal property;

(b) the amount, if any, by which the total determined under subparagraph 74.2(1)(a)(ii) exceeds the total determined under subparagraph 74.2(1)(a)(i) shall be deemed to be an allowable capital loss of the individual for the year from the disposition of property other than listed personal property;

(c) the amount, if any, by which

(i) the amount that the total of the recipient’s gains for the year from dispositions occurring in the attribution period of listed personal property that is lent or transferred property or property substituted therefor would be if the recipient had at no time owned listed personal property other than listed personal property that was lent or transferred property or property substituted therefor exceeds

(ii) the amount that the total of the recipient’s losses for the year from dispositions of listed personal property that is lent or transferred property or property substituted therefor would be if the recipient had at no time owned listed personal property other than listed personal property that was lent or transferred property or property substituted therefor, shall be deemed to be a gain of the individual for the year from the disposition of listed personal property;

(d) the amount, if any, by which the total determined under subparagraph 74.2(1)(c)(ii) exceeds the total determined under subparagraph 74.2(1)(c)(i) shall be deemed to be a loss of the individual for the year from the disposition of listed personal property; and

(e) any taxable capital gain or allowable capital loss or any gain or loss taken into account in computing an amount described in paragraph 74.2(1)(a), 74.2(1)(b), 74.2(1)(c) or 74.2(1)(d) shall, except for the purposes of those paragraphs and to the extent that the amount so described is deemed by virtue of this subsection to be a taxable capital gain or an allowable

capital loss or a gain or loss of the individual, be deemed not to be a taxable capital gain or an allowable capital loss or a gain or loss, as the case may be, of the recipient.

Income Tax Interpretation Bulletin

Interspousal and Certain Other Transfers and Loans of Property

IT-511R

DATE: February 21, 1994

SUBJECT: INCOME TAX ACT

Interspousal and Certain Other Transfers and Loans of Property

REFERENCE: Section 74.2 and subsection 74.1(1) (also section 74.3 and subsections 56(4.1) to (4.3), 74.5(1) to (3), (5) to (12), 96(1.8), 248(5), (22), (23) and (25) and 252(4))

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Application

This bulletin cancels and replaces Interpretation Bulletin IT-511, dated December 30, 1987, primarily to describe relevant changes in the Income Tax Act since that bulletin was published.

Summary

This bulletin discusses a comprehensive set of rules intended to prevent a taxpayer and the taxpayer's spouse from splitting income from property so as to reduce the total amount of tax payable on that income. Except where fair market value consideration is paid by the spouse or the parties are living separate and apart by reason of a breakdown of their marriage, income earned and capital gains and losses realized on property transferred or loaned from a taxpayer to the taxpayer's spouse (and on property substituted for that property) are generally deemed to be the income, gains or losses of the taxpayer and not of the taxpayer's spouse.

The bulletin also discusses an anti-avoidance rule that applies, in certain cases, where an individual incurs indebtedness to acquire property, to attribute the income from the property (and on property substituted for that property) to the debtor. The provision applies where, among other things, the individual and the debtor do not deal at arm's length and one of the main reasons for the indebtedness was to reduce or avoid tax.

While this bulletin deals only with the attribution rules relating to spouses, subsections 74.1(2) and 75(2) also apply to attribute the income from property in certain circumstances. For comments on these subsections, see the current versions of IT-510, *Transfers and Loans of Property made after May 22, 1985 to a Related Minor*, and IT-369, *Attribution of Trust Income to Settlor respectively*.

The commentary below discusses the applicable rules in greater detail.

Discussion and Interpretation

1. In this bulletin, the terms listed below have the following meanings:

Transferred or Loaned Property: means all transfers or loans of property whether accomplished directly or indirectly, by means of a trust or by any other means. An indirect transfer occurs for example, where a husband and wife own all the shares of a corporation in a ratio of 90:10 and the corporation issues sufficient shares to the wife for consideration that is less than the fair market value of the additional shares to change the ratio of ownership to 50:50. A transfer includes a sale whether or not at fair market value, as well as a gift but does not include a genuine loan.

Spouse: Subsection 252(4), which applies after 1992, expands the meaning of spouse to include a person of the opposite sex who at a particular time lives with the taxpayer in a conjugal relationship and either has so lived with the taxpayer throughout a 12-month period ending before that time, or the two individuals are the parents of the same child. Where individuals have lived with each other as spouses in the past, they shall be deemed to be living as spouses at any later time. However, if the spouses have lived apart for a

period of at least 90 days because of a breakdown of their conjugal relationship, then commencing at the beginning of that 90 day period they will no longer be deemed to be living as spouses. A person can become the individual's spouse either as a result of their marriage or as a consequence of the operation of subsection 252(4). Prior to 1993, a party to a common-law relationship was not regarded as a spouse in respect of that relationship. The rules in subsections 74.1(1) and 74.2(1) apply to a person who is an individual's spouse or to a person who became the individual's spouse after the loan or transfer of property was made to that person. The rules in sections 74.3 and 74.4 apply to a designated person which includes a person who at any time is an individual's spouse.

Note: *On August 30, 1993 the Minister of Finance issued Amendments to the Income Tax Act and Related Statutes. Explanatory notes were issued which elaborate on the proposed changes. The Explanatory notes describe that subsection 252(4) will be amended to ensure that where the two individuals are considered to be spouses because they are the parents of the same child, they will be so considered only if they are the natural or adoptive parents of that child. If enacted as proposed the amendment will apply after 1992.*

Marriage: After 1992, by virtue of subsection 252(4), a reference to marriage includes a conjugal relationship between two individuals that would make them spouses of each other.

Beneficially Interested: An individual is "beneficially interested" in a trust if the individual has any right (whether immediate or future, whether absolute or contingent or whether conditional on or subject to the exercise of a discretionary power by any person or persons) to receive any of the income or capital of the trust, either directly from the trust or indirectly through one or more other trusts. See 15 below for examples of situations where an individual is beneficially interested in a trust.

Substituted Property: Paragraph 248(5)(a) provides that in the circumstances discussed in this bulletin, where a taxpayer has disposed of or exchanged a particular property and acquired other property in substitution for it and subsequently, by one or more further transactions, has effected one or more further substitutions, the property acquired by any such transaction is deemed to have been substituted for the particular property. For further comments on this topic see 27 below.

Designated Person: pursuant to subsection 74.5(5), a "designated person" in respect of an individual means a person who is

- (a) the individual's spouse or
- (b) a related minor.

Related Minor: a person who is under 18 years of age, and who

- (a) does not deal with the individual at arm's length (e.g. a parent and a child or other descendant whether by blood relationship or adoption, do not deal at arm's length - see the current version of IT-419, Meaning of Arm's Length), or
- (b) is a niece or nephew of the individual.

Prescribed Rate: means the interest rate prescribed by section 4301 of the Regulations.

Attribution of Income from Transferred or Loaned Property

2. Subsections 74.1(1) and 74.3(1) provide that where an individual has transferred or loaned property (including money) to the individual's spouse or to a trust in which that spouse is beneficially interested at any time any income or loss from the property or property substituted for it is deemed to be the individual's income or loss for a taxation year. See the discussion under the "Exclusions" caption starting at 18 below for exceptions to the rules. Further, although subsections 74.1(1) and 74.3(1) do not apply to common-law relationships before 1993, subsection 56(4.1) applies to attribute income on indebtedness of one individual to another where, among other things, the individuals do not deal at arm's length. Other than individuals connected by blood relationship, marriage or adoption, it is a question of fact whether the parties to a relationship deal with each other at arm's length at a particular time. See 30 to 34 below for a discussion of subsections 56(4.1) to 56(4.3).

Attribution of Capital Gains and Losses

3. Pursuant to paragraphs 74.2(1)(a) and (b), where an individual has transferred or loaned property to the individual's spouse any taxable capital gains or allowable capital losses arising from the dispositions of the property or property substituted for it (other than listed personal property) are deemed to be taxable capital gains or allowable capital losses of the individual. Also, pursuant to paragraphs 74.2(1)(c) and (d), any

gains or losses arising from the disposition of loaned or transferred listed personal property or property substituted for it are deemed to be gains or losses of the individual from the disposition of the listed personal property. See the discussion under the "Exclusions" caption starting at 18 below for exceptions to the rules.

4. Any taxable capital gains and allowable capital losses on dispositions of property attributed to a transferor by virtue of subsection 74.2(1) may be included in computing the transferor's lifetime capital gains deduction under section 110.6.

Application of Attribution Rules

5. It is necessary to distinguish between income or loss from property and income or loss from a business. Neither subsection 56(4.1) nor 74.1(1) applies to attribute business income or losses even if the business operates with some or all of the property obtained originally from the transferor. Although the income from a partnership is usually income from a business, subsection 96(1.8), which generally applies to 1989 and subsequent taxation years, provides an exception for the purposes of sections 74.1 and 74.3 and subsection 56(4.1). Where a taxpayer is a specified member of a partnership, that person's share of the income or loss of the partnership for a fiscal period, in which the person was a member of the partnership, is deemed by subsection 96(1.8) to be income or loss from property. "Specified member" is defined in subsection 248(1) and is essentially a member of a partnership who is a limited partner (as defined in subsection 96(2.4)), an inactive partner or a person who is not engaged in a business similar to that carried on by the partnership except as a member of the partnership.

6. Income or loss derived from the investment or other use of the income from transferred property is not attributed to the transferor and thus for income tax purposes is income or loss of the transferee. For example, interest on any interest allowed to accumulate is not attributed to the transferor and is income of the transferee.

7. Pursuant to subsection 74.1(3), the attribution rules in subsection 74.1(1) apply to transferred or loaned property which is used either to repay borrowed money that was used to acquire property or to reduce an amount payable for that property. For example, if an arm's length lender lends a taxpayer the money to acquire income producing property and later, the taxpayer's spouse makes a gift to the taxpayer equal to the taxpayer's indebtedness on the property and the gift is applied to retire the indebtedness, the income from the property will attribute to the taxpayer's spouse.

8. Subsection 74.5(6) applies in two situations where an individual has transferred or loaned property to a third party. The provision applies where

(a) the property or substituted property is, or

(b) the transfer or loan occurs on condition that any property be,

transferred or loaned by a third party to or for the benefit of the individual's spouse. Where the subsection applies, pursuant to paragraph 74.5(6)(c), the property transferred or loaned by the third party is deemed to have been transferred or loaned by the individual to or for the benefit of the spouse and, pursuant to paragraph 74.5(6)(d), any consideration received by the third party is deemed to have been received by the individual.

9. Subsection 74.5(7) applies where an individual must ensure repayment of a loan or any interest on a loan that is made by a third party to or for the benefit of the individual's spouse. Where the provision applies, the property loaned by the third party is deemed to have been loaned by the individual to or for the benefit of the spouse, and interest paid on the loan by the individual is ignored for the purposes of paragraphs 74.5(2)(b) and (c) (see 22 below).

10. Subsection 74.5(9) provides that where an individual has transferred or loaned property to a trust in which the individual's spouse is beneficially interested the transfer or loan is deemed to be for the benefit of the spouse.

11. Where an individual has transferred or loaned property to a trust in which a designated person who is the individual's spouse is beneficially interested at any time, paragraph 74.3(1)(a) applies to determine an amount that is deemed to be the income of the spouse from the property. This income is included in the individual's income pursuant to subsection 74.1(1).

12. Pursuant to paragraph 74.3(1)(a) the income of the spouse from the property transferred or loaned to the trust is the lesser of

(a) the spouse's income under paragraph 12(1)(m) from the trust, and
(b) the proportion of the income earned by the trust from the transferred or loaned property that
(i) the spouse's income under paragraph 12(1)(m) from the trust
is of

(ii) the aggregate income from the trust of all persons each of whom is throughout the year a related minor or the individual's spouse.

In (b) the "income earned by the trust" excludes capital gains and is calculated before any deductions under subsection 104(6) or (12).

13. Paragraph 74.3(1)(b) applies where an individual has transferred or loaned property to a trust in which the individual's spouse is beneficially interested at any time to determine the taxable capital gain of the spouse that is attributed to the individual pursuant to subsection 74.2(1) (see 3 above). The attributed amount is the lesser of

(a) the amount that was designated under subsection 104(21) for the spouse in the trust's income tax return for the year, and

(b) the net taxable capital gains for the year from the disposition by the trust of property that has been transferred or loaned to the trust by the individual.

14. An example of the operation of subsection 74.3(1) follows:

An individual transfers, for no consideration, bonds which pay interest of \$1,500 per annum to a family trust the beneficiaries of which are the individual's spouse and two children, one of whom is 16 years of age and the other 20 years of age. The trust's income before any deductions under subsection 104(6) or (12) is \$2,700, including a taxable capital gain of \$300, of which \$180 was realized on the disposition of the bonds transferred from the individual. Each beneficiary has an equal entitlement to the trust income, all of which is payable in the year. The trust designated \$100 of taxable capital gains for each beneficiary.

The spouse and the 16 year old child are designated persons.

The income from the transferred bonds for each designated person is the lesser of:

- the income of the designated person from the trust = \$800 (i.e., $1/3$ of $(\$2,700 - \$300)$), and
- $(A \times B) \div C$,

where

A is the income of the trust from the transferred property (\$1,500),

B is the income of the designated person from the trust (\$800), and

C is the income of all the designated persons from the trust (\$1,600).

$(\$1,500 \times \$800) \div \$1,600 = \$750$

Income of \$750 is attributed to the individual from the spouse.

The taxable capital gain from the transferred property for the spouse is the lesser of:

- the amount designated under subsection 104(21) for the spouse (\$100), and
- the net taxable capital gain realized on the disposition of the transferred bonds (\$180).

A taxable capital gain of \$100 is attributed to the individual from the spouse.

15. The following are examples of situations where an individual is beneficially interested in a trust:

(a) trust income is payable to the individual;

(b) income is held in trust and will be paid upon the individual's attainment of a certain age;

(c) the individual is one for whom a preferred beneficiary election may be made;

(d) the individual is one of a class who has a remainder interest under the trust.

The individual is beneficially interested in the trust in (b) even if the individual's right to receive income ceases if the individual should die before attaining the specified age. Similarly, the individual is beneficially interested in the trust in (c) even if the trustees have full discretionary powers concerning the distribution of the capital or income of the trust so that the individual may in fact receive nothing from the trust.

16. If depreciable property of a prescribed class is transferred to a spouse and immediately before that time the spouse had no property of that class, the income or loss from the property attributed to the transferor must reflect any amount of capital cost allowance, terminal loss or recapture of capital cost allowance for the class which would otherwise be taken into account in computing the income of the spouse.

If depreciable property of a prescribed class is transferred to a spouse and immediately before that time the spouse had other property of that class,

(a) a reasonable portion of the capital cost allowance claimed by the spouse for the class (which may not exceed the maximum capital cost allowance that would be deductible for the transferred property if the property were in a separate class) may be deducted in computing the income or loss from the property attributable to the transferor, and

(b) also in that computation, a terminal loss or recapture of capital cost allowance that would otherwise be included in computing the income of the spouse for the class of depreciable property must be taken into account to the extent that such amount can reasonably be considered to relate to the transferred property. After the year of disposition of the transferred property and provided a substituted depreciable property is not acquired by the spouse, there is no attribution of income or loss in respect of any capital cost allowance, terminal loss or recapture of capital cost allowance that arises for the class.

17. Where income arises from depreciable property transferred to a trust the amount attributed to the transferor is determined as described in 12 above, even though the trust's income calculation includes amounts for capital cost allowance, terminal loss or recapture of capital cost allowance for the class.

Exclusions

18. Subsections 74.1(1) and 74.2(1) do not apply to attribute any income or loss or any taxable capital gains or allowable capital losses to the transferor that relates to a period

(a) following the death of the transferor or transferee,

(b) throughout which the transferor is not resident in Canada, or

(c) after the transferee ceases to be the transferor's spouse, (e.g., when a divorce becomes final).

19. By virtue of paragraph 74.5(3)(a), the attribution rules for income under subsection 74.1(1) do not apply for the period when spouses are living separate and apart by reason of a breakdown of their marriage.

20. By virtue of paragraph 74.5(3)(b), the attribution rules for capital gains under subsection 74.2(1) do not apply to dispositions of property occurring at any time while the spouses are living separate and apart because of a breakdown of their marriage if the spouses jointly elect not to have section 74.2 apply. Section 74.2 will cease to apply for the year the joint election is filed and thereafter. The election, which may be filed for any taxation year ending after the separation, should be filed with the transferor's income tax return.

21. Pursuant to subsection 74.5(1), income or loss from transferred property or any taxable capital gains or allowable capital losses on the disposition of the transferred property does not attribute to the transferor in a particular year where

(a) the sale or other transfer is made to the transferor's spouse for consideration equal to fair market value of the transferred property,

(b) the sale price or other consideration for the transfer is

(i) fully paid by the transferee in cash or kind (and not from property furnished by the transferor), or

(ii) satisfied in whole or in part by indebtedness on which interest is charged at a rate not less than the lesser of

(A) the prescribed rate and

(B) the rate that would be agreed upon between arm's length parties under similar circumstances

at the time the indebtedness is incurred, if all such interest is paid no later than 30 days after the end of each calendar year in which it becomes payable, and

(c) the transferor elects not to have the provisions of subsection 73(1) apply (i.e., any gain or loss is realized at the time of transfer).

If the interest in (b)(ii) is not paid within the described time then the indebtedness will not meet the requirements for exemption from the attribution rules under subsection 74.5(1) in the particular year or in any later year.

See the current version of IT-325, *Property Transfers After Separation, Divorce and Annulment*, for comments on subsection 73(1).

22. Pursuant to subsection 74.5(2), subsections 74.1(1) and 74.2(1) do not apply in a particular year to loans where interest is charged on the indebtedness at a rate not less than the lesser of

(a) the prescribed rate and

(b) the rate that would be agreed upon between arm's length parties under similar circumstances at the time the indebtedness is incurred, if all such interest is paid no later than 30 days after the end of each calendar year in which it becomes payable.

If the interest is not paid within the described time then the indebtedness will not meet the requirements for exemption from the attribution rules under subsection 74.5(2) in the particular year or in any later year.

If property has been acquired with a loan that satisfied the requirements of subsection 74.5(2) and the loan is repaid, neither subsection 74.1(1) nor 74.2(1) will apply after the repayment to income earned on the property or capital gains arising on the disposition of the property.

When a loan that satisfied the requirements of subsection 74.5(2) is forgiven the exemption in subsection 74.5(2) ceases to apply and section 80 becomes applicable.

23. Paragraph 74.5(12)(a) provides that neither subsection 74.1(1) nor 74.2(1) is applicable to attribute amounts arising from premiums paid under a registered retirement savings plan where the transferor's spouse is the annuitant to the extent the premium is deductible under subsection 146(5.1) or paragraph 60(j.2).

24. Paragraph 74.5(12)(a.1) provides that neither subsection 74.1(1) nor 74.2(1) is applicable to attribute amounts contributed, as permitted by paragraph 60(v), to a prescribed provincial pension plan under which the individual's spouse is the annuitant or the owner of the account under the plan, provided the contributions to the plan do not exceed the amount provided for by paragraph 74.5(12)(a.1). Part LXXVIII of the Regulations identifies the prescribed provincial pension plans.

25. Paragraph 74.5(12)(b) provides that the attribution rules described in subsection 74.1(1) and subsection 74.2(1) do not apply to an interspousal transfer of property when transferred as or on account of an amount paid that is

(a) deductible in determining the payer's income for the year, and

(b) required to be included in the payee's income.

For example, the payment of money to the payer's spouse as remuneration for services provided in a business conducted by the payer is a transfer of property, but, where conditions (a) and (b) are satisfied, not a transfer to which attribution applies. In such cases, any income or loss or taxable capital gain or allowable capital loss arising from any subsequent investment of the remuneration by the spouse is not attributable to the payer.

26. Subsection 74.1(1) provides an exemption for any portion of a retirement pension that is assigned from one spouse to another pursuant to section 64.1 of the Canada Pension Plan or pursuant to a comparable provision of the Quebec Pension Plan or a prescribed provincial pension plan.

Substituted Property

27. Where a taxpayer transfers capital property to the taxpayer's spouse and the spouse subsequently disposes of that property and acquires new property in exchange for it, income or losses arising from the spouse's ownership of the new property and any taxable capital gains or allowable capital losses on its disposition are attributed to the taxpayer. Since the foregoing represents a change in the Department's position as set out in IT-258R2 under the caption "Substituted Property Income", the current interpretation will apply only for substituted property acquired by the spouse after December 30, 1987.

Example

Assume the following:

(1) in 1975, the taxpayer transferred capital property with a fair market value of \$50,000 to the taxpayer's spouse at the taxpayer's adjusted cost base of \$20,000,

(2) in 1979, the spouse sold the transferred property for \$80,000 and acquired a substituted property with the proceeds from the sale,

(3) in 1988, the spouse disposed of the substituted property for \$120,000 and acquired substituted property with the proceeds from the disposition, and

(4) in 1990, the spouse disposed of the substituted property for \$150,000.

The following are the income tax consequences of each transaction:

(a) Since the taxpayer transferred the property at its adjusted cost base pursuant to subsection 73(1) (as it then applied) there were no tax consequences in 1975.

- (b) A \$30,000 taxable capital gain (1/2 of the \$60,000 gain) was attributable to the taxpayer in 1979.
- (c) A \$16,666 taxable capital gain (2/3 of 5/8 of the \$40,000 gain) was attributable to the taxpayer in 1988 (see IT-258R2).
- (d) A \$22,500 taxable capital gain (3/4 of the \$30,000 gain) was attributable to the taxpayer in 1990.

Artificial Attribution

28. Subsection 74.5(11) provides that the attribution rules do not apply where one of the main reasons for a transfer or loan of property or a series of these is to reduce the amount of income tax that would be payable on the income or gains. For example, if an individual with little taxable income were to borrow money from a chartered bank to acquire bonds which were subsequently sold at less than fair market value to the individual's spouse who has significant taxable income, subsection 74.5(11) could apply to prevent the attribution from the spouse to the individual of the income from the bonds.

Partitioning after Dissolution of Matrimonial Regimes in the Province of Quebec

29. Subsections 248(22) and (23), which apply after July 13, 1990, provide rules concerning the ownership of property that is subject to partition following the dissolution of a matrimonial regime, such as a community of property created under the laws of Quebec (or in another civil law jurisdiction).

Property owned continuously by one spouse from a time before that property became subject to the regime is deemed by paragraph 248(22)(a) to be owned exclusively by that spouse. Thus all income or loss and taxable capital gains or allowable capital losses from the property are attributable to the owner spouse where paragraph 248(22)(a) applies. Where paragraph 248(22)(a) does not apply, paragraph 248(22)(b) deems the property to be owned by the spouse who has administration of that property and not by the other spouse. Where paragraph 248(22)(b) applies the income or loss and taxable capital gains or allowable capital losses from the property are attributable to the spouse who has administration of the property.

Subsection 248(23) applies where, as a consequence of the partition of property upon the dissolution of a matrimonial regime, property that was property of one spouse immediately before the dissolution of the regime is allocated to the other spouse or the estate of that other spouse. Where the allocation is to the other spouse, the property is deemed to have been transferred by the former spouse to the latter immediately before the dissolution. Where the dissolution of the matrimonial regime results from the death of one spouse the transfer is deemed to have occurred immediately before the deemed disposition on death. For further comments on subsections 248(22) and (23), see the current version of IT-325, *Property Transfers After Separation, Divorce and Annulment*.

The definition of "spouse" and "former spouse" of a particular individual in subsections 248(22) and (23) is extended by subsection 252(3) to include another individual of the opposite sex who is a party to a voidable or void marriage with the particular individual.

Example:

The following is an example of how the dissolution of a matrimonial regime may affect the attribution rules in subsections 74.1(1) and 74.2(1).

Assume:

- (1) On their marriage, A and B adopted community of property as their matrimonial regime.
- (2) At the time of their marriage A owned shares of Opco and retained them until the time described in (4) below.
- (3) During their marriage, B acquired and administered shares of Realtyco until the time described in (4) below.
- (4) A and B decided to alter their matrimonial regime to that of separation of property and accordingly prepared an inventory of community property.

Pursuant to paragraph 248(22)(a), A is deemed to own the Opco shares and pursuant to paragraph 248(22)(b), B is deemed to own the Realtyco shares.

If, in partitioning the property, A obtains full ownership of the Realtyco shares, pursuant to subsection 248(23) there will have been a transfer of property from B to A immediately before the partitioning. This transfer will be a transfer for the purposes of subsections 74.1(1) and 74.2(1).

If, in partitioning the property, A obtains full ownership of the Opco shares, subsection 248(23) would not apply with the result that there would be no transfer to which subsections 74.1(1) and 74.2(1) could apply.

Note: On August 30, 1993 the Minister of Finance issued Amendments to the Income Tax Act and Related Statutes. Explanatory notes were issued which elaborate on the proposed changes. The Explanatory notes describe that

- subsection 248(23) will not apply to dispositions arising as a consequence of deaths occurring after December 21, 1992 and
- subsection 248(23.1) applies to certain transfers of property in a province where the laws provide for the sharing of certain property owned or acquired by a spouse during marriage. The subsection applies on transfers of property after the death of a taxpayer occurring after December 21, 1992 and deems these transfers of property to have occurred either as a consequence of the death of the taxpayer (in the case of property transferred to the deceased taxpayer's spouse) or immediately before the time that is immediately before the death of the taxpayer (in the case of property transferred to the deceased taxpayer's estate).

Subsection 56(4.1) after 1990

30. For income relating to 1991 and later taxation years, subsection 56(4.1) provides that where an individual has received a loan from or become indebted to another individual or a trust under certain conditions the income from that property and property substituted for it is attributed to the creditor. For the subsection to apply, the following conditions must be met:

- (a) a particular individual (other than a trust) or a trust in which the individual is beneficially interested must have received a loan from or become indebted to another individual or to a trust (the creditor),
- (b) where the creditor is an individual, the individuals must not have dealt at arm's length when the loan or indebtedness arose,
- (c) where the creditor is a trust, the "original transferor", that is, an individual other than a trust, must have transferred property to the trust, and the original transferor
 - (i) must have been resident in Canada at any time when the loan or indebtedness was outstanding and
 - (ii) must not have dealt at arm's length with the particular individual when the loan or indebtedness arose,
- (For example, a mother (the original transferor) who is resident in Canada, settles property in a trust in favour of her son and the trust (the creditor) makes a loan to that son (the particular individual).) and
- (d) it must be reasonable to consider that one of the main reasons for making the loan or incurring the indebtedness was to reduce or avoid tax by including in the income of the particular individual income from
 - (i) the loaned property,
 - (ii) property that the loan or indebtedness allowed the particular individual to acquire, or
 - (iii) property substituted for such property.

Income is not attributed under subsection 56(4.1) to the extent that it is attributed under section 74.1.

Where the conditions are met, any income (including amounts included in income pursuant to subsection 104(13) or (14)) of the particular individual for a taxation year from the property noted in (d) above that relates to a time during which

- (e) the creditor was resident in Canada and
- (f) the particular individual was not dealing at arm's length with the individual (if the creditor is an individual), or the original transferor (if the creditor is a trust)

shall be deemed to be the income of the creditor and not of the particular individual.

Where the creditor is a trust, subsection 75(2) may subsequently apply to deem the income of the trust to be the income of the person described in subsection 75(2). For a discussion of subsection 75(2), see the current version of IT-369, Attribution of Trust Income to Settlor. Where the provisions of subsection 75(2) apply, the income will be taxed under that provision rather than under subsection 56(4.1) as income of the creditor.

Note: On August 30, 1993 the Minister of Finance issued Amendments to the Income Tax Act and Related Statutes. Explanatory notes were issued which elaborate on the proposed changes. The Explanatory notes describe that subparagraph 56(4.1)(b)(ii), as described in (d)(ii) above, is amended so that it may also apply where one of the main purposes for making a loan or incurring indebtedness was to reduce or avoid tax by causing income from property acquired by a trust in which a particular individual is beneficially interested

to be included in the income of that individual. If enacted as proposed the amendment will apply to income relating to periods commencing after December 21, 1992.

31. Pursuant to subsection 56(4.2), subsection 56(4.1) does not apply to any income derived in a particular taxation year where interest is charged on the loan or indebtedness at a rate that was not less than the lesser of

(a) the prescribed rate and

(b) the rate that would have been agreed upon between arm's length parties under similar circumstances at the time the loan was made or the indebtedness was incurred, if all such interest was paid no later than 30 days after the end of each calendar year in which it became payable.

If the interest is not paid within the described time then the indebtedness will not meet the requirements for exemption from the attribution rules under subsection 56(4.2) in the particular year or in any later year.

If property has been acquired with a loan which satisfied the requirements of subsection 56(4.2) and the loan is repaid, subsection 56(4.1) will not apply after the repayment to income earned on the property.

32. Pursuant to subsection 56(4.3), the attribution rules in subsection 56(4.1) apply to loaned property or indebtedness which is used either to repay borrowed money that was used to acquire property or to reduce an amount payable for that property.

33. Subsection 56(4.1) does not apply

(a) to transfers of pension benefits between spouses,

(b) to gifts made by one party in a non-arm's length relationship to the other,

(c) after the death of either the individual or original transferor, as the case may be, or the "particular individual,"

(d) to guarantees of indebtedness where the guarantor does not deal at arm's length with the debtor, or

(e) to loans made to a corporation in which a person (such as an adult child), who does not deal at arm's length with the lender, has a significant interest, provided the loan cannot be linked to any loan the corporation has made or will make to the person.

With regard to (d) above, however if the guarantee is honoured by the guarantor and if the purpose test in subsection 56(4.1) is met, the subsection may apply. For example, if a father guarantees a bank loan for an adult son, subsection 56(4.1) will not apply; however, if the father must honour his guarantee and one of the main reasons for the loan was to reduce or avoid tax, then subsection 56(4.1) could apply.

Subsection 56(4.1) before 1991

34. For income relating to 1989 and 1990, subsection 56(4.1) provides that where an individual loans property to another individual under certain conditions the income from that property or property substituted for it is attributed to the lender. For the subsection to apply, the following conditions must be met:

(a) an individual must have loaned property to another individual,

(b) the individuals must not have dealt at arm's length when the property was loaned and during the period to which the income relates,

(c) it must be reasonable to consider that one of the main reasons for the loan was to reduce or avoid tax (by causing income from the property or substituted property to be included in the income of the other individual) and

(d) the individual was resident of Canada during the period to which the income relates.

Income is not attributed under subsection 56(4.1) to the extent that it is attributed under section 74.1.

Where subsection 56(4.1) applies, any income from property or from property substituted for it is deemed to be income of the individual who is the lender and not of the other individual.

The comments in 31 to 33 above apply equally to loans outstanding in 1989 and 1990.

Dividend Tax Credit

35. Subsection 82(2) provides, in effect, that where sections 74 to 75 or, after June 18, 1987, subsection 56(4.1) apply and the transferor of property includes in income a dividend received or deemed to be received by the transferee from a taxable Canadian corporation, the transferor is required to gross-up the dividend and is entitled to the dividend tax credit.

Non-Resident Transferee

36. Where an amount paid or credited to a non-resident of Canada is included in another taxpayer's income by virtue of sections 74 to 75 or, after the 1988 taxation year, subsection 56(4.1) and is thereby subject to tax under Part I of the Act, subsection 212(12) provides that non-resident withholding tax is not exigible on such amount.

Liability for Payment of Tax

37. Where as a result of a transfer of property an amount (including a taxable capital gain from the disposition of the transferred property or property substituted for it) has been included in the income of a transferor for a taxation year by virtue of sections 74 to 75.1, the transferee and transferor are jointly and severally liable under paragraph 160(1)(d) for any increase in the transferor's Part I tax liability resulting from the inclusion of that amount in income. Furthermore, paragraph 160(1)(e) provides that the transferee and transferor are jointly and severally liable for any liability of the transferor under the Act for the year in which the transfer took place or any preceding taxation year, to the extent that, at the time of the transfer, the fair market value of the transferred property exceeded the fair market value of any consideration received for it. However, pursuant to subsection 160(4), where there has been an interspousal transfer of property pursuant to a decree, order or judgment of a competent tribunal or pursuant to a written separation agreement and, at that time, the spouses were separated and living apart as a result of the breakdown of their marriage, the transferee shall not be liable under paragraph 160(1)(d) to pay any amount with respect to any income from, or any gain from the disposition of, the property so transferred (or property substituted for it) and, for the purposes of paragraph 160(1)(e), the fair market value of the property at the time it was transferred shall be deemed to be nil. Notwithstanding the joint and several liability described above, section 160 does not limit the liability of the transferor under the Act.

If you have any comments regarding the matters discussed in this bulletin, please send them to:

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Explanation of Changes for Interpretation Bulletin IT-511R Interspousal and Certain Other Transfers and Loans of Property

Introduction

The purpose of the *Explanation of Changes* is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised departmental interpretations.

Overview

The title of the bulletin has been changed to accommodate a discussion of subsections 56(4.1) to (4.3). The bulletin reflects amendments to the *Income Tax Act* resulting from Bills C-64 (1987), C-139 (1988), C-28 (1990), C-18 (1991) and C-92 (1993) and makes incidental changes. Proposals contained in the *Amendments to the Income Tax Act and Related Statutes* issued by the Minister of Finance on August 30, 1993 are noted in numbers 1, 29 and 30.

Legislative and Other Changes

The Summary has been revised to mention subsection 56(4.1) - an anti-avoidance rule that applies where a debt has been incurred to acquire property. In certain circumstances, income from the property is attributed to the lender. This provision is described more fully in numbers 30 to 34 of the bulletin.

In ¶ 1, the following changes to the meanings of words have been made:

- "transferred or loaned property" has been expanded to provide an example of indirect transfers.
- "spouse" has been expanded to reflect the addition of subsection 252(4) in Bill C-92, which defines "spouse" to include what is generally referred to as a common-law spouse.
- "marriage" has been added to note the Bill C-92 definition in paragraph 252(4)(b).
- "prescribed rate" has been added to note the Regulation which prescribes the rate for interest.

¶ 2 was revised to add comments concerning subsections 56(4.1) to (4.3) which attribute income where indebtedness exists between individuals who do not deal at arm's length and one of the main reasons for the indebtedness is to avoid tax by having income included in the hands of the debtor.

Before the definition of "spouse" was expanded these provisions could have applied to the parties in a common-law relationship where it was found as a question of fact that the parties did not deal with each other at arm's length.

¶ 5 was revised to describe subsection 96(1.8) which was added by Bill C-139. Generally, income from a partnership is business income; however, subsection 96(1.8) provides an exception where the circumstances discussed in this paragraph apply so that the income from a partnership is deemed to be property income. The result is that the partnership income of a person can attribute to someone else.

¶ 7 was revised to add an example which illustrates the operation of subsection 74.1(3).

¶ 9 was rewritten to improve clarity.

¶ 20 reflects changes to paragraph 74.5(3)(b) contained in Bill C-18. The amendment changes the time at which spouses, following the breakdown of their marriage, may file their joint election to negate the effect of section 74.2.

¶s 21 and 22 were revised to reflect the Bill C-28 amendments to subsections 74.5(1) and (2) which changed the reference from "...interest prescribed for the purpose of subsection 161(1)..." to interest at the "prescribed rate". The paragraphs were also revised to explain that if the interest is not paid within the appropriate time, the indebtedness will not meet the requirements for exemption from the attribution rules in the year and in all subsequent years.

¶ 22 was further revised to observe that the attribution rules will not subsequently apply if a loan is repaid that previously provided an exception to the application of the attribution rules.

¶ 23 is revised to observe that premiums paid to a spousal RRSP and deductible under paragraph 60(j.2) are exempt from the attribution rules.

New ¶ 24 comments on paragraph 74.5(12)(a.1), added by Bill C-64, which provides that the attribution rules will not apply to interspousal contributions to provincial pension plans.

New ¶ 26 replaces the italicized note following former number 24 to describe the amendment to subsection 74.1(1), contained in Bill C-64. The amendment provides that the attribution rules will not apply to the assignment of benefits from certain governmental pension plans.

¶ 27, the former ¶ 25, is revised to reflect Bill C-139 changes in the inclusion rates for capital gains and losses. For individuals, the proportion of a capital gain that becomes a taxable capital gain has increased from 1/2 to 2/3 after 1987, and to 3/4 after 1989.

New ¶ 29 introduces amendments contained in Bill C-18 to subsections 248(22) and (23) to provide rules concerning the ownership of property that is subject to partition following the dissolution of a marriage. These rules only apply to matrimonial property regimes such as community of property created under the laws of Quebec or another civil law jurisdiction. A note has been added following number 29 concerning proposed changes to subsections 248(22) and (23) announced in the *Amendments to the Income Tax Act and Related Statutes* issued by the Minister of Finance on August 30, 1993.

New ¶s 30 to 34 describe subsections 56(4.1) to (4.3) before 1991 (Bill C-139) and after 1990 (Bill C-18). Before 1991, subsection 56(4.1) provided that where an individual lent property to a non-arm's length individual and one of the main purposes of the loan was to reduce or avoid tax, the income from the property was deemed to be income of the lender. After 1990, subsection 56(4.1) was broadened to cover all indebtedness and to include trusts as lenders. Subsection 56(4.2) provides an exemption from subsection 56(4.1) when interest on the loan was charged at a commercial rate and the interest was paid within 30 days after the end of the year. Subsection 56(4.3) provides rules that apply on the repayment of existing debt. A note has been added following ¶ 30 concerning proposed changes to subsection 56(4.1) announced in the *Amendments to the Income Tax Act and Related Statutes* issued by the Minister of Finance on August 30, 1993.

¶s 35 and 36, the former ¶s 27 and 28 respectively, were revised to add a reference to subsection 56(4.1) by virtue of amendments in Bill C-139.

¶s 3, 4, 6, 8 and 10 to 19 were carried forward substantially unchanged from IT-511 as were ¶ 25 (former ¶ 24), 28 (former ¶ 26) and 37 (former ¶ 29).

Income Tax Interpretation Bulletin

Transfers and loans of property made after May 22, 1985 to a related minor
IT-510

DATE: December 30, 1987

SUBJECT: INCOME TAX ACT

Transfers and loans of property made after May 22, 1985 to a related minor

REFERENCE: Subsection 74.1(2) (also section 74.3, subsections 74.1(3), 74.5(1), (2) and (6) to (11) and paragraph 74.5(12)(b))

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Application

This bulletin applies to transfers and loans of property made after May 22, 1985 to related minors. For transfers of property made before May 23, 1985 to minors, see IT-260R, the Special Release thereto and subsection 75(1) of the Act.

Summary

This bulletin discusses a comprehensive set of rules intended to prevent a taxpayer and a related minor from splitting income from property so as to reduce the total amount of tax payable thereon. Except where fair market value consideration is paid by the related minor, income earned on property transferred or loaned from a taxpayer to a related minor (and on property substituted therefor) is generally deemed to be income of the taxpayer and not of the related minor.

The commentary below discusses the applicable rules in greater detail.

Discussion and Interpretation

1. For the purposes of this bulletin, the following terms and their meanings are explained:

Transferred or Loaned Property - means all transfers or loans of property whether accomplished directly or indirectly, by means of a trust or by any other means whatever. A transfer includes a sale whether or not at fair market value, as well as gifts but has never included a genuine loan. (Prior to May 23, 1985 loans that were not considered genuine (see IT-260R) were treated as transfers but this distinction is no longer necessary.)

Related Minor - a person who is under 18 years of age, and who

(a) does not deal with the individual at arm's length (e.g. a parent and a child or other descendant whether by blood relationship or adoption, do not deal at arm's length - see IT-419), or

(b) is a niece or nephew of the individual.

Beneficially Interested - An individual is "beneficially interested" in a trust if the individual has any right (whether immediate or future, whether absolute or contingent or whether conditional on or subject to the exercise of a discretionary power by any person or persons) to receive any of the income or capital of the trust either directly from the trust or indirectly through one or more other trusts. See 12 below for examples of situations where an individual is beneficially interested in a trust.

Substituted Property - Paragraph 248(5)(a) provides that in the circumstances discussed in this bulletin, where a taxpayer has disposed of or exchanged a particular property and acquired other property in substitution therefor and subsequently, by one or more further transactions, has effected one or more further substitutions, the property acquired by any such transaction is deemed to have been substituted for the particular property.

Attribution of Income from Transferred or Loaned Property

2. Subsection 74.1(2) provides that where an individual has transferred or loaned property (including money) to a related minor or to a trust in which a related minor is beneficially interested at any time any income or loss from the property or property substituted therefor is deemed to be income or loss of the individual for a taxation year unless the minor has attained the age of 18 years before the end of the year; see 15 to 18 below for additional exceptions to the rule.

Application of Attribution Rules

3. It is necessary to distinguish between income or loss from property and income or loss from a business. Subsection 74.1(2) does not apply to attribute business income or losses even if the business operates with some or all of the property obtained originally from the transferor.

4. Income or loss derived from the investment or other use of the income from transferred property is not attributed to the transferor and thus for income tax purposes is income or loss of the transferee. For example, interest on any interest allowed to accumulate is not attributed to the transferor and is income of the transferee.

5. Pursuant to subsection 74.1(3) the attribution rules in subsection 74.1(2) apply to transferred or loaned property which is used either to repay, in whole or in part, borrowed money that was used, in whole or in part, to acquire property or to reduce an amount payable in respect of that property.

6. As it applies to a related minor (a "specified person" under subsection 74.5(8)) subsection 74.5(6) provides that where an individual has transferred or loaned property to a third party

(a) and that property or property substituted therefor is, or

(b) on condition that any property be

transferred or loaned directly or indirectly by the third party to or for the benefit of a related minor, pursuant to paragraph 74.5(6)(c), the property transferred or loaned by the third party is deemed to have been transferred or loaned by the individual to or for the benefit of the related minor, and pursuant to paragraph 74.5(6)(d) any consideration received by the third party is deemed to have been received by the individual.

7. Subsection 74.5(7) provides that where an individual is obligated either absolutely or contingently to effectively ensure repayment in whole or in part of a loan or any interest in respect thereof made by a third party directly or indirectly to or for the benefit of a related minor,

(a) the property loaned by the third party is deemed to have been loaned by the individual to or for the benefit of the related minor, and

(b) interest paid on the loan by the individual is ignored for the purposes of paragraphs 74.5(2)(b) and (c) (see 17 below).

8. Subsection 74.5(9) provides that where an individual has transferred or loaned property to a trust in which a related minor is beneficially interested the transfer or loan is deemed to be for the benefit of the related minor.

9. As it applies to a related minor (a "designated person" under subsection 74.5(5)), paragraph 74.3(1)(a) applies where an individual has transferred or loaned property to a trust in which a related minor is beneficially interested at any time and determines an amount that is deemed to be the income of the related minor which is included in the individual's income pursuant to subsection 74.1(2).

10. Pursuant to paragraph 74.3(1)(a) the income of the minor described in 9 above is the lesser of

(a) the minor's income under paragraph 12(1)(m) from the trust, and

(b) the proportion of the income earned by the trust from the transferred or loaned property that

(i) the minor's income under paragraph 12(1)(m) from the trust is of

(ii) the aggregate income from the trust of all persons each of whom is throughout the year a related minor or the individual's spouse.

In (b) the "income earned by the trust" excludes capital gains and is calculated before deductions are made under subsections 104(6) and (12).

11. An example of the operation of paragraph 74.3(1)(a) follows:

An individual transfers, for no consideration, bonds which pay interest of \$1,200 per annum to a family trust the beneficiaries of which are the individual's three children, two of whom are less than 18 years of age throughout the year. The trust's income prior to any deductions under subsections 104(6) or (12) is \$1,500. Each beneficiary has an equal entitlement to the trust income all of which is payable in the year.

The two related minors are designated persons.

The income from the transferred bonds in respect of each of the related minors is the lesser of:

(a) the income of the designated person from the trust (\$500, i.e., 1/3 of \$1,500), and

(b) $A \times (B \div C)$,

where

A is the income of the trust from the transferred property (\$1,200),

B is the income of the relevant minor from the trust (\$500), and

C is the income of all the designated persons from the trust (\$1,000).

$\$1,200 \times (\$500 \div \$1,000) = \$600$

Thus the amount of income attributed to the individual in respect of each related minor is \$500.

12. The following are examples of situations where an individual is beneficially interested in a trust:

(a) trust income is payable to the individual;

(b) income is held in trust and will be paid upon the individual's attaining a certain age;

(c) the individual is one in respect of whom a preferred beneficiary election may be made;

(d) the individual is one of a class who has a remaindership interest under the trust.

The individual is beneficially interested in the trust in (b) even if the right to receive the income ends should the individual die before attaining the specified age and in (c) even if the trustees have full discretionary powers concerning the distribution of the capital or income of the trust so that the individual may in fact receive nothing from the trust.

13. Where depreciable property is transferred to a related minor and the minor has no other property of the same class as the property transferred, the income or loss from the property attributed to the transferor should reflect any amount of capital cost allowance, terminal loss or recapture of capital cost allowance in respect of the class which would otherwise be taken into account in computing the income of the minor. Where depreciable property is transferred to a related minor and the minor has other property of the same class as the property transferred, in computing the income or loss from the property attributed to the transferor

(a) a reasonable portion of the capital cost allowance claimed by the minor in respect of the class (which portion may not exceed the maximum capital cost allowance that would be deductible in respect of the transferred property if the property were in a separate class) may be deducted, and

(b) a terminal loss or recapture of capital cost allowance which arises and would otherwise be included in computing the income of the minor in respect of the class of depreciable property should be taken into account to the extent that such amount can reasonably be considered to relate to the transferred property. After the year of disposition of the transferred property and provided a substitute depreciable property is not acquired by the minor, there is no attribution of capital cost allowance, terminal loss or recapture of capital cost allowance that arises in respect of the class.

14. Where income arises from depreciable property transferred to a trust the amount attributed to the transferor is determined as described in 10 above, even though the trust's income calculation includes amounts in respect of capital cost allowance, terminal loss and recapture of capital cost allowance in respect of the class.

Exclusions

15. Subsection 74.1(2) does not apply to attribute income or loss to a transferor that relates to a period

(a) following the death of the transferor or transferee or

(b) throughout which the transferor is not resident in Canada.

16. Pursuant to subsection 74.5(1), income or loss from transferred property does not attribute to the transferor where

(a) the sale or other transfer is made for consideration equal to fair market value of the transferred property, and

(b) the sale price or other consideration for the transfer is

(i) fully paid by the transferee in cash or kind (and not from property furnished by the transferor), or

(ii) satisfied in whole or in part by indebtedness in respect of which interest is charged at a rate not less than the lesser of the rate of interest prescribed for the purposes of subsection 161(1) and the rate that

would be agreed upon between arm's length parties under similar circumstances at the time that the indebtedness is incurred, if all such interest is paid not later than 30 days after the end of the year in which it becomes payable.

17. Pursuant to subsection 74.5(2), subsection 74.1(2) does not apply in respect of loans where interest is charged on the indebtedness at a rate not less than the lesser of the rate of interest prescribed for the purposes of subsection 161(1) and the rate that would be agreed upon between arm's length parties under similar circumstances at the time the indebtedness is incurred, if all such interest is paid not later than 30 days after the end of the year in which it becomes payable. When such a loan is forgiven the exemption in subsection 74.5(2) ceases to apply and section 80 becomes applicable.

18. Pursuant to paragraph 74.5(12)(b), the attribution rules described in 2 above do not apply to a transfer of property to a related minor when transferred as or on account of an amount paid that is

(a) deductible in determining the payer's income for the year, and

(b) required to be included in the payee's income.

For example, the payment of money to a related minor as remuneration for services provided in a business conducted by the payer is a transfer of property, but, where conditions (a) and (b) are satisfied, not a transfer to which attribution applies. In such cases, any income or loss arising from any subsequent investment of the remuneration by the minor is not attributable to the payer.

Capital Gains and Losses

19. Where property is transferred to a related minor or to a trust where a related minor is beneficially interested, subsection 74.1(2) does not apply to attribute to the transferor any taxable capital gain or allowable capital loss arising from a subsequent disposition of that transferred property by the minor or the trust. However, in respect of the *inter vivos* transfer of certain farm property to a child under 18 years of age, section 75.1 may apply to attribute to the transferor any taxable capital gain or allowable capital loss from the disposition of the transferred property by the child (see IT-268R3).

20. Any taxable capital gains and allowable capital losses on dispositions of property which are attributable to a transferor by virtue of section 75.1 may be included in computing the transferor's lifetime capital gains deduction under section 110.6.

Artificial Attribution

21. Subsection 74.5(11) provides that the attribution rules do not apply where one of the main reasons for a transfer or loan of property or a series thereof is to reduce the amount of income tax that would be payable on the income or gains.

Dividend Tax Credit

22. Subsection 82(2) provides, in effect, that where the transferor of property includes in income a dividend received or deemed to be received by the transferee from a taxable Canadian corporation, the transferor is required to gross-up the dividend and is entitled to the dividend tax credit.

Non-Resident Transferee

23. Where an amount paid or credited to a non-resident of Canada is included in another taxpayer's income by virtue of sections 74 to 75 and is thereby subject to tax under Part I of the Act, subsection 212(12) provides that non-resident withholding tax is not exigible on such amount.

Liability For Payment Of Tax

24. Where as a result of a transfer of property an amount (including a taxable capital gain from the disposition of the transferred property) has been included in the income of a transferor for a taxation year by virtue of sections 74 to 75.1, the transferee and transferor are jointly and severally liable under paragraph 160(1)(d) for and increase in the transferor's Part I tax liability resulting from the inclusion of that amount in income. Furthermore, paragraph 160(1)(e) provides that the transferee and transferor are jointly and severally liable for any liability of the transferor under the Act in respect of the year in which the transfer took place or any preceding taxation year, to the extent that, at the time of the transfer, the fair market value of the transferred property exceeded the fair market value of any consideration received for it. Notwithstanding the joint and several liability described above, section 160 does not limit the liability of the transferor under the Act.

Attribution of Income Received From a Trust.

Subsection 74.3(1) applies where an individual has loaned or transferred property directly or indirectly, by means of a trust or by any means whatever to a trust **but not an estate**, in which a "designated person" in respect of the individual is **at any time "beneficially interested"** and it operates to cause attribution of income or gain realized on the transferred or loaned property or income realized by the "designated person" from the trust, (whichever is lesser), back to the transferor/lender. "Designated person" is defined in Sec. 74.5(5) in respect of the transferor/lender to be his spouse or a person under 18 with whom he does not deal at arms length or was his niece or nephew. The provision applies where such a "designated person" was "beneficially interested" at any time in the trust and while "beneficially interested" is defined in Sec. 74.5(10) it is interesting to note the difference between it and the technical definition of trust "capital" and "income interest" in Sec. 108(1)(c) and (e).

A designated person is "beneficially interested" in a trust, for purposes of Sec. 74.3(1), if he has any right to **receive** any of the income or capital of the trust, either directly or indirectly through **one or more trusts**, regardless of whether the right is immediate or future, absolute or contingent, **or whether conditional on or subject to the exercise of a discretionary power**. If the designated person has the right to **receive** the income or capital through a partnership he would still be beneficially interested in the trust since under Sec. 96(1)(f) the source characteristic of partnership income flows through to the partners as they recognize the income. An interesting question of trust rights arises in respect of the essence of the phrase "has any right...to receive income or capital of the trust...indirectly through one or more trusts" being that a right in a trust is not necessarily a right in the particular property held by the trust but may be only a right that causes the holder to be entitled to the income or capital of the trust as per the conditions set out in the deed, and it is only through the execution of this deed, that can be compelled by the beneficiary, that the beneficiary realizes the property. A right to income of a trust the legal ownership of which is held by a trustee or trust for another beneficiary is not, in the author's opinion, **a right** of the beneficiary of that holding trust, even though he can compel the trustee to pay the income realized in respect of it unless he has beneficial ownership of it. If the beneficiary had a right to the primary trust that was phrased so as to cause the income therefrom to be payable to the secondary trust, (under which he would have income rights), then he would have a right "to receive any of the income...of the trust...indirectly through one or more trusts" however if he himself does not hold the legal title of the equitable right held in the primary trust **"he"** does not have a right to receive the income indirectly. A question of beneficial ownership of that income right in the operating trust becomes paramount in this respect since if the beneficial ownership of that right rests with the final beneficiary, and he isn't simply entitled to the income accruing to/realized by the holding trust, then he has such an indirect right. Perhaps an even more interesting aspect about the Sec. 74.5(10) targeting definition of "beneficially interested" is that¹²⁷⁶ **it does not apply to beneficiaries who have a right to have the income or capital applied for their benefit by the trust without them receiving it**, but only applies where they themselves have a right to **receive it**. In other words, if the right is phrased so as to cause the income or capital only to be applied to maintain, educate, provide for the advancement of the beneficiary without him ever obtaining legal title to it he will not be "beneficially interested" for the purposes of the attribution provisions.¹²⁷⁷ One then has to ask whether, in formulating such a technical approach, the Department has recognized a forfeiture of its ability to attack instances of constructive receipt of a beneficiary on the historic grounds that the right to or to receive the income, as a distinct property, was transferred by the taxpayer to the designated person, as in the case of Fasken. In the author's opinion, it hasn't, but, by holding a right to, instead of **to receive** income or capital the beneficiary has negated the application of Sec. 74.3(1) and thus the Department must prove that the income/capital used for her indirect benefit was that procured from the property transfer/loan, thus giving the taxpayers a chance to bury, by intermingling of the scope of possible rights, the direct connection between

1276. similar to the other definition of "beneficially interested" in Sec. 94(7), though unlike the definitions of "capital" and "income interests" in Sec. 108(1)(c)(e)

1277 If the phrase is given a fairly meticulously phrased definition for the purposes of the Act, then even though the phrase may be more encompassing in meaning, the definition will always override any common law functional definition. See *Mattabi Mines v. M.N.R.*, 82 D.T.C. 6200, for the judicial opinion: "Interpretation according to the 'object and spirit' of the legislation cannot, in my view, overcome a clear statutory definition."

receipt and source. Subsection 74.3(1) was formulated to counter such instances.

“Transfers or loans to a trust – Sec. 74.3(1)”

(1) Where an individual has lent or transferred property (in this section referred to as “lent or transferred property”), either directly or indirectly, by means of a trust or by any other means whatever, to a trust in which another individual who is at any time a designated person in respect of the individual is beneficially interested at any time, the following rules apply:

(a) for the purposes of section 74.1, the income of the designated person for a taxation year from the lent or transferred property shall be deemed to be an amount equal to the lesser of

(i) the amount in respect of the trust that was included by virtue of paragraph 12(1)(m) in computing the income for the year of the designated person, and

(ii) that proportion of the amount that would be the income of the trust for the year from the lent or transferred property or from property substituted therefor if no deduction were made under subsection 104(6) or (12) that

(A) the amount determined under subparagraph 74.3(1)(a)(i) in respect of the designated person for the year is of

(B) the total of all amounts each of which is an amount determined under subparagraph 74.3(1)(a)(i)

for the year in respect of the designated person or any other person who is throughout the year a designated person in respect of the individual; and

(b) for the purposes of section 74.2, an amount equal to the lesser of

(i) the amount that was designated under subsection 104(21) in respect of the designated person in the trust’s return of income for the year, and

(ii) the amount, if any, by which

(A) the total of all amounts each of which is a taxable capital gain for the year from the disposition by the trust of the lent or transferred property or property substituted therefor exceeds

(B) the total of all amounts each of which is an allowable capital loss for the year from the disposition by the trust of the lent or transferred property or property substituted therefor, shall be deemed to be a taxable capital gain of the designated person for the year from the disposition of property (other than listed personal property) that is lent or transferred property.

Definition of “designated person”

(2) In this section, “designated person”, in respect of an individual, has the meaning assigned by subsection 74.5(5).

“excluded consideration”

“excluded consideration”, at any time, means consideration received by an individual that is

(a) indebtedness,

(b) a share of the capital stock of a corporation, or

(c) a right to receive indebtedness or a share of the capital stock of a corporation.

“Transfers and loans to corporations – Sec. 74.4(2)”

(2) Where an individual has transferred or lent property, either directly or indirectly, by means of a trust or by any other means whatever, to a corporation and one of the main purposes of the transfer or loan may reasonably be considered to be to reduce the income of the individual and to benefit, either directly or indirectly, by means of a trust or by any other means whatever, a person who is a designated person in respect of the individual, in computing the income of the individual for any taxation year that includes a period after the loan or transfer throughout which

(a) the person is a designated person in respect of the individual and would have been a specified shareholder of the corporation if the definition “specified shareholder” in subsection 248(1) were read without reference to paragraphs (a) and (d) of that definition and if the reference therein to “any other corporation that is related to the corporation” were read as a reference to “any other corporation (other than a small business corporation) that is related to the corporation”,

(b) the individual was resident in Canada, and

(c) the corporation was not a small business corporation, the individual shall be deemed to have received as interest in the year the amount, if any, by which

(d) the amount that would be interest on the outstanding amount of the loan or transfer of the property for such periods in the year if the interest were computed thereon at the prescribed rate of interest for such periods exceeds the total of

(e) any interest received in the year by the individual in respect of the transfer or loan (other than amounts deemed by this subsection to be interest),

(f) all amounts included in the individual’s income for the taxation year pursuant to subsection 82(1) or 90(1) in respect of taxable dividends received (other than dividends deemed by section 84 to have been received) by the individual in the year on shares that were received from the corporation as consideration for the transfer or as repayment for the loan that were excluded consideration at the time the dividends were received or on shares substituted therefor that were excluded consideration at that time, and

(g) where the designated person is a specified individual in relation to the year, the amount required to be included in computing the designated person’s income for the year in respect of all taxable dividends received by the designated person that

(i) can reasonably be considered to be part of the benefit sought to be conferred, and

(ii) are included in computing the designated person's split income for any taxation year.

The Two Different Treatments.

Subsection 74.3(1) consists of two parts, para. (a) and (b), each starting with the phrase "for purposes of section 74.1..." or "for the purposes of section 74.2..." respectively and in this regard it applies only as a means of providing technical support for those two main attribution provisions and does not in fact impose attribution on its own. The reason for this provision, which is applicable in respect of transfers made after May 22, 1985 or loans outstanding on or after May 22, 1985, can be related to at least two factors, implicit in Sec. 108(5) which provides that income recognized under subdivision K by a beneficiary will be considered income from a property which is an interest in a trust although the provision finishes with the phrase "...nothing in this subsection shall affect the application of subsection 56(4.1) and section 74 to 75." Income can be realized by a trust from an infinitesimal number of properties owned by it and while the income beneficiaries may have their income entitlements expressed clearly in reference to certain streams of income coming from specific property, they may also have them expressed very generally as a certain percentage or absolute amount of the income realized by the trust. It thus becomes, in the latter case, sometimes technically impossible, where the referencing of the right is so non-specific, to prove that income or gain from a particular property transferred or loaned by the taxpayer to the trust is, in fact **in specie**, the income or gain realized by the beneficiary since under the trust all income may become intermingled. It becomes equally difficult in such a case, to prove that the subject property, (since the property producing the income was not transferred to the beneficiary), was at least transferred for the particular beneficiary's benefit; the second alternative qualification under the section 74.1 or 74.2 attribution provisions. The Department eliminated this possible protection by introducing Sec. 74.5(9) which provides that when a taxpayer has loaned or transferred property to a trust, by any means etc., in which a designated person or any taxpayer is **"beneficially interested"** for purposes of the attribution provisions in section 74.1, 74.2, 74.3, and 74.4, he shall be **deemed** to have transferred or loaned the property **to**, or for the benefit of, the designated person. The argument that could have been previously put forward amounting to the fact that the income from the particular property transferred to the trust, that as per the trust deed in describing the income right held by the designated beneficiary, could not be payable to him, (thus not attributable), is now irrelevant since as per the effect of Sec. 74.5(9) or (10) it is no longer important to what property or what income the designated beneficiary's income/capital right refers to. It will be deemed to have been transferred or loaned to him or for his benefit, but once again only when he is "beneficially interested". The weakness in the Sec. 74.5(10) provision is that it applies only to "beneficially interested" parties hence powers of appointment prove to be one method by which the provisions can be undermined. Until the power is exercised the subsequent beneficiary isn't beneficially interested.

Paragraph 74.3(1)(a) computes the amount of income that the designated person will be deemed to have realized from the property transferred or loaned to the trust for purposes of section 74.1 and it does not apply to losses, (hence one would be wasteful to transfer loss producing property to a trust for the benefit of a designated person, unless he caused Sec. 75(2) to purposefully apply to it, since he would be losing the loss recognition). The amount of income that the designated person would be deemed to have realized from the property is equal to the lesser of two amounts, 1), the amount in respect of the **trust though not necessarily to which the transfer or loan was made**, that was included in computing the income of the **designated person** by virtue of Sec. 12(1)(m) and, 2), the proportion of the income from the property or its substitute realized by the trust in the year prior to any deduction made under Sec. 104(6) or (12), (but apparently after all others), that the amount determined in 1. is of the amount recognizable by all the other designated beneficiaries who were of the status **throughout** the year. Obviously the second attribution base is the limiting factor causing the attribution amount to be at a maximum the amount of income the trust realizes from the property or its substitute and the application of the entire Sec. 74.3(1) provision is on a property by property basis hence losses from some property transferred cannot be netted against income from others¹²⁷⁸. It is only that portion

¹²⁷⁸. though they may reduce the income the beneficiaries have to recognize under sec. 12(1)(m) thus indirectly the attributable amount

of the income of the trust for the year from the property that will be attributable and although such "income of the trust" is to be computed before any Sec. 104(6) or (12) deduction it can be reduced by C.C.A., E.C.E.A., and any other deductions specifically related to the property or its substitute.¹²⁷⁹

The Attribution Bases.

The primary attribution base is the amount of income of the particular trust to which the property was loaned or transferred that is included in computing the income of the designated person in the year by virtue of Sec. 12(1)(m) which refers to all amounts required under subdivision K to be included except an amount deemed by that subsection to be a taxable capital gain of the taxpayer and in this regard there are the four inclusion provisions that could cause attribution; Sec. 104(13),(14), 105(1) and (2).¹²⁸⁰ The way in which income is considered to be includable in income of the beneficiary (or taxpayer) varies from provision to provision but basically all of them (except for Sec. 105(1)) have as their basis the net Division B income of the trust, that is to say, after C.C.A., E.C.E.A., have been deducted. Although the targeting of the provision consists of the amount of income the beneficiary must recognize under sec. 12(1)(m) from the trust, **the trust need not be that to which the property was transferred or loaned** due to the effect of Sec. 74.5(9).

Even if the designated beneficiary is, in common law, only a beneficiary under a second tier trust which is beneficially interested in the top tier trust¹²⁸¹, by virtue of Sec. 74.5(9) the trust will be deemed to have been loaned or transferred the property that the head trust received. There are methods of working around these rules of course, one of which is to employ the Sec. 104(13.1) income payable cut back to reduce the Sec. 104(13) or 105(2) recognition and thus the Sec. 12(1)(m) inclusion being recognized by the beneficiary however its use doesn't prevent the Department from attacking with a Sec. 105(1) assessment thus causing full income inclusion¹²⁸² of the cut back amount. Such an amount would be attributable. If loss producing property is transferred to the trust in such a way as to cause Sec. 75(2) to apply then both trust and contributor can recognize the loss and thus a Sec. 104(13.1) cut back would not be needed to be made exposing the beneficiary to a Sec. 105(1) inclusion, while the losses would eliminate the recognition of the income in the trust's hands. The income entitlement of the trust/beneficiary would have to be properly structured however so as to allow him to receive cash accounting income without being accountable for tax losses. Subsection 74.3(1) **deems** the amount derived from the operation of the provisions to be the designated person's income from the property: there isn't any room to fall back on the pre section 74.3 principles to ascertain the designated person's income from the property if an amount is deemed to be nil and thus it can't be any other amount.¹²⁸³ If the second tier trust can only be the subject of a power of appointment then it isn't beneficially interested in the head trust until the power is exercised.

"Transfers or loans to a trust"

(9) Where a taxpayer has lent or transferred property, either directly or indirectly, by means of a trust or by any other means whatever, to a trust in which another taxpayer is beneficially interested, the taxpayer shall, for the purposes of this section and sections 74.1 to 74.4, be deemed to have lent or transferred the property, as the case may be, to or for the benefit of the other taxpayer.

Altering the Type of Recognition.

If the beneficiary recognizes income from the trust in a capacity other than as a beneficiary then the Sec. 12(1)(m) inclusion base will not be applicable and thus neither will it serve as an attribution base under Sec.

¹²⁷⁹ Even if a Sec. 104(19) designation is made by the trust in respect of taxable dividends realized so as to cause the trust to be precluded from recognizing them the Sec. 74.3(1)(a) provision will cause attribution since the trust still cannot reduce its income from the shares held unless it takes a Sec. 104(6) or (12) deduction.

¹²⁸⁰ This solves the "Pichosky problem".

¹²⁸¹ See *Hayim v. Citibank N.A.*, 1987 3 W.L.R. 83 (PC), *F.C.T. v. Totledge*, 1982 12 A.T.R. 830. As per *Grey v. I.R.C.*, 1960 A.C. 1 (HL), *Grainge v. Wilberforce*, 1889 5 T.L.R. 436, *Lyle Ltd. v. Rosher*, 1958 3 All E.R. 597 (HL), *Re: Lashmar*, 1891 1 Ch. 258 (CA), if an intermediary trustee is bare of any dispositive/administrative powers and is merely a custodian the top tier trustee holds on trust for the ultimate beneficiary. If the intermediary has some degree of administrative duties he doesn't disappear from the picture and a sub-trust arrangement exists.

¹²⁸² and double taxation of that income

¹²⁸³ See *Hobbs v. F.C.T.*, 98 C.L.R. 151.

74.3(1). In such a case the beneficiary could loan capital to the trust which could then invest in property which it could roll out tax free to the beneficiary. If the interest paid by the trust is deductible (and it can be in certain instances) then the creditor-beneficiary will realize an inclusion and the trust will recognize an equivalent deduction, without the effect of attribution. Understandably if the beneficiary and the trust are not at arm's length attribution rules may directly apply to the lending however the success of the arrangement depends on the ability of the trust to recognize the interest deductions, and have the substance of the loan distributed back out to the beneficiary. A "few" incidental transactions may be enough to satisfy these requirements. Where the interest isn't deductible by the trust it will be effectively taxed twice when paid to the beneficiary thus it would be beneficial to suffer an attribution situation. The Sec. 74.5(10) definition of beneficially interested does not restrict the right holder to acting only in the capacity of a beneficiary under the trust but instead he'll be captured if he's a simple creditor however in order for attribution to occur he must recognize a Sec. 12(1)(m) income inclusion in respect of that trust; **which only results if he stands in the capacity of a beneficiary**. If income isn't deductible by the trust in respect of the beneficiary then it must be either deducted in respect of a payable etc. in respect of another beneficiary, or capitalized at an *inter vivos* trust tax rate of 29%, the latter an expensive proposition.

Spousal Gains and Losses Attribution.

Paragraph 74.3(1)(b) applies for purposes of section 74.2 which attributes capital gains and losses itself when a spouse disposes of property loaned or transferred to her by her spouse. For purposes of section 74.2 an amount equal to the lesser of two amounts described will be deemed to be a taxable capital gain of the designated person from the disposition of the property, other than listed personal property, that has been loaned or transferred to her hence the disposition of listed personal property by a trust can never attract attribution. The two amounts are the amount that has been designated under Sec. 104(21) in respect of the designated person in the return of the trust which received the property, and, the net taxable capital gain (net of allowable losses) from the disposition of the particular trust of property or substitute property, in the year. Once again the same technical deficiencies exist in the paragraph as that found in para. (a). If the Sec. 104(21) designation isn't made then para. (a) will apply to cause income attribution and not capital gain attribution.

Obviously the effect of the section 74.3 provision in accompany with Sec. 74.5(9) and (10), is to eliminate the defence taxpayers may have previously had consisting of the ability to intermingle in a trust the income or capital accretions from the property so as to be able to avoid the application of the attribution provisions. The Sec. 74.3(1) provision has as one of its bases of attribution the amount of income or gain that a designated person is required to recognize by virtue of Sec. 12(1)(m) or section 38 and thus if the beneficiary can avoid the recognition of income under Sec. 12(1)(m) attribution will not result and the subject income will then be exposed to the effective tax rates applicable to the trust or beneficiary.

Subsection 104(13.1) and (13.2) provide provisions that can be utilized to reduce the amount of income recognizable by a beneficiary from a trust under Sec. 104(13) or in respect of that of a taxable capital gain nature as designated by Sec. 104(21), which will cause the trust to continue to recognize their tax liability, which will be reduced by non-capital and net capital (Div. C) loss carry forwards. Where the Sec. 104(13.1) and (13.2) provisions are utilized, (though with some statutory restriction), the beneficiary will recognize less Sec. 104(13) income and thus less income or gain could be attributable. Obviously the restrictions on the favorable use of Sec. 104(13.1) and (13.2) provisions are in the prorating basis described in their preambles, however, if entitlements are properly tailored and income/loss patterns properly controlled through deductions/transfers etc. the trust may be able to book substantial non-capital/net capital losses and then use them to absorb Division B income that would otherwise be attributable back to the settlor/contributor due to Sec. 74.3(1). Subsection 74.5(11) provides artificial transaction anti-avoidance in respect of sections 74.1 to 74.4 **only**, and not Sec. 75(2) hence it could be possible for a contributor to transfer loss producing property to a trust, and have both the trust and himself recognize the losses. Given that the contribution of property to an otherwise testamentary trust will cause it to lose its status, thus becoming an *inter vivos* trust, the tax rate of which is set at 29%, the highest, there can be little advantage obtained on having the income simply recognized by an *inter vivos* trust. An advantage can obviously be obtained if the income is negated by losses recognized by the trust which reduce the effective taxation of the income **before it is capitalized** and paid out

as capital; the most advantageous situation being where Sec. 75(2) is made to apply to loss producing property transferred to the trust so as to allow both the trust and the contributor to recognize the eventual deductible loss. Book the losses in the trust with the application of Sec. 75(2), roll the income producing property in and elect Sec. 104(13.1) frequently and absorb the losses ... that's the ticket.¹²⁸⁴

The bases upon which the attribution is applied consist of the Sec. 104(13), (14), 105(1) & (2) inclusions regardless of how those subsections came to apply and, in general, the Sec. 74.3(1) provision can be said to target the benefits realized or recognized as being received by the beneficiary far more effectively than the provisions that previously existed.

Three Interesting Points.

There are three fundamental aspects about the Sec. 74.3(1) provision that effectively cause it not to apply in certain instances. It applies only where "an individual" has made a transfer or loan or property, (the legal title of which was owned by him), hence where the individual has never held the legal title to the property and causes it to be transferred to the trust, attribution will not follow. Partnerships, trusts, and corporations, being distinctively recognized ownership bases under the Act that cannot be identified with their members, contributors, or shareholders thus provide an excellent vehicle with which property can be purchased and contributed to the trust, even when the action was initiated by the taxpayer by virtue of his control of their functioning. The attribution rules also apply to substitute property hence property which is to be transferred should be purchased by the intermediary with consideration other than property that can directly be traced to that contributed by the taxpayer.

The provision, like all of the attribution provisions in section 74 to 75, applies only to transfers of property which cause "income from property" to be attributable and in this regard, if the transferor transfers property, such as an apartment building, held by him as an investment and not as an active business asset, to a trust which as per its terms carries on **the business** of renting apartments then automatically the income recognized **by the trust** will be business income. Normally, when trust income is paid out to an income beneficiary, as per Sec. 108(5)(a), "an amount included in computing the income...of a beneficiary of a trust...shall be deemed to be income of the beneficiary for the year from **a property** that is an interest in the trust and not from any other source".¹²⁸⁵ Hence normally although the trust carries a business, the income is recognized as property income by the beneficiary...**except**, the Sec. 108(5) provision finishes off with "but, for greater certainty, nothing in the subsection shall affect the application of subsection 56(4.1) and sections 74 to 75."¹²⁸⁶ A business is a property but a property isn't necessarily a business and thus where the taxpayer transfers a property to another taxpayer who uses it to produce business income attribution will not result **if** the property is a business in the hands of the transferor. If the taxpayer transfers his business to a corporation and takes back shares in the corporation so that he owns the corporation, (and not the business), then understandably the dividends received from the corporation will be income from the property being the shares and not the business which isn't owned by the shareholder directly. If the business is transferred to a trust whereby it is used to produce property income and not business income then notwithstanding Sec. 108(5) the income paid out to the beneficiary should not be attributable as property income since if the taxpayer would have transferred legal title to the property directly to produce business income attribution would not have resulted. The ultimate source of the income avoided is

¹²⁸⁴. But to reiterate, nothing in Sec. 104(13.1) prevents the Department from assessing the beneficiary in respect of a Sec. 105(1) benefit.

¹²⁸⁵. **Sec. 108(5)**

(5) Interpretation. Except as otherwise provided in this Part.

(a) an amount included in computing the income for a taxation year of a beneficiary of a trust by virtue of subsection 104(13) or (14) or section 105 shall be deemed to be income of the beneficiary for the year from a property that is an interest in the trust and not from any other source, and

(b) an amount deductible in computing the amount that would, but for subsections 104(6) and (12), be the income of a trust for a taxation year shall not be deducted by a beneficiary of the trust in computing his income for a taxation year,

but, for greater certainty, nothing in this subsection shall affect the application of subsection 56(4.1) and sections 74 to 75.

¹²⁸⁶ The section 74 to 75 provisions have as their purpose the attribution of **property** income however the application of them to trust situations has resulted in the tradition whereby the property that causes the attribution is the trust interest transferred to the beneficiary. The property transferred to the beneficiary that causes attribution is the interest in the trust.

a business, not a property. The attribution rules also do not apply to the income on the attributed income or on the income that was accumulated i trust to avoid attribution. Interest on interest will not be attributable nor will gains on gains.

The third aspect about the section 74.3 provision is that it applies only to **trusts and not estates**. A "trust" is defined through Sec. 248(1), (as well as estate, (**individually**), to the definition in Sec. 104(1) which provides that "a reference to a trust or estate, (in **this subdivision** referred to as "trust"), shall be read as a reference to the trustee or the executor, administrator, heir, or other legal representative having ownership or control, of the trust property", and thus the provision identifies separate distinct legal parties upon which a liability can be identified, and by the very fact that some qualification is placed upon the interchangeability of the terms "estate" and "trust" by the Act and by the fact that they are both identified it would appear that they are not to be equated as the same tax entities in the other parts of the Act. If the beneficiary has to otherwise recognize a Sec. 105(1) inclusion Sec. 74.3(1) will attribute it to the contributor of the property while Sec. 4(4) prevents the addition of that amount to the amount of income the contributor is recognizing under Sec. 104(14), but not necessarily Sec. 75(2), in respect of the property. In the case of a Sec. 75(2) inclusion the contributor is recognizing income from the property in specie¹²⁸⁷ since the source is in the same place.

Income Tax Ruling - ATR-70

Creation of a trust for the benefit of a minor. April 17, 1978

Facts

1. Mr. A intends to create a trust for the benefit of his grandchild B, who is 10 years old.
2. He wants to establish the trust to ensure that funds will be available for B's benefit, primarily for his education, although the wording of the trust deed (a copy of which was submitted) does not restrict the use of the trust funds for educational purposes only.
3. The trust makes provision for the following:
 - (a). The trustees will hold the trust fund for B and will pay him such amount of the net income or those amounts out of the capital as the trustees consider advisable until B turns 18.
 - (b). When B turns 18, the trustees will give him any amount of income produced by the trust fund that B requests from time to time for his education or advancement in life.
 - (c). When B becomes 28, the capital of the trust fund or any amount of money remaining will be paid or transferred to him.
 - (d). If B dies before reaching age 28, the trustees will manage the trust fund or the amount of money remaining in the following manner:
 - (i) Until the time that B would have turned 28, the net income and any amounts from the capital that the trustees consider advisable will be given to B's children, if any or failing that, to his legal spouse. If B had never married, the money will be distributed equally among trusts for Mr. A's other grandchildren.
 - (ii) On the date that B would have turned 28 or on an earlier date established at the trustees' discretion, the capital of the trust fund or the amount of money remaining will be given to B's children, if any, or failing that, his legal spouse, or failing that, the money will be distributed equally among trusts for Mr. A's other grandchildren.

Rulings Requested

4. You have requested the following rulings concerning the income of the trust and the eventual distribution of capital to B.
 - (a). that during the time the beneficiary is under the age of 18, any income from property transferred to the trust by the settlor or from property substituted shall, according to subsection 75(1) of the Income Tax Act, be considered the income of the settlor, not of the beneficiary;
 - (b). that during the time the beneficiary is under the age of 18, any taxable capital gains from property transferred to the trust by the settlor or from property substituted shall be considered to be the taxable

¹²⁸⁷ however if the beneficiary is non-resident attribution will not occur since he is not recognizing a Sec. 12(1)(m) inclusion, nor can he since Part XIII doesn't capture Sec. 105(1) benefits

capital gains of the settlor, and not of the beneficiary;

- (c) . when the trust becomes 18 years of age or over, any income from property transferred to the trust by the settlor or from property substituted shall be the income of the trust, and according to subsection 104(13), shall be included in computing the income of the person to whom it became payable in the year;
 - (d) . that during the time the beneficiary is 18 years of age or over, any taxable capital gains from property transferred to the trust by the settlor or from property substituted shall be considered to be the taxable capital gains of the beneficiary;
 - (e) . that upon distribution of the trust property to the beneficiary at age 28:
- (i) the trust shall be considered to have disposed of the property for proceeds of disposition equal to its cost amount to the trust immediately before that time; and
 - (ii) the beneficiary shall be considered to have acquired the property at a cost equal to the aggregate of its cost amount to the trust immediately before that time under the provisions of subsection 107(2).

Rulings Given

- 5. Provided that our understanding of the facts as outlined above is correct and the transaction is completed as described in your submission, we confirm ruling requests (a), (c) and (e) as stated above. With regard to rulings (b) and (d), we would like to point out that where property has been transferred to a minor or a trust for the benefit of a minor, in circumstances where subsection 73(3) (farm property transferred to a child) or 75(2) did not apply, there is no attribution of capital gains or losses realized by the minor or the trust for the benefit of the minor on the disposition of property thus transferred. In the case of the trust described in your submission, we would advise that after the property in question has been transferred by Mr. A to the trust, any capital gains or losses arising from the disposition of the property thus transferred would be the gains or losses of the trust unless any capital gains are designated by the trustees under the provisions of subsection 104(21), in which case the gains would be that of the beneficiary. Therefore, there would be no attribution of such gains to Mr. A.
- 6. These Rulings are given subject to the general limitations and qualifications set forth in Information Circular 70-6 dated September 14, 1970, issued by the Department of National Revenue, Taxation and are binding provided the proposed transaction is completed by...

Income Tax Rulings are published for the general information of taxpayers but are considered to be binding on the Department only in respect of the taxpayer to whom the ruling was given.

Subsection 74.4(2).

Subsection 74.4(2) applies where an individual has transferred or loaned, by whatever means...etcetera, property to a corporation and **one** of the main purposes of the transfer or loan can be considered to be to reduce his income **and** to benefit directly or indirectly etc., a person who is a designated person in respect of the individual but it only applies when the individual is resident in Canada, the corporation was not a small business corporation, and the designated person would have been a "specified shareholder" of the corporation if the definition thereof in Sec. 248(1) were read without reference to para. (a) or (d). The provision does not apply to cause attribution of the income realized by the corporation in respect of the property but instead deems the individual to have received as interest the amount of hypothetical interest otherwise computable on the "outstanding amount" of the loan or transfer, calculated at prescribed rates, that exceeds the aggregate amount of interest **he** actually received and 5/4ths of all taxable dividends received by **the individual** on shares that were "excluded consideration" received for the transfer or loan, (or on substitute shares).¹²⁸⁸ Subsection 74.4(2), much like 75(2), clearly is a penalizing provision in that it causes double taxation in that the interest/dividend paid to a designated beneficiary/person will be taxed in his hands and the subsection will still cause attribution.

¹²⁸⁸. If the contributor receives 80% of the prescribed interest value of the property back as dividends on excluded consideration attribution will not occur, depending of course on the prescribed interest rate, and the dividend tax credit in section 121 will usually reduce taxation on what dividends he does realize.

The Purpose Test.

One of the first differences from the other attribution provisions one recognizes as the provision is read is that there is a "purpose test" that must be satisfied in order for it to apply being that **one** of the main purposes that the loan/transfer was made must be reasonably considered to be to reduce the transferor's income **and** to benefit either directly or indirectly the designated person. If both of these aspects cannot be substantiated then the provision will not be applicable.

The Amount Attributed.

The amount of "net interest" that is applicable to the individual on the property is calculated on the period in the tax year in which the individual was alive and resident in Canada, the corporation was not a S.B.C., and the person was a designated person in respect of the individual and was a "specified shareholder". "Specified shareholder" means a taxpayer who owns, directly or indirectly, at any time in the year, 10% or more of the issued shares of any class of capital stock of the corporation or of any corporation which is related to it. While paragraph (c) of the definition concerns partnerships, para. (b) provides that each beneficiary of a trust, (although apparently not an estate), shall be deemed to own the proportion of the shares owned by the trust that the fair market value of its **beneficial** interest therein is of the total FMV of all of the beneficial interests under the trust at that time.¹²⁸⁹

"Excluded consideration" is defined in Sec. 74.4(1) while "outstanding amount" is defined in Sec. 74.4(3) and since they are overly complicated for the purposes of this discussion they require no more attention, however, it must be noted that the amount of "interest" that the individual will be deemed to recognize will be reduced only by the amount of interest **he** actually receives and the 5/4ths of the taxable dividends **he** receives on the excluded consideration shares. If he has thus disposed of the debt or shares which are the source of the interest or dividends he will be required to recognize the whole "interest" amount, even though the interest/dividends will be included in another taxpayer's income when received. Unlike interest income dividends from shares of taxable Canadian corporations are taxed at the lower rates at the second tier individual level when they are received, via the dividend tax credit however unlike interest income the corporation cannot deduct their payment in computing taxable income. Depending on the corporation's ability to access the M. & P. deduction or S.B. deduction, or its ability to reduce taxable income through loss/C.C.A. application it could be more beneficial to issue shares under a Sec. 85(1) contribution application than to issue debt as consideration for a transfer. The former will not usually cause immediate tax consequences to the contributor while the latter may cause him to recognize immediately any tax consequences inherent in the property contributed as per its fair market value. If the corporation has non-capital losses, etc. that allow it to substantially reduce its taxable income, (and it can benefit from the M. & P.D., S.B.D.), it would be disastrous to issue debt as consideration on a transfer when the interest income would immediately lead to a tax liability while the interest expense deduction would not lead an tax benefit due to lack of income.

The Trust Exemption.

Subsection 74.4(4) provides yet again another entertainingly technically deficient provision in the form of an exemption to the application of Sec. 74.4(1) whereby "one of the main purposes of a transfer or loan of an individual to a corporation shall **not be considered to be to benefit, either directly or indirectly**, a designated person in respect of the individual..." where certain conditions exist. The conditions that must be satisfied are: that the only interest the designated person has in the corporation is a "beneficial interest" in the shares of it held by a trust and, by the terms of that trust he may not, (at apparently any time or upon any event), receive or obtain the use of the income or the capital of the trust while he is a designated person, and, only where the designated person has not received or obtained the use of any of the capital or the income of the trust and no deduction has been made by the trust under Sec. 104(6) or (12) in respect of amounts paid or payable to, or included in the income of, that particular person while he was a designated person,...and after all of that there appears to be **no restriction** on what the trust can do with the dividend income and whether it

¹²⁸⁹. A power of appointment held by a friendly party that is exercisable in respect of an ultimate beneficiary is obviously more beneficial than that ultimate beneficiary actually holding the interest, absolute or otherwise.

can pay it out to a non-designated beneficiary immediately. The second condition may be broader than it appears in that there is no qualification as to whether the trust can be terminated. If the designated beneficiary can have the trust legitimately varied or revoked under the provincial Variation of Trusts Acts then technically he **may** be able to receive or obtain the use of the capital or income of the trust while being a designated person. Even worse, it appears that the trust must be expressly precluded from ever transacting exchanges of property with the designated person, even in an arm's length environment, since that would allow her to receive or obtain the capital/income of the trust. Although she may not receive or obtain any capital or income of the trust, it must be by virtue of the **terms of the trust itself** hence she is not precluded from pledging the beneficial interest she holds as collateral for a loan or from **simply selling it outright**¹²⁹⁰. The third condition is even wider than the first two being that if at any time, **before or after** the shares in the corporation were acquired by the trust, the designated person received or obtained the use of the income or capital thereof, the provision would not be effective and thus the third condition necessitates the creation of a separate holding trust and its quarantine "from" the designated person before and after its holding of the shares in order that the provision apply.¹²⁹¹ It is not redundant in Sec. 74.4(4)(c) that no deduction can be made under Sec. 104(6) or (12) by the trust in respect of the designated beneficiary in respect of amounts paid or payable to the person since he cannot receive or obtain the use of any income of the trust in the first place. The interaction of the two subparagraphs disallows the Sec. 104(13.1) mechanism from being used to avoid the necessity of a Sec. 104(6) deduction when income is in fact paid.

"Benefit not granted to a designated person – Sec. 74.4(4)"

(4) For the purposes of subsection 74.4(2), one of the main purposes of a transfer or loan by an individual to a corporation shall not be considered to be to benefit, either directly or indirectly, a designated person in respect of the individual, where

(a) the only interest that the designated person has in the corporation is a beneficial interest in shares of the corporation held by a trust;

(b) by the terms of the trust, the designated person may not receive or otherwise obtain the use of any of the income or capital of the trust while being a designated person in respect of the individual; and

(c) the designated person has not received or otherwise obtained the use of any of the income or capital of the trust, and no deduction has been made by the trust in computing its income under subsection 104(6) or (12) in respect of amounts paid or payable to, or included in the income of, that person while being a designated person in respect of the individual.

The subsection 74.4(4) provision is designed as an exempting clause and it functions automatically when the meticulously defined conditions exist and in this regard it has an extremely important fundamental flaw being that it is not precluded from applying where the income or capital flows through the trust to another party, other than the designated person, that may be related to her. The provision applies to provide that a benefit shall not be recognized to have been conferred or possibly conferred, upon the designated person, even when, even though the conditions are properly satisfied, the income or capital is payable to her/his holding corporation. It may even be payable by one trust holding the interests in another trust, (as sole beneficiary), which holds the shares under which she may be the sole income and capital beneficiary without affecting the application of Sec. 74.4(4). The subsection 74.4(4) provision doesn't prevent Sec. 74.3(1) from applying to the

¹²⁹⁰. It would be possible for the designated beneficiary to sell her divisible income rights to the dividends accumulating in the trust on an annual basis for a tax affected price that reflects the net cash inflow to the trust after the dividend tax credit and the amount of taxation she'll be suffering under a Sec. 106(1) disposition.

¹²⁹¹ There does not appear to be the ability for the "attribution" to be applied retroactively after the shares have been disposed of by the trust and the designated person then receives or obtains the use of the income or capital following a variation.

trust hence where shares were received by the trust from the taxpayer both may apply unless the specified person doesn't recognize income from the trust.¹²⁹²

One has to examine how nebulous the term "may" may be as it functions in Sec. 74.4(4) and how far removed the designated person must be from the receipt of trust income/capital in respect of para. (c).¹²⁹³ The provision operates to negate the recognition of any direct or indirect benefit while all para. (b) calls for is that the designated person may not receive or otherwise obtain the use of any of the capital or income of the trust but it does not indicate if this receipt/use may be **indirect**.¹²⁹⁴ Once a trust distributes income/capital to a holding corp. the shareholders of the holding corp. receive that income/capital in the capacity of shareholders of the corporation not as beneficiaries of the trust and since Sec. 74.4(4) fails to attend to the "direct-indirect" characteristic it could easily be argued that the intention of Parliament was direct receipt as a beneficiary only. If the provision had been so qualified then the designated person would have been precluded from receiving the trust capital/income in any capacity since original character and source of the benefit would have been carried through just as it is in so many other places in section 74.1 - 74.5. If the S.B. corporation pays all of its earnings to the trust so as to preserve its small business status the trust will be able to take the section 121 D.T.C. and reduce second tier taxation. The trust will eventually become cash pregnant but could make immediate distributions to former designated persons once they turn 18 or they can structure out accumulated income funds for preferred shares on an incorporation. Subsection 75(2) could also be of use.

Finally,...it would appear, that if the designated person has a beneficial interest in the dividends payable/paid in respect of the corporation's shares, as compared to a beneficial interest in the shares themselves, the conditions are not satisfied regardless of the fact that those in para. (b) & (c) are.¹²⁹⁵ Contingency clauses cannot be used, either way, to disconnect the interest in the dividends and thus powers of appointment over accumulated dividends exercisable in respect of the designated person may be the only means by which the Sec. 74.4(4) exception can be assessed and allow the designated person to ultimately benefit from the corporation. Subsection 74.4(4) offers plenty of opportunity to structure income splitting since accumulated income, reduced in taxation by section 11, can be distributed via a power of appointment to a designated persons holding corporation etc..

General Exemptions and Modified Anti-avoidance.

While subsections 74.5(1),(2),(3),(4), and (12) apply to provide general exempting provisions in respect of all of the main attribution charging provisions, subsection 74.5(6), (7), and (11) provide more modified anti-avoidance provisions concerning instances where the main attribution provisions can be circumvented so as not to apply by technical manoeuvres executed by the taxpayer.

Fair Market Value Transfers and Loans.

Subsection 74.5(1) provides that Sec. 74.1(1), (2) and section 74.2 will not apply to a transfer of the legal title of property if the fair market value of the property received as consideration was at least equal to the fair market value of the property transferred, or where consideration included indebtedness the interest rate charged on it was at least equal to the lesser of the prescribed rate and that which would have been agreed upon at the time by arm's length parties. (The interest would have to be paid within 30 days of the year end.) The Sec. 74.5(1)(a) requirement operates fully or not at all in that if the FMV of the consideration is less than the FMV of the property transferred attribution will follow, even though Sec. 69(1) may also apply to cause the recognition of the receipt of "**proceeds of disposition**" by the transferor. A good method to avoid attribution and at the same time lessen the tax consequences that could be recognized on the resulting disposition would

1292. Where Sec. 104(18) applies arbitrarily to require a minor's Sec. 104(13) income inclusion the minor, as a designated person, will not allow Sec. 74(4) to apply.

1293 If the designated person has a power of appointment over any of the trust property exercisable only in respect of parties other than himself he will not be exposed while not so if he can exercise it and become entitled to capital or income **immediately**.

1294 Subsection 74.5(10) recognizes explicitly both direct receipt and indirect receipt while the "direct-indirect" characteristic appears throughout the section 74-75 attribution rules.

1295 If the beneficiary has rights in specie to the shares and not the dividends reduced by the shares there shouldn't be any problems.

be to take back as consideration a note receivable whereby payments of principal are stretched over several years whereby the recognition reserve provision in Sec. 40(1)(a)(iii) can be favorably applied. Capital losses in subsequent periods could eliminate taxation on the gain as it is recognized through that subsection. The interest on the note may be a deductible expense to the transferee and income to the transferor.

Subsection 74.5(2) provides an exempting provision basically equivalent to Sec. 74.5(1) except that it concerns loans rather than transfers. It also applies for the purposes of Sec. 74.1(1), (2), and 74.2 to negate attribution when interest is charged on the loan equal to or greater than the lesser of the prescribed rate at the time of the loan and the rate that would otherwise be agreed upon at that time by parties dealing at arm's length. The interest would actually have to be paid within 30 days after the tax year end. Obviously if the property is realizing income at a greater effective return rate than the interest that would be applicable under Sec. 74.5(2) it would be advantageous to transfer or loan the property regardless since the interest paid, as required, would be deductible however other factors such as marginal tax rates, accrued gains, etc. would have to be considered in order to ascertain whether or not, over the long term, such an arrangement would be beneficial. Subsection 56(4.1) provides some restriction here as well.

Since subsections 74.5(1) & (2) apply for purposes of the charging provisions in Sec. 74.1(1),(2) & 74.2, they also apply to the technical modification provision in section 74.3 concerning trusts and whenever the conditions stated arise between the transferor/lender and the subject trust attribution will not occur.

“Transfers for fair market consideration – Sec. 74.5(1)”

(1) Notwithstanding any other provision of this Act, subsections 74.1(1) and (2) and section 74.2 do not apply to any income, gain or loss derived in a particular taxation year from transferred property or from property substituted therefor if

(a) at the time of the transfer the fair market value of the transferred property did not exceed the fair market value of the property received by the transferor as consideration for the transferred property;

(b) where the consideration received by the transferor included indebtedness,

(i) interest was charged on the indebtedness at a rate equal to or greater than the lesser of

(A) the prescribed rate that was in effect at the time the indebtedness was incurred, and

(B) the rate that would, having regard to all the circumstances, have been agreed on, at the time the indebtedness was incurred, between parties dealing with each other at arm's length,

(ii) the amount of interest that was payable in respect of the particular year in respect of the indebtedness was paid not later than 30 days after the end of the particular year, and

(iii) the amount of interest that was payable in respect of each taxation year preceding the particular year in respect of the indebtedness was paid not later than 30 days after the end of each such taxation year; and

(c) where the property was transferred to or for the benefit of the transferor's spouse or common-law partner, the transferor elected in the transferor's return of income under this Part for the taxation year in which the property was transferred not to have the provisions of subsection 73(1) apply.

“Loans for value – Sec. 74.5(2)”

(2) Notwithstanding any other provision of this Act, subsections 74.1(1) and (2) and section 74.2 do not apply to any income, gain or loss derived in a particular taxation year from lent property or from property substituted therefor if

(a) interest was charged on the loan at a rate equal to or greater than the lesser of

(i) the prescribed rate that was in effect at the time the loan was made, and

(ii) the rate that would, having regard to all the circumstances, have been agreed on, at the time the loan was made, between parties dealing with each other at arm's length;

(b) the amount of interest that was payable in respect of the particular year in respect of the loan was paid not later than 30 days after the end of the particular year; and

(c) the amount of interest that was payable in respect of each taxation year preceding the particular year in respect of the loan was paid not later than 30 days after the end of each such taxation year.

Marriage Breakdowns.

Subsection 74.5(3) applies to exempt from attribution instances where property has been loaned or transferred to or for the benefit of a spouse and the spouse and taxpayer have subsequently terminated their marriage. With respect to a trust, property can be contributed to a spousal trust described in Sec. 73(1)(c) whereby there will not be any tax consequences however such is not possible after the spouse and taxpayer have separated. Under Sec. 74.5(3) attribution under Sec. 74.1(1) will not occur in a period where the spouse and the taxpayer are living "separate" **and** "apart" by reason of a breakdown in their marriage while section 74.2 will not apply to dispositions of property during a period where the taxpayer and the spouse were living "separate" and "apart" due to a breakdown in their marriage and during the tax period in which they commenced to live apart and separate they completed jointly an election not to have the attribution provision apply.

Subsection 74.5(4) provides another exempting provision hindering Sec. 74.4(2) "interest" attribution from applying in respect of a designated person who was the spouse of the individual, during a period in which they were also living separate and apart, due to a breakdown in their marriage.

“Spouses or common-law partners living apart – Sec. 74.5(3)”

(3) Notwithstanding subsection 74.1(1) and section 74.2, where an individual has lent or transferred property, either directly or indirectly, by means of a trust or by any other means whatever, to or for the benefit of a person who is the individual's spouse or common-law partner or who has since become the individual's spouse or common-law partner,

(a) subsection 74.1(1) does not apply with respect to any income or loss from the property, or property substituted therefor, that relates to the period throughout which the individual is living separate and apart from that person by reason of a breakdown of their marriage or common-law partnership; and

(c) section 74.2 does not apply to a disposition of the property, or property substituted therefor, occurring at any time while the individual is living separate and apart from that person because of a breakdown of their marriage or common-law partnership, if an

election completed jointly with that person not to have that section apply is filed with the individual's return of income under this Part for the taxation year that includes that time or for any preceding taxation year.

"Idem – Sec. 74.5(4)"

(4) No amount shall be included in computing the income of an individual under subsection 74.4(2) in respect of a designated person in respect of the individual who is the spouse or common-law partner of the individual for any period throughout which the individual is living separate and apart from the designated person by reason of a breakdown of their marriage or common-law partnership.

Certain Other Exemptions.

Subsection 74.5(12) provides that the attribution charging provisions in sections 74.1 to 74.3 do not apply with respect to the transfer of certain property by an individual, where the property was a payment of a premium under a R.R.S.P. under which immediately after the transfer the taxpayer's spouse was an annuitant but only to the extent that the premium is deductible in the particular year in computing the income of the individual, or where the property was an amount contributed under a provincial pension plan described in Sec. 60(v). Also excluded from effect are amounts paid by the individual to his spouse or person under 18 with who he does not deal with at arm's length or his niece or nephew, that were deductible in computing his income **and** are required to be included in computing the income of the recipient.

"Where ss. 74.1 to 74.3 do not apply – Sec. 74.5(12)"

(12) Sections 74.1, 74.2 and 74.3 do not apply in respect of a transfer by an individual of property

(a) as a payment of a premium under a registered retirement savings plan under which the individual's spouse or common-law partner is, immediately after the transfer, the annuitant (within the meaning of subsection 146(1)) to the extent that the premium is deductible in computing the income of the individual for a taxation year;

(a.1) as an amount contributed under a provincial pension plan prescribed for the purposes of paragraph 60(v) under which the individual's spouse or common-law partner is, immediately after the transfer, the annuitant (within the meaning assigned by subsection 146(1)) or the owner of the account under the plan to the extent that the amount does not exceed the amount by which the amount prescribed for the purposes of subparagraph 60(v)(ii) for the year in respect of the plan exceeds the total of all other contributions to the plan for the year to the account of the spouse or common-law partner under the plan;

(a.2) as a payment of a contribution under a registered disability savings plan;

(b) as or on account of an amount paid by the individual to another individual who is the individual's spouse or common-law partner or a person who was under 18 years of age in a taxation year and who

(i) does not deal with the individual at arm's length, or

(ii) is the niece or nephew of the individual, that is deductible in computing the individual's income for the year and is required to be included in computing the income of the other individual; or

(c) to the individual's spouse or common-law partner,

(i) while the property, or property substituted for it, is held under a TFSA of which the spouse or common-law partner is the holder, and

(ii) to the extent that the spouse or common-law partner does not, at the time of the contribution of the property under the TFSA, have an excess TFSA amount (as defined in subsection 207.01(1)).

Anti-Avoidance.

Subsection 74.5(6), (7), as well as (11) provide modified anti-avoidance measures, the purpose of which is to counter arrangements that would fail to be subject to the general charging provisions due to technicalities imposed by the transferor/lender.

The first two concern transactions affecting "specified persons" which are defined in Sec. 74.5(8) to be a designated person or a corporation other than a S.B.C. of which a designated person is a specified shareholder.

Intermediate Parties.

Subsection 74.5(6) concerns instances where the individual has loaned or transferred property to another person and that property or its substitute has been transferred by any person to or for the benefit of the specified person or where the property has been transferred or loaned to another person on condition that property (**any** property) be loaned or transferred by **any** person to or for the benefit of the specified person. If one of the two situations arises for purposes of sections 74.1, 74.2, 74.3, and 74.4 the property loaned or transferred by the third party, (and not by the initial individual), will be deemed to have been loaned or transferred by the individual to or for the benefit of the specified person while for purposes of Sec. 74.5(1) the consideration received by the third party will be deemed to have been received by the individual.

"Back to back loans and transfers"

(6) Where an individual has lent or transferred property

(a) to another person and that property, or property substituted therefor, is lent or transferred by any person (in this subsection referred to as a "third party") directly or indirectly to or for the benefit of a specified person with respect to the individual, or

(b) to another person on condition that property be lent or transferred by any person (in this subsection referred to as a "third party") directly or indirectly to or for the benefit of a specified person with respect to the individual, the following rules apply:

(c) for the purposes of sections 74.1, 74.2, 74.3 and 74.4, the property lent or transferred by the third party shall be deemed to have been lent or transferred, as the case may be, by the individual to or for the benefit of the specified person, and

(d) for the purposes of subsection 74.5(1), the consideration received by the third party for the transfer of the property shall be deemed to have been received by the individual.

"Outstanding amount – Sec. 74.4(3)"

(3) For the purposes of subsection 74.4(2), the outstanding amount of a transferred property or loan at a particular time is

(a) in the case of a transfer of property to a corporation, the amount, if any, by which the fair market value of the property at the time of the transfer exceeds the total of

(i) the fair market value, at the time of the transfer, of the consideration (other than consideration that is excluded consideration at the particular time) received by the transferor for the property, and

(ii) the fair market value, at the time of receipt, of any consideration (other than consideration that is excluded consideration at the particular time) received by the transferor at or before the particular time from the corporation or from a person with whom the transferor deals at arm's length, in exchange for excluded consideration previously received by the transferor as consideration for the property or for excluded consideration substituted for such consideration;

(b) in the case of a loan of money or property to a corporation, the amount, if any, by which

(i) the principal amount of the loan of money at the time the loan was made, or

(ii) the fair market value of the property lent at the time the loan was made, as the case may be, exceeds the fair market value, at the time the repayment is received by the lender, of any repayment of the loan (other than a repayment that is excluded consideration at the particular time).

Loan Guarantees.

Under Sec. 74.5(7) where **an individual** is obligated, absolutely or contingently, to enter into any undertaking including guarantees, covenants or agreements given to ensure the payment of any principal or interest in respect of a loan made, (but apparently not a debt incurred), to or for the benefit of a specified person for purposes of sections 74.1, 74.2, 74.3, and 74.4 the property **loaned** by the third party shall be deemed to have been loaned by the individual while any interest actually paid to the third party will be deemed, only for purposes of Sec. 74.5(2)(b) and (c), and not for the income computation rules of Part I, to have been made to the individual. In a technical interpretation rendered by the Financial Industries Division (July 24, 1989) opined that it is a question of fact if a trustee could limit his guarantee of the trust debt through disclaimer to the value of the trust's property. If a beneficiary of a trust is a "specified persons" vis-a-vis the trustee who by virtue of his office causes the trust debt to be guaranteed Sec. 74.5(7) could be applied. In such a case the trustee will be deemed to have loaned for the benefit of the beneficiary the funds and attribution will flow back to the trustee in respect of the beneficiary's Sec. 12(1)(m) inclusion. It can be held however that by virtue of the fact that a trustee's liability after an appropriate disclaimer is limited to the assets of the trust that he doesn't guarantee the loan to the trust for purposes of Sec. 74.5(7). In T.I. 5-8006 rendered in May 1989 the F.I.D. was asked a similar question, differing only that overdraft protection is arranged for the trust but the father-trustee doesn't personally guarantee the debt, and it responded that it would need to examine the trust documents to establish if the attribution provisions could apply.

"Guarantees"

(7) Where an individual is obligated, either absolutely or contingently, to effect any undertaking including any guarantee, covenant or agreement given to ensure the repayment, in whole or in part, of a loan made by any person (in this subsection referred to as the "third party") directly or indirectly to or for the benefit of a specified person with respect to the individual or the payment, in whole or in part, of any interest payable in respect of the loan, the following rules apply:

(a) for the purposes of sections 74.1, 74.2, 74.3 and 74.4, the property lent by the third party shall be deemed to have been lent by the individual to or for the benefit of the specified person; and

(b) for the purposes of paragraphs 74.5(2)(b) and

(c), the amount of interest that is paid in respect of the loan shall be deemed not to include any amount paid by the individual to the third party as interest on the loan.

Disallowance from Relying on their Rules of The Game.

Subsection 74.5(11) provides a general anti-avoidance provision which provides that notwithstanding any other provision in the Act the section 74.1 to 74.4 provisions do not apply where it may be reasonably concluded that **one** of the main reasons of the transaction was to reduce the amount of tax that would be payable under Part I on income or gains from the property or its substitute but it doesn't comment on who may realize the potential reduction or for whom it was made regardless of if it successfully reduced the tax payable, hence it could apply to any person, not just limited to being the transferor/lender or the transferee/recipient. The provision does not comment on subsection 75(2).

“Artificial transactions”

(11) Notwithstanding any other provision of this Act, sections 74.1 to 74.4 do not apply to a transfer or loan of property where it may reasonably be concluded that one of the main reasons for the transfer or loan was to reduce the amount of tax that would, but for this subsection, be payable under this Part on the income and gains derived from the property or from property substituted therefor.

“Where an Individual has transferred or loaned...”

Subsections 74.1(1),(2), 74.2(1), 74.3(1), 74.4(2), and 74.5(6), all being attribution charging provisions, as well as now repealed Sec. 74(1) and 74(2) are all based upon the incident "where an individual has transferred or loaned property"...to or for the benefit of another person and since the Act does not provide a definition of "transfer" or "lend" one must look to the jurisprudence existing with respect to the attribution provisions for interpretation however before doing that one must recognize just what the attribution provisions are solely and primarily designed to do; limit income splitting arrangements with respect to property entered into by taxpayers and it would be at risk of sounding ridiculous to argue that they were not formulated solely in respect of the transactions that taxpayers enter into in respect of their own property to achieve this result.

There are two distinct aspects about the phrase "where an individual has transferred or loaned property...to or for the benefit of...etc."; there must be a transfer or lending of legal title to the property, and the property must have been transferred or loaned by the individual who owns it otherwise it would not be the individual who "has transferred or loaned" the property.

In *Murphy v. The Queen*¹²⁹⁶ Cattanach, J. commented on how, in at least three major landmark cases, the concept of a "transfer" was described as it related to taxing statutes. There are not one but two similarities in all of them. In *St. Aubyn v. Attorney General*¹²⁹⁷ Lord Radcliffe held:

"If the word "transfer" is taken in its primary sense, a person makes a transfer to another person if he does the act or executes the instrument which divests him of the property and at the same time vests it in that other person."

¹²⁹⁶ 80 D.T.C. 6314 (FCTD)
¹²⁹⁷ [1952] A.C. 15, (HL)

In *Fasken Estate v. M.N.R.*¹²⁹⁸ Thorson P. held, in respect of Sec. 74(1), that:

"The word "transfer" is not a term of art and has not a technical meaning. It is not necessary to a transfer of property from a husband to his wife that it should be made to any particular form or that it should be made direct. All that is required is that **the husband should so deal with the property as to divest himself of it** and vest it in his wife, that is to say, pass the property from himself to her. The means by which **he accomplishes** this result, whether direct or circuitous, may not properly be called a transfer..."

And finally in *Dunkelman v. M.N.R.*¹²⁹⁹ Thurlow J. held:

"The expression "has transferred" in S. 22(1) has, in my opinion, a similar meaning. All that is necessary is that **the taxpayer shall have so dealt with property belonging to him as to divest himself of it and vest it in a person** under 19 years of age..."¹³⁰⁰

All three judges of the former cases implicitly recognized that the attribution provisions of the time were targeted at where the donor was **voluntarily** dealing with his property with the dispositive power implicit in the holding of its legal title however¹³⁰¹, there may be instances where, due to the imposition of terms of ownership or exercise of dispositive powers in respect of the property other than those agreed to by the legal title holder, the property is forced to be transferred from the holder to another. Such conditions and powers clearly include conditions imposed upon a gift, whereby should events beyond the control of the acquiror occur, the acquiror will lose the legal title and the property will revert back to the donor or pass on to a third party while in the case of the power, a power of appointment held and exercised by a party which did not receive it from the legal title holder and was at arm's length with the holder could divest the legal title from the holder and vest it in someone else, the property being in this case a trust interest which is clearly a "property" that could cause attribution. If a transfer is made of property to an individual with terms upon the acquisition whereby, should a non-related event in respect of the acquiror occur, the property is to divest from him, one would have serious problems attempting to prove that as a result of the dealings, acts, or executions of the taxpayer **he** transferred or caused to transfer the property. If the taxpayer creates a trust through the transferring of property to it, under which the spouse or his children, nieces or nephews are not "beneficially interested", but the trustees receive a general power of appointment over the property and they exercise the power and grant a beneficial interest to the spouse, as per Sec. 74.5(6) attribution will commence upon the exercise and result of the power, (and only then), however if the taxpayer has only an existing beneficial interest in property held under a trust that he didn't create that is subject to a power of appointment, and the power is exercised to give his spouse the operative beneficial title to the demise of the taxpayer, since he did not give the power to the trustee can it be proven that "he" transferred the beneficial title, when it was an involuntary disposition in his respect?

(If the taxpayer transferred property to a trust and took back an interest, along with other beneficiaries, the exercise of a power of appointment inherent in the trust agreement that operated to debase his beneficial interest would most likely be looked upon by the courts as only a segment of the dispositive act of the contribution that he executed which transferred the title to the favored beneficiary. The contributor knew of the power when the property was transferred to the trust and recognized a potential result of its exercise. The same reasoning applies where the beneficiaries initiate a variation to the trust so as to grant a power of appointment over property which forms the basis of the interests but the "connectedness" characteristic can be avoided if the variation occurs when the interests are owned by other beneficiaries and are then acquired by the contributor. This could occur when property is contributed to a spousal trust and the sole interests thereunder are owned by the spouse and the trust is varied by her. If the interests are transferred back to the

1298 1948 Ex.C.R. 580

1299 1960 Ex. C.R. 73

1300 As cited in *Quain v. M.N.R.*, an old attribution case, the concept is described in *Langley v. Kahnert*, 1904 7 O.L.R. 556, as:

"The word "transfer" is not, I think, to be read as meaning merely "delivery", but, as it is defined in *Bouvier's Law Dictionary*, "the act by which the owner of a thing delivers it to another person, with **the intent** of passing the rights which he has in it to the latter."

1301 This was precisely the case in the Federal Court - Trial decision in *Garant v. The Queen* where *Rouleau J.* held:

"A person making a transfer must give up possession of the property which he had and **at the same time place the person to whom the transfer is made in possession of it**. The characteristic feature of a transfer is that of unilateral control. The transferor decides to make the transfer and selects the transferee..."

settlor, and the powers are held by the offspring exercisable in respect of themselves can the exercise of the power be connected with the original transfer by the settlor? See *Murphy v. The Queen*¹³⁰².)

It is a question of interpretation of purpose and resulting scope of the attribution provisions as to whether they apply to transfers of legal and beneficial title in a property as a unit or can they apply individually to both beneficial title to the property and more importantly legal title. A "transfer", in a general sense, need not only occur when the legal title of a property has been divested from one party and vested in another and this necessitates the recognition of a disposition by the transferor. Under Sec. 54(c)(v) however, a disposition, except as expressly provided in the Act, does not occur where there is "transfer" of property by virtue of a change in the legal ownership without any change in the beneficial ownership of the property, (other than a transfer by a trust resident in Canada to a trust that is non-resident), however this applies only for purposes of subdivision C. It seems interesting how the term "transfer" can be used to describe instances where a disposition is considered not to be recognizable even though there has been a divesting of title and vesting thereof in another party, and even though the Act may not allow the recognition of a disposition upon the occurrence of an event, it may still be recognized as a transfer.

The attribution provisions have the purpose of providing anti-avoidance with respect to taxpayers dealing with their property which they own and previously it was described how the legal title could be divested involuntarily from them. The fact that it could be divested was incidental to its status of being legally held. Where the legal title to a property is transferred to a person under a trust agreement, whereby that person is compelled to hold the title under the status of a trustee, and not for his personal benefit, clearly whatever transactions he subsequently executes with respect to the legal title of the property **cannot** be described as transactions with respect to "his property" since in his **personal status** he does not own the property. The bare legal title is vested in him, the beneficial title, under the trust, is vested in someone else. When that person divests himself of the legal title, (possibly as per the terms of the trust), he has not disposed of the property, but the trust has disposed of the property and for the purposes of imposing the substance of the taxing statutes upon him he cannot, in his personal capacity, be seen to be a transferor for the purposes of the attribution rules.

In *G.M. Miller v. M.N.R.*¹³⁰³ the Minister attempted to apply Sec. 160(1) to an arrangement where the taxpayer, who owed a considerable amount of taxes, "transferred" the subject property legally owned by him to another person, thus under Sec. 160(1) that other person would become partially jointly and severally liable for the taxpayer's bill by virtue of "the transfer of the property". Subsection 160(1) charges effectively identically with that in the attribution provisions being: "where a person has...transferred property either directly or indirectly,...etc". The taxpayer's tax liability was a liability incurred in his personal regard, and not in respect of the trusts for which he was trustee, while the property he "transferred" was subject to the trust. Applying the legal maxim "nemo dat qui non habet", (one cannot transfer what one does not own), the Court found that Sec. 160(1) could not apply to the transfer of legal title only. The taxpayer was the bare trustee of the property, not its legal and **beneficial** owner. As an application of this principle, all a taxpayer would have to do when he makes a transfer of legal title is to prove that it was held, in the capacity of a bare trustee, under a trust agreement, verbal or otherwise, for another person who held beneficial title, in order to avoid the attribution rules. (He could even enjoy the benefits of the property previously.)¹³⁰⁴ Providing proof of such could prove interesting. See *E. Bouchard v. The Queen*¹³⁰⁵. In *McGillivray v. M.N.R.*¹³⁰⁶ in the instance of a divorce, a husband disposed of property which the Court found the spouse to be the beneficial **owner** of and the Minister assessed her as disposing of the property thus attributing the gain to her hands. Although the disposition of the legal title to the property was initiated by the husband and considered an involuntary transfer in the spouse's respect *Brulé T.C.J.* found that the attribution provisions would apply to her by virtue of her **beneficial ownership**, (as opposed to being simply beneficially entitled in the constructive trust).¹³⁰⁷ In the author's

1302 80 D.T.C. 6314

1303 88 D.T.C. 1488, (TCC)

1304 See *Shiels v. Shiels*, 1990 90 A.T.C. 4,306, for a very similar situation. this is precisely what occurred in *Gardner v. M.N.R.*, 88 D.T.C. 1649 TCC.

1305 83 D.T.C. 5193

1306 25 E.T.R. 181,

1307 See also *P. de Graaf v. the queen*, 1985 1 C.T.C. 375, for similar concerns regarding who recognizes a Sec. 54(c)

opinion this Tax Court judgment does not represent valid jurisprudence when one recognizes that the spouse had no control over the disposition. Since she was the beneficial owner of the property she should have recognized the gain, as per **Sec. 75(2)**, however not because of Sec. 74(1).¹³⁰⁸

Subsections 56(2), (4).

Subsection 56(2) concerns payments or transfers of property made pursuant to the direction of, or with the concurrence of a taxpayer to some other person, but only where they were made for the benefit of the taxpayer or as a benefit that the taxpayer desired to have conferred on that other person. Such payments shall be included in computing the taxpayer's income only to the extent that they would be if they had been paid or transferred to him.¹³⁰⁹

"Indirect payments – Sec. 56(2)"

(2) A payment or transfer of property made pursuant to the direction of, or with the concurrence of, a taxpayer to some other person for the benefit of the taxpayer or as a benefit that the taxpayer desired to have conferred on the other person (other than by an assignment of any portion of a retirement pension pursuant to section 65.1 of the *Canada Pension Plan* or a comparable provision of a provincial pension plan as defined in section 3 of that Act or of a prescribed provincial pension plan) shall be included in computing the taxpayer's income to the extent that it would be if the payment or transfer had been made to the taxpayer.

The provision applies only to amounts that would otherwise have been included in computing the taxpayer's income had they been paid or transferred to him and it doesn't specify what portion thereof need be includable. A payment of capital, other than upon the extinguishment of a capital interest, to a capital beneficiary would either reduce the adjusted cost base of his interest as per Sec. 53(2)(h)(i.1), which **could** cause the immediate recognition of a disposition and capital gain if the ACB became negative, or could have hypothetically affected the a.c.b. of the capital interest, (without actually affecting it), thus avoiding the inclusion in income as per Sec. 105(1)(b)(i).¹³¹⁰ A capital payment to a capital beneficiary may not be included in computing his income hence when it is paid to another person with the direction or concurrence of the beneficiary Sec. 56(2) would not apply, however Sec. 105(1) could apply to that other person to cause him to recognize the payment **fully** in his income, (however not when it could be somehow related to a capital interest he had in the trust).¹³¹¹ Where the trustees of a personal trust, the capital interest in which the other taxpayer did not acquire for consideration payable, exercise a discretionary power, or where the subject taxpayer himself exercises a discretionary power that causes the capital to be payable to the other taxpayer, **in respect of his interests**, Sec. 56(2) may not apply if such a payment would not have caused an income recognition by the original taxpayer when received by him. The same can be said about powers of appointment held by the trustees or by the beneficiary to whom the capital and not income would otherwise have been payable to.¹³¹²

The provision applies only where the payment or transfer was made pursuant to the direction of or with the concurrence of the taxpayer and thus if the trust pays income or capital to another person when it would otherwise have been payable to the taxpayer, and the taxpayer/trust objects and commences legal

disposition.

¹³⁰⁸ An alternation in community of property regime pursuant to Quebec law to separate property will not constitute a transfer: *Garant v. the Queen*, 86 D.T.C. 6256 (FCTD).

¹³⁰⁹ Obviously this provision captures instances where a beneficiary under a trust has directed the trustees to pay the income that was subject to the enforceable entitlement held by the beneficiary to the other person or even to a trust arranged for that person, however, not when the income recognizable would not be included in the beneficiary's income. Such an instance would arise where the payments were that of funds realized as non-taxable dividends by the trust or amounts that had been "cut back" to not being recognizable by the beneficiary by virtue of Sec. 104(13.1)-(13.2) etc.

¹³¹⁰ Hypothetical adjustments take place only in respect of capital interests in personal trusts acquired by the taxpayer for no consideration or interests in trusts described in Sec. 108(1)(j)(ii) to (v).

¹³¹¹ In the author's opinion Sec. 105(1) would apply to the beneficiary or the recipient unless either was non-resident in the respective case. A creditor doesn't realize a benefit if payment is received from the trust though the beneficiary does. A beneficiary doesn't realize a benefit from the trust if the payment to a third party doesn't confer an advantage.

¹³¹² The provision doesn't necessitate the recognition by any party of a disposition or transfer.

proceedings against the recipient to remedy the situation, the Sec. 56(2) provision clearly doesn't apply since the payment was not made with the concurrence or direction of the taxpayer. If the recipient is non-resident Sec. 105(1) cannot apply to cause the recipient to recognize the payment in income. If the actions are successful then the amount representing the capital or income will be paid back to the trust. The essential factor is that if the taxpayer did not concur with the proceedings between the trust and the recipient Sec. 56(2) cannot apply.

Subsection 56(2) is broad enough to apply to an instance where an income interest is disclaimed/renounced causing the income payable to other income beneficiaries to be increased.

Subsection 56(2), following the Appeal Court's decision in *The Queen v. McClurg*¹³¹³ may not pose much of a danger in splitting income from a trust's property through its incorporation where the beneficiaries take back high dividend paying shares and the trust takes back low dividend paying shares on a Sec. 85(1) roll of the property out of the trust. In the above case the husband taxpayers owned one class of shares of the corporation and their wives another while the wife assessed had been, to a certain extent, substantially involved in the business and had purchased the shares with her own funds. She had personally guaranteed some of the corporation's debt in some instances and was instrumental in its incorporation. While the husbands' shares entitled them to all of the accumulated earnings they could make resolutions to pay dividends on the wives' class of shares. They exercised this authority, **in the capacity of directors**, for three relevant tax years and did not declare dividends payable to themselves. The Minister attempted to have Sec. 56(2) apply to them but a two to one majority of the appeal court found that if Sec. 56(2) was to apply to such instances where **directors** of a corporation directed dividends in a certain way the draftsman should have used far more explicit diction.¹³¹⁴ If a trust has substantial property that is to be incorporated capital and income interests under the trust have substantial value and can be transferred on a Sec. 85(1) roll into the corporation for consideration of certain classes of shares paying certain dividends and having residual ownership rights that reflect the original interests' characteristics vis-a-vis the other interests and the trust property. If the trustees elect in the trust's income producing property, possibly pursuant to an expressed contingency, the trust may take back low dividend paying shares while understandably corporate control via the holding of the exclusive voting rights may be required by the circumstances or the deed to be retained by the trustees.¹³¹⁵ In such an instance they can become directors and sprinkle income in the same manner as that in *McClurg*. To play it safe valuable consideration should be given for the shares by all parties involved. Section 245 could be the Department's weapon of choice in this instance.¹³¹⁶

1313 88 D.T.C. 6047, aff'd on more thorough reasons in the Supreme Court at 91 D.T.C. 5001.

1314 See also *Titley et al. v. M.N.R.*, 77 D.T.C. 36, *Champ v. The Queen*, 83 D.T.C. 5029 (FCTD), and *Clinche v. M.N.R.*, 86 D.T.C. 1571 (TCC). *McClurg* creates an interesting precedent in that it allows, it appears, an income beneficiary who is also an income sprinkling trustee, to exercise his discretion to divert income away from himself to another beneficiary without Sec. 56(2) applying to him. Could this result also where he has a general trust power of appointment that can grant income interests to other parties? At the Supreme Court level the separate identity of the corporation and the fact that if the discretionary exercise had not been made the dividends would have continued to be its earnings and not receivable by the directors was of importance. In an instance of a trust if the income is otherwise **currently** payable to the power holder unless the taxpayer exercises a diversionary power to pay it to another taxpayer Sec. 56(2) may apply since the exercise operates to divert the receipt of an amount that would otherwise have been income and the fact that the person exercising the power does so subject to fiduciary parameters, albeit broad ones, does not negate that fact that it is that recipient who is diverting **his** income. If the diversionary power is held by a taxpayer who will not receive the income then such will not be the case nor will it be when the income isn't to be paid currently but capitalized for one period and then distributed to the power holder: the receipt would not be **income** but capital. See also *Jones v. Garnett* [2006] 2 All E.R. 381 UK CA for the use of a trust to divert income to a spouse.

1315 Subsections 85(1)(e.2) and 15(1) restrict the ability of trustees to take back insignificant preferred shares in exchange for substantial assets. Under the former if a taxpayer **related to the trust** can reasonably be considered to have realized a benefit the Sec. 85(1) election proceeds will be increased while in the latter instance the beneficiaries may realize a benefit only to the extent that dividends are not included in their income. Trust companies and beneficiaries may be unrelated.

1316 The Supreme Court of Canada delivered judgment on *McClurg* in 91 D.T.C. 5001 and with a slim majority held that the legislative provision's purpose and the economic and commercial reality of the arrangement is of importance and stressed the fact that the provision is to apply to payments otherwise receivable by the taxpayer. In *McClurg* the discretionary dividends would **not** have been receivable by the director/shareholder/husband since such a declaration wasn't made and the amount would remain corporate earnings. Such would also be the case in respect of trusts the income of which is accumulating but due to a discretionary power can be paid to an alternate beneficiary other than the beneficiary who is to receive the capital. The income could even be otherwise accumulated for the benefit of the discretionary power

The Tax Review Board jurisprudence of *Guthrie v. M.N.R.*¹³¹⁷ may pose some danger here where the contributions of the trust and beneficiaries result in an unrealistic alteration in the value of their property. In *Guthrie* a Canadian taxpayer corporation, owned and directed by a Canadian individual taxpayer, decided it was going to invest in some preferred shares of a Bahmanian corporation. The common shares (voting) were owned by the Canadian resident trust which was set up for the taxpayer and his offspring and the corporate taxpayer owed a considerable amount of taxes to the R.G.. Pursuant to the "sound" advice of the taxpayer's accountant and lawyer the funds "visited the islands" via the help of the corporation's solicitors, and subsequently the corporate taxpayer was wound-up (bankrupt) with the cancellation of its charter. The Minister, seeing that the preferred shares were essentially worthless, went after the shareholder/director with Sec. 56(2) contending that the investment in the preferred shares was a benefit wished to be conferred by the individual taxpayer on the trusts for the kids; the preferred shares had a redemption par value, didn't pay any dividends, were non-cumulative, and simply had no market value due to their terms. The Minister's counsel commented that: "...if there is an imbalance in consideration given and the property received and returned, then there is an inference of a benefit". Piercing through two corporate veils, that of the corporate taxpayer and the investee the Tax Appeal Board concluded that the individual taxpayer had realized a \$185,000 benefit. Considerable was the influence of the fact that the arrangement did not have the appearance of a bona fide investment. This jurisprudence applies to a trust incorporation with perhaps restricting results since it would appear that if the trust's preferred shares have a reduced value either Sec. 56(2) or 105(1) could apply to the former beneficiary turned shareholder. If however, the trustees are made directors the dividend payments on the preferred shares could be controlled while if not all of the trust's property, but that producing substantial income, is incorporated along with the entirety of the beneficiaries' interests neither Sec. 56(2) nor 105(1) may apply.

In *Pitt Estate v. M.N.R.*¹³¹⁸ a testator caused a corporation he was the major shareholder of to sell its business to his son and son-in-law prior to his death and the corporation was in the process of forgiving debt to be received on the sale when he died. The corporation continued to forgive the debt due to be extinguished at the rate of \$5,000 per year and the Minister was successful at arguing before the Tax Appeal Board that the forgiving of the debt amounted to a benefit wished to be conferred on the acquirors by the testator and that the Sec. 56(2) provision applied, acting in concert with the equivalent of present Sec. 15(1) being that the benefit would have been includable in the testator's income had he realized it.¹³¹⁹ The then Sec. 15(1), (equivalent to Sec. 56(2)) was found to apply **to the estate** even though it was recognized that it was the deceased taxpayer who was the taxpayer which conferred the benefit, however if one reads the present Sec. 56(2) provision one has a serious problem accepting that the provision can be applied to an estate since if the above situation occurred it would not be the estate which wished to have the benefit concurred. An estate is administered as per the terms of the will and this causes it to draw its actions from directions provided by the deceased which wished to confer the benefit. This does not negative the fact that the estate is considered separate from its deceased taxpayer and thus it is not the estate which can be charged under Sec. 56(2). The provision can easily apply where an income beneficiary also has a general power of appointment over the trust's income and exercises it to grant another taxpayer some income rights thereto while the same can be said about statutory variations that cause the same.

Subsection 56(2) was also a rather unique weapon of choice in *Cox v. the Queen*¹³²⁰. A taxpayer had attended to an aging individual's commercial affairs on the condition that the residue of her estate be left to his wife. The individual amended her will before she died and although the taxpayers were threatening to launch a claim on a quantum meruit basis for the consideration the executor/beneficiary settled the dispute with the

holder as per the *McClurg* circumstances but distributed for legitimate purposes to the other beneficiaries.

1317 72 D.T.C. 1070

1318 59 D.T.C. 275

1319 See *Boardman et al. v. The Queen*, 85 D.T.C. 5628, and *Galway Family Trust v. M.N.R.* 90 D.T.C. 1913, for similar applications. The latter concerned an application of Sec. 15(1)-56(2) to a trust which owned a corporation that purchased trustee's shares for excessive consideration whereby the trust was assessed under Sec. 56(2). It would also be possible to assess the trustee in such a situation with Sec. 105(1) as receiving a benefit from the trust via his control, albeit in the capacity of a trustee, of the trust's property. In T.I. 5-1710 of Oct. 1986 it was opined by the General and Small Business Section that where a F.L.A. order compels a husband to ensure that his wholly owned corporation pay 10% of its profits to a wife for 5 years under section 11(2) of that Act Sec. 56(2) and 15(1) would apply to include them in the husband's income.

1320 82 D.T.C. 6287

transfer of an estate property to the taxpayer and his wife which was subsequently disposed of. The proceeds were assessed in the taxpayer's hands under Sec. 56(2), as a payment for services rendered thereby, which were paid to his wife. The Federal Court - Trial Division upheld the assessment. Even if there hadn't been a dispute and the property had been transferred, and the Minister became aware of the reason why, Sec. 56(2) could apply. Quantum meruit claims are creditors' claims rather than beneficial entitlements and their settlement does not gain section 107 treatment, while they do not lead to a deduction to the estate, though they are included in the recipient's income, since they were not incurred to produce income/gain.¹³²¹ Their **tax effected** value to the recipient may be a bargaining position to the executors/beneficiaries.

"Transfer of rights to income - Sec. 56(4)"

(4) Where a taxpayer has, at any time before the end of a taxation year, transferred or assigned to a person with whom the taxpayer was not dealing at arm's length the right to an amount (other than any portion of a retirement pension assigned by the taxpayer under section 65.1 of the *Canada Pension Plan* or a comparable provision of a provincial pension plan as defined in section 3 of that Act) that would, if the right had not been so transferred or assigned, be included in computing the taxpayer's income for the taxation year, the part of the amount that relates to the period in the year throughout which the taxpayer is resident in Canada shall be included in computing the taxpayer's income for the year unless the income is from property and the taxpayer has also transferred or assigned the property.

Subsection 56(4) concerns transfers or assignments of rights to "an amount" occurring between parties not at arm's length before the transactions, if the amount would have been included in the taxpayer's income, (had the right to it not been transferred), for the year in that it would have been received or receivable in or in respect of the year. Such an amount would be attributed to the taxpayer where the right is assigned or transferred but **not** where the property in respect of which it is earned is also transferred or assigned to the recipient. An enforceable income interest represents a property in respect of which income of a trust is payable, as per Sec. 108(5)(a), and thus it is clearly the property described in Sec. 56(4) when the right to its trust income of a particular period is transferred or assigned. An income right is a right that is measurable with respect to duration and amount as per the terms of the trust which may also apply to cause it to be indivisible into smaller rights with respect to a particular period. If the income right granted under the trust agreement can be divided up as per the periods in respect of which it is enforceable and part thereby transferred to the other person so as to avoid the application of Sec. 56(4) the original right holder would still have to recognize the proceeds of disposition under Sec. 106(2), however, if the initial holder was acting under the presumption that the income that to be realized from the right was less than the amount eventually realized, he could dispose of it for far lesser proceeds than the income realized by the acquiror, and thus he would recognize less income.

Subsection 56(4.1)-(4.3) consist of provisions enacted by the 1988 tax reform that are to operate in conjunction with some of the section 74.1-74.2 provisions, and they concern loans to individuals other than spouses or children not at arm's length with the lender, who would otherwise not subject the loan to the general attribution provisions by virtue of the fact that they are not described as target recipients under those provisions. In effect, the Sec. 56(4.1)-(4.3) provisions are targeted directly at loans **to, but not for the benefit of**, an individual not dealing at arm's length with the lender who was not a minor and not his spouse. Subsection 56(4.1) does not apply to transfers.

Where a loan has been made by an individual, by whatever means, to another individual not at arm's length with him, and it can be reasonably considered that **one** of the main reasons of the loan was to reduce or avoid tax by causing income from the property or its substitute to be recognized by the other individual then the income recognized when the lender is not at arm's length with the recipient and is resident in Canada, shall be deemed to be income of the lender and not of the recipient individual, but only to the extent that section

¹³²¹ Can there be an amended terminal return by the deceased in respect of them when they are established as binding on the estate?

74.1 is not applicable. The subsections do not apply to businesses or business income. Subsection 56(4.1) clearly applies to loans to trusts which were not at arm's length with the lender, regardless of whether any beneficiaries under the trust are related to him however it does not apply when it cannot be reasonably concluded that one of the main reasons of the loan was to reduce or avoid tax, apparently by any party anytime, on any income.¹³²²

The provision does not apply to loans made to benefit an individual, rather than to the individual directly hence if a loan is made, interest free, to a corporation in order to allow it to pay dividends to a shareholder which could be a trust, although the individual will not realize any interest income and the corporation won't obtain an interest deduction Sec. 56(4.1) won't apply since the loan was not made ~~to~~ an individual, even though it has the effect of reducing the lender's income and tax by reducing the actual amount of interest he realizes on those funds. Subsection 74.4(2) won't apply.

Although Sec. 56(4.3) provides a modified anti-avoidance provision applicable to cause attribution where a loan is made to a person to repay borrowed money with which other property was acquired or to reduce an amount payable for other property Sec. 56(4.2) provides the general exempting provision that negates possible attribution where interest at the lesser of the prescribed rate or the generally available commercial rate, at the time of the loan, is applied and paid on the value thereof within 30 days after the end of the particular year.

Finally a trust itself can be the attributee individual described in any of the attribution provisions but obviously it cannot have a spouse or niece/nephew.

Sections 74.1, 74.2, 74.3, and 74.4, all concern attribution from property transferred directly or indirectly to a recipient but they don't apply to attribute income on income from the property. In light of this a taxpayer could transfer or lend cash to a trust that was previously stuffed with losses using Sec. 75(2) and have the income thereupon recognized by the trust which could be negated with a booked loss. Once the Department amends Sec. 75(2) to remove double loss potential preferred beneficiary elections would have to be relied upon to get the income out of the trust's hands where it is taxed at high rates. The capitalized income could then be transferred to the reactive recipient.

Income Tax Interpretation Bulletin

Transfer of Rights to Income

IT-440R2

DATE: June 20, 1995

SUBJECT: INCOME TAX ACT

Transfer of Rights to Income

REFERENCE: Subsection 56(4) (also subsections 82(2), 147.3(5) and 212(12))

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This document is also available for download in PDF format.

Transfer of Rights to Income

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¹³²² See MacDonald v. C.I.R., 23 T.C. 449.

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Application

This bulletin replaces and cancels Interpretation Bulletin IT-440R dated November 30, 1989.

Summary

This bulletin discusses subsection 56(4), which provides a rule directed against potential avoidance of tax through the transfer of a right to income between parties not dealing at arm's length. Generally, under this provision, the income in question continues to be taxed in the hands of the transferor. The comments below explain the application of subsection 56(4) and related tax consequences.

Discussion and Interpretation

General

¶ 1. Subsection 56(4) applies where a taxpayer (transferor) has transferred or assigned to a person (transferee) with whom the transferor was not dealing at arm's length (see ¶ 2 below) the right to an amount which, had the right not been so transferred or assigned, would be included in the income of the transferor. The amount that is included in income, for the 1992 and subsequent taxation years, is the part of the amount that relates to the period in the year throughout which the transferor is resident in Canada. See the current version of IT-221, *Determination of an Individual's Residence Status*, for more information on residency. The right to an amount as referred to in subsection 56(4) is commonly called a right to income. A transfer or assignment includes a sale whether or not the sale is at fair market value. The subsection serves as an obstacle to switching income from the transferor to the transferee by providing that the amount arising from the right be included in the transferor's income.

¶ 2. In determining whether a transferor and transferee are dealing with each other at arm's length, please refer to the current version of IT-419, *Meaning of Arm's Length*. Spouses are deemed, by virtue of their marital relationship, not to be dealing with each other at arm's length and thus subsection 56(4) would usually apply where a right to income is transferred from one spouse to another. Subsection 252(4), which applies after 1992, expands the meaning of "spouse" to include a person of the opposite sex who at a particular time lives with the taxpayer in a conjugal relationship and either has so lived with the taxpayer throughout a 12-month period ending before that time, or the two individuals are the natural or adoptive parents of the same child.

Pension Benefits

¶ 3. Subsection 56(4) does not apply to any portion of a retirement pension that the taxpayer assigns under section 65.1 of the *Canada Pension Plan* or under a comparable provision of a provincial pension plan as defined in section 3 of the *Canada Pension Plan*. The *Quebec Pension Plan* is the only provincial pension plan that has a comparable provision.

¶ 4. Generally, the pension benefits legislation of a province provides the terms under which a portion of the pension benefits of a member of a pension plan may be paid to a spouse or former spouse under a domestic contract, a written separation agreement, or a divorce decree or court order under a provincial family law act relating to the division of property on the breakdown of a marriage. Subsection 147.3(5) permits a direct transfer of a lump sum amount from one registered pension plan to another, or to a registered retirement savings plan or a registered retirement income fund for the benefit of the spouse or former spouse of a plan member. Subsection 147.3(5) applies where the spouse or former spouse is entitled to an amount under a decree, order or judgment of a competent tribunal, or under a written agreement, relating to the division of property between the member of the plan and the spouse or former spouse in settlement of rights arising out of, or on a breakdown of, their marriage. Where the spouse or former spouse of a plan member receives an amount from the registered pension plan, registered retirement savings plan or registered retirement income fund, subsection 56(4) will not apply to include the amount in the income of the plan member.

Subsection 56(4) Not Applicable

¶ 5. Subsection 56(4) does not apply to an amount that is income from property where the transferor has also transferred or assigned the property. Although a right to an amount constitutes property as defined in subsection 248(1) and could be assigned as such, in order to fall under this exempting provision of subsection 56(4) the property must be separate and distinct from the income which arises from it so that it

would be possible to transfer one while retaining the other. For example, a life interest created under a trust or testamentary instrument is considered to be a property separate and distinct from the income which arises from it. Consequently, where a life tenant transfers a life interest in an estate to one or more of the persons entitled to the residual interest in the estate, subsection 56(4) does not apply since there is a transfer of property as well as a transfer of the right to income.

¶ 6. While subsection 56(4) does not apply to an amount that is income from property where the transferor has also transferred or assigned the property, other provisions of the Act, such as, section 74.1, may apply to attribute the income from the property to the transferor. For a discussion of section 74.1, see the current versions of IT-510, *Transfers and Loans of Property made after May 22, 1985 to a Related Minor*, and IT-511, *Interspousal and Certain Other Transfers and Loans of Property*.

¶ 7. The right to an amount in the context of ¶ 1 above refers to the right to income, as opposed to losses, from all sources. However, where an amount of income to which subsection 56(4) applies is invested or otherwise used by the transferee to earn further income, subsection 56(4) will not apply to include the further amount of income in the income of the transferor.

Other

¶ 8. Where a taxable dividend received by the transferee from a taxable Canadian corporation is included in the transferor's income by virtue of subsection 56(4), the dividend is deemed by subsection 82(2) to have been received by the transferor for purposes of the gross-up and dividend tax credit provisions.

¶ 9. Where an amount paid or credited to a transferee who is a non-resident of Canada is included in the transferor's income by virtue of subsection 56(4) and is subject to tax under Part I of the Act, subsection 212(12) provides that the amount is not subject to non-resident withholding tax under Part XIII of the Act.

¶ 10. An amount to which subsection 56(4) applies could be included in the income of both the transferor and transferee. However, where the transfer or assignment of the right to an amount that is income does not constitute a deliberate attempt to evade or avoid tax, the amount will be included only in the income of the transferor.

Explanation of Changes

Introduction

The purpose of the *Explanation of Changes* is to explain the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised departmental interpretations.

Overview

Where a transferor transfers a right to receive income to a transferee with whom the transferor does not deal at arm's length, income received under the right generally is income of the transferor rather than the transferee.

The bulletin reflects amendments to subsection 56(4) resulting from S.C. 1994, c. 21 (formerly Bill C-27) and adds interpretative comments. The amendments to subsection 56(4) apply to the 1992 and subsequent taxation years.

Legislative and Other Changes

¶ 1 reflects a Bill C-27 amendment to subsection 56(4) to provide that only the income that relates to a period throughout which the transferor is resident in Canada is included in the transferor's income.

¶ 2 has been revised to incorporate the expanded meaning of "spouse" in subsection 252(4) and to delete the comments concerning the exemption from the application of subsection 56(4) when pension income is assigned by a taxpayer under section 65.1 of the *Canada Pension Plan* or under a comparable provision of a provincial pension plan.

¶ 3 contains the deleted comments from the former ¶ 2. It also reflects a Bill C-27 amendment to subsection 56(4), which repealed the reference to "prescribed provincial pension plan."

¶ 4 is a new paragraph to explain that, under the pension benefits legislation of a province, a portion of the pension benefits of a member of a pension plan may be paid to a spouse or a former spouse of the member on the breakdown of their marriage. The paragraph also describes subsection 147.3(5) which permits, on

the breakdown of a marriage, the transfer of an amount from the registered pension plan of one spouse to the registered pension plan, registered retirement savings plan or registered retirement income fund of the other spouse.

¶ 6 is a new paragraph which observes that while subsection 56(4) does not apply to income from property if the transferor has also transferred or assigned the property, other provisions of the Act may require the transferor to report the income.

¶ 8 (former ¶ 5) has been revised to delete comments on the interest and dividend income deduction which applied before 1988.

Notice -- Bulletins do not have the force of law

Interpretation bulletins (ITs) provide Revenue Canada's technical interpretations of income tax law. Due to their technical nature, ITs are used primarily by departmental staff, tax specialists, and other individuals who have an interest in tax matters. For those readers who prefer a less technical explanation of the law, the Department offers other publications, such as tax guides and pamphlets.

While the ITs do not have the force of law, they can generally be relied upon as reflecting the Department's interpretation of the law to be applied on a consistent basis by departmental staff. In cases where an IT has not yet been revised to reflect legislative changes, readers should refer to the amended legislation and its effective date. Similarly, court decisions subsequent to the date of the IT should be considered when determining the relevancy of the comments in the IT.

An interpretation described in an IT applies as of the date the IT is published, unless otherwise specified. When there is a change in a previous interpretation and the change is beneficial to taxpayers, it is usually effective for all future assessments and reassessments. If the change is not favourable to taxpayers, it will normally be effective for the current and subsequent taxation years or for transactions entered into after the date of the IT.

A change in a departmental interpretation may also be announced in the *Income Tax Technical News*.

If you have any comments regarding matters discussed in this IT, please send them to:

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Reversionary Trusts and Income Attribution.

Subsection 75(2) provides for income attribution where property is held on the condition by a trust created since 1934, that it (or substitute property), may "revert to the person from whom the property...was directly or indirectly received", "pass to persons to be determined by him at a time subsequent to the creation of the trust", or, during the lifetime of the person from whom it was directly or indirectly received it cannot be disposed of except with the person's consent or in accordance with his direction. The income or loss from the property, or substituted property or any taxable capital gain or allowable capital loss from the disposition thereof will be attributed where it is subject to any of the above conditions but only when the subject person contributor is resident in Canada. The taxable net gain realized from the disposition of listed personal property would not be caught by the scope of the provision however it should not be over looked that the provision does not provide a "clean" attribution but only deems the gain/loss/income to be that of the contributor. Unlike the other major attribution provisions in section 74.1, 74.2, Sec. 75(2) does **not** provide that the trust will be deemed not to have realized the income/gain attributed whereby as per the strict application of the provision both the trust and the attributee may have to recognize the same gain/income.¹³²³ Due to the fact that the provision does apply to attribute losses, of either the capital or income nature, it breaks considerably with the norm whereby losses realized by the trust must be deducted by it and not only by any other party. (This point will be further elaborated upon subsequently.)

The overall scope of the provision allows it to apply where the property is held on any of the conditions described, regardless of whom the "person" is or how the property came to exist under the trust agreement. In this sense it doesn't apply just to settlers, in the technical tax sense of the word, but to any person from whom the property was "directly or indirectly received" whereby only the income/loss from the **subject** property or its substitute will be attributed.

All property is held "on condition" under an inter vivos trust instrument for the intentions of the settlor may be subject to misapplication with unacceptance of the interest therein by the beneficiary, thus causing the gift to be incomplete, the trust to become a resulting trust for the settlor and the return of property to him. Unfortunately without too much clarity, the provision will apply when the property is "held on condition" of any one of three possible arrangements which are very uniquely described however it is also here where the provision, technically, breaks apart in that if the property isn't held on any one of the three conditions the provision won't apply. It would be foolish to support the idea that when any one of the three arrangements merely exists the provision will apply in that the provision states that the particular arrangement must be the condition upon which the property is held. The reason for which the property is held in trust must be for one of the reasons detailed in the provision. (Logically, one would think that taken oppositely, if the condition did **not** exist the property would **not** be held in the trust and it is this fundamental "arrangement-purpose" that gives the provision its flaw.) All trusts express that subject property is to be held in trust but not all express that it will be held in trust exclusively due to a particular condition and in some instances a series of conditions may be listed which may affect the ultimate ownership of the property. If a trust deed specifies that certain property is to be held in trust for a particular period of time after which it will be delivered to a beneficiary is it also **held** on condition if the contributor retains a power of appointment over it that is only incidental to the transfer, (and that will cease to exist upon death or passage of time)? The subsection 75(2) provision refers to property **held on condition, not subject to an incidental power and the reason for which it is held must be one of the described conditions.**¹³²⁴

The provision provides that where the property is **held on condition** that it or property substituted therefor **may "revert"** to the person from whom it was directly or indirectly "**received**", or, pass to person to be determined by him at a time subsequent to the **creation** of the trust, attribution will occur. If the **condition** upon which the property is held is other than these two events or arrangements then the provision will not apply and to further comment on the matter it would appear that the existence of the described arrangement must be the **sole condition** upon which the property is held from a strict reading of the opening preamble.

¹³²³ Income of bare trusts can be taxed more than once due to this provision while the trust to which it applies need not be bare of dispositive/distributive powers.

¹³²⁴ Is this a situation where too many words were employed in a decrepit provision, "held on condition"?

This provision is very dangerous since since it applies to **one single property** in the particular trust, **all** property owned by the trust doesn't benefit from effective tax-free roll-out mechanics as described in Sec. 107(4.1).

"Trusts – Sec. 75(2)"

(2) Where, by a trust created in any manner whatever since 1934, property is held on condition

(a) that it or property substituted therefor may

(i) revert to the person from whom the property or property for which it was substituted was directly or indirectly received (in this subsection referred to as "the person"), or

(ii) pass to persons to be determined by the person at a time subsequent to the creation of the trust, or

(b) that, during the existence of the person, the property shall not be disposed of except with the person's consent or in accordance with the person's direction,

any income or loss from the property or from property substituted for the property, and any taxable capital gain or allowable capital loss from the disposition of the property or of property substituted for the property, shall, during the existence of the person while the person is resident in Canada, be deemed to be income or a loss, as the case may be, or a taxable capital gain or allowable capital loss, as the case may be, of the person.

"Subsection 75(2) does not apply to property held in a taxation year – Sec. 75(3)"

(a) by a trust governed by a deferred profit sharing plan, an employee benefit plan, an employees profit sharing plan, a registered disability savings plan, a registered education savings plan, a registered pension plan, a registered retirement income fund, a registered retirement savings plan, a registered supplementary unemployment benefit plan, a retirement compensation arrangement or a TFSA;

(b) by an employee trust, a related segregated fund trust (within the meaning assigned by paragraph 138.1(1)(a)), a trust described in paragraph (a.1) of the definition "trust" in subsection 108(1), or a trust described in paragraph 149(1)(y);

(c) by a trust that

(i) is not resident in Canada,

(ii) is resident in a country under the laws of which an income tax is imposed,

(iii) is exempt under the laws referred to in subparagraph 75(3)(c)(ii) from the payment of income tax to the government of the country of which the trust is a resident, and

(iv) was established principally in connection with, or the principal purpose of which is to administer or provide benefits under, one or more superannuation, pension or retirement funds or plans or any funds or plans established to provide employee benefits;

(c.1) by a qualifying environmental trust; or

(c) by a prescribed trust.

Reversions.

The first paragraph describes one of the conditions that will attract application being where the property or substitute property **may revert** to the person from whom it was directly or indirectly received. As described this paragraph may apply to considerably diverse situations being that it will technically apply not only where, as per the trust terms, the property must "revert" to the contributor thereof, but also where there is **any possibility** of this occurring.¹³²⁵ This would thus include instances where the property is to be held for a specific period of time before it is transferred back out to the contributor as to allow its income to accumulate for other beneficiaries as well as the instances where due to the disclaiming of an interest in the trust the gift fails and the title to the property reverts back to the contributors.¹³²⁶ This paragraph is a major deterrent to arranging a flexible estate freeze in that if the shares of the subject corporation are issued to the trust for the offspring for consideration provided by the contributor, with the possibility of gift over if the "kids don't behave themselves" the substitute property will possibly revert as a condition. If consideration used to invest in the corporation is nominal, and was provided by a non-reversionary settlor/contributor Sec. 75(2) won't apply to any dividends/gains on the shares.¹³²⁷

In order for the paragraph to apply the property must be capable of reverting to the person from whom it was directly or indirectly received and although the provision was drafted so as to apply both to original and substitute property, and direct and indirect receipt thereof, it does not comment on how the property may "revert" to the contributor. Since the provision lacks this specification its draftsmen mustn't have had an **indirect** reversion in mind being that the reversion of property is a particular event in the life of a trust and not two in sequence. The paragraph applies where the property "may revert to the person" in respect of the particular trust which holds the property. It does not apply, in the author's opinion, where it "may **indirectly** revert to the person" thus if the property may revert to another trust set up by a person under which he is the main beneficiary then it will not "revert to him" but to his trust. From that trust it may then "revert" to the contributor. The second trust may be one for sale only.¹³²⁸

The property or substitute property which may revert to the contributor must be that which was received directly or indirectly from the contributor and in this respect the application of the provision may result from considerably diverse situations. If a person has disposed of property to his majority age son and recognizes fair market value tax consequences and the son then creates a trust out of the property for his father then Sec. 75(2) may be applied to attribute income/gain etc **to the father** since the property is held on condition that it revert to him, the person from whom it was indirectly "received". This phenomenon extends to thus include, and make potentially subject to the Sec. 75(2) provision, **any** person who owned the property regardless of the character of the relationship to the trust. There appears to be no restriction or exemptions in respect of how the property can be received thus if the property is sold for its fair market value and the person recognizes all of the appropriate tax consequences then if the property is, held on condition that it

¹³²⁵ In the author's opinion Reed J. of the Federal Court Trial Division made a slip of the tongue in *Fraser v. The Queen*, 91 D.T.C. 5123, when he believed that there had to be an "absolute" right of reversion in order for Sec. 75(2)(a) to apply.

¹³²⁶ To avoid the provision a gift should allow subsequent transfer to a spouse or offspring or personal holding corporation so as to prevent the contributor from having a reversionary interest. A reversion under common law upon the failure of the trust could be argued not to be a condition upon which the property is held in the trust.

¹³²⁷ Placing control of the corporation in a trust so as to facilitate discretionary allocation of the shares in a less tax costly manner will not suffer from Sec. 75(2) if the shares the contributor contributes do not pay dividends. See *Woods Estate v. M.N.R.*, 54 D.T.C. 1164, for example of reverter interest.

¹³²⁸ As per *I.R.C. v. Warden*, 22 T.C. 416 (CS), if the settlor doesn't retain revocation powers to allow reversion but the trustees have the power to determine the trust income should be attributed to the settlor. Reversion may not necessarily occur in specie as well. If the property is held on condition of possible reversion of sale proceeds only Sec. 75(2) would appear to apply. See *Re Philips New Zealand Ltd*, [1997] 1 N.Z.L.R. 93, HC NZ, where a partial reversion was varied into a trust.

may revert to any previous disponent in the ownership chain, Sec. 75(2) may apply. The legal ownership of the property must be capable of reverting and "reverting" in this sense is to be given its trust law technical definition. Loaned property, where the contributor retains legal ownership, cannot "revert" to its legal title holder and thus unless section 74.3 or Sec. 56(4.1) can apply to the property lending the property to an arm's length trust offers some income splitting ability.¹³²⁹ Thus there can be a chain of ownership of the property before it gets to the trust and unless CRA/Justice can argue that the provision was to apply to only two persons all will be possible candidates as a group for reversion that amplifying the impact of the provision in both extremes as will be seen.

One unfortunate aspect about the reversion of the title to the person from whom it was received is that it applies both to instances when a legitimate holding of rights to the property exists as well as where tax/trust planning powers are held. Where the contributor assumes the liability of a mortgage on the property that was contributed by him he may be caught where he reserves himself the right to revoke the contribution in the case of a financial crises whereby he would obtain title to the property. If the contributor has obtained, or even is potentially entitled to obtain, a power of appointment **over the property** which is not constructed so as to specifically exclude himself as being a beneficiary, he may be caught by the provision however once again the property must be held on this condition by the trust.¹³³⁰

Powers to Direct Beneficial or Legal Interests.

Under subparagraph (ii) where the property is held on condition that it pass to person to be determined by the contributor at a time subsequent to the **creation** of the trust the provision will apply to attribute income/gain etc. from the particular property or substitute.

1329 In T.I. 5-6651 of January 1989 rendered by the F.I.D. it was held that loans do not constitute property held on conditions described in Sec. 75(2). In T.I. 5-8210 provided in August of 1989 by the same Division it was held that Sec. 75(2) will not attribute income from property acquired with the proceeds of a loan to the trust if the loan is genuine and the property is not otherwise held on conditions which, on its own terms, cause Sec. 75(2) to apply. If the vendor of property to the trust in such a situation is also the trustee Sec. 75(2) was said to apply while the vendor also controls the property under the terms of the loan the same was said to result. A similar opinion was provided in T.I. 5-7120 of the F.I.D. provided in January 1989. In Q 7 of the 1991 Roundtables it was opined that Sec. 75(2) would not apply to attribute income when the income producing property was sold to the trust for an interest free note regardless of whether the seller was the trustee or settlor.

1330 In *I.R.C. v. Wolfson*, 1949 1 All E.R. 865, the U.K. tax authorities attacked a taxpayer under section 38 of the Finance Act (1938) to attribute income from shares held in trust by the taxpayer and another. Ten percent of the shares of a private corporation were held by the trust and 70% were held by the settlor on his personal account thus placing him in a position to control the dividend flow to the trust or to even wind-up the corporation. (Subsection 38(1) of the F.A., in this case, caused attribution where the taxpayer-settlor is able to through a list of means **connected with or arising out of the terms of the settlement** vary it or determine its nature or withhold payment to it.) The Commissioners contended that by virtue of his position the taxpayer could determine the nature of the settlement and the House of Lords thought otherwise. Lord Normand was of the opinion that the power of the taxpayer must arise out of the terms of the settlement itself while Lord Morton of Henryton provided:

"In my view, no settlement comes within s. 38(1)(a) of the Finance Act, 1938, unless the power described in that subsection is found in, and conferred by, the terms of the settlement. This seems to me to be the natural meaning of the words used. The Solicitor-General sought to rely on the difference in the wording between the opening words: "If and so long as the terms of any settlement are such that" and the phrase "if the terms of the settlement provide" which is to be found in s. 21(8) of the Finance Act 1936. It would, indeed, be a trap for the taxpayer if the legislature intended the scope of taxation to be extended by some subtle difference in the meaning between "the terms of the settlement are such that" and "the terms of the settlement provide"; and, for my part, I think that the two phrases have the same meaning. The view which I have expressed as to the construction of s. 38(1)(a) is fatal to the Crown's contentions in this case, for it is plain that the deed of covenant of Mar. 26, 1940, does not come within the subsection, so construed, and the Crown concedes that the only document to be considered in the present case is the deed of covenant... As to the other questions raised in argument, I agree with Somervell, L.J., and Atkinson, J., that, if the respondent were to use his majority shareholding to withhold the payment of a dividend by L.G.E. Ltd., in any year, he would not thereby "revoke or otherwise determine the settlement or any provision thereof". Every clause in the settlement would remain in full force, and the only result would be that the "annual sum" mentioned in cl. 2 would be nil in that year."

It should be noted that subsection 75(2) applies only when the property is held on the conditions described, not where through the actions of the taxpayer outside of the deed it can be manipulated to the same effective ends. The phrase "property is held on condition" is just as indicative as "the terms of the settlement are such that", in expressing the draftsman's intention that only powers/rights under and arising from the trust deed are to be considered. See also *Jenkins v. I.R.C.*, 1944 2 All E.R. 491. In T.I. 5-902602 rendered Nov. 1990 by the F.I.D. it was opined that the terms of the trust may go beyond those specified in the trust deed to encompass those terms attached to the property subject to the trust while powers to appoint trustees or alter provisions under the trust deed will also be relevant.

The fact that the provision refers to determination subsequent to **creation** of the trust, and not contribution of property, serves to indicate that the provision's draftsmen were concerned with the transfer of property upon the creation of the trust and not the transfer of property to an already constituted trust. If so, then just about every transfer of property to a trust after it has been constituted will be caught by the provision at a time subsequent to the **creation** of the trust. If the qualifying time is the time at which the trust is **created** then regardless of the conditions or lack thereof in relation to the transfer of property to the trust after it has been created attribution will result and given that **losses** may be attributed out to the contributor this paragraph then becomes particularly valuable. It would be foolish to believe that the term "creation" was used in the place of "contribution", which would serve to considerably narrow the scope of the subparagraph in that at common law a subsequent contribution of property to a previously existing trust does not necessarily constitute the creation of another trust but may merely enlarge the substance of the first. The provision's draftsmen clearly had the initial constitution of a previously non-existing trust in mind when they used the term "creation" rather than contribution. If the Department chooses to interpret "creation" as "contribution" then it would be undoubtedly entertaining to see the matter resolved in the Courts.¹³³¹

The manner in which the property is to "pass to persons to be determined by the person" may include, again, many diverse arrangements however one cannot overlook the necessity that it be the condition upon which the property is held by the trust. If the contributor has a power of appointment or **trust** discretionary power that allows **him** to determine to whom the property will pass to the arrangement may be caught.¹³³² **If such a power is instead vested with another party which is not at arm's length with him then the question of whether it is he who determines the beneficial rights to the property must be examined. There are no supporting provisions in respect of this non-arm's length relationship that could cause the arrangement to be caught by the subparagraph.** A particularly broad interpretation of the scope of the provisions may include instances where the contributor has taken back the remainderman interest in the property himself and then transfers it to the person whom he wishes to confer the benefit on ultimately. Such an arrangement **could** be caught by subpara. (i) in that the property may revert to the contributor however one wonders whether it would if the property could revert where the contributor holds the beneficial title to the property and it is only transferable or enforceable **after** death. In such a case subparagraph (i) would not apply, in that the title to the property could not revert back to the contributor but may to his resulting estate, while the property would not be **held on condition** that it would pass to persons to be determined by him. It would be held on condition that it revert back to the holder of the interest therein, after his death, and thus by transferring the interest therein, as a testamentary gift, the application of both subpara. (i) and (ii) could be avoided.^{1333 1334}

The provision indicates that the property must be held on condition that it "pass to **persons** to be determined by him at a time subsequent" and in the plurality of the forum "pass to **persons**" one wonders whether the provisions draftsmen were contemplating groups of **persons** as being potential beneficiaries or a singular **person**. Read as a whole the provision states "where... property is held on condition that it or property substituted therefore may pass to persons to be determined by him at a time subsequent to the creation of the trust..." It could just as easily have said "pass to a **person or persons**..." and the fact that it

1331. The Minister's counsel in *Fraser v. The Queen*, 91 D.T.C. 5123 FCTD, seemed to recognize this when he expressly argued that the force of the provision was the creation of the trust.

1332 Can the provision be satisfied if the power to appoint is a special power in/with trust characteristics attached so that the person exercising it is not free to use her personal discretion? Is the power-holder/trustee the "same person" as the contributor for these purposes when she wears two hats? In the author's opinion, they are not: a trustee satisfying the terms of the trust set out from the beginning and compellable to adhere to the instrument is not the same person as that who is the free person who contributed the property to begin with. In the author's opinion, this provision should be interpreted more narrowly since it would apply to legitimate instances above described otherwise.

1333 There may be a fundamental weakness in this arrangement in that as per the terms of the will he would be determining to whom the property may pass however if the legal representative is given the power to determine to whom the interest in the property will pass upon the wind-up of the estate the provision may be circumvented. The person who makes this decision need not be the legal representative but may also be a family member acting as the executor of the estate.

1334 See "Trusts: Settlor Reserved Powers" by Donovan Waters in *Estates, Trusts and Pensions* Vol. 25 Pg. 234 where a rather exhaustive review of numerous jurisdictions' instances of the taxation of settlor powers is examined.

does not may prove significant, in that most, if not all provisions in the ITA signify a person or groups of persons by a reference to "a person or persons" while if the plural form of the term is used it **must** indicate the plurality of the object.¹³³⁵

Dispositive Vetoes/Disposal Powers.

The third type of arrangement which may be caught by this subsection is where property is held on condition by the trust whereby, during the **"that, during the existence of the person, the property shall not be disposed of except with the person's consent or in accordance with the person's direction"**. Given that the paragraph expressly uses the term "disposed of" rather than "transferred" one has to recognize that in respect of the definition of "disposition" of properties in Sec. 54(c) as it applies for purposes of subdivision C, taxable capital gains and allowable capital losses, the disposition may occur in any number of ways.¹³³⁶

"Disposition" includes the event wherein the property is transferred from the trust to the beneficiary and in this regard where the property is held on condition that it will not pass to a particular person, as expressed in the trust deed, until the contributor has exercised a discretionary power in respect of the **timing** of the distribution then such an arrangement will be caught. Also subject to the provision is the circumstance where the property is to be distributed (disposed of) and the person has a discretionary power over the choice of beneficiary to whom it will be distributed. Understandably this is exactly the situation to which subpara. (ii) of para. (a) would apply whereby that the property passes to persons determined by him at a time subsequent to the creation of the trust. If the property is not to be disposed of without the consent of or in accordance with the direction of a person other than himself with whom he may not be at arm's length, the provision will not apply.

This provision may affect far more broadly a trust agreement than otherwise perceived in that where property is held in trust on condition that it not be disposed of except in accordance with the contributor's direction **any** trust could be referred to. Where a trust is created through the expressed intention of the settlor the property held by it may be disposed of by the trust, as per its terms, without his consent or in accordance with his direction since the trust holding the property and its subsequent distribution thereof **is exactly in accordance with his direction**. By expressing in the deed that a specific property will not be disposed of except to a particular beneficiary the property is held on condition that it not be disposed of except in accordance with the settlor's direction and thus due to a non-qualification of the terms "except with his consent or in accordance with his direction" the provision can be interpreted to some bizarre results. Obviously this isn't the intention of the provision but speaks for the lack of care in its creation.

Some would argue that this is a too narrowly construed interpretation and that the provision's draftsmen had only in mind when writing the provision a power held by the contributor that would allow him to restrict the disposition of the property to any particular person once the property was held in trust. In not recognizing that property is **always** held in trust in accordance with the direction of the settlor and that habitually the settlor may provide that the property is not to be disposed of except in certain instances, (which constitutes direction given by the settlor), the wording of the paragraph is completely inadequate. It is this paragraph

¹³³⁵ This subparagraph is another major deterrent in structuring flexible estate planning where shares and/or control of a corporation are held by a discretionary trust for the benefit of the original contributor's offspring and will be distributed to them in proportions to be determined by the contributor based on his regard of their involvement in the business. In such a situation clearly the contributor has the ability to determine to whom the property will pass and thus any dividends paid in respect of them while held in the trust will be recognizable by the contributor and the trust. One way to avoid this result is to ensure that the particular shares do not produce dividends but carry voting control or that the spouse of the contributor or his personal holding corporation etc. has the allocation powers and not the contributor himself. Dividends could be payable upon shares that were to be passed indefeasibly to one beneficiary or the other and a power of allocation could be used to sprinkle the income amongst those deserving without causing attribution. Another way to avoid attribution would be to only transfer the remainder interest in the shares to the trust and have the income rights to the shares retained by the settlor determinable upon his death. Subsection 70(5) would not capture the shares, more a.c.b. could be apportioned to the remainder interest to reduce the tax consequences on the *inter vivos* transfer, and Sec. 75(2) attribution would not occur unless the remainder interest itself is disposed of. The settlor could control its destination in a manner similar to above but since it doesn't otherwise produce income Sec. 75(2) need not be avoided.

¹³³⁶ For the definition of "disposition" see that in subsection 248. It's diverse and contemplates all sorts of transactions that have nothing to do with actual transfers of title to beneficiaries.

that may cause considerable difficulty in structuring investment vetoes for the security of the settlor: if the settlor is reserved a power to determine the nature of the investments of the trust, and to have them altered, the income therefrom will be attributable. Even more disturbing is the fact that such a power need not be held personally but would appear to include powers held quo trustee.¹³³⁷

One major difference between the scope of paragraph (b) as compared to (a) is that the former applies only to instances where the property cannot be disposed of except with the consent or direction of the contributor as he has an absolute immediate right to hinder a disposition. Apparently if he has only a contingent right to hinder a disposition, which is not enforceable at any particular time but may arise upon the occurrence of an event, until that event occurs he has no right to hinder the disposition and it may proceed without his consent or direction. Where the event occurs it is only then that the property will become held on condition that it not be disposed of except with his consent or direction and it is only at that time that attribution will commence. The trust deed could be structured to give the trustee's or contributor's spouse a power to grant the contributor a dispositive veto and until that power is exercised the contributor does not possess a veto.¹³³⁸ Until the event occurs the property may be disposed of as per the terms of the trust or the discretion of the trustees, etc.¹³³⁹

Some Case Law.

In *Glyn v. C.I.R.*¹³⁴⁰ the English High Court of Justice had to decide whether income of a trust was

¹³³⁷ A settlor creates a trust and becomes trustee instilled with a power of appointment over the property. The power is targeted by Sec. 75(2)(b) and since the trustee contributor holds it quo trustee the income is attributable to the settlor on his personal account: the capacity in which the power is held is irrelevant. This was the opinion of the Financial Industries Division on Nov. 16th, 1989 when it rendered Technical Interpretation 5-8848 to that effect. It is, however, arguable whether this was the intention of the draftsmen when they enacted the provision: their intention may not have been to capture those instances where the settlor's powers are so restricted by fiduciary duty as to render them incapable of conferring on him a benefit that he could not otherwise realize if the property was transferred to arm's length trustees. Trust law and expressed duties arising in conjunction with the occurrence of the disposition where the contributor declares to hold on trust etc. may serve to exhaustively eliminate any control the contributor has to confer a benefit on himself and instead he may have to adhere to the fiduciary standards applicable to his disposition. In this case is there a difference between this instance and where the taxpayer transfers the property to a trust company which cannot be influenced by the contributor? Are not the two trustees completely strapped into their duties in the exact same way? The intention of this provision was obviously to limit instances where the ownership/income recognition of property has been diverted to another taxpayer without the contributor losing **the widest of powers** to control its destination and in the above case where the contributor, though acting as trustee, has lost his ability to apply latently arising **personal** preferences has he not ceased to be a target of the provision? See *C.I.R. v. Schroder*.

¹³³⁸ It should be kept in mind that it's only a power to restrict the disposition of the property that is contingent, not an interest in the property itself.

¹³³⁹ See *I.R.C. v. Nicholson & Anor.*, 1953 2 All E.R. 123, for an interesting twist concerning this.

¹³⁴⁰ 30 T.C. 321. See also the recent UK case of *Lorber (Decision No.1) v Revenue & Customs* [2011] UKFTT 101 (TC) (03 February 2011) where the taxpayer was assessed as a settlor of joint account funds with his wife and attempted to argue that it was his parents that had settled the amounts and that he was only acting as beneficiary, under a very similar provision in the UK ICTA. The First-Tier Tribunal held :

27. The critical question is who was the settlor in relation to the children's accounts. The dispositions or transfers of funds from Adolf were effected by Paul in exercise of the power of attorney. He was acting as agent for Adolf and, if that be accepted as a fact, he cannot be regarded as "the person by whom the settlement was made". Is Paul to be deemed to have made the settlement within section 660G(2) on the basis that he provided the funds now represented by the children's accounts?

28. HMRC's case for invoking the taxation of settlor provisions is that the evidence has not satisfied them that the funds in the children's account and other deposits came from Adolf and Berta. HMRC invite us to conclude that Paul must have been the source of those funds because they must have come out of moneys in Paul's beneficial ownership. We understand their case to be based on the reality of the whole arrangement. The moneys in the children's accounts were really and at all times at the unrestricted disposal of Paul. This is evidenced by the fact that a large amount was used to pay for the Driffeld house as a home for Susan.

...

35. The Driffeld house was purchased, apparently as a matter of urgency, in the latter part of 2003. It was to be Susan's home and, we presume, a home for Simon and George when they were with her. A significant proportion of the funds came from moneys standing to the children's accounts. The rest came from Paul and Susan. Our attention was drawn to various transfers in and out of the Nationwide account that had originally been opened for

assessable in the hands of the trust's settlor when he reserved himself a power of appointment in respect of it albeit the power was only jointly exercisable with another person with no single party having the ability to appoint without the consent of the other. There were no restrictions placed on the selection of recipients under the exercise of the power and the Commissioners contended that by virtue of subsection 38(4) of the Finance Act the income could be made payable to the settlor at any time. That subsection, being dissimilar to Sec. 75(2) of the I.T.A. in many technical attributes read:

"For the purpose of the last foregoing subsection, the settlor shall be deemed to have an interest in income arising under or property comprised in a settlement, if any income or property which **may at any time** arise under or be comprised in that settlement is, or will or **may become**, payable to or applicable for the benefit of the settlor or the wife or husband of the settlor **in any circumstances whatever**."

Subsection 38(3), "the foregoing subsection" required the settlor to include in computing his accessible income that amount described in Sec. 38(4).

The Court in this case acting regardless of the fact that the power was joint found that, quite appropriately, the Sec. 38(4) provision caught the tax/settlor technically on the grounds that the income could become

Simon in December 1998 with Paul and Susan as trustees. For example, on 3 July 2003, in preparation for the purchase, £7,513 was received into that Nationwide account. On 7 July two payments of £7,513 left a chequing account that had always belonged to Paul and Susan. On 9 July £19,990 (being the proceeds of sale of Paul's premium bonds) was received into the Nationwide account held for Simon. On 4 August £29,136 was placed in that account by Paul: this money, he said, represented the proceeds of sale of shares of his. Eventually £153,650 was withdrawn from that Nationwide account and paid into the Nationwide account held for George. Paul said of that payment that it had been made from one Nationwide account to another to build up the final payment for the house.

36. The arrangement of finance for the Driffeld house, to the extent that any conclusion can be drawn from the disjointed facts summarised above, demonstrates that Paul and Susan regarded the children's accounts as sources of funds for needs other than those exclusively of Simon and George. Paul and Susan knowingly mixed their children's funds with their own moneys and applied them for their own purposes. This feature of the family financial arrangements calls in question Paul's assertion that Adolf and Berta, and not he, had been the settlors of the "settlement" comprising the children's accounts. Was the reality of the situation that Paul had appropriated Adolf's property for his and Susan's own use back in 1998 when he had the power of attorney? Had he, instead of giving effect to his father's wishes, retained the gifted funds, not as trustee for Simon and George, but as the disguised beneficial owner? We have looked through the correspondence and listened to Mr Allen's cross-examination; we can find no allegation to that effect and we would not be prepared to reach such inferences on our own account. We have to assess the evidence before us in an unblinkered way and with an eye to the realities of the situation. Even so, we think on the balance of probabilities that Adolf was the settlor and not Paul; our conclusion on this is not altered by the way the funds in the children's accounts have been, in effect, pooled and used as a family resource. We also observe that questions about how the assets were applied are only at all relevant if the source of the funds was Paul as settlor of the arrangement.

37. Our reasons for our conclusion that Paul is not the settlor can be shortly summarised. The interest arising from the funds has been consistently returned for tax purposes as the children's own income. There is nothing inherently wrong in investing children's funds in a house which is to be a home for their mother and, presumably, for the children themselves when they are staying with her. Having regard to Paul's explanation of the background of his parents and his ailing father's interest in his grandchildren's well being, the conclusion that he (Adolf) provided the funds for the "settlement" is, we think, reasonable. We have taken into account Paul's evidence that the funds and the income in the children's accounts are normally kept separate save for an emergency such as the Driffeld house purchase. The amounts standing to the children's accounts are separately recorded on the schedule prepared by Paul. Finally we have had the opportunity of hearing Paul give evidence and we are inclined to accept it. In this connection we mention that at no time did HMRC address any direct challenge to Paul's evidence. The whole strategy of their presentation was to invite us to infer that theirs (HMRC's) was the more likely inference. As we have observed, the evidence does not support that.

This case is very relevant since it speaks of who is actually a transferor of property to the trust to which Sec. 75(2) is focused. In this case the whole argument was based on the fact that it was the taxpayer's father who had actually made the transfer and established the settlement through a power of attorney given to the son that was the basis of the assessment. See also *Jones v. Garnett* (Her Majesty's Inspector of Taxes) [2007] UKHL 35 (25 July 2007) for a recent UK HL pronouncement on how similar provisions apply in their ICTA.

payable in some obscure circumstances however the case has its illustrative effect in the Canadian context.¹³⁴¹ The Sec. 75(2)(a)(ii) and (b) provisions both refer implicitly to powers held by the contributor allowing him to decide to whom the legal title will eventually pass or allowing him to have a veto of the disposition of the property by the trust. They both refer to such powers held by the contributor as a singular party and it would appear that if the contributor shares the mentioned powers jointly with another party, possibly under his influence, then at least the former mentioned target arrangement can be avoided in that the power to determine to whom property will pass will not be exclusively his but shared with another person. In the latter instance, (where property cannot be disposed of without "his" consent or in accordance with his direction), if he is a joint holder of a power to veto a disposition of property then he will not be caught since the power operates only as a veto and not a dispositive power and if he withheld his consent the property could still be sold due to the opposite opinion of the other joint power holder, (thus causing the power to be unenforceable).¹³⁴²

A slightly different case was that of *C.I.R. v. Gaunt*¹³⁴³ whereunder a taxpayer settled a trust which was to accumulate income and reserved himself a power to appoint the property to new trusts created under the power but the power was especially drafted so that it could not be exercised favorably in respect of himself or his spouse. The Commissioner of Inland Revenue contended that the income of the trust should be taxable in the taxpayer's hands since he could indirectly benefit from it and the King's Bench Division held that the taxpayer could secure a benefit indirectly through exercising the power and creating a sub-trust under which he could have a discretionary interest hence although the power itself could not cause the taxpayer to be caught, (under what could be a provision very similar to Sec. 75(2)), the result of the exercise thereof could. It should be pointed out that Sec. 75(2) refers to the ability to have property revert ("may"), and it would appear that if a power is reserved by the contributor to create a sub-trust and the beneficiaries of that sub-trust can be changed from those of the former the power could attract the application of Sec. 75(2) since the contributor can determine to whom the property will pass. This assumes that indirect reversions are also targeted, which isn't necessarily the case. The same with the shares in which such same beneficiaries share. If the power does not expressly preclude the contributor from being a beneficiary under the sub-trust the same results on the reasoning in *C.I.R. v. Gaunt*.¹³⁴⁴

In *C.I.R. v. Schroder*¹³⁴⁵ some question arose whether the settlor was "able in any manner whatever, and whether directly or indirectly, to control the application of the income" from property contributed to four trusts when he retained the power to nominate trustees to the trusts. A certain committee, the purpose of which was to monitor the trustees' exercise of discretionary distributions, had the power to remove the trustees and although the settlor did not retain the power to expand or terminate the committee he could appoint parties to it, should a vacancy occur, during his lifetime. The committee controlled the trustees' exercise of discretionary powers over how the trust income was to be applied. The trusts were settled in the Bahamas and Bermuda and were expressly structured to be for charitable purposes thus negating the possibility of a resulting trust in respect of the settlor in the event that the trustees didn't exercised their discretionary powers. The crux of the Commissioner's application of the attribution provision was that the powers retained by the settlor allowing him to nominate members to the committee or trustees, **in the case of vacancies**, allowed him to control the application of income of the trusts in that those two parties controlled the discretionary powers. The trust deeds allowed him to appoint additional trustees without waiting for vacancies and thus the Commissioner was of the opinion that the settlor could "pack" the committee and body of trustees that would act under his direction with respect to the exercise and validation of the

¹³⁴¹ See also *The Marchioness v. Brown*, 17 T.C. 333, for contrary.

¹³⁴² As per the underlying conclusion in *Lord Herbert v. I.R.C.*, 25 T.C. 93, there can be more than one contributor of the property though income should be apportioned between contributors who were former co-owners.

¹³⁴³ 24 T.C. 69

¹³⁴⁴ In *Vestey's Executor's v. I.R.C.*, 1949 1 All E.R. 1108, the House of Lords had to ascertain whether a U.K. resident settlor could have income attributed to him from a non-resident trust to which rent was to be paid and accumulated for the benefit of his widow. He reserved himself a power to vary the investments of the trust as well as a **special** power of appointment with which he could appoint interests to offspring or their spouses. The Crown attempted to assess the income in his hands as if he had an interest in it but the House found that the investment power was of a fiduciary nature and could not be used to make interest free loans to himself.

¹³⁴⁵ 57 T.C. 94

discretionary distributive powers. The settlor had in fact incorporated a company to act as a trustee and after it had been appointed by the settlor to act as such the other trustees resigned. The corporation's shareholders consisted of three friends of the family one of which was on the committee. The trust deeds spelt out that the beneficiaries were to be certain specified class parties other than himself, his father, two aunts, and their wives, husbands, widows and widowers.

Vinelott J. held with respect to the Commissioner's contentions:

"Mr. Nicholls submitted that under these provisions the settlor has the practical ability to remove a trustee and appoint a new trustee in the place of the trustee so removed, and so can in effect make and unmake trustees until he has secured a body which will prove compliant to his wishes. I do not think the settlor has in fact power even directly to make and unmake trustees. The power to remove trustees is vested in the committee, and although the settlor can fill vacancies or possibly appoint additional members of the committee even when there is no vacancy, that power, like the power to appoint new trustees, must I think be a fiduciary power. It could not properly be used to "pack" the committee to insure that the settlor has a majority which will follow his directions. Similarly, the committee's power to remove and his power to appoint new trustees are fiduciary powers. Even though these powers are unusual it cannot in my judgment be said that the settlor has put himself in a position where he can secure the appointment of trustees who would follow his wishes and who would not exercise any discretion of their own."

The weakness in the Commissioner's submissions was obviously the fact that the powers to appoint and remove trustees were not mere or "intermediate" powers but were in fact trust or fiduciary powers requiring their exerciser to evaluate and act upon the intentions of the grantor.^{1346 1347} This case should be compared

¹³⁴⁶ See *In re: Hay's Settlement Trusts*, [1982] 1 W.L.R. 202.

¹³⁴⁷ See also *Scaffidi -V- Montevento Holdings Pty Ltd* [2011] WASCA 146 (7 July 2011), an Aust. case, replete with jurisprudence, where the majority of the Appeal Ct. opined with respect to abilities to alter trustees to benefit personally:

144 Clause 11 of the trust deed confers a power to remove trustees and appoint new ones. It is convenient to note at the outset certain principles relating to powers of that kind.

145 Whether the power given in an instrument to remove trustees and appoint new trustees is, by its terms, wide enough in scope to allow an appointor to appoint himself or herself as trustee, is a question as to the proper construction of the language of the power: *Montefiore v Guedalla* (1903) 2 Ch 723, 725 - 726; *In re Christina Brown* (1921) 22 SR (NSW) 90, 93 - 94.

146 Even where the language is wide enough to permit the appointor to appoint himself or herself as trustee, it is a 'very salutary' or 'most salutary' rule that the power should only be exercised to that end in 'exceptional circumstances' or 'special circumstances': *Montefiore v Guedalla* (725, 726); *In re Christina Brown* (93 - 94); *In re Power's Settlement Trusts* [1951] Ch 1074, 1080.

147 In a discretionary trust (and subject to the terms of the instrument) the power to appoint trustees may be construed as a 'fiduciary power': *In re Skeats' Settlement* (1889) 42 Ch D 522, 526; *In re Newen* (1894) 2 Ch 297, 309; *Re Burton* [1994] FCA 1146; (1994) 126 ALR 557, 559 - 560; *Pope v DRP Nominees Pty Ltd* [1999] SASC 337; (1999) 74 SASR 78 [46] - [48].

148 In *Re Skeats'* case, Kay J said (526 - 527):

The ordinary power of appointing new trustees, under a settlement such as this is, of course imposes upon the person who has the power of appointment the duty of selecting honest and good persons who can be trusted with the very difficult, onerous, and often delicate duties which trustees have to perform. He is bound to select to the best of his ability the best people he can find for the purpose. Is that power of selection a fiduciary power or not?

...

Now what is the rule, the universal rule, observed in Courts of Justice as to a duty of that kind? The universal rule is that a man should not be judge in his own case; that he should not decide that he is the best possible person, and say that he ought to be the trustee. Naturally no human being can be imagined who would not have some bias one way or the other as to his own personal fitness, and to appoint himself among other people, or excluding them to appoint himself, would certainly be an improper exercise of any power of selection of a fiduciary character such as this is. In my opinion it would be extremely improper for a person who has a power to appoint or select new trustees to appoint or select himself, for that principal reason. Has, then, the practice of such a person appointing himself been sanctioned by conveyancers or the profession in general? The answer must be, certainly not.

149 Even if not correctly technically described as a 'fiduciary power' (see the discussion in Finn PD (as his Honour then was), *Fiduciary Obligations* (1977) [627], [644]), such a power must nevertheless be exercised bona fide for

with *C.I.R. v. Gaunt*¹³⁴⁸ just previously commented upon.

In *I.R.C. v. Fitt*¹³⁴⁹ a taxpayer had settled certain sums on a trust to be payable to persons that he could appoint while such persons were restricted to those which were/could be employed by the taxpayer or corporation of which he was/had been a director or among members of a rowing club of which he was a member. The Crown attempted to assess him on the income from the trust under section 38 of the U.K. Finance Act on the grounds that he could appoint property onto himself if he satisfied the conditions of the class while under the deeds creating the trusts he did not expressly prevent himself from being an object of the power's exercise. The Court of Appeal found however that the trusts were intended by the taxpayer to be for the benefit of "other persons" and through examining his actions and the history of the power it was found that an exercise in respect of himself would be contrary to the fiduciary intention instilled with the power.¹³⁵⁰

There has been little judicial opinion on the application of Sec. 75(2) however one case decided at the Income Tax Appeal Board level provides some useful information. In *No. 40 v. M.N.R.*¹³⁵¹ a taxpayer sold shares to his sons whereby, as a form of sale the taxpayer transferred the shares to a trustee who would only transfer them to the vendor when the purchase price had been fully paid to the vendor, and until that time they could not be encumbered, assigned, or transferred by the purchasers while they could be voted as per the direction of the vendor. Dividends were to be taxed in the purchaser's hands while the trust agreement existed. A dividend was paid and the Minister attempted to assess the vendor in respect of it

the purpose for which it was conferred: *Re Burton* (559); *Duke of Portland v Topham* [1864] EngR 339; (1864) 11 HLC 32, 54. The purpose of the power of removing and appointing trustees is ascertained by reference to the fiduciary nature of the office the object of the appointment. The trustee is the 'archetype' fiduciary: *Maguire v Makaronis* [1997] HCA 23; (1997) 188 CLR 449, 473. The office exists for the benefit of the beneficiaries: *Letterstedt v Broers* (1884) 9 App Cas 371, 386. It is an essential element of the trust that the trustee is under a personal obligation to deal with the trust property for the benefit of the beneficiaries, an obligation giving correlative rights to the beneficiaries. There is an irreducible core of obligations owed by the trustees to the beneficiaries and enforceable by the beneficiaries which is fundamental to the concept of a trust: Heydon JD and Leeming LJ, *Jacobs' Law of Trusts in Australia* (7th ed, 2006) [110], [1620]. If these do not exist, or if the beneficiaries have no rights to enforce them, there is no trust. The minimum duty is the duty to perform the trust honestly and in good faith, for the benefit of the beneficiaries. See *Armitage v Nurse* [1998] Ch 241, 253 - 254.

150 Accordingly, notwithstanding the breadth of the discretion conferred on the trustee in an instrument such as the one in this case, the discretion is to be exercised by reference to the objects and purposes of the trust, having regard to the competing interests of the various potential beneficiaries, and without taking into account improper, irrelevant or irrational considerations. The discretions must be exercised personally and not in conjunction with, or under the direction of, somebody else. See *Elovalis v Elovalis* [2008] WASCA 141 [51], [70]. For a case illustrating a breach of trust in such circumstances, see for example, *Nicholls v Louisville Investments Pty Ltd* (1991) 10 ACSR 723.

151 If, however, on the proper construction of the instrument, the power of the appointor to remove and appoint trustees may be exercised for the purpose of controlling the trust estate for the appointor's benefit, the trust property may be regarded, at least for certain statutory purposes, as effectively owned by the appointor, or as property in which the appointor has a contingent interest: *Australian Securities and Investments Commission v Carey (No 6)* [2006] FCA 814; (2006) 153 FCR 509 [19], [29], [37] - [46]; *Public Trustee v Smith* [2008] NSWSC 397; (2008) 1 ASTLR 48; [108] - [138]; *In the Marriage of Goodwin* [1990] FLC 92-192; 1990) 101 FLR 386, 392; *In the Marriage of Davidson (No 2)* [1991] FLC 92-197; (1990) 101 FLR 373.

152 It has been held that it is not proper to appoint new trustees without communicating with beneficiaries and hearing their objections, at least where it is likely that they would oppose the appointment: *Marshall v Sladden* [1849] EngR 910; (1849) 7 Hare 428 [439]; *O'Reilly v Alderson* [1849] EngR 680; (1849) 8 Hare 101 [103]. However, beneficiaries cannot dictate or control the exercise of the power: *In re Brockbank* [1948] Ch 206, 209 - 211.

1348 24 T.C. 69

1349 1943 2 All E.R. 228

1350 See *I.R.C. v. Delamere*, 1939 3 All E.R. 386 for an absolute discretion and *Muir v. I.R.C.*, 1966 3 All E.R. 38, and latterly *I.R.C. v. Jamieson*, 1963 2 All E.R. 1030, for a House of Lords opinion on the effect of a special power of appointment exercisable in respect of the settler's offspring though attacked with a vaguely similar attribution provision. See also "Redoing the Estate and Gift Taxes..." T.L. Review V.43, 1987-88, pg. 275-277 for a U.S. perspective of fiduciary powers and situations similar to the avoidance of Sec. 75(2), as well as *Neely v. U.S.*, 775 F.2d 1092.

1351 52 D.T.C. 16,

under the then Sec. 22(2) provision being identical to Sec. 75(2). While the Minister contended:

"That certain shares of ...limited with respect to which the aforementioned dividend was paid had not been effectively divested from the ownership of the Appellant or had been only conditionally disposed of."

Fordham, K.C., provided in respect of the sale agreement in conclusion:

"I fail to see how the provisions of that section can be invoked here. The transaction was not the creation of the trust, but a sale. The trust feature of it is only incidental to the sale. Under the agreement, reversion to the vendors can occur only if default in payment is made by the purchasers, which stipulation is common to most sale agreements. Paragraph (a)(ii) clearly cannot apply, as there is no doubt as to the purchasers' identity. There is also nothing in the agreement affecting the time when the property in the shares should pass to the purchasers. As regards paragraph (b), the restrictions or transfer, which are of the usual kind, are to last until the balance of the purchase price is paid..."

In the author's opinion the conclusion of the Chairman is slightly in error. The shares had been transferred to the trust and their transfer to the beneficiary as recognized in the agreement was conditional upon the payment by him of FMV consideration to the settlor.¹³⁵² If such consideration was not forthcoming to whom would the legal title to the shares vest? The contributor; and irrelevant is the fact that most of the purchase price has been paid; the basis of the application of Sec. 75(2)(a)(i) is that the property **may** revert to the person from whom it was received. (In the author's opinion beneficial ownership by the transferor had been severed.) The trust agreement was not incidental to the sale. If the charge of the payment of the purchase price had been fully extinguished then the purchaser's recourse would be against the trustee, as beneficiary, if the shares were not transferred. One cannot blink away the legal realities of the arrangement regardless of its ultimate form and result. Assuming for a moment that the reasoning in #40 could be held as correct at a higher level the use of the trust form in a way similar to that in #40 could be extremely beneficial, especially if the condition for the transfer of legal title to the beneficiary from the trust isn't so much the provision of a purchase price but instead the performance of an act etc. as consideration for a "sale".¹³⁵³

¹³⁵² See *Commr. of S.D. v. Pandal Nominees Pty. Ltd.*, 84 A.L.R. 590.

¹³⁵³ In *Fraser v. The Queen*, 91 D.T.C. 5123 FCTD, the Minister argued the point when the taxpayer attempted to contend that the provision applied to a true trust situation. Citing the opinion of L. Raphael of the Department's Legal Services Department in "Canadian Income Taxation of Trusts" which could be said to be based on Case #40, a Tax Appeal Board decision, the Court did not comment on the Minister's defensive approach contending the trust in the situation wasn't a true trust but merely incidental to the transaction. In T.I. 7-900408 provided in May 1990 by the F.I.D. to the Vancouver D.O. the following was provided:

"In many real estate transactions, a law firm may be required to hold monies in trust on behalf of either the purchaser or vendor of the real estate. For example, the vendor's solicitors may be holding the deposit of the purchaser in its trust account. If the real estate transaction does not proceed or if the purchaser is in default, the deposit and any interest earned thereon is often forfeited to the vendor as liquidated damages. On the other hand, if the real estate transaction does proceed and the transaction closes, the deposit and any interest earned thereon is for the benefit of the purchaser and is credited to the purchase price of the property. If these monies are held for a considerable period of time (e.g., two years), has a trust been created such that the law firm is acting as a trustee and must therefore file a T3 return in respect of any interest that has accrued on the deposit but has yet to be paid or become payable to either the purchaser or vendor? What happens if the vendor or purchaser is a non-resident at all times? Does the law firm have an obligation to withhold and to remit in respect of any interest earned on the deposit and if so, at what time does this obligation arise?"

The F.I.D. held:

"The relationship between the involved parties can be determined only upon a review of all relevant documentation. Where the relationship is one of agent/principal, the interest will be included in the income of the person for whom the solicitor is acting as agent, a question of fact. If that person is a non-resident, Part XIII tax should be withheld at the time the interest is paid to the agent/solicitor. If the interest is paid to the agent without an amount being withheld, subsection 215(3) of the Act provides that the agent shall forthwith remit the applicable Part XIII tax.

Where the relationship is one of trust/beneficiary and no litigation is involved, the interest will be included in the income of the purchaser by virtue of paragraph 75(2)(a) of the Act where the purchaser is resident in Canada. No trust return is required as the interest is deemed under subsection 75(2) to be income of the purchaser rather than the trust. However, where the purchaser is a non-resident, subsection 75(2) does not apply. Rather, the provisions of section 104 apply and the solicitor/trustee should file a T3 trust return. The solicitor/trustee should withhold the applicable Part XIII tax on the earlier of the days mentioned in subsection 214(3)(f) of the Act and, pursuant to subsection 215(1) of the Act, forthwith remit that amount to the Receiver General."

Where litigation is involved the treatment recommended by I.T. 129R applies.

In *Barr's Trustees v. C.I.R.*¹³⁵⁴ a settlor had provided, as a fourth possible contingency, that should both his sons as beneficiaries of the trust die prior to becoming entitled to the trust fund then the trust property was to be divided among the **heirs** and representatives of the son. The Commissioner contended that there was a chance that the trust property could revert to the settlor and thus under section 38 of The Finance Act they similarly contended that the income from the trust property would be assessed in the settlor's hands. They were successful. In respect of the ITA Sec. 75(2) provision if a taxpayer drafted a trust-deed whereby should the beneficiaries thereunder meet untimely deaths the substance of their respective beneficial interests would revert to him, Sec. 75(2) would clearly apply, but not so if it was passed to his wife or personal holding corporation, or partnership, or personal trust and it is from there precluded from being distributed to the contributor.

The subsection 75(2) provision will apply where the contributor of the property was not resident in Canada at the time of the contribution, even though the provision is fundamentally gauged towards attributing taxable Canadian income, while the trust need not be resident in any particular country in order for it to apply. It will attribute income/gain/loss only when the person is alive and only during the period in which he is resident in Canada. Under Sec. 212(12) where attribution has occurred and the income is then credited or paid to a non-resident withholding tax will not be applied upon it. Since the trust will obtain a Sec. 104(6) deduction in respect of the formerly attributed income which is paid/payable to the non-resident this is the one instance where Canadian double taxation of that attributed amount will not occur, but as per Sec. 104(7) the trust must reside in Canada throughout its tax year in order for this to occur. If the subject is non-resident at the time the particular property is disposed of attribution will not occur.

*CIR v. Otto Octav Bontar*¹³⁵⁵ is an excellent recent UK Ct. of Appeal case illustrating how loosely termed powers of appointment can be mis-construed and lead to litigation when the stream of economic benefit from their exercise has not been written to conclusively diverge their subject matter away from the settlor. In this case the Revenue authorities argued that by the way a power could be exercised, even though the targeted contributor was explicitly excluded not to benefit on first level of exercise, he could "benefit" within the terms of the particular statute, by being named as a beneficiary under a receiving trust. While not on point on a provision exactly the same as Sec. 75(2), it does provide an instance where a similar objective has been attained in a slightly complex environment.¹³⁵⁶

In the recent case of *Her Majesty The Queen v. Peter Sommerer*¹³⁵⁷ the Tax Court had to consider the CRA's assessment of a Cdn. resident on a non-resident trust's disposition of shares that it had purchased from the resident and which were later on-sold at a substantial profit. The Minister attempted that s. 75(2) applied on the sale. The Tax Court initially held that:

3. If a trust existed, does subsection 75(2) of the Act apply to attribute to Mr. Sommerer the gains on the disposition of the Vienna and Cambrian shares by the SPF?

[83] Subsection 75(2) of the Act provides:

Where, by a trust created in any manner whatever since 1934, property is held on condition

(a) that it or property substituted therefor may

(i) revert to the person from whom the property or property for which it was substituted was directly or indirectly received (in this subsection referred to as "the person"), or

(ii) pass to persons to be determined by the person at a time subsequent to the creation of the trust, or

(b) that, during the existence of the person, the property shall not be disposed

¹³⁵⁴ 25 T.C. 72

¹³⁵⁵ CHRV 98/1692/3

¹³⁵⁶ See also the UK cases of *Oakes v Commissioner of Stamp Duties New South Wales* [1954] Appeal Cases 57, *Eversden & Eversden* [2002] EWHC 1360 (Ch), *Lyon and the Trustees of the Alloro Trust* SPC 00616 and *Buzzoni & Ors v Revenue & Customs* [2011] UKFTT 267 (TC) (21 April 2011) that brings them all together in the context of a reservation of a benefit in a settlement scenario.

¹³⁵⁷ 2011 TCC 212. Appealed: 2012 FCA 207

of except with the person's consent or in accordance with the person's direction,

any income or loss from the property or from property substituted for the property, and any taxable capital gain or allowable capital loss from the disposition of the property or of property substituted for the property, shall, during the existence of the person while the person is resident in Canada, be deemed to be income or a loss, as the case may be, or a taxable capital gain or allowable capital loss, as the case may be, of the person.

[84] A number of issues flow from the application of this provision to the facts before me:

- (i) can the defined "person" in 75(2)(a)(i) apply to a beneficiary vendor who sells property to the trust at fair market value (i.e. Mr. P. Sommerer);
- (ii) if so, can such property revert to Mr. Sommerer?
- (iii) if not, can such property pass to such persons determined by Mr. Sommerer? (see subparagraph 75(2)(a)(ii) of the Act)
- (iv) if not, can such property only be disposed of with Mr. Sommerer's consent or in accordance with his direction? (see paragraph 75(2)(b) of the Act)

(i) Who is the "person" as defined in subparagraph 75(2)(a)(i) of the Act?

[85] The Respondent argues there is no requirement that the "person" be the settlor, but that it could be any person, including a beneficiary vendor of property sold to the trust at fair market value. The Respondent relies on IT369 which indicates that it is the department's view that a person, other than the settlor, may transfer property to a trust and become subject to the attribution rules. With respect, I disagree with the Respondent's view of the definition of person.

[86] It is well established that income tax legislation is to be interpreted in a textual, contextual and purposive manner. It is meant as no unkindness to the drafters of income tax legislation, but they have at times made this task exceedingly difficult: subsection 75(2) of the Act is an example of (trying to put this fairly) awkward language.

Textual interpretation

[87] The opening words are significant - "by a trust created...property is held on condition". In this case, one could insert the date and have the opening words: "where, by a trust created on October 3, 1996, property is held on condition". The provision does not say "where property is held in trust or in a trust on condition". ***It specifically refers to a trust created and a time at which the trust is created. I suggest it invites an interpretation to look at the conditions on the creation of the trust, the creation in this case by Mr. Herbert Sommerer, the settlor. The nature of the trust, and whether it is of a type contemplated by subsection 75(2) of the Act, is to be discerned at the time of creation.*** On the creation of the trust by a settlor, there can only be one person from whom property is received – the settlor. There is no other person. This does not however preclude the possibility of another person settling property in trust with the same trustee and on the same terms, but in such a case, I would suggest there is another trust created. In effect, by the opening words of subsection 75(2) of the Act only a settlor, or a contributor akin to a settlor is contemplated as being the defined person.

[88] This interpretation is confirmed by examining the two situations contemplated by subsection 75(2) of the Act: first, what is the effect if the trust holds the original property, and second, what is the effect if the trust holds "property substituted therefor". In that regard, it is clear with respect to the SPF that it could, as trustee, substitute property for the original endowment. And indeed it did.

[89] So let us look at the wording of subsection 75(2) of the Act in the first situation, where the trust simply holds the original property endowed by Mr. Hebert Sommerer. The text of subsection 75(2) of the Act would read:

Where, by a trust created in October 1996, property is held on condition that it may revert to the person from whom the property was directly or indirectly received.

That seems straightforward and requires no acrobatic semantics to discern what the provision means. The property would be the Austrian shillings and the person could only be the settlor, Mr. Herbert

Sommerer.

[90] Let us now look at the wording of subsection 75(2) of the Act in the second situation where the trust holds substituted property. The text of subsection 75(2) of the Act would then read:

Where a trust created in October 1996, property (shillings) is held in on condition that the property (shillings) or property substituted therefor (shares) may revert to the person from whom the property for which the shares were substituted (i.e. shillings) was directly or indirectly received.

Again, this can only be the settlor of the trust. This is a logical, textual, grammatical reading of subsection 75(2) of the Act, when one notes the difference between "property substituted therefor" in subsection (a) and "property for which it was substituted" in subsection (a)(i).

[91] While I would not go so far as to suggest it is perfectly clear, it is, I would suggest, a correct textual reading. Any other reading gives an artificial interpretation to the term "property for which it was substituted". The "it" in that phrase can only mean the "property substituted therefor". The Respondent would have me read "property for which it was substituted" as "property substituted therefor". It cannot and should not be read that way. In "property for which it was substituted" the "it" can only mean the shares, and therefore the "property for which it was substituted" can only mean the shillings – only the settlor, Mr. Herbert Sommerer endowed the shillings. If one attempted to read the "it" in that phrase as referring to the shillings, the phrase becomes meaningless as the shillings were not substituted for anything; it was the shares that were substituted for the shillings. I recognize that this may take the reader several readings of what at first might seem simple language. It is not. But once properly unravelled and viewed grammatically and logically, the only interpretation is that only a settlor, or a subsequent contributor who could be seen as a settlor, can be the "the person" for purposes of subsection 75(2) of the Act.

[92] The other possibility from the Respondent is that the reference to "property" in the first line of subsection 75(2) of the Act could refer to the substituted property, in this case, the shares. In effect the section would have to be read as follows:

Where, by a trust created on October 3, 1996, the Vienna shares are held on condition that the Vienna shares may revert to the person from whom the Vienna shares or property for which the Vienna shares were substituted, i.e. the original shillings, were directly or indirectly received.

[93] There are three flaws in this approach. First, as previously discussed, by the trust created on October 3, 1996 the only property held on condition was the original endowment of the shillings. Second, this approach could result in more than one "person" to whom the attribution rules might apply, in this case both Mr. Sommerer and his father (were he Canadian) There is no mechanism for an allocation in that case, obviously, I would suggest, because it is incorrect to read the provision as resulting in more than one attributee. Third, because subsection 248(5) of the Act deems subsequent substituted properties to be substituted for the original property, there are only two types of property to which subsection 75(2) of the Act can refer: the original property and substituted property. This is in line with the later attribution wording in subsection 75(2) of the Act which refers to income or loss from "the property or from property substituted for the property". The income or loss can derive from either, but can only be attributable to one person: the donor of the original property. The opening words of subsection 75(2) of the Act do not refer to substituted property being held on condition, just property, the original property.

[94] Does this mean that Mr. Peter Sommerer could never be "the person" for purposes of this section? No. If he settled the shares in the same trust, by contributing them to the trust (that they be held on the same conditions), he could be seen as creating a new trust and could, therefore, be a settlor and subject to the application of subsection 75(2) of the Act. He would, however, had to have been a contributor. But he did not do that. He did not transfer shares into the SPF as a settlor or contributor creating a trust. He sold the shares unconditionally to the SPF, who, as trustee of the property, held the property on conditions created by Mr. Herbert Sommerer, substituting those shares for the shillings endowed by Mr. Herbert Sommerer. In these circumstances, Mr. Peter Sommerer

could not be "the person" as defined.

[95] Having reached this conclusion on the textual interpretation of subsection 75(2) of the Act, I was concerned that the wording of the French version differed with respect to the expression "property for which it was substituted". The French version uses the same expression "biens qui leur sont substitués" in paragraph 75(2)(a) and subparagraph 75(2)(a)(i), unlike the English version which uses "property substituted therefor" in paragraph 75(2)(a) and "property for which it was substituted" in subparagraph 75(2)(a)(i). I asked the parties to provide further submissions, given this significant difference in wording between the English and French versions.

[96] The Appellant argues that the French text does not derogate from their argument on the English interpretation, which I have accepted. The Appellant makes two arguments: first, the French phrase in subparagraph 75(2)(a)(i) was intended to convey the same meaning as "property for which it was substituted"; second, the two phrases are simply irreconcilable and the English version better accords with the intention of Parliament. Indeed, the Respondent agrees with the Appellant in this regard.

[97] From a literal reading of the French version, the Appellant concludes that it would enable the Government to find more than one "person" for the purpose of applying subsection 75(2). The Appellant provided an example of how this could arise:

... Suppose A settles \$100 on a trust and reserves the right to revoke the trust. The trust then uses the \$100 to buy shares from B (at their fair market value at the time of purchase). During the period that the trust owns the shares, it receives dividends. The trust subsequently sells the shares to C for \$200 (their fair market value at the time of sale). Immediately thereafter, the trust uses the \$200 proceeds to buy real estate from D which generates rental income during the period it is owned by the trust. B and D are capital beneficiaries of the trust.

There is no dispute that all three subsequent properties – the shares, the \$200 and the real estate – are, by virtue of s. 248(5), property substituted for the original \$100. As the appellant has previously submitted, the intent of s. 75(2) is to attribute to A the income (or loss) from, or capital gain (or capital loss) from the disposition of the \$100 and from the shares and from the \$200 and from the real estate. The rationale for s. 75(2) is that, in such cases, A is not considered to have fully disposed of the \$100 (because of the right to revoke the trust) and therefore the income from that property or property substituted for it, or the gain from the disposition of the property or the property substituted for it, should be attributed to A. However, to give effect to the literal French meaning of "ou les biens qui leur sont substitués" in preference to the English meaning of "or property for which it is substituted" would attribute the income or gain from the shares and real estate to B and D as well as to A. As stated in our earlier submission, such an interpretation should be avoided because it is contrary to public policy to permit the Minister to choose to impute the income (or gain) from the shares and the real estate amongst any or all of A, B and D unless the language of the provision clearly made them jointly, or jointly and severally, liable for a single charge to tax. Indeed, this interpretation would permit the Minister to attribute the income from shares and the gain from the disposition of the shares to D (because the real estate is substituted for the shares) even though D did not transfer any property to the trust during the period that the trust owned the shares. In other words, if the literal French meaning of the phrase "ou les biens qui leur sont substitués" were to determine the scope of s. 75(2)(a)(i), it would remove any temporal connection between the transfer of property by a person to the trust and the attribution of income from the trust property (including previously-owned trust property) to that person.

...

[98] This reasoning makes eminent sense to me. Subsection 75(2) of the Act is neither in the French nor English versions drafted by any reference to persons (plural), only to a person. It contemplates just the one person.

[99] The Appellant brought to my attention seven provisions of the Act where the English language version refers to "the property...or...property for which it was substituted"[18] and six provisions that use the phrase with identical meaning "the property...or...property for which the property was substituted".[19] The Appellant argues that all of these provisions concern a tax consequence or tax attribute at a particular point in time and include conditions applicable during a specified period before that time. Almost all of the provisions deal with the tax consequences of disposition of a property, and the conditions that must be met at the time of disposition and prior to the time of disposition. According to the Appellant, it is clear from the text and purpose of all of these provisions that the phrase in issue must refer to a previously held property and not to a subsequently substituted property. Consequently, the use of the phrase "un bien qui lui est substitué" is intelligible in these contexts only if it is understood as referring back to previously owned property. The Appellant suggests that the most obvious examples are paragraphs 110.6(1.2)(a), 110.6(1.3)(a) and 110.6(1.3)(c). In effect, the French phrase should be taken as referring to the property for which the substituted property was substituted, and not the substituted property itself.

[100] Again, this makes sense: it accords with my earlier view of how to properly parse subsection 75(2) of the Act into the two situations, one, where the original property is held, and two, where the substituted property is held. If I look to the French version in applying the second situation where the trust holds substituted property, subsection 75(2) of the Act would effectively read:

Soit que des biens qui leur sont substitués puissent revenir à la personne dont les biens leur sont substitués...

[101] It is apparent that "leur" referred to in the latter phrase must reference the substituted property, and therefore, the latter phrase can only mean, in English, the property for which the substituted property was substituted.

[102] All to say, that despite this considerable head-spinning, a review of the French version has not altered my view that subsection 75(2) of the Act is not meant to apply to more than one person, that person being the settlor.

Contextual

[103] Support for this textual interpretation of "the person" can be found in the context of the balance of subsection 75(2) of the Act. Specifically, subparagraph 75(2)(a)(ii) refers to property passing to persons to be determined by "the person" at a time subsequent to the creation of the trust. The only person to whom the time of the creation of the trust holds any relevance is the settlor, not a beneficiary vendor for value. It is implicit that if the settlor retains any such authority, it is he or she who may be caught by subsection 75(2) of the Act.

[104] This view has garnered some favour amongst the academics. Maurice Cullity in *Taxation and Estate Planning* indicates the usual object of subsection 75(2) attribution is the settlor, though could apply to a subsequent transferor in the sense of a contributor. In that regard, I concur with Justice Bowie's comments in *Greenberg Estate v. The Queen*[20] that "contributed" signifies a voluntary payment made to increase the capital of the estate: a sale to the trust at fair market value does no such thing. As I indicated earlier, if Mr. Peter Sommerer was to contribute to the trust, he might be viewed as a settlor creating a new trust. A fair market sale of property to a trust is not a contribution and the vendor is not a contributor, nor therefore a settlor. The property sold to the trust cannot, as argued by the Respondent, be viewed as "original property"; it can only be substituted property, as consideration was given for it by the trust.

Purposive

[105] On its face, subsection 75(2) of the Act is an avoidance provision that denies the taxpayer the use of a trust to defer and perhaps avoid tax. Counsel was unable to provide any commentary from the Department of Finance or anywhere in the Government for that matter, at the time of the introduction of this provision, to shed light on the Government's view of its purpose. Neither party was able to rely on this tool of interpretation to assist me. Unlike other attribution provisions or anti-avoidance provisions, subsection 75(2) of the Act does not appear to require any element of intent. It has been suggested that this provision could be a trap for the unwary, who establish trusts

for non-tax purposes. I remain guided, therefore, by the textual and contextual view of subsection 75(2) of the Act.

(ii) If the Respondent is correct that Mr. Sommerer can be the "person" as defined in subsection 75(2) of the Act, can the property revert to him?

[106] There is no question that Mr. Sommerer is an ultimate beneficiary entitled to the property in the event Mr. Herbert Sommerer revokes the SPF. The Appellant relies on the case of *Fraser v. The Queen*[21] to argue that a reversionary interest must be an absolute reversionary interest for subsection 75(2) of the Act to apply and that that is not the case for Mr. Sommerer. I do not accept the *Fraser* decision as a strong authority for that proposition. In *Fraser*, the parties agreed that if the Court found a trust existed rather than an agency, then the trust was taxable. Only on the last day of trial was it even suggested that subsection 75(2) of the Act might apply to attribute losses to the investors. Justice Reed gives this relatively short shrift:

In addition, it is argued that subsection 75(2) only applies when the beneficiary has a reversionary right and that no such right exists in this case. It is argued that while the GMS Agreement states that the plaintiff may request a sale or redemption of her units, and the agreement goes on to state that the syndicate will not continue making investments until redemption has taken place, there is in fact no absolute right to redemption. It is argued that the documentation does not give an absolute right of reversion. I accept this as a correct interpretation of subsection 75(2) and the facts of the present case. In my view, subsection 75(2) anticipates a situation in which the whole corpus of the trust is capable of reverting to the settlor (75(2)(a)) or where the corpus during the life of the trust remains under the control of the settlor (75(2)(b)). ...

[107] If the investors in the mortgage syndicate wanted out, they could seek to sell their interest or seek redemption from the syndicate itself, if the syndicate was not in a loss position. This is what Justice Reed likely meant when she referred to the documentation not giving an absolute right of reversion. This is not at all similar to the situation before me. If Mr. Herbert Sommerer revokes the Foundation, Mr. Peter Sommerer gets half the corpus of the trust. Unlike the case before Justice Reed, the Vienna and Cambrian shares were held subject to an absolute condition as to how they, or substituted property, were to be distributed in the event of a revocation. No, I do not see how the *Fraser* case is of any assistance to Mr. Sommerer, if Mr. Sommerer is found to be the "person" as defined in subsection 75(2) of the Act.

[108] This does confirm for me, however, that Mr. Sommerer, as a vendor beneficiary for fair market value, should not be the "person", as a reversionary right implies the right of the transferor, yet here the right vests in the settlor via his right of revocation, not in Mr. Peter Sommerer. By applying subsection 75(2) of the Act to Mr. Peter Sommerer as the "person", words such as "revert" need to be stretched to accommodate an interpretation that, I respectfully suggest, was never contemplated. In a trust, property can revert to a settlor: a reversionary trust. Mr. Peter Sommerer did not settle a reversionary trust but the property he sold to the trust, by operation of the trust, can be distributed to him; again, Mr. Sommerer should not be considered the "person".

[109] Having said that I still conclude that, if Mr. Peter Sommerer is the "person" from whom property was received by the trust, and I am forced to look to how "revert" applies to him, then I find the property "may revert" to him, as it is enough that by the terms of the trust upon which the property is held, the property shall be distributed to him in the event of revocation. No technical meaning need be ascribed to "revert" in the context of property distributed to a beneficiary that was previously owned by the beneficiary. He owned it once: he could own it again without having to pay for it.

(iii) and (iv) Subparagraphs 75(2)(a)(ii) or 75(2)(b) of the Act

[110] It is unnecessary to consider subparagraph 75(2)(a)(ii) or 75(2)(b) of the Act given this conclusion, but if I had to make those determinations, I would conclude that it was not Mr. Sommerer who could determine to whom trust property would pass, though the Advisory Board effectively had a veto power with respect to income distributions (Foundation Declaration section 6(1)), nor was his consent or direction required for a disposition of the trust property as the Foundation Declaration was

silent in this regard. That authority ultimately vested with the Executive Board, notwithstanding Mr. Sommerer, as the dominant member of the Advisory Board, had some considerable influence. I will have more to say on this with respect to agency.

On appeal the Minister attempted to argue that the provision could apply to sales as well as to possibly multiple attributes while the Appeal Ct. held:

(A) Introduction to subsection 75(2)

[34] Broadly speaking, subsection 75(2) is intended to ensure that a taxpayer cannot avoid the income tax consequences of the use or disposition of property by transferring it in trust to another person while retaining a right of reversion in respect of the property or property for which it may be substituted, or retaining the right to direct the disposition of the property or substituted property. Subsection 75(2) operates by attributing any income or loss from the use of trust property, and any gain or capital loss on the disposition of trust property, to the person from whom the property, or property for which it was substituted, was received by the trust.

[35] Subsection 75(2) reads as follows:

...

(D) Does subsection 75(2) apply?

[44] The Sommerer Private Foundation used part of the money it received from Herbert Sommerer as an endowment to pay Peter Sommerer part of the purchase price of the Vienna shares. The Sommerer Private Foundation later sold the shares and realized a capital gain. The position of the Crown is that subsection 75(2) applies to attribute that capital gain to Peter Sommerer.

[45] I reproduce here the parts of subsection 75(2) upon which the Crown relies:

...

[46] This provision must be read together with paragraph 248(5)(a) of the *Income Tax Act*, which provides, broadly speaking, that for the purposes of most provisions of the *Income Tax Act*, the notion of the substitution of property contemplates any number of substitutions. It reads in relevant part as follows:

(5) For the purposes of this Act ...,

(a) where a person has disposed of or exchanged a particular property and acquired other property in substitution therefor and subsequently, by one or more further transactions, has effected one or more further substitutions, the property acquired by any such transaction shall be deemed to have been substituted for the particular property....

...

[47] The Crown argues that subsection 75(2) applies to this case because when Peter Sommerer sold the Vienna shares to the Sommerer Private Foundation in October of 1996, it was possible under the constating documents of the Sommerer Private Foundation that the Vienna shares or property substituted for them (including the proceeds of their sale, any property that might be acquired with the proceeds of their sale, and so on), might one day be distributed to Peter Sommerer as a beneficiary or an ultimate beneficiary. I agree that Peter Sommerer may one day be entitled to a distribution from the Sommerer Private Foundation of property that, by virtue of paragraph 248(5)(a), would be property substituted for the Vienna shares. However, Justice Miller found that to be an insufficient basis for the application of subsection 75(2). I agree.

[48] Subsection 75(2) must be interpreted and applied to give effect to its language, read in its proper context and with a view to giving effect to its intended purpose. As mentioned above, subsection 75(2) generally is intended to ensure that a taxpayer cannot avoid the income tax consequences of the use or disposition of property by transferring it to another person in trust while retaining a right of reversion or a right of disposition with respect to the property or property for which it may be substituted. A common example of the application of subsection 75(2) is the settlement of a trust where the settlor is also a beneficiary with an

immediate or contingent right to a distribution of the trust property. In that situation, and in many other situations contemplated by paragraphs 75(2)(a) and (b), subsection 75(2) achieves its intended purpose.

[49] In this case, the Crown contends that the application of subsection 75(2) applies also in respect of property that has been *purchased* by a trustee from a beneficiary at fair market value and held subject to the terms of the trust. In my view, to interpret subsection 75(2) so that it could apply to a beneficiary in respect of property that the trust acquired from the beneficiary in a *bona fide* sale transaction leads to outcomes that are absurd and could not have been intended by Parliament.

[50] A series of examples will illustrate this point. (For the sake of simplicity, assume that to the extent the trust in these examples earns any income from the use of its property, the income is distributed to the beneficiaries on a current basis, so that no property of the trust represents retained income or property substituted for retained income.)

[51] An individual, Mary, settles a \$10,000 trust for her children, naming them all as beneficiaries who are to share equally in all distributions of property of the trust, and naming herself as the sole beneficiary in the event that all of the children predecease her. In this case, subsection 75(2) would apply to attribute to Mary all of the income and losses of the trust from the use of its property, and all of the capital gains and losses realized by the trust on the disposition of its property (during her lifetime as long as she is resident in Canada).

[52] Now a complication is added. One of Mary's children, Jack, donates a painting to the trust, stipulating that it is to be held subject to the existing terms of the trust except that if the painting is still held by the trust in ten years time, the painting would revert to Jack. The trust sells the painting five years later, realizing a capital gain on the sale. The capital gain is attributed to Jack pursuant to subsection 75(2) because it was realized on the disposition of property that the trust acquired from Jack subject to the terms of the existing trust, and also subject to the condition that the property could revert to him. It is important to observe that, because the painting was donated to the trust by Jack and the trust gave nothing to Jack in return, it cannot be said that the painting is property substituted for any property that the trust received from Mary, so there could be no attribution to Mary of any gain on the sale of the painting, or any income or gains associated with property substituted for the painting.

[53] Now suppose that Jack, instead of donating the painting to the trust, sells it to the trust for its fair market value with no conditions attached. The painting is sold by the trust at a time when Jack is the only child of Mary still alive. The trust realizes a capital gain on the sale. At that point, either Mary or Jack could become entitled to receive all of the property of the trust, depending upon which of them dies first.

[54] Under the conventional understanding of subsection 75(2), the painting would be considered property substituted for money that the trust received from Mary. That is because all of the property of the trust can be traced, through the substituted property rule, to whatever property Mary donated to the trust when it was settled. Because the painting and any property substituted for the painting could revert to Mary, subsection 75(2) would apply to attribute to Mary the capital gain on the sale of the painting. However, if the Crown's interpretation is correct, it would be equally valid to say that because the trust received the painting from Jack when the terms of the trust were such that the painting could revert to him, subsection 75(2) attributes to Jack the capital gain on the sale of the painting.

[55] Thus, under the Crown's interpretation of subsection 75(2), the same capital gain is attributed simultaneously to Mary and Jack. That cannot be. Nothing in subsection 75(2) contemplates an outcome involving the attribution of the same gain to more than one person. This double application of subsection 75(2) cannot be avoided by a discretionary use of subsection 75(2), because it is not a discretionary provision. It applies automatically to every situation it describes.

[56] For the same reason, it is no answer to say that in this particular case, subsection 75(2)

could never apply to Herbert Sommerer, the "settlor" of the trust, because he is not a resident of Canada. Again, because subsection 75(2) applies automatically to every situation it describes, it is not acceptable to adopt one interpretation for transactions involving only residents of Canada, and a different interpretation for transactions involving residents of other countries.

[57] I conclude that the Crown's proposed interpretation is wrong because it is based on the incorrect premise that subsection 75(2) can apply to a beneficiary of a trust who transfers property to the trust by means of a genuine sale. Justice Miller reached the same conclusion through a comprehensive application of the principles of statutory interpretation to specific words and phrases in subsection 75(2). His main conclusion is stated succinctly at paragraph 91 of his reasons:

... once properly unravelled and viewed grammatically and logically, the only interpretation is that only a settlor, or a subsequent contributor who could be seen as a settlor, can be the "the person" for purposes of subsection 75(2) of the Act.

[58] It remains only to apply this conclusion to the present case. The Sommerer Private Foundation purchased the Vienna shares from Peter Sommerer using money from the original endowment from Herbert Sommerer. Peter Sommerer has not endowed the Sommerer Private Foundation with any other money or property. Therefore, subsection 75(2) cannot apply to attribute any income or gains of the Sommerer Private Foundation to Peter Sommerer.

[59] That is a sufficient basis for dismissing this appeal.

In this author's opinion, this is not good law. While the issue of FMV transfers is properly addressed appropriately, per the immediately following subchapter, this provision can effortlessly double recognition between trust and normal attributee because of what can be interpreted from its evolution and its present wording.

Income/Loss Doubling.

One of the most beneficial aspects of the provision that has apparently been completely overlooked is the fact that when applicable it will attribute both income **and** loss, taxable capital gain **and** allowable capital loss to the attributee and it is this that runs counter to the basic premise under subdivision K which is continually generalized, that "all losses realized by the trust can only be deducted by the trust."¹³⁵⁸

Even more interesting is the fact that unlike all of the other basic attribution provisions in Sec. 74.1(1), (2), 74.2(1) which provide that once income or gain is attributed the person who actually realized the income/gain will not have to recognize it, Sec. 75(2) provides that the income or gain will be deemed to be that of "person" *without it being precluded from recognition by the trust*. Any income or capital gain attributed will thus be required to be recognized twice, both by the trust and the attributee,...and this also applies to losses and allowable capital losses. The provision simply deems the results to be that of the transferor: by statutory convention, in all the other attribution provisions, the provision must then go on to specify explicitly that they are NOT those of the contributor. Where an "income-producing" property is continually realizing non-capital losses it would undoubtedly pay to transfer it to a trust and allow the transferee to retain a discretionary power over it such as that described in para. (b) or subpara. (a)(ii) or allow him to be a beneficiary to whom the property may revert as per subpara. (a)(i), in that in doing so the contributor could **double** the amount of loss both could recognize.

Income War Tax Act Sec. 32(1)

¹³⁵⁸ One would then want to argue for the application of the provision in cases where the trust property has been developing losses.

(1) Transfers to Minors. Where a person transfers property to a minor, eighteen years of age or under, either directly or indirectly or through the intervention of a trust or by any other means whatsoever, such person shall nevertheless during the said period of minority of the transferee, be liable to be taxed on the income derived from such property or from property substituted therefor as if the said transfer had not been made. Subsequent to the said period of minority the said transferor shall continue to be taxed in respect of the income derived from such property or from property substituted therefor as if such transfer had not been made, unless the Minister is satisfied that such transfer was not made for the purpose of evading the taxes imposed under this Act.

(2) Transfers to spouse. Where a husband transfers property to his wife, or vice versa, the husband or the wife, as the case may be shall nevertheless be liable to be taxed on the income derived from such property or from property substituted therefor as if such transfer had not been made.

(3) Transfers in trust. Where a person transfers property in trust and provides that the corpus of the trust shall revert either to the donor or to such persons as he might determine at a future date or where a trust provides that during the lifetime of the donor no disposition or other dealing with the trust properly shall be made without the consent, written or otherwise, of the donor, such person shall nevertheless be liable to be taxed on the income derived from the property transferred in trust or from property substituted therefor as if such transfer had not been made.

The "New" Act - 1949

Sec. 21(1)

(1) Where a person has, on or after the first day of August, 1917, transferred property, either directly or indirectly, by means of a trust or by any other means whatsoever, to his spouse, or to a person who has since become his spouse, the income for a taxation year from the property or from property substituted therefor shall be deemed to be income of the transferor and not of the transferee.

Sec. 22(1)

(1) Transfers to minors. Where a taxpayer has, since 1930, transferred property to a person who was under 19 years of age, either directly or indirectly, by means of a trust or by any other means whatsoever, the income for a taxation year from the property or from property substituted therefor shall be deemed to be income of the taxpayer and not of the transferee unless the transferee has before the end of the year attained the age of 19 years.

Sec. 22(2)

(2) Trusts. Where, by a trust created in any manner whatsoever since 1934, property is held on condition

(a) that it or property substituted therefor may

(i) revert to the person from whom the property or property for which it was substituted was directly or indirectly received, or

(ii) pass to persons to be determined by him at a time subsequent to the creation of the trust, or

(b) that, during the lifetime of the person from whom the property or property for which it was substituted was directly or indirectly received, the property shall not be disposed of except with his consent or in accordance with his direction,

income from the property shall be deemed to be income of such person [??????].

Subsection 32(3) of the Income War Tax Act formed the basis of what would eventually become Sec. 75(2) and it provided that the contributor of property to the trust would be liable for the tax on the income from the property as if the transfer had not been made. This attribution provision was identical in thrust to the other general attribution provisions (Sec. 32(2); spousal) and the diction was practically identical.¹³⁵⁹ On June 30th, 1948, the predecessor of the present Act was enacted and the I.W.T.A. disappeared from the Canadian taxation scene. Subsection 21(1) therein caused the income to "be deemed to be income of the transferor and **not of the transferee**" when the spousal attribution conditions existed. Subsection 22(1) thereof provided that income from property transferred to a minor "shall be deemed to be income of the taxpayer and **not of the transferee**" if the minor income attribution conditions existed. Subsection 22(2) provided the provision applicable to trusts, which was identical to that of Sec. 75(2) save for the closing paragraph which provided "income from the property shall be deemed to be income of such person" (contributor). Why did Parliament deliberately choose not to take that extra step in the case of the provision in respect of trusts to ensure that only one party was to recognize the income realized? Why did they diverge from the other income attribution provisions that were amended in exact same manner to create one that stood out? All the result is is that the income/loss that is subject to the attribution is deemed to be that of the contributor; it does not deem it NOT to be that of the trust which by convention in the other attribution provisions was adopted as the phraseology. This is more than a mere difference in diction but indicative of difference in policy. In the author's opinion obviously there was the intention that this feature serve to penalize those arrangements entered into by contributors/settlers of property where they preserved certain elements of control over its benefit (though not necessarily beneficial ownership) to double the recognition of the same income and this is undeniable given that previous to the enactment of the "new" provisions the Income War Tax Act attributed income in the three situations exactly in the same way. While the general conditions of application in respect of "former" Sec. 32(3) and 22(2) are the same Parliament went that extra step of ensuring that the double recognition feature was not removed in the text with the new enactment when such was pursued in the case of the other two attribution provisions at the same time under the same reform.¹³⁶⁰

1359. Technically all the attribution provisions of that era could cause double recognition since they operated to cause the transferor to incur the tax consequences from the property as if the transfer had not occurred though did not operate to prevent the transferee from recognizing those actually realized. With the 1949 reform this feature was attended to explicitly through the new introduction of the critical phrase that would prevent the latter.

1360 The Supreme Court of Canada has already repeated many times that any ambiguities found in the taxing statutes shall be resolved in favour of the taxpayer as per Mr. Justice Estey in *Johns-Manville Canada Inc. v. The Queen*, 85 D.T.C. 5373 (SCC) at 5384 where he stated:

Such a determination is, furthermore, consistent with another basic concept in tax law that where the taxing statute is **not explicit, reasonable uncertainty or factual, ambiguity resulting from lack of explicitness in the statute should be resolved in favour of the taxpayer.**

In addition, Justice Sopinka of the Supreme Court of Canada held in *Fries v. The Queen*, 90 D.T.C. 6662 (SCC) said that: We are not satisfied that the payments by way of strike pay in this case come within the definition of 'income... from a source' within the meaning of s. 3 of the Income Tax Act. **In these circumstances the benefit of the doubt must go to the taxpayers."**

In *M.N.R. v. TD Bank*, 2004 FC 169, it was opined:

"[26] Further, the wording of section 232.2(2) is clear and in my view does not permit an interpretation that disregards the literal meaning in favour of an interpretation which is considered more likely to advance the objectives of the Act, which might be possible in the case of less clear legislation.

[27] In *Canada v. Antosko*, [1994] 2 S.C.R. 312, at 326-327, the Supreme Court of Canada said: While it is true that the courts must view discrete sections of the *Income Tax Act* in light of the other provisions of the Act and of the purpose of the legislation, and that they must analyze a given transaction in the context of economic and commercial reality, such techniques cannot alter the result where the words of the statute are clear and plain . . . [My emphasis.]

[28] In this regard, I adopt the comment on *Antosko*, *supra*, by Peter Hogg, cited with approval by Major J. in *Friesen v. Canada*, [1995] 3 S.C.R. 103, at 113-114:

. . . P.W. Hogg and J.E. Magee, *Principles of Canadian Income Tax Law* (1995), Section 22.3(c) "Strict and purposive interpretation", at pp. 453-54:

It is equally important to note that per *Her Majesty The Queen v. Peter Sommerer*, above described, at the FCA the Crown sought to argue that the provision could double recognition between two beneficiaries: if the Crown has this interpretation in court, clearly could it cause double recognition between trust and attributee.

It should also be noted that the similar attribution provision, s. 56(2) can cause double recognition when the underlying party realizes the benefit and it is attributed as well to the attributee however CRA has stated

It would introduce intolerable uncertainty into the *Income Tax Act* if clear language in a detailed provision of the Act were to be qualified by unexpressed exceptions derived from a court's view of the object and purpose of the provision . . . [The *Antosko* case] is simply a recognition that "object and purpose" can play only a limited role in the interpretation of a statute that is as precise and detailed as the *Income Tax Act*.

[29] Further, as P.A. Côté stated in his text *The Interpretation of Legislation in Canada*, 3d ed., at pages 624 and 625:

The guideline affirming the primacy of the text is principally grounded on two arguments. First, the highly detailed style of drafting for this type of legislation naturally contributes to accentuate the importance of the text for the taxpayer and their counsellors. And, eventually for the official interpreter, the judge. Further, some fear that the tremendous possibility offered when doing away with the literal meaning of the text, in favour of a meaning deemed more apt to promote the objectives of the statute, will introduce too much uncertainty in an area of law where decisions are taken, daily, based on the letter of the provision."

In *Markevich v. Canada*, 2003 SCC 9, [2003] 1 S.C.R. 94 it was further opined concerning statutory prescription (para. 15):

"It is "a basic principle of statutory interpretation that the court should not accept an interpretation which requires the insertion of extra wording where there is another acceptable interpretation which does not require any additional wording": see *Friesen v. Canada*, [1995] 3 S.C.R. 103, at para. 27. This principle weighs against accepting the appellant's interpretation. The provision does not include the words "at any time", and is capable of a reasonable construction without that insertion. The legislative silence with regard to prescription gives rise to the logical inference that Parliament intended for limitation provisions of general application to apply to the Minister's collection powers."

In Australian jurisprudence the issue is also stated in *Nekon Pty Ltd v Commissioner of State Revenue* [2010] TASSC 2 (16 February 2010):

7 It is worth repeating some statements of principle that have been made in the High Court about statutory interpretation. In *Amalgamated Society of Engineers v Adelaide Steamship Co Ltd* [1920] HCA 54; (1920) 28 CLR 129 at 161 – 162, Higgins J said:

"The fundamental rule of interpretation, to which all others are subordinate, is that a statute is to be expounded according to the intent of the Parliament that made it; and that intention has to be found by an examination of the language used in the statute as a whole. The question is, what does the language mean; and when we find what the language means, in its ordinary and natural sense, it is our duty to obey that meaning, **even if we think the result to be inconvenient or impolitic or improbable.**"

8 In *Project Blue Sky Inc v Australian Broadcasting Authority* [1998] HCA 28; (1998) 194 CLR 355 at par[78], McHugh, Gummow, Kirby and Hayne JJ said (omitting footnotes):

"However, the duty of a court is to give the words of a statutory provision the meaning that the legislature is taken to have intended them to have. Ordinarily, that meaning (the legal meaning) will correspond with the grammatical meaning of the provision. **But not always. The context of the words, the consequences of a literal or grammatical construction, the purpose of the statute or the canons of construction may require the words of a legislative provision to be read in a way that does not correspond with the literal or grammatical meaning.**"

9 In *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue* [2009] HCA 41; (2009) 239 CLR 27 at par[47], Hayne, Heydon, Crennan and Kiefel JJ said (omitting footnotes):

"This Court has stated on many occasions that the task of statutory construction must begin with a consideration of the text itself. Historical considerations and extrinsic materials cannot be relied on to displace the clear meaning of the text. The language which has actually been employed in the text of legislation is the surest guide to legislative intention. The meaning of the text may require consideration of the context, which includes the general purpose and policy of a provision, in particular the mischief it is seeking to remedy."

in one of its Interpretation Bulletins, 335R2¹³⁶¹ that administratively, if possible, it will eliminate double recognitions. The important aspect to recognize here is that CRA will discretionarily make administrative adjustment to remove double recognition if it legally can within the open periods of assessment, but if it can't then by consequence double recognition will occur. Given that the CRA has maintained this aspect in respect of s. 56(2), and not made same statement with respect to s. 75(2), then can it be inferred that the policy isn't the same? If a statement is absent on such can the taxpayer not infer that the alternative is being inferred through CRA's conduct and that s. 75(2) can double gains, **and losses**?

In 1955 the attribution provisions were altered to apply only while the transferor was resident in Canada. In 1972 Bill C-259 came into force which shifted the attribution provisions to sections 74 - 75 and materially altered them. Subsection 75(2) was altered so as to apply to losses and allowable capital losses as well as income and taxable capital gains and this treatment was allowed to spousal/minor attribution provisions which all previously applied only to income and gains. Potential for double taxation was not removed and it was here where the Department of Finance hung themselves: if the provision would have been amended to prevent the transferee from recognizing the income or loss, **like the other attribution provisions**, Sec. 75(2) would not be such a wonderful provision. Whether or not Finance recognized the double taxation feature in the heady days of tax reform fever leading up to C-259 is the all important issue here in that while material alterations to the above noted attribution provisions did occur the basic provisions may not have been properly evaluated with respect to the effect of this wording. When such a blatant divergence exists is it reasonable to believe that Finance did not make a review of the reasons why when formulating the alterations? Would Parliament have noticed?¹³⁶² In the author's opinion, though Finance may be cited and celebrated for some, at the minimum, linguistic blunders in formulating legislation it is a considerable leap to believe that the double taxation feature was not tacitly recognized during the relevant period.

The legislative intent, at the time the provision was first introduced, was to cause double taxation of the income and this intention has been implicitly maintained right up to the present when the provision has gone through two material amendments and still offers a doubling of whatever is attributed. By **not** removing the double recognition feature it is doubted if the Department can now rely of the defense of the convention of not assessing as such: merely because they have not chosen to enforce the legislation given to them by Parliament says nothing when the provision has been tacitly maintained through the ages as such.¹³⁶³ Of course super abusive uses of the provision to annihilate the Canadian tax base will not be tolerated when section 245 sits in the wings but if the effect of the provision can be proven to have been accessed without a tax motivation section 245 isn't of concern. Here's a provision that double's losses **explicitly without help from another provision and from its introduction and maintenance has explicitly broken from the general scheme of the Act to double recognitions. How could its legitimate application not be within the object and spirit of the Act as a whole when it forms an explicit exception?**

If one recognizes that the provision applies where the property can revert to the person from whom it was **directly or indirectly** received then one can see the outline of an extremely offensive arrangement. If

¹³⁶¹ "Inclusion of an amount in the income of a taxpayer and in the income of the recipient of the property"
¶ 13. An amount to which subsection 56(2) applies could be included in the income of both the taxpayer and the person who receives the payment or the property. However, it is normally the Canada Revenue Agency's (CRA) practice not to assess the same income twice. Accordingly, where the taxpayer agrees to the reallocation, the recipient's income will be reduced. Where the taxpayer does not agree, the CRA will also reduce the recipient's income, without requiring a waiver, provided that at the time of the assessing action, the recipient's return was not about to become statute-barred; in those cases, the CRA will seek a waiver."

¹³⁶² The author has not reviewed budget speeches, nor had the opportunity to scrutinize internal records for the relevant periods, nor is he aware of whether this provision was cited as frequently to counter avoidance innuendo as it is presently: these are all worthy considerations.

¹³⁶³ The author was not able to find a **single** Departmental opinion on this provision, either expressing its purpose or policy, in any technical report accompanying any budget or otherwise. As at Dec. 23rd, 1991 **nothing** existed in any of the documentation held at the National Archives as released by Finance. The Carter Report recognized the double taxation feature implicitly in Vol 4, pg. 189, para. 2. Paragraph 22 of the **original I.T. 394R, not 394R2**, seemed to recognize that double income inclusions will occur when income can be attributed while also elected upon under the P.B.E. mechanics: they changed the administrative opinion in the new IT, but not the actual law.

a loss producing property is acquired by a spouse from her husband for consideration equal to its fair market value and if three or five years later it is acquired by an offspring again for consideration equal to its fair market value, whereby all parties recognize "fair market value" tax consequences and if the property is then transferred to a trust where it is held on condition that it revert to either the contributor, his mother or his father, from whom is the property being directly or indirectly received? Has it not been **received** either directly or indirectly from all of them? In essence, since all three individuals have had legitimate ownership of the property before it was received by the trust can it not be said that income realized by it will be attributed to all of them. Does the same apply to losses? One can see even when the ownership chain is inter-spliced with arm's length parties the property may revert to any particular parties from whom it was indirectly or directly received. It is to be noted that the Sec. 73(1) spousal trust transfer provision, being very much unlike the Sec. 70(6) testamentary transfer provision, does not require that the subject property vest indefeasibly in the trust in fact save for Sec. 73(1.1)(c) the vesting of the property isn't even considered. With this in mind the Sec. 75(2)(a)(ii) or (b) attribution criteria can be satisfied without upsetting the favorable roll-over provision application, where the contributor can determine to whom the property will eventually pass on during his lifetime, without his consent or direction, the spousal trustees will be unable to dispose of the property.

It should also be recognized that the Sec. 74.5(11) artificial transactions provision negates the effect of sections 74.1 to 74.4 **only**, when they have been utilized to reduce taxes, and it does not refer to Sec. 75(2). (A polite and interesting question would be "why not?".)

Question 48 of the 1988 Roundtable Discussions commented on the fact that subsection 74.2(2) operates to cause attributed capital gains from spouses under Sec. 74.2(1), to be treated as the attributee's capital gain for the purposes of allowing the utilization of net capital losses or capital gains deductions/exemptions in respect of them. It was pointed out that there isn't a Sec. 74.2(2) provision equivalent in respect of the Sec. 75(2) attribution provision with the result that capital gain attributed out under the latter will not be negated by the above deductions/exemptions. Finally in 1990, this was changed with an amendment to Sec. 74.2(2) so that it now allows capital gains exemptions to be taken in respect of Sec. 75(2) attributed gains.

Equally, with respect to recognition doubling, the CRA does make an administrative adjustment to prevent such, though both returns must state the income, however, per the Act, it doesn't have to. **The provision is clearly meant to penalize instances where the taxpayer has maintained some incidents of control over his settled property and s. 107(4) does prompt for FMV dispositions of ANY of the trust's property to which s. 75(2) has applied in respect of any of them.** With s. 107(4) clearly Finance wanted harsh conditions to apply to this environment so, if this prompts for recognition doubling, then why shouldn't it double everything?

In the author's opinion, this is the most dangerous provision that he knows of since it arbitrarily doubles losses and there seems to be no legal reason to argue the opposite based on its history and present terminology.

Fair Market Value Distributions.

There is an inherent limitation imposed upon the constructive use of Sec. 75(2) in the form of Sec. 107(4.1) which causes the trust and the beneficiary to recognize less than tax neutral consequences when any property of a trust caught by Sec. 75(2) is distributed to taxpayers, other than the two specified, in **satisfaction of the taxpayer's capital interest**, however it should be recognized that if the legal title to the property isn't distributed to the taxpayer holding the Sec. 108(1)(c) technically defined capital interest, **in satisfaction of that interest or part thereof**, Sec. 107(4.1) will not apply. Thus if the legal title to the property is distributed under Sec. 106(3) in satisfaction of an income interest Sec. 107(4.1) will not apply, however if the property distributed was the Sec. 75(2) subject property then the tax consequences of the

disposition recognizable under Sec. 106(3) will be attributable.¹³⁶⁴ Where the property is distributed to a creditor of the capital interest holder, but not in satisfaction of his interest, so that the beneficiary never receives its legal title, then again Sec. 107(4.1) will not apply, while since the rights of the recipient against the beneficiary in respect of the debt are canceled, he cannot be said, in the author's opinion, to be "benefiting" from the trust in that he is giving up something of "equal value" and thus Sec. 105(1) will not apply to him. Since the beneficiary's right is not being satisfied through the distribution subsection 107(4.1) will not apply while the distribution will be left to be handled by Sec. 105(1) or 53(2)(h). Since the beneficiary obviously realizes a benefit in the form of an obligation to pay/debt reduction Sec. 105(1) will apply to him since the value of the benefit isn't otherwise included in his income nor does it lead to, or hypothetically cause, a capital interest ACB adjustment since the distribution was **not paid to him**.¹³⁶⁵ Since the property is capital and since such a transfer cannot be said to be benefiting to the recipient Sec. 56(2) may not apply.

Subsection 107(4.1) applies where any property is transferred to any capital beneficiary other than the person from whom the property or its substitute was received or his spouse, while it ceases to apply where the Sec. 75(2) contributor dies. If it does apply, on the distribution of the property the trust will be deemed to recognize a disposition thereof for proceeds equal to the property's fair market value, or that value between its FMV and its capital U.C.C. in the case of depreciable capital property, which will be attributed to the contributor of the property if the property-contributor relationship was subject to Sec. 75(2).

It's to be noted that pursuant to the reasoning in *Peter Sommerer And Her Majesty The Queen*¹³⁶⁶ detailed in the above descriptions including contributions to the trust and the creation of those identical out of a former's terms that s. 107(4.1) can be argued not to apply to anyone except the beneficiaries of the latently created "second" trust created through the later contribution. Again, through adoption of a previously created trust's terms, possibly with inherent conditions attached to interests thereunder or other aspects the primary founding trust's property is sheltered from being captured by this subsection.

"Where subsection 75(2) applicable to trust – Sec. 107(4.1)"

(4.1) Subsection (2.1) applies (and subsection (2) does not apply) in respect of a distribution of any property of a particular personal trust or prescribed trust by the particular trust to a taxpayer who was a beneficiary under the particular trust where

(a) the distribution was in satisfaction of all or any part of the taxpayer's capital interest in the particular trust;

(b) subsection 75(2) was applicable at a particular time in respect of any property of

(i) the particular trust, or

(ii) a trust the property of which included a property that, through one or more dispositions to which subsection 107.4(3) applied, became a property of the particular trust, and the property was not, at any time after the particular time and before the distribution, the subject of a disposition for proceeds of disposition equal to the fair market value of the property at the time of the disposition;

(c) the taxpayer was neither

(i) the person (other than a trust described in subparagraph (b)(ii)) from whom the particular trust directly or indirectly received the property, or property for which the property was substituted, nor

¹³⁶⁴ unless the application thereof can be countered before commutation

¹³⁶⁵ Subsection 105(1) doesn't apply to non-residents.

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(ii) an individual in respect of whom subsection 73(1) would be applicable on the transfer of capital property from the person described in subparagraph (i); and

(d) the person described in subparagraph (c)(i) was in existence at the time the property was distributed.

Uses and Abuses.

The usefulness of Sec. 75(2) should not be overlooked by a group of taxpayers who are related as per Sec. 251(2) when they are contemplating incorporating an activity that has not yet proven its economic viability. If all of the incorporators are individuals related to each other then they can transfer their respective properties to a trust jointly created by them, and retain a power of appointment over the property or a reversionary interest in it. Both the Sec. 248(1) definition of personal trust will be satisfied, allowing the taxpayers to receive back the property tax free as per Sec. 107(2) while any loss, accounting or otherwise, sustained or recognized by the trust in respect of the properties in the course of the activity will also be recognizable by the contributors as per Sec. 75(2).¹³⁶⁷ Losses can then be doubled and the trust's portion can be booked and applied against subsequent income recognized. Once income begins to be consistently recognized the applicability of Sec. 75(2) would have to be negated, possibly through the distribution of the subject property, while the trust would need to retain some income producing property to absorb the booked losses, capability that is not subject to Sec. 75(2).¹³⁶⁸ Subsection 107(4.1) allows a reversion of the property, (or its substitute or any property for that matter), to be on a tax free basis if it reverts to the contributor. Subsequent distributions of property by the trust to non-contributor parties, other than their spouses would however be subject to the taxed distribution provision in Sec. 107(4.1). Once the activity has been established and the losses sustained the property could be rolled into a corporation under Sec. 85(1) without tax consequences either directly by the trust or indirectly through reversion and then incorporation. **(Substitute property** (shares) can be distributed tax free as per sec. 107(4.1).)

A very effective method of "churning up capital losses all over the place", (though not necessarily causing them to be deductible), would be to have a contributor transfer non-depreciable capital property to a personal trust and recognize the taxable disposition. The capital gain or loss would vary depending on the ACB of the property and its fair market value while the trust agreement would grant a capital interest to a beneficiary, who may be related or not. The tax cost of the property to the trust would be reflected in the tax cost of that capital interest directly, (depending on the amount of property held by the trust and the amount of its debt), which would allow the beneficiary to receive proceeds of disposition tax free up to that cost amount. The interest would be disposed of to a tax loss recipient immediately or some time after the beneficiary receives it for proceeds directly based on the fair market value of the property hence interest and thus would allow the second beneficiary (acquiror) to recognize a **legitimate** tax cost(ACB) as per Sec. 107(1.1) without causing tax consequences to the initial beneficiary.¹³⁶⁹ Once the transfer has occurred the taxpayers or related parties cause the fair market value of the property underlying the interest to plummet and the secondary beneficiary disposes of his capital interest sustaining a capital loss as per Sec. 107(1)(b) and section 40 that is not hindered by Sec. 107(6) since the loss accrued when the interest was owned by the disposing beneficiary. If the contributor of the property to the trust retained a veto over its possible disposition, a power to appoint it to another party, a reversionary interest in it or a power to cause the trustee

¹³⁶⁷ Subsection 75(2) does not apply to businesses transferred to the trust hence this arrangement could arise only in respect of investment property. If a business is carried on by the trust in respect of the property the loss sustained may not be attributable.

¹³⁶⁸ If the trust is resident in a tax haven country Sec. 212(12) will apply to deny withholding tax and the income/loss will be recognized only by the contributor. If income begins to be recognizable the taxable Canadian property trust could become non-resident without tax consequence, and in fact it need not return to Canada in order to allow the Canadian resident contributor to recognize losses: non-resident reversionary trusts are a major offensive device, depending on the applicability of section 94 & 94.1, in the author's opinion.

¹³⁶⁹ The interest could also be given to a non-resident who subsequently becomes resident thus benefiting from the Sec. 128.1(1) bump in cost.

to sell it, so as to allow Sec. 75(2) to apply, then some pretty "lean and mean" tax consequences will follow on the disposition of the property and the satisfying of the interest. The contributor and the trust would recognize the loss in value, being equal to the amount between the proceeds that the former received on its disposition to the trust and its ultimate resale consideration as per Sec. 75(2) not negated by Sec. 74.5(11) and the beneficiary would have also recognized a loss on the disposition of the interest equal to that amount. Essentially, **at the worst**, when the fair market value of the property can be reduced or is expected to be reduced the 1\$ worth of capital gain at the beginning of the arrangement will produce 3\$ worth of capital loss. The initial beneficiary could be the contributor's spouse to whom he was going to make a gift anyway while the secondary beneficiary could be an offspring, related corporation, partnership, etc. Work out the financial implications and the application of Sec. 75(2) becomes very interesting, especially when one considers that in the above the possible use of the capital interest itself **as the loss producing property** was not developed.

As per Question 32 of the 1988 Roundtable Discussions CRA has provided that when a bare trust exists the settlor/contributor will usually be subject to the application of subsection 75(2) in respect of his beneficial ownership of the trust property so as to cause him to recognize the income/loss etc. from that property as if he held legal title as well however this may cause some difficulties in using bare trusts in commercial or non-commercial settings. First of all it is only Sec. 75(2) that is capable of equating the beneficial ownership of the property with its legal ownership and since the provisions purpose was undoubtedly not to attend to the problems created through the recognition of a bare trust as a separate tax base it should not be a surprise that it does so only incidentally and in at least two instances not at all.

Since Sec. 75(2) doesn't attribute business income where the property is a business it could easily be possible to structure the trust through direct language to carry on business and thus preclude attribution. The manner in which property is used/business carried on must be shown to have a commercial purpose other than the investing of money.¹³⁷⁰

Subsection 75(2) does not apply to attribute income from a business¹³⁷¹ and it doesn't apply to attribute income or loss to a non-resident settlor/contributor who retains beneficial ownership of the property. Since business income can not be attributed under Sec. 75(2) the trust would have to take C.C.A., E.C.E.A. etc, on its subject assets before it pays income to the beneficial owner since he would only be able to recognize a Sec. 104(13) income inclusion in respect of that income, and C.C.A., etc., cannot be taken in respect of a trust interest which as per Sec. 108(5) is the source of the income payment.¹³⁷² In the instance where the bare trustee holds legal ownership of property, in the income attribution sense of the word, then again the beneficial owner will recognize the income from the property under Sec. 75(2), net of C.C.A., E.C.E.A. etc though not expenses incurred by the beneficial owner in respect of the property. Subsection 75(2) applies to attribute income net of the deductions available in computing that source of income as per subdivisions b and c. If it didn't then the use of the terms "**taxable** capital gain" and "**allowable** capital loss" as attribution targets, instead of "capital gain" or "capital loss" would be an incorrect use of terminology. The provision attributes income from the sources as computed using subdivisions b and c fully. With this in mind then it should be obvious that those deductions available in subdivision b or c will be taken at the trust level while since the income retains its source characteristic as per the operation of the provision the beneficial owner will still be able to deduct expenses, such as interest, that he has incurred at his level.¹³⁷³ Subsection 75(2)

1370 I.R.C. v. Sangster, [1920] 1 K.B. 587, and Fry v. Salisbury House Estate Ltd., (1930) A.C. 432, are illustrative cases where distinctions were analyzed while in the latter Lord Macmillan provided accurate commentary about the statutory distinction of a provision under the Finance Act:

"This clearly contemplates a separate between the two characters of landowner and trader. A landowner may conduct a trade on his premises, but he cannot be represented as carrying on a trade of owning land because he makes an income from letting it."

1371 See Fraser v. The Queen, 91 D.T.C. 5123 FCTD.

1372 It's a question of interest whether when this ancient provision was introduced "property", under the Act, included businesses.

1373 If a partner incurs debt and interest charges personally to finance a partnership asset that will produce income exclusively for him he'll be able to deduct the interest at his level even though the partnership takes the subdivision b deductions at its level exclusively.

doesn't change the character of the income.¹³⁷⁴

Of course if the bare trustee is to carry on a business with the property then it would be better for him to incur the interest/operating expenses at his level, some would say, since Sec. 75(2) will not attribute business income however what will happen if the settlor/beneficiary is realizing/recognizing any and all income that arises anyway as per Sec. 104(13)? In such an instance, where the beneficial owner incurs financing costs outside of the trust, and has a right to all of the income that the trust property generates, will those expenses related to the property not be incurred by him directly so as to produce taxable income? Subsection 108(5) doesn't apply for purposes of Sec. 75(2). They should be deductible against his Sec. 104(13) income recognized.¹³⁷⁵

Perhaps the major weakness in the reliance on Sec. 75(2) to equate beneficial ownership with legal ownership is where non-resident beneficial owners are involved for in such an instance Sec. 75(2) doesn't operate to attribute any type of income and thus the connection is completely severed. In such an instance, again, the beneficial owner may be recognizing Sec. 212(1)(c) withholding tax on the income payments the bare trustee is making to him but Part XIII doesn't compute income per se hence any interest/operating costs the non-resident incurs will have no effect on the Part XIII tax liability, (even though they may cause some degree of equitable deduction under the foreign jurisdiction's tax law). In such an instance it would prove more beneficial, from a Canadian taxation point of view, to have the legal owner incur as much of the expenses as possible so as to reduce the Sec. 212(1)(c) amount of income payable. The treaties however would have to be examined in detail to ascertain appropriate action.¹³⁷⁶ Property subject to a revocable trust regardless of its residence is also fully subject to the Family Law Act equalization payment elections and such could terminate the trust if application for the treatment is made.¹³⁷⁷

Income Tax Interpretation Bulletin

Attribution of Trust Income to Settlor

IT-369R

DATE: March 12, 1990

SUBJECT: INCOME TAX ACT

Attribution of Trust Income to Settlor

REFERENCE: Subsection 75(2) (also section 110.6 and subsections 74.2(2), 75(3), 160(1), 212(12) and 248(5))

Notice to the reader:

- Bulletins do not have the force of law.
- This is an HTML version of the original document. It is also available in other formats, including PDF (which is an exact rendition of the original).

Application

¹³⁷⁴ Some commentators have expressed the opinion that C.C.A. can be deducted only by the party that has incurred the cost of the property and in the case of a transfer of mere legal ownership to a trustee the trustee would not be able to claim C.C.A.. This is true, but if such an arrangement exists then a disposition of the property has not been recognized and thus the original acquiror can still deduct C.C.A.. If beneficial ownership hasn't been severed, for C.C.A. purposes, who conducts the activity, the trust or the taxpayer directing the trustee? If the beneficial owner merely transferred cash to the trustee whereafter the trustee acquired the property the same results since Sec. 75(2) operates fully and the trust can be seen to have a cost of the property instead of the beneficial owner. In either case the C.C.A. and interest expenses etc. can be deducted at one level or the other.

¹³⁷⁵ This is not the case when someone else is to realize the income since technically neither the trust nor the beneficial owner has incurred the expenses to earn taxable income.

¹³⁷⁶ If a Canadian resident sets up a non-resident trust with cash and the trustees create a Canadian resident trust under which the Canadian resident contributor has a power of appointment the Canadian resident trust will be subject to Sec. 75(2) in respect of the contributor since it has received property indirectly from the contributor.

¹³⁷⁷ *Porter v. Porter*, 1986 1 R.F.L. (3d) 12, is an instance where a seemingly revocable trust was found not to be revocable.

This bulletin replaces and cancels Interpretation Bulletin IT-369 issued on April 4, 1977. Current revisions are designated by vertical lines.

Summary

This bulletin deals with a trust (other than those referred to in 2 below) the terms of which are such that the trust's property may revert to the person from whom the property was directly or indirectly received, or a certain degree of control of that property rests with that person (see 3 below).

The commentary below discusses situations in which the trust's income or loss from property (but not from a business), or its taxable capital gain or allowable capital loss from the disposition of property, is included in the income of the person from whom the trust directly or indirectly received the property, provided that the person is living and resident in Canada.

Discussion and Interpretation

1. The provisions of subsection 75(2) may apply where property is held under any trust established since 1934, other than those trusts referred to in 2 below. Unlike (for example) section 74.3, the application of subsection 75(2) does not depend upon a "loan" or "transfer" of property but upon the fact that property is "held" by the trust under one or more of the conditions described in 3(a), (b) and (c) below. The application of subsection 75(2) results in certain amounts, derived from the property held by the trust, being attributed to the person from whom the property was directly or indirectly received. Its application ends if the person dies or ceases to be resident in Canada.

2. Subsection 75(2) does not apply where the particular property is held by trusts listed in subsection 75(3). These include

- (a) trusts governed by certain deferred income plans,
- (b) employee trusts,
- (c) related segregated fund trusts,
- (d) vacation pay trusts,
- (e) non-resident trusts in certain circumstances, and
- (f) prescribed trusts.

With respect to 2(f), there are no prescribed trusts as of the date of publication of this bulletin.

3. The "property" referred to in subsection 75(2) includes "substituted property", as defined by subsection 248(5). Any income or loss from the property, as well as any taxable capital gain or allowable capital loss from the disposition of it, is attributed to the person from whom the property was directly or indirectly received if the terms of the trust are such that the property

- (a) may revert to that person,
- (b) may be distributed to beneficiaries determined by that person at a time after the trust was created, or
- (c) may only be disposed of with the consent of, or at the direction of, that person while alive.

Subsection 75(2) may apply to any income from, or any gain or loss from the disposition of, property received from a person who, by the exercise of a power of appointment, may determine the beneficiaries to whom that property may pass. It may also apply where the property may revert to the person from whom it was received as a consequence of the death of the last of all other beneficiaries under the trust. After September 30, 1983 and before 1987, its application was extended to attribute to a person any capital gain or capital loss realized by a trust from an indexed security investment plan, to the extent that the gain or loss can reasonably be considered to be derived from property received from that person.

4. Although any income, gain and loss in respect of property received from a person is attributed by subsection 75(2) to that person only during a period when that person is resident in Canada, the application of the attribution rules does not depend upon the person having been resident in Canada at the time the property was received by the trust.

5. In applying subsection 75(2), it is necessary to distinguish between income or loss from property and income or loss from a business. The subsection does not apply to attribute business income or losses even if the business operates with some or all of the property received from the particular taxpayer.

6. Any income or loss derived from the investment or other use of the earnings from property (or property substituted therefor) received from a person is not attributed to that person. For example, if the property received from a person is money which is deposited by the trust into a bank account, the interest on the

initial deposit will attribute to that person but interest on the interest left to accumulate in the bank account will not attribute.

7. Any non-business income or loss derived from the investment or other use of proceeds of disposition of a property (or a property substituted therefor) received from a person will attribute to that person. For example, if the property received from a person is a building which is subsequently disposed of for \$100,000, yielding a taxable capital gain of \$20,000, not only will the taxable capital gain attribute to that person but also so attributable will be any non-business income earned on the \$100,000 proceeds.

8. With respect to the \$20,000 taxable capital gain referred to in 7 above, as there is no provision similar to subsection 74.2(2) affecting subsection 75(2), taxable capital gains attributed to a person under subsection 75(2) are not eligible for the capital gains deduction under section 110.6. For a further discussion on the attribution of taxable capital gains, refer to the current version of IT-511 "Interspousal Transfers and Loans of Property made after May 22, 1985".

9. Subsection 75(2) refers to a "person", which is defined by subsection 248(1) to include a "corporation". Although the lifetime of a corporation is indeterminate, the Department's view is that this fact would not preclude the attribution of trust income to a corporation in circumstances where subsection 75(2) would otherwise apply.

10. Subsection 212(12) provides that where an amount is attributed to a person under subsection 75(2) on account of an amount paid or credited to a non-resident, no Part XIII tax is payable upon that amount. Similarly, the Department considers that an amount which has been attributed to a person under subsection 75(2) is normally to be excluded from the income of a resident beneficiary to whom it was paid or payable in the year, and from the income of the trust where it was not paid or payable to the resident beneficiary.

11. Generally, it is the settlor who transfers property to a trust described in subsection 75(2) and to whom the income therefrom is attributed. Nevertheless, it is the Department's view that a person other than the settlor may transfer property to a trust under one or more of the conditions described in 3(a) to (c) above and become subject to the attribution rules of the subsection.

12. Since a transfer to a trust described in 75(2) is often not at arm's length, certain of the arrangements to which subsection 75(2) applies may result in subsection 160(1) applying to both the trust and the person from whom property was received. Where subsection 160(1) applies to a subsection 75(2) situation, the transferor and transferee are jointly and severally liable to pay

a) that part of the transferor's Part I tax, for each taxation year, that is attributable to the subsection 75(2) attribution, and

(b) an amount equal to the lesser of

(i) the transferor's tax liability for the year in which the property was transferred and for any preceding year, and

(ii) the amount by which the fair market value of the transferred property exceeds the fair market value of the consideration given therefor.

Income Tax Interpretation Bulletin

S.R. Attribution of Trust Income to Settlor (Revision to it369r dated March 12, 1990)

IT-369RSR

DATE: June 24, 1994

SUBJECT: INCOME TAX ACT

S.R. Attribution of Trust Income to Settlor (Revision to it369r dated March 12, 1990)

REFERENCE: SPECIAL RELEASE

APPLICATION

The purpose of this Special Release is to revise Interpretation Bulletin IT-369R dated March 12, 1990, to reflect the amendments to the Income Tax Act resulting from S.C. 1991, c. 49 (formerly Bill C-18). Other changes have also been made for clarification purposes. The comments in the bulletin are not affected by proposed amendments to the Income Tax Act contained in Bill C-27, which received first reading in the House of Commons on May 5, 1994.

The changes to the bulletin given below reflect the stylistic and structural changes contained in the Income Tax Act as revised by the 5th Supplement to the Revised Statutes of Canada, 1985, which came into force on March 1, 1994. This Special Release does not, however, change other paragraphs of the bulletin that may be affected solely by the 5th supplement revisions. All such changes will be incorporated into the next full revision of the bulletin.

BULLETIN REVISIONS

1. Paragraph 1 of the bulletin is cancelled and replaced by the following new paragraph. A discussion has been added on the implications, in relation to subsection 75(2), of a genuine loan made to a trust under certain circumstances.

1. The provisions of subsection 75(2) may apply where property is held under any trust established since 1934, other than those trusts referred to in 2 below. Unlike (for example) section 74.3, the application of subsection 75(2) does not depend upon a "loan" or "transfer" of property, but upon the fact that property is "held" by the trust under one or more of the conditions described in 3(a), (b) and (c) below. A genuine loan to a trust would not by itself be considered to result in property being "held" by the trust under one or more of these conditions (i.e., would not by itself result in the application of subsection 75(2)), if the loan is outside and independent of the terms of the trust. For a discussion on when a loan can be considered genuine, see the current version of IT-258, Transfer of Property to a Spouse and IT-260, Transfer of Property to a Minor. Where subsection 75(2) applies, certain amounts derived from property held by the trust are attributed to the person from whom the property was directly or indirectly received. Subsection 75(2) ceases to apply if the person dies or ceases to be resident in Canada.

2. The last sentence of paragraph 3 of the bulletin is cancelled because it has no current relevance.

3. Paragraph 8 of the bulletin is cancelled and replaced by the following, in order to reflect the amendment to subsection 74.2(2) in S.C. 1991, c. 49. This amendment was effective for the 1987 and subsequent taxation years.

8. For purposes of the capital gains deduction under section 110.6, any taxable capital gain or allowable capital loss attributed to a person in a taxation year pursuant to subsection 75(2) is deemed, by virtue of subsection 74.2(2), to have arisen from the disposition by that person, in that year, of the property on which the gain or loss was realized. Consequently, a taxable capital gain attributed to a person under subsection 75(2) is eligible for the capital gains deduction to the same extent and in the same manner as if the gain had been realized directly by that person.

Note: The Federal Budget released by the Minister of Finance on February 22, 1994 proposes to eliminate the \$100,000 capital gains deduction for gains realized on dispositions of property occurring after February 22, 1994 and for gains brought into income after 1994 by the capital gains reserve mechanism. The Budget further proposes that individuals (other than trusts) and certain personal trusts and partnerships could elect to crystallize accrued gains in order to use any portion of the \$100,000 capital gains deduction available under the law. For more information on these proposed changes, reference should be made to budget documents.

4. Part (ii) of paragraph 12(b) of the bulletin is cancelled and replaced by the following. This revision clarifies that the fair market values referred to are the ones at the time the property is transferred (as indicated in subparagraph 160(1)(e)(i)).

(ii) the amount by which the fair market value of the property, at the time it was transferred, exceeds the fair market value, at that time, of the consideration given for the property.

If you have any comments regarding the matters discussed in this release, please send them to:

Director, Technical Publications Division
Legislative and Intergovernmental Affairs Branch
Revenue Canada - Customs, Excise and Taxation
875 Heron Road
Ottawa, Ontario, K1A 0L8

Transfer of funds to trusts with minor beneficiaries.

ATR-80

March 19, 1979

Facts

1. Mr. and Mrs. X have three children; A aged 2, B aged 4 and C aged 6.
2. Mr. X proposes to establish three separate trusts, one for the benefit of each of the above-named children and to transfer to the trusts certain funds.
3. The essential terms of each trust will be as follows:
 - (a) the capital and income of the trust will be held and invested until the child attains the age of 20 years at which time the sum of \$.... will be distributed to him or her; the remaining income and capital of the trust will be retained and invested until the child attains the age of 25 years at which time the entire balance of the trust fund will be distributed to the child;
 - (b) if the child dies before attaining age 25 years, the fund will be held for the benefit of the child's children, if any, in equal shares;
 - (c) if the child dies before attaining age 25 years and leaves no surviving children, the trust fund shall be held for any surviving children of Mr. X in equal shares;
 - (d) the trustee will also have the discretion to encroach on the trust fund at any time in order to provide for the maintenance, education or general advancement of any beneficiary;
 - (e) the trustee will also have the discretion to encroach on the trust fund for purposes of assisting any beneficiary to undertake a profession or business, or to purchase a place of residence for his or her own occupation;
 - (f) in the event that all of Mr. X's children die before attaining age 25 leaving no surviving children, the property of each trust would be delivered to Mrs. X if she was then alive;
 - (g) in the event that Mrs. X was not alive at the time of death of the last child to die, the property of each trust would be divided equally between two charities.
4. Mr. and Mrs. X will act as co-trustees of each trust.
5. In the event of the death of either co-trustee, the survivor will be entitled to act as sole trustee.

Proposed Transaction:

6. Mr. X proposes to settle the sum of \$.... on each trust forthwith and to make additional contributions to each trust from time to time.

Rulings Requested

The applicants request a ruling that:

7. The provisions of subsection 75(2) of the *Income Tax Act* will have no application to any property settled on the proposed trusts by Mr. X;
8. Any income or loss from the said property or any gain or loss from its disposition realized after the beneficiary owner thereof attains the age of 18 years, will not be attributed to the settlor for the purposes of the *Income Tax Act*;
9. Each of the proposed trusts will be deemed to be a separate individual for purposes of the *Income Tax Act* and subsection 104(2) of that Act will not apply to deem Mr. X to be an individual whose property of all three trusts and whose income is the income of all three trusts.

Rulings Given

10. Provided our understanding of the above-mentioned facts is correct, we confirm your rulings as requested.
11. This ruling is given subject to the general limitations and qualifications set forth in Information Circular No. 70-6R, dated December 18, 1978, issued by the Department of National Revenue, Taxation, and is binding provided the proposed transactions are completed prior to [.....]
Income Tax Rulings are published for the general information of taxpayers, but are considered to be binding on the Department only in respect of the taxpayer, to whom the ruling was given.

Taxable Capital Gains.

The General Situation.

Upon a disposition of capital property a trust will be required to compute its taxable capital gain if any as per the rules in subdivision C while it will also be able to avail itself of the deferred recognition method offered in Sec. 40(1)(a)(iii) hence it will not have to recognize the entire taxable capital gain in the year of disposition where the total amount of proceeds may not be realizable for some time.

A trust may also designate as having been realized by a beneficiary who recognized trust income under Sec. 104(13), (14), or section 105 a part of its "net taxable capital gain" for the year, as being part of the four basic income inclusions providing

- the trust was resident in Canada throughout its tax year,
- where the beneficiary was also resident in Canada in its tax year in which the disposition was recognized by the trust¹³⁷⁸ and
- where the amount was not designated in respect of another beneficiary, and
- providing that the amount can reasonably be considered to be part of the beneficiary's income inclusion in respect of the four trust income inclusion provisions having regard to all of the circumstances including, but not limited to, the trust terms and conditions.

The *raison d'être* of the taxable capital gain designation is to allow the beneficiaries who are, or will eventually be, entitled to receive the capital or its increase in value realized, to have their tax rates applied to the realized economic benefit and not the trust's, as well as allowing them to negate the t.c.g. inclusion with allowable capital losses, net capital losses, or **to a limited degree**, their capital gain exemption at their level while if the designation wasn't made the economic benefit realized by them in the year, or ultimately, will not receive the equitable treatment afforded it if the beneficiary had held the property personally and disposed of it.

The first requirement to be satisfied in order that the designation may be made is that the trust must be resident in Canada **throughout** its tax year thus it is no longer possible to have the beneficiaries absorb the tax consequences that may apply when Sec. 128.1 causes deemed dispositions upon the trust ceasing to be resident in Canada, **however**, if the trustees transfer the property to a foreign resident trust especially set up by the beneficiaries, receive cash therefrom as consideration, recognize the gains, roll the cash out to the uppermost parties then wind up, it will be able to make the designations, while at the same time the beneficiaries under the initial trust will also be beneficially interested in the non-resident trust, and thus nothing but residency would have changed.¹³⁷⁹

The beneficiary need not have been resident throughout its tax year in which the trust's year ends: all that must occur is that the amount must have been recognized by the beneficiary under Sec. 104(13)-(14)-105(1)-(2) and such inclusions are recognizable, in the case of testamentary trusts in the beneficiary's tax year in which the trust's tax year ends. If the beneficiary becomes resident half way through his tax year and recognizes, in the latter half, a Sec. 104(13) inclusion due to an amount becoming payable after that time the Sec. 104(21) designation can be made in respect of it. The ultimate test is obviously when the right to the gain became enforceable by the beneficiary and his residency at that time.¹³⁸⁰

The amount designatable as well as being limited to the trust's "net taxable capital gains" for the year, must be reasonably considered to be part of the Sec. 104(13), (14) or section 105 income inclusion that the designatee recognized in the year¹³⁸¹ having regard to all of the circumstances including the trust terms and arrangement conditions. If the beneficiary does not have the ability in the year to enforce a distribution of trust law income (or capital appreciation realizations) then unless tax law income is actually paid to him he will not

¹³⁷⁸ in the case of non-mutual fund trusts

¹³⁷⁹ Understandably one would not want to do this where the trust is bloated with taxable Canadian property since the deemed dispositions would not occur under Sec. 128.1(1), while the resident trust need not be wound up...

¹³⁸⁰ This was the gist of a Technical Interpretation provided in August 1990 by the F.I.D..

¹³⁸¹ the same tax year in which the testamentary trust's tax year ends

recognize a Sec. 104(13) inclusion while the preferred beneficiary election may also not be available to him due to a variety of reasons due to the restrictiveness of the Sec. 104(15) rules or their application. If the designation is to be made in respect of a Sec. 105(2) upkeep benefit inclusion the capital consisting of the net taxable capital gain portion must be paid out in the year since that provision only applies to income and the capital gain represents income in that instance only during the year. An unvaried spousal trust will have as its sole income beneficiary the spouse hence a designation can be made only in respect of her however if the trust is varied so as to allow other income rights the designation process can be extended over more beneficiaries allowing possible utilization of more allowable capital losses, net capital losses, or capital gains deductions. If the spouse under the spousal trust hasn't a right to the capital of the trust a Sec. 104(21) designation can be made in respect of her on the basis of a preferred beneficiary election inclusion, even though she has realized income from the trust with another source.¹³⁸² A power of appointment, general or special, may also be used to entitle a particular beneficiary to the gain proceeds, as well as a power of advancement, while the important note to be made is that the beneficiary must have recognized the t.c.g. inclusion under Sec. 104(13), (14), 105(1) or (2) in the year. As per income/capital integration subsection 53(2)(h) precludes a capital interest ACB adjustment if the amount distributed at a later date was previously included in the income under **Sec. 104(13)** of the **particular** beneficiary or if the amount was equal to 1/3 of the "net taxable capital gain" designated in respect of the **particular** beneficiary (which equates to the "1/4" non taxable capital gain portion), however the deficiencies here should be obvious being that if a designation is made in respect of a Sec. 104(14) preferred beneficiary election, a subsequent distribution **will cause** an ACB adjustment.¹³⁸³ In fact the non-taxable portion of the gain **will not** produce an ACB adjustment but the taxable portion will since it wasn't included via Sec. 104(13) in computing the beneficiary's income.

"Taxable capital gains – Sec. 104(21)"

(21) Such portion of the net taxable capital gains of a trust for a taxation year throughout which it was resident in Canada as

(a) may reasonably be considered (having regard to all the circumstances including the terms and conditions of the trust arrangement) to be part of the amount that, by virtue of subsection 104(13) or 104(14) or section 105, as the case may be, was included in computing the income for the taxation year of

(i) a particular beneficiary under the trust, if the trust is a mutual fund trust, or

(ii) a particular beneficiary under the trust who is resident in Canada, if the trust is not

¹³⁸² Subparagraph 104(15) allows the spouse to have a share of the accumulating income of the trust equal to all of it if it's a spousal or previously spousal trust and the fact that she will never realize the gain does not prevent the Sec. 104(21) designation from being made. In some instances however the Sec. 104(4)(a) trust characteristics will not exist and the P.B.E. flexibility will be limited under Sec. 104(15)(b)-(d). If this is the case she may be able to acquire the right to the capital gain from another beneficiary who otherwise cannot immediately realize the proceeds due to the spousal trust characteristics, and have the capital distributed to her. This would be possible where the trust deed does not prevent a distribution of capital to the trust in the case where she has acquired a right to capital: (a feature included with foresight to achieve flexibility), or where the trust deed can be varied before the end of the trust's tax year to allow the amount to be distributed. Even if the previous is not possible the trustees can simply distribute the sums and the capital gain will constitute income "paid" within the context of Sec. 104(13), even though the beneficiaries have a right, though they will not exercise it, to have the sum retained in the trust to possibly generate an enrichment in respect of their interests until it is otherwise to be distributed. In some situations the acquisition of such an interest will only be possible where it is a severable interest, (is specifically based on the property and is not in the form of a residuary entitlement) and due to Sec. 107(1)(a) capital gains need not be generated due to the cost assimilations provided for. If so then the former beneficiary may have to rely on his capital gains deduction or loss carryforward position, which would otherwise be the case if he had realized the property and disposed of it. Rarely however will the capital gain the former beneficiary recognizes on the interest disposition equal that inherent in the property disposed of, usually due to other trust property holdings however the alternative is to have the trust absorb the capital gain, as income, at its rates.

¹³⁸³ A.c.b. adjustments will not occur if the trust isn't a specified commercial trust or if it's a personal trust and the capital interest was not acquired for consideration payable.

a mutual fund trust, and

(b) was not designated by the trust in respect of any other beneficiary under the trust,

shall, if so designated by the trust in respect of the particular beneficiary in the return of its income for the year under this Part, be deemed, for the purposes of sections 3 and 111, except as they apply for the purpose of section 110.6, and subject to paragraph 132(5.1)(b), to be a taxable capital gain for the year of the particular beneficiary from the disposition by that beneficiary of capital property.¹³⁸⁴

1384 July 2010 FINANCE TECHNICAL NOTES (Part 1 - technical): Subsection 104(21) permits a trust to designate, in respect of a beneficiary under the trust, a portion of its net taxable capital gains. Where the designation is made, the amount designated is deemed, for the purposes of sections 3 and 111 (except as they apply for the purposes of determining whether a beneficiary is entitled to claim a capital gains exemption under section 110.6 and subject to paragraph 132(5.1)(b)), to be a taxable capital gain for the year of the beneficiary from the disposition of capital property.

Subsection 104(21) is amended to clarify that where a designation, in respect of a taxpayer, is made by a trust in respect of its net taxable capital gains for a particular taxation year of the trust, the designated amount is deemed to be a taxable capital gain, for the taxation year of the taxpayer in which the particular taxation year ends, from the disposition by the taxpayer of capital property.

The deeming rule does not apply, however, unless a number of conditions are met. One of these conditions— that a designated amount not be made in respect of more than one beneficiary under the trust — is replaced with a new requirement that the total amounts designated under subsection 104(21) by the trust for a particular taxation year of the trust not exceed the trust's net taxable capital gains for the particular taxation year.

The deeming rule under subsection 104(21) applies, in respect of a beneficiary under a trust, only to the portion of the net taxable gains of the trust that may reasonably be considered (having regard to all the circumstances including the terms and conditions of the trust arrangement) to be part of the amount that, by reason of subsection 104(13) or 104(14) or section 105, as the case may be, was included in computing the income of a beneficiary under the trust. This condition is also amended and now provides that an amount, in respect of the trust's net taxable capital gains, is deemed to be a taxable capital gain from the disposition by a taxpayer of capital property only if the amount may reasonably be considered (having regard to all the circumstances including the terms and conditions of the trust) to be part of the amount that, because of paragraph 104(13)(a) or subsection 104(14) or section 105, was included in computing the income of that taxpayer (i.e., the taxpayer in respect of whom the amount is designated).

The amended reference in the above rule to paragraph 104(13)(a), instead of subsection 104(13), applies to taxation years that end after July 18, 2005. This change clarifies that the deeming rule does not apply to employee benefit plan trusts and ensures consistency with amended subsection 104(19). For taxation years that end after February 27, 2004 and on or before July 18, 2005, the referenced provision is subsection 104(13).

Subsection 104(21) is also amended to clarify that the deeming rule does not apply to a designation made by a trust, for a particular taxation year of the trust, in respect of a non-resident beneficiary, unless the trust is a mutual fund trust throughout the particular taxation year.

Except as provided above, these amendments apply to taxation years that end after February 27, 2004. Nov. 9, 2005 Dept. of Finance letter: See under 131(6) capital gains dividend account".

Dec. 2004 FINANCE TECHNICAL NOTES (budget): Subsection 104(21) permits a trust to designate, in respect of a beneficiary under the trust, a portion of its net taxable capital gains. Where the designation is made, the amount designated is deemed, for the purposes of sections 3 and 111 (except as they apply for the purposes of determining whether a beneficiary is entitled to claim a capital gains exemption under 110.6), to be a taxable capital gain for the year of the beneficiary from the disposition of capital property.

Subsection 104(21) is amended as a consequence of the addition of new subsection 132(5.1) to ensure that the designation is subject to new paragraph 132(5.1)(b). Paragraph 132(54)(b) provides that if a mutual fund trust designates an amount under subsection 104(21) for a taxation year of the trust in respect of a trust beneficiary who is a non-resident person or a partnership that is not a Canadian partnership, for the purposes of Part I and Part XIII, the amount designated is deemed by subsection 104(21) to be a taxable capital gain of the beneficiary only to the extent that it exceeds the amount of the TCP gains distribution. In addition, one-half of the TCP gains distribution is to be added to the amount otherwise included under subsection 104(13) in computing the income of the beneficiary, and is deemed to be an amount to which paragraph 212(1)(c) applies.

1988 FINANCE TECHNICAL NOTES: See under 104(19)—(22).

Nov. 1985 FINANCE TECHNICAL NOTES: Subsection 104(21) permits a trust to designate a portion of its taxable capital gains for a taxation year as a beneficiary's taxable capital gain for the year from the disposition of a capital property for the purposes of sections 3 and 111. This paragraph is amended by adding a reference to the trust's net taxable capital gains. A trust's "net taxable capital gains" for a taxation year is defined in new subsection 104(21.3) and as defined does not represent a substantive change in those taxable capital gains of a trust to which subsection 104(21) applies. Subsection 104(21) is also being amended to provide that a designation thereunder does not apply for the purposes of determining whether a beneficiary is entitled to claim a capital gains exemption under new section 110.6 in respect of his portion of the trust's net taxable capital gains as the result of such designation.

“Late, amended or revoked designation – Sec. 104(21.01)”

(21.01) A trust that has filed its return of income for its taxation year that includes February 22, 1994 may subsequently designate an amount under subsection 104(21), or amend or revoke a designation made under that subsection where the designation, amendment or revocation

(a) is made solely because of an increase or decrease in the net taxable capital gains of the trust for the year that results from an election or revocation to which subsection 110.6(25), 110.6(26) or 110.6(27) applies; and

(b) is filed with the Minister, with an amended return of income for the year, when the election or revocation referred to in paragraph 104(21.01)(a) is filed with the Minister.

“Late, amended or revoked designation – Sec. 104(21.02)”

(21.02) A designation, amendment or revocation under subsection 104(21.01) that affects an amount determined in respect of a beneficiary under subsection 104(21.2) may be made only where the trust

(a) designates an amount, or amends or revokes a designation made, under subsection 104(21.2) in respect of the beneficiary; and

(b) files the designation, amendment or revocation referred to in paragraph 104(21.02)(a) with the Minister when required by paragraph 104(21.01)(b).

“Late, amended or revoked designation – Sec. 104(21.03)”

(21.03) Where a trust designates an amount, or amends or revokes a designation, under subsection 104(21) or 104(21.2) in accordance with subsection 104(21.01),

(a) the designation or amended designation, as the case may be, is deemed to have been made in the trust’s return of income for the trust’s taxation year that includes February 22, 1994; and

(b) the designation that was revoked is deemed, other than for the purposes of this subsection and subsections 104(21.01) and 104(21.02), never to have been made.

1983 FINANCE TECHNICAL NOTES: Subsection 104(21) enables a trust to designate a portion of its capital gain to be a beneficiary's capital gain. The aggregate amount designated in a particular taxation year cannot exceed the trust's taxable capital gains net of its allowable capital losses for the year and any amount deductible under paragraph 111(l)(b) in respect of a net capital loss carryover.

Under section 111 as amended, a taxpayer is no longer required to claim a net capital loss carryover in the earliest year in which it may be deducted but instead may preserve the loss to be carried forward to later years in the carryover period. The amendment to subparagraph 104(21)(a)(ii) is strictly consequential on this greater flexibility with respect to the application of loss carryovers. It changes the existing reference to amounts "deductible" under paragraph 111(l)(b) to a reference to amounts "deducted" under that paragraph.

1976 FINANCE NOTICE OF WAYS AND MEANS MOTION: That withholding tax not be exigible on taxable capital gains designated by a mutual fund trust in respect of a non-resident beneficiary under the trust subject to rules for designation similar to those in subsection 104(21) of the Act.

“Beneficiary’s taxable capital gain – Sec. 104(21.1)”

(21.1) Notwithstanding subsection 10(21) or section 38, where in a particular taxation year, commencing before 1990, of a taxpayer (other than an individual who is not a testamentary trust) the taxpayer is a beneficiary of a trust with a taxation year ending in the particular year, the amount (other than that part of the amount that can be attributed to an amount deemed under subsection 14(1) to be a taxable capital gain of the trust) deemed by subsection 104(21) to be a taxable capital gain of the taxpayer for the particular year in respect of the trust shall be the amount determined by the formula

A × B/C where

A is the amount, if any, by which the amount (other than that part of the amount that can be attributed to an amount deemed under subsection 14(1) to be a taxable capital gain of the trust) deemed by subsection 104(21) to be the taxpayer’s taxable capital gain for the particular year in respect of the trust exceeds the amount (other than that part of the amount that can be attributed to an amount deemed under subsection 14(1) to be a taxable capital gain of the trust) designated by the trust for the particular year in respect of the taxpayer under subsection 104(13.2);

B is the fraction that would be used under section 38 for the particular year in respect of the taxpayer if the taxpayer had a capital gain for the particular year; and

C is the fraction that is used under section 38 for the year of the trust.

“Taxable capital gain – Sec. 104(21.2)”

(21.2) Where, for the purposes of subsection (21), a personal trust or a trust referred to in subsection 7(2) designates an amount in respect of a beneficiary in respect of its net taxable capital gains for a taxation year (in this subsection referred to as the “designation year”),

(a) the trust shall in its return of income under this Part for the designation year designate an amount in respect of its eligible taxable capital gains, if any, for the designation year in respect of the beneficiary equal to the amount determined in respect of the beneficiary under each of subparagraphs 104(21.2)(b)(i) and 104(21.2)(b)(ii); and

(b) the beneficiary is, for the purposes of sections 3, 74.3 and 111 as they apply for the purposes of section 110.6,

(i) deemed to have disposed of the capital property referred to in clause (ii)(A), (B) or (C) if a taxable capital gain is determined in respect of the beneficiary for the beneficiary’s taxation year in which the designation year ends under those clauses, and

(ii) deemed to have a taxable capital gain for the beneficiary’s taxation year in which the designation year ends

(A) from a disposition of a capital property that is qualified farm property (as defined for the purpose of section 110.6) of the beneficiary equal to the amount determined by the formula

$$(A \times B \times C)/(D \times E)$$

(B) from a disposition of a capital property that is a qualified small business corporation share (as defined for the purpose of section 110.6) of the beneficiary equal to the amount determined by the formula

$$(A \times B \times F)/(D \times E) \text{ and}$$

(C) from a disposition of a capital property that is a qualified fishing property (as defined for the purpose of section 110.6) of the beneficiary equal to the amount determined by the formula

$$(A \times B \times I)/(D \times E) \text{ where}$$

A is the lesser of

(I) the amount determined by the formula

G – H where

G is the total of amounts designated under subsection (21) for the designation year by the trust, and

H is the total of amounts designated under subsection (13.2) for the designation year by the trust, and

(II) the trust's eligible taxable capital gains for the designation year,

B is the amount, if any, by which the amount designated under subsection (21) for the designation year by the trust in respect of the beneficiary exceeds the amount designated under subsection (13.2) for the year by the trust in respect of the beneficiary for the taxation year,

C is the amount, if any, that would be determined under paragraph 3(b) for the designation year in respect of the trust's capital gains and capital losses if the only properties referred to in that paragraph were qualified farm properties of the trust disposed of by it after 1984,

D is the total of all amounts each of which is the amount determined for B for the designation year in respect of a beneficiary under the trust,

E is the total of the amounts determined for C, F and I for the designation year in respect of the beneficiary,

F is the amount, if any, that would be determined under paragraph 3(b) for the designation year in respect of the trust's capital gains and capital losses if the only properties referred to in that paragraph were qualified small business corporation shares of the trust, other than qualified farm property, disposed of by it after June 17, 1987, and

I is the amount, if any, that would be determined under paragraph 3(b) for the designation year in respect of the trust's capital gains and capital losses if the only properties referred to in that paragraph were qualified fishing properties of the trust disposed of by it on or after May 2, 2006, and for the purposes of section 110.6, those capital properties shall be deemed to have been disposed of by the beneficiary in that taxation year of the beneficiary.

"Capital gains of trust determined – Sec. 104(21.3)"

(21.3) For the purposes of this section, the net taxable capital gains of a trust for a taxation year is the amount, if any, by which the total of exceeds the total of

(a) its allowable capital losses for the year, and

(b) the amount, if any, deducted under paragraph 111(1)(b) in computing its taxable income for the year.

Certain Problems with The General Mechanics vis-a-vis Trust Law Entitlements.

The subsection 104(21) provision provides that such "net taxable capital gains" of the trust for the year that were effectively "designated out" to the beneficiary in the trust's T.3 for the year shall be deemed for purposes of section 3 and 111, but not for section 110.6, to be a taxable capital gain of the beneficiary for the year of the particular beneficiary from the disposition of capital property by him, while Sec. 104(21.3) provides that "net taxable capital gains" for this purpose are the excess of the trust's taxable capital gains for the year over the trust's allowable capital losses for the year **and** the amount of net capital loss deduction taken by the trust in the year in computing its Part I taxable income. If the trust has net capital losses booked it would be far more beneficial, **if possible** taking into account the relevant statutory limitations therein, to fine tune the beneficiary's income recognition under Sec. 104(13.2), to absorb the net capital loss rather than allow him to recognize income and designate in respect of it, especially if all of the possible capital beneficiaries themselves have booked net capital losses, and the trust is, or will be shortly, winding-up.

If capital beneficiaries' entitlements are referenced to specific property and a capital loss is recognized on one disposition it would be favorable in the same year to dispose of another beneficiary's entitlement base with absorbing accrued capital gain so that the latter would benefit from the former's demise however this will only occur if the trustees do not maintain running historic accounts of each beneficiary's capital gains and losses, or if the gaining beneficiary pays some sort of consideration to the "losing" beneficiary for the use of the negating effect of the capital loss. Capital beneficiary-trustee agreements may be instituted so as to allow for this however if they are not, then equity could cause the trustee to retain the net capital loss balance for the exclusive use of the beneficiary to whose demise it occurred. If dispositions of property with **equal** amounts of capital gain and loss occur in the year then the capital gain entitled beneficiary may not recognize "income", under the initial three beneficiary income inclusions, by virtue of the fact that there isn't any "income" to recognize however if the capital gain amount is distributed out to him¹³⁸⁵ then he will not be taxed on the amount under either Sec. 105(1) nor 53(2)(h). The basis of the designation is the net taxable capital gain **of the trust not in respect of the beneficiary** in respect of which a designation is wished to be made. This may cause problems: a loss recognized must be done so in the particular year in which the disposition occurred and net capital losses described in Sec. 111(8)(a) are based on the net amount of **both** Sec. 3(b)(ii) and 3(b)(i) allowable capital losses and taxable capital gains. A loss recognized will reduce the recognizable taxable capital gain of the trust so as to reduce the beneficiary's tax exposure via a Sec. 104(13)-(14)-105 inclusion though the "loss" beneficiary will not benefit from the loss sustained. An appropriation to separate testamentary trusts in this instance may be appropriate while in the case of *inter vivos* trusts equitable accounting would have to occur so as to compensate the "loss" beneficiary for the lost tax benefit while disallowing the "gain"

¹³⁸⁵ and the capital interest in the personal trust he has wasn't purchased

beneficiary from being unjustly enriched at the demise of the "loss" beneficiary: the tax rules don't provide for such.¹³⁸⁶

If some of the property producing a capital loss in the year were held on condition that it satisfy one of the attribution conditions in Sec. 75(2) the capital loss would be attributable out to the contributor without it being precluded from recognition by the trust hence although it would possibly negate the ability of the trust to make designations in respect of capital beneficiaries who have "gained" at least two particular beneficiaries would gain from the loss **effectively** attributed out through the accounting **and** through the tax rules.

Since the amount subject to the designation is a **net** taxable capital gain, having already been computed as per the subdivision C rules, even when the trust cannot realize the full proceeds from the disposition in the current period the beneficiary designatee will not be able to avail himself of the Sec. 40(1)(a)(iii) capital gain reserve but the trust will have to take it at its level.

It should be recognized that only the trust's "net taxable capital gains" can be "designated out" to the beneficiaries and as per the definition thereof in Sec. 104(21.3) taxable net gains from the disposition of listed personal property will not be included thus gains therefrom will have their character trapped in the trust. Subparagraph 54(e) provides a definition of l.p.p., and obviously, if the gains are manageable, l.p.p. being transferred into a spousal trust should not be treated under Sec. 73(1) or 70(6).¹³⁸⁷

Income Tax Interpretation Bulletin

Trusts -- Capital Gains and Losses and the Flow-Through of Taxable Capital Gains to Beneficiaries
IT-381R3

DATE: February 14, 1997

SUBJECT: INCOME TAX ACT

Trusts -- Capital Gains and Losses and the Flow-Through of Taxable Capital Gains to Beneficiaries

REFERENCE: Subsections 104(21), (21.2) and (21.3) (also sections 3, 105, 110.6 and 111; subsections 104(4), (5), (5.3), (6), (7.1), (12), (13), (13.1), (13.2), (14), (18) and (24) and 107(4); the definitions of "accumulating income," "eligible taxable capital gains," "pre-1972 spousal trust," "preferred beneficiary" and "testamentary trust" in subsection 108(1) and the definition of "personal trust" in subsection 248(1); and paragraphs 53(2)(h) and 122(2)(d))

Notice -- Bulletins do not have the force of law

This document is also available for download in PDF format.

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- Application
- Summary

1386 See the recent Aust. case of *Greenhatch* and Commissioner of Taxation [2011] AATA 479 (8 July 2011) where the taxpayer argued that his share of the capital gain off a trust was different from what his trust law entitlement was and that the conduit principle had to be adhered to to look through the trust shell to determine it. Australia has very similar legislation to us on this and should be examined in detail.

1387 Subsection 104(21.1) provides a transitional provision applicable to the changing capital gains inclusion rates, applicable to the tax years starting prior to 1990 of individuals other than testamentary trusts whereby the amount designated by the trust is adjusted on an apportionment basis; that the inclusion rate of the individual for the particular tax year described under section 38, is of, the inclusion rate of the trust for its tax year in which the designation was made, also described under section 38. It should be recognized that this provision applies only to natural individuals and *inter vivos* trusts. The fraction (inclusion rates) referred to in section 38 consists of "2/3" instead of the "3/4" amount where the taxpayer is an individual (or a partnership) but only in respect of tax years ending after 1987 and before 1990 hence the trust designating the n.t.c.g. may have the transitional inclusion rate of "2/3" where its tax year ends before 1990 but the individual beneficiary will have a rate of "3/4" where his tax year ends after the beginning of 1990, thus causing the Sec. 104(21.1) provision to take on the computational structure

Designated n.t.c.g. x "3/4" = designated amount
of trust "2/3" to the beneficiary

The Sec. 104(21.1) provision does not apply to taxable capital gains that could be attributable to the taxpayer in respect of eligible capital property described under Sec. 14(1).

- Discussion and Interpretation
 - Income of a Beneficiary of a Trust (§ 1)
 - Deductions in Computing Income of a Trust (§ 2)
 - Capital Gains of a Trust (§ 3)
 - Flow-through of Taxable Capital Gains to a Beneficiary (§s 4, 5)
 - Capital Gains Deduction Claims by a Beneficiary of a Personal Trust (§s 6-8)
 - Taxation of Trust on Taxable Capital Gains Not Included in Income of Beneficiary (§ 9)
 - Capital Losses (§ 10)
 - Restrictions on Deductions by Spousal Trusts (§s 11-15)
 - Anti-avoidance Rule (§ 16)
 - Double Taxation Relief (§s 17-19)
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Application

This bulletin cancels and replaces Interpretation Bulletin IT-381R2 dated November 29, 1991.

Summary

This bulletin discusses rules for determining a beneficiary's income for tax purposes from a trust as well as the deductions available to the trust for its income distributions and allocations to beneficiaries. The discussion of these rules serves as the background for the main topics of the bulletin, which are the flow-through of net taxable capital gains of a trust to a beneficiary for purposes of determining the income of the beneficiary; and

the designation, to a beneficiary of a personal trust, of eligible taxable capital gains from dispositions of qualified farm property or qualified small business corporation shares, to enable the beneficiary to claim a capital gains deduction.

Related subjects that are covered in the bulletin include

the tax treatment of a trust's taxable capital gains that are not included in the income of a beneficiary;

the tax treatment of a trust's unused capital losses;

restrictions on the deductions with respect to taxable capital gains that may be claimed by spousal trusts; and

rules to prevent double taxation of any income distributions that are not deductible by the trust or that it has chosen not to deduct in full.

The provisions discussed in the bulletin are intended to determine which amounts of income, including taxable capital gains, should be taxed in the hands of a trust and which amounts should be taxed in the hands of its beneficiaries; and

to ensure that the characterization of capital gains flowing from a trust to its beneficiaries is retained for their income reporting purposes and, in the case of beneficiaries of personal trusts, for purposes of their claiming a capital gains deduction.

It should be noted that a discussion of the application of the 21-year deemed realization rule for trusts, as well as related rules, is outside the scope of this bulletin.

Discussion and Interpretation

Income of a Beneficiary of a Trust

¶ 1. The income, for income tax purposes, of a beneficiary of a trust for a particular taxation year may include the following:

(a) the share of an amount included in the income of the trust that is paid or payable to the beneficiary in the year under the terms of the trust, to the extent that it was not included in the beneficiary's income in a previous year (see subsection 104(13) and also subsections 104(18) and (24));

(b) that part of the "accumulating income" of the trust that is designated to the beneficiary in a preferred beneficiary election (see subsection 104(14) and related provisions, including the definitions of "preferred

beneficiary" and "accumulating income" in subsection 108(1); see also the current version of IT-394, *Preferred Beneficiary Election*);

(c) a benefit conferred on the beneficiary resulting from the maintenance, out of income of the trust, of a property for the beneficiary's use (subsection 105(2)); or

(d) any other benefit to the beneficiary in the year from or under the trust, except to the extent that it is otherwise required to be included in the beneficiary's income for the year, or has been deducted under paragraph 53(2)(h) in calculating the adjusted cost base of the beneficiary's interest in the trust, or would be so deducted if paragraph 53(2)(h) applied to the beneficiary's interest in the trust and were read without reference to clause 53(2)(h)(i.1)(B).

(Such other benefits are included in the beneficiary's income under subsection 105(1)).

Deductions in Computing Income of a Trust

¶ 2. As a general rule, amounts included in the income of a trust's beneficiary under subsections 104(13), 104(14) or 105(2) (described in ¶s 1(a) to 1(c) above) are deductible by the trust under subsection 104(6) or 104(12), as applicable, in computing its income. A trust's deduction under subsection 104(12) pertains to that part of the trust's "accumulating income" that is included in a beneficiary's income under a subsection 104(14) preferred beneficiary election. Paragraph 104(6)(b) generally provides for a deduction by a trust of the following amounts:

- an amount included in the income of the trust that is paid or becomes payable to a beneficiary; and
- an amount included in a beneficiary's income under subsection 105(2).

A paragraph 104(6)(b) deduction is available to a trust if one of the other paragraphs in subsection 104(6) does not apply to it (these other paragraphs in subsection 104(6) pertain to certain special types of trusts, e.g., an employee trust or a trust governed by an employee benefit plan). There are certain restrictions on the amounts that a trust may deduct under paragraph 104(6)(b) or subsection 104(12). Restrictions that can apply with respect to capital gains (the main subject of this bulletin) are discussed in ¶s 11 through 16 below. Also, if a trust is entitled to a deduction under paragraph 104(6)(b), it may choose to deduct an amount that is less than the amount of its income distributions. This may be done, for example, to enable the trust to utilize, in a particular year, losses from prior years without affecting the ability of the trust to distribute its income currently. If a trust is precluded from deducting an amount or if a trust chooses to deduct an amount that is less than the amount of its income distributions, designations to prevent double taxation are available as discussed in ¶s 17 to 19 below.

Capital Gains of a Trust

¶ 3. Under trust law, a capital gain realized by a trust is generally considered to be part of the capital of the trust. For income tax purposes, however, a taxable capital gain realized by a trust is included in computing its income. All or part of the amount of a taxable capital gain realized by a trust may, under certain circumstances, be included in the income of one or more of its beneficiaries under one of the provisions discussed in ¶ 1 above (note that, since such an amount included in the income of a beneficiary will also have been included in the trust's income, a corresponding deduction could then be claimed by the trust as discussed in ¶ 2 above).

Any amount of a taxable capital gain realized by a trust that is paid or payable to a beneficiary is included in the beneficiary's income under subsection 104(13) (see ¶ 1(a) above). This could occur, for example, where the terms of the trust allow for an encroachment on the capital of the trust and the trustees determine by written resolution that an amount of a taxable capital gain realized by the trust will be paid or payable to a beneficiary.

Also, although a taxable capital gain may not form part of trust income under trust law, it does enter into the calculation of "accumulating income" (as defined in subsection 108(1) of the *Income Tax Act*) and thus an amount of a taxable capital gain can be included in the income of a preferred beneficiary by means of a subsection 104(14) preferred beneficiary election (see ¶ 1(b) above).

The actions taken by the trustees of the trust that cause an amount of a taxable capital gain to be included in the income of a beneficiary under subsection 104(13) or (14) should not contravene the terms of the trust indenture. Finally, it should be noted that when an amount of a trust's taxable capital gain is included in the

income of a beneficiary under subsection 104(13) or (14), neither of those provisions deems the amount to be a taxable capital gain of the beneficiary (see, instead, the discussion of subsection 104(21) below).

Flow-through of Taxable Capital Gains to a Beneficiary

¶ 4. For the "net taxable capital gains" (see ¶ 5 below) of a trust for a taxation year throughout which it was resident in Canada, provision is made in subsection 104(21) to preserve the character of such gains flowing through the trust to its beneficiaries resident in Canada and, if the trust is a mutual fund trust, to its non-resident beneficiaries. This flow-through of net taxable capital gains applies for purposes of sections 3 and 111 in determining a beneficiary's income for the year and the amounts of losses from other years which the beneficiary may deduct in determining taxable income for the year, but not for purposes of a capital gains deduction in section 110.6 (in the case of a beneficiary of a personal trust, however, see ¶s 6 and 7 below).

¶ 5. A trust that has realized taxable capital gains in a particular taxation year may, within the limits of subsection 104(21), designate in its return of income for the year all or part of the amount of those gains as a taxable capital gain for the year of one or more beneficiaries. An amount designated to a beneficiary under subsection 104(21) must reasonably be considered to be part of the amount included in the beneficiary's income for that year under any of the provisions referred to in ¶ 1 above (see also ¶ 3 above). The total of the amounts designated under subsection 104(21) may not exceed the amount of the trust's "net taxable capital gains" for the year. For this purpose, subsection 104(21.3) provides that the amount of the trust's net taxable capital gains equals the amount (if any) by which the trust's taxable capital gains for the year exceed the total of

(a) its allowable capital losses for the year, and

(b) the amount of net capital losses of other years that are deducted by it in determining its taxable income for the year.

As indicated in ¶ 18 below, the amount of taxable capital gains otherwise included in a beneficiary's income for the year by reason of subsection 104(21) is reduced by any amount designated to the beneficiary for the year under subsection 104(13.2).

Capital Gains Deduction Claims by a Beneficiary of a Personal Trust

¶ 6. If a "personal trust," as defined in subsection 248(1) of the Act, designates to a beneficiary an amount under subsection 104(21) in respect of its **net taxable capital gains** for a taxation year (see ¶s 4 and 5 above), subsection 104(21.2) provides that the trust shall also designate to the beneficiary an amount or amounts in respect of its **eligible taxable capital gains**, if any, for the year. (The calculation of a personal trust's "eligible taxable capital gains" is discussed in ¶ 8 below.) A subsection 104(21.2) designation can occur only if the amount designated to the beneficiary under subsection 104(21) pertains to net taxable capital gains of the trust from the disposition of qualified farm property or qualified small business corporation shares. These are the two types of property that qualify for a section 110.6 capital gains deduction. There is a formula for each of these types of property in subsection 104(21.2). The effect of each of these formulas is that the amount designated to a particular beneficiary is equal to the beneficiary's proportionate share of

all the trust's subsection 104(21) designations for the year to its beneficiaries in respect of its **net taxable capital gains** for the year

minus

all the trust's subsection 104(13.2) designations for the year to its beneficiaries (see ¶ 18 below), to the extent that the amount so calculated represents **eligible taxable capital gains** of the trust for the year from the disposition of qualified farm property or qualified small business corporation shares (depending on which formula is being applied).

¶ 7. An amount designated to a beneficiary by a personal trust under either formula in subsection 104(21.2) is deemed to be a taxable capital gain of the beneficiary from a disposition (by the beneficiary) of his or her qualified farm property or qualified small business corporation shares (depending on which formula is being applied). The beneficiary's deemed taxable capital gain occurs in the beneficiary's taxation year in which

the taxation year of the trust (for which the subsection 104(21) designation was made) ends. This deeming rule in the subsection 104(21.2) formulas applies only for purposes of the beneficiary's claiming a section 110.6 capital gains deduction. It is important to note that the beneficiary must still meet all of the requirements of section 110.6 in order to claim a capital gains deduction. For example, a beneficiary who has already claimed the full \$500,000 capital gains exemption in prior years would not be able to use a subsection 104(21.2) designation to claim any further capital gains deduction.

¶ 8. The amount of a personal trust's "eligible taxable capital gains" for a particular taxation year is defined in subsection 108(1) as the lesser of two amounts:

- (a) the trust's "annual gains limit" for the year (as determined under subsection 110.6(1)); and
- (b) the trust's "cumulative gains limit" at the end of the year (as determined under subsection 110.6(1)) less the total of all amounts designated by the trust to beneficiaries under subsection 104(21.2) for prior taxation years.

Taxation of Trust on Taxable Capital Gains Not Included in Income of Beneficiary

¶ 9. Any portion of the amount of a taxable capital gain realized in a taxation year by a trust that is not included in the incomes of beneficiaries for that year (see ¶ 1 and also ¶ 3 above) is taxable in the hands of the trust. Such portion of the taxable capital gain, net after tax, remains as trust capital pending its distribution as such in accordance with the terms of the trust.

Capital Losses

¶ 10. As indicated in ¶ 5 above, a trust's allowable capital losses for a particular taxation year are netted against its taxable capital gains for the year when calculating its "net taxable capital gains" that can be designated to beneficiaries under subsection 104(21). However, if the trust's allowable capital losses are greater than its taxable capital gains for the year, the resulting net allowable capital loss

- may not be designated to beneficiaries for the year, and
- may not be deducted by the trust in determining its income for the year.

Instead, such net allowable capital loss is included in the trust's "net capital loss" for the year. A trust's net capital loss for a particular year

- may be applied against its taxable capital gains for another year or years in accordance with paragraph 111(1)(b) and the related rules in section 111; and
- if so applied, will reduce the trust's "net taxable capital gains" for such other year or years as described in ¶ 5 above.

If a trust's net capital loss is carried back to an earlier year, the following should be noted:

- This will not cause any reduction to the amounts originally included in the income of the beneficiaries under subsection 104(13) or 104(14) or section 105 with respect to that earlier year.
- The above-mentioned reduction to the trust's "net taxable capital gains" for that earlier year may, however, cause a reduction to the portion of the total amount included in the income of the beneficiaries that can be designated to beneficiaries as a deemed taxable capital gain under subsection 104(21). This would occur if the amount originally designated to the beneficiaries under subsection 104(21) is greater than the revised net taxable capital gains. (See ¶s 4 and 5 above.)
- Furthermore, if the trust is a personal trust, any such reduction to the amount designated to the beneficiaries under subsection 104(21) may in turn cause a reduction to the amount designated to the beneficiaries under subsection 104(21.2) (i.e., for purposes of a section 110.6 capital gains deduction by the beneficiaries -- see ¶s 6 and 7 above).

Restrictions on Deductions by Spousal Trusts

¶ 11. As indicated in ¶ 2 above, an amount of income of a trust that is paid or becomes payable to a beneficiary is generally deductible by the trust under paragraph 104(6)(b). However, a spousal trust as described in paragraph 104(4)(a) (sometimes referred to as a "post-1971 spousal trust") may not deduct under paragraph 104(6)(b) the amount of any taxable capital gains arising in the year from deemed dispositions of trust property that occur

- (a) under subsection 104(4) or 104(5) on the day on which the life tenant spouse dies (see also ¶ 14 below), or

(b) under subsection 107(4) when the property is distributed to a beneficiary other than the life tenant spouse and the spouse is alive on the day the property is distributed.

¶ 12. Also, a spousal trust as described in paragraph 104(4)(a) may not deduct under paragraph 104(6)(b) an amount of income, including a taxable capital gain (if not already disallowed by the rule described in ¶ 11(b) above), that is paid or payable to a beneficiary other than the life tenant spouse if the spouse is still alive throughout the year in which the amount was so paid or payable. This restriction does not apply, however, if the trust altered its terms and conditions on or before December 20, 1991 to permit such a distribution.

¶ 13. By virtue of the definition of "accumulating income" in subsection 108(1), taxable capital gains of

- a trust that is a "pre-1972 spousal trust," as defined in subsection 108(1), at the end of the year;
- a spousal trust as described in paragraph 104(4)(a); or
- a trust that elected under subsection 104(5.3) for a preceding taxation year

that result from deemed dispositions of trust property under subsection 104(4), 104(5) or 107(4) are excluded from the trust's "accumulating income" for the year. As a result, they do not qualify for inclusion in a beneficiary's income under a preferred beneficiary election as described in ¶ 1(b) above or for a deduction by the trust under subsection 104(12) as described in ¶ 2 above.

¶ 14. If the life tenant spouse of a spousal trust as described in paragraph 104(4)(a) dies during the trust's taxation year, the following rules apply with respect to the trust's taxable capital gains for the year if it ends after July 19, 1995:

- The trust will not be allowed to deduct for the year under paragraph 104(6)(b) any amount of a taxable capital gain that is paid or payable to a beneficiary other than the spouse if the amount is attributable to one or more dispositions by the trust of capital property (other than excluded property) before the end of the day on which the spouse dies. Thus, the trust will not be able to avoid the tax effect of a disallowance of a paragraph 104(6)(b) deduction for a taxable capital gain from a deemed disposition described in ¶ 11(a) above by means of a disposition of the property before the spouse dies.
- The "accumulating income" of the trust for the year (as defined in subsection 108(1)) will be calculated as if any disposition by the trust of capital property before the end of the day on which the spouse dies had not occurred. Thus, the trust will not be able to avoid the tax effect of a disqualification of a taxable capital gain from a deemed disposition described in ¶ 11(a) above as "accumulating income" (for purposes of a preferred beneficiary election or a deduction under subsection 104(12) -- see ¶ 13 above) by means of a disposition of the property before the spouse dies.

¶ 15. The restrictions discussed above cause the spousal trust itself to be taxable on a taxable capital gain described above, even if the amount of the taxable capital gain is otherwise payable by the trust to a beneficiary and to be included in the beneficiary's income under subsection 104(13) (see ¶ 1(a) above). However, rules to eliminate double taxation of such income are discussed in ¶s 17 to 19 below. It should also be noted that a spousal trust may be able to claim a capital gains deduction under subsection 110.6(12) for its eligible taxable capital gains (see ¶ 8 above) for its taxation year that includes the day on which the life tenant spouse dies. Subsection 110.6(12) essentially makes available to the spousal trust after the spouse dies, subject to certain limitations, the spouse's unused capital gains exemption.

Anti-avoidance Rule

¶ 16. A deduction by a trust under paragraph 104(6)(b) for an amount of trust income paid or payable to a beneficiary may be disallowed by an anti-avoidance rule relating to the improper allocation of income to beneficiaries that is contained in subsection 104(7.1). Should such a disallowance of a paragraph 104(6)(b) deduction occur, the rules for the elimination of double taxation, as discussed in ¶s 17 to 19 below, can be used.

Double Taxation Relief

¶ 17. Generally, under the provisions of subsection 104(13) and paragraph 104(6)(b), the amount of income of a trust for a taxation year that is paid or becomes payable, within the meaning of subsections 104(18) and (24), to a beneficiary is subject to tax as income in the beneficiary's hands and not in the hands of the

trust (see ¶s 1(a) and 2 above). However, if a trust is prevented from deducting an amount of income that is paid or payable to a beneficiary (see ¶s 11 to 16 above) or if a trust chooses to deduct an amount that is less than the amount of its income distributions (see ¶ 2 above), such amount is also subject to tax in the hands of the trust. To eliminate this double taxation, designations may be made under subsections 104(13.1) or 104(13.2).

¶ 18. Subsections 104(13.1) and (13.2) can be used by a trust for any taxation year throughout which it is resident in Canada and not exempt from Part I tax by reason of subsection 149(1). Subsection 104(13.1) provides the mechanism for the trust to designate to its beneficiaries their respective shares of that portion of the trust's income distributions that has not been deducted in computing its income for the year. The amount of trust income designated to a beneficiary under subsection 104(13.1) will be deemed, for the purposes of subsections 104(13) and 105(2), not to have been paid or to have become payable in the year to or for the benefit of the beneficiary or out of income of the trust. In other words, the amount will not be required to be included in the beneficiary's income under subsection 104(13) or 105(2). A subsection 104(13.2) designation contemplates the situation in which a trust has a non-capital loss carry-forward from a prior taxation year and current taxable capital gains. In such circumstances, as indicated in ¶ 2 above, the trust may choose not to deduct the full amount to which it is entitled under paragraph 104(6)(b) in order to allow the non-capital loss carry-forward to absorb the current taxable capital gains. The designation in subsection 104(13.2) allows the trust to designate to its capital beneficiaries their respective shares (based on the trust's subsection 104(21) designations) of the portion of the potential deduction under subsection 104(6) that has not been deducted under that subsection or used in a designation under subsection 104(13.1). An amount designated to a beneficiary for the year under subsection 104(13.2)

- is not included in the income of the beneficiary for the year under subsection 104(13) or 105(2); and
- reduces the amount of taxable capital gains otherwise included in the beneficiary's income for the year by reason of subsection 104(21).

The provision in subsection 104(13.2) for the above-mentioned reduction of the subsection 104(21) amount does not apply, however, for purposes of applying the rules in subsection 104(21.2). Instead, subsection 104(21.2), in its own calculation, provides for a reduction of the subsection 104(21) amount by an amount designated under subsection 104(13.2). By virtue of paragraph 53(2)(h), an amount designated to a beneficiary by a trust under subsection 104(13.1) or (13.2) will generally reduce the adjusted cost base ("ACB") of the beneficiary's capital interest in the trust. However, if the beneficiary's capital interest is an interest in a "personal trust" (as defined in subsection 248(1) of the Act) and the interest was acquired by the beneficiary for no consideration, there is no such ACB reduction under paragraph 53(2)(h). An amount designated under subsection 104(13.1) or (13.2) and included in the computation of the trust's income will not be subject to tax in the hands of a beneficiary when that amount, net after tax, is paid out to the beneficiary. The designation of an amount as provided by subsections 104(13.1) and (13.2) is to be made by a trust in its return of income for the year under Part I of the Act.

¶ 19. An income beneficiary may agree to pay a trust's tax liability arising from a designation under subsection 104(13.1) or (13.2). Often this is done because the payment of tax by the trust would reduce the value of the capital interests held by other beneficiaries. The payment of tax by the income beneficiary is not a contribution for the purpose of paragraph (b) or (c) in the subsection 108(1) definition of "testamentary trust," nor is it a gift for the purposes of paragraph 122(2)(d). The payment must equal the tax payable by the trust on the income that is deemed not to have been paid or payable to the beneficiary because of the designation. The payment can be made by

- (a) reimbursing the trustee,
- (b) providing a cheque payable to the taxing authority, or
- (c) receiving a net amount from the trustee reflecting the beneficiary's share of income less the relevant taxes payable by the trust.

Explanation of Changes

Introduction

The purpose of the *Explanation of Changes* is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised departmental interpretations.

Reasons for the Revision

This bulletin has been revised because of amendments to the *Income Tax Act* that were enacted by the 5th Supplement to the Revised Statutes of Canada, 1985; S.C. 1994, c. 7 (formerly Bill C-15); S.C. 1995, c. 3 (formerly Bill C-59) and S.C. 1996, c. 21 (formerly Bill C-36). The comments in the bulletin are not affected by any draft legislation released before January 1, 1997.

Legislative and Other Changes

New ¶s 6 and 7 (replacing former ¶s 5, 6 and 7) reflect an amendment to subsection 104(21.2) that took effect for taxation years of trusts beginning after February 22, 1994. The amendment to subsection 104(21.2) changed the formulas for determining the amount designated to a particular beneficiary in respect of the disposition of qualified farm property and qualified small business corporation shares and eliminated the formula in respect of the disposition of other types of property. These changes were made as a consequence of the elimination of the \$100,000 capital gains exemption (in section 110.6) for dispositions of the above-mentioned "other" types of property after February 22, 1994. Because the \$500,000 capital gains exemption in respect of qualified farm property or qualified small business corporation shares

- was not eliminated in section 110.6, and
- is not available for property owned by a trust which is not a personal trust,

the amendment to subsection 104(21.2) also narrowed the person making a designation under that subsection from a "trust" to a "personal trust."

New ¶ 8 (replacing former ¶ 9) is revised to reflect an amendment to the definition of "eligible taxable capital gains" in subsection 108(1), which took effect for taxation years beginning after February 22, 1994. The amended definition ties in with the rules in section 110.6 (as amended to discontinue the \$100,000 capital gains exemption for dispositions of property after February 22, 1994). Also, the amended definition of "eligible taxable capital gains" is narrowed in its application from a "trust" to a "personal trust" for essentially the same reason as was done with respect to the person making a designation under subsection 104(21.2) (see explanation for new ¶s 6 and 7 above).

The definitions of "accumulating income," "eligible taxable capital gains" and "testamentary trust" were removed from paragraphs 108(1)(a), (d.2) and (i) of the Act, respectively, and instead placed (along with other definitions) in alphabetical order in subsection 108(1). These structural changes in the revised Act are reflected in **new ¶s 8, 13 and 19 (which replace former ¶s 9, 15 and 21, respectively)**.

New ¶ 10 replaces and clarifies former ¶s 11, 12 and 13. New ¶ 10 clarifies that carrying back a net capital loss to a particular year will not cause any reduction to the amounts originally included in the income of the beneficiaries under subsection 104(13) or 104(14) or section 105 with respect to that year.

In **new ¶ 11 (replacing all but the last three lines of former ¶ 15)**, the former references to "income gains" and to "subsection 104(5.2)" are removed because the bulletin is essentially concerned with the tax treatment, particularly the flow-through, of a trust's taxable capital gains.

New ¶ 12 has been added to the bulletin to describe rules that took effect for taxation years of trusts ending after December 20, 1991 (subject to the exception mentioned in new ¶ 12).

In **new ¶ 13 (replacing the last three lines former ¶ 15)**, references to the trusts described in the first and third bullets were added to the subsection 108(1) definition of "accumulating income" for the 1991 and subsequent taxation years.

New ¶ 14 has been added to the bulletin to describe rules that took effect for taxation years of trusts (i.e., spousal trusts as described in paragraph 104(4)(a)) ending after July 19, 1995.

In **new ¶ 15 (replacing former ¶ 16)**, a reference to subsection 110.6(12) is now given as additional information. (This provision was first added to the Act for the 1985 and subsequent taxation years and it has been amended from time to time as a consequence of amendments to the section 110.6 capital gains exemption rules.)

Former ¶ 17 is discontinued in the new bulletin because it has had no basis in law since the amendment to paragraph 104(6)(b) that took effect for the 1991 and subsequent taxation years. (It should be noted, however, that if a trust made a charitable gift to a person described in parts (a) to (g) of the definition of "total charitable gifts" in section 118.1 or made a gift to Her Majesty in right of Canada or a province, a tax credit to the trust under section 118.1 would be possible.)

In addition to the changes described above, **other changes** in the new bulletin include:

- the discontinuance of the discussion of matters that are considered to be outside the scope of the bulletin;
- elimination of **former ¶s 1(d), 8 and 14** as well as other information contained in the former bulletin that is no longer relevant for purposes of current taxation years; and
- clarification changes, including changes in wording or the provision of additional information.

Notice -- Bulletins do not have the force of law

Interpretation bulletins (ITs) provide Revenue Canada's technical interpretations of income tax law. Due to their technical nature, ITs are used primarily by departmental staff, tax specialists, and other individuals who have an interest in tax matters. For those readers who prefer a less technical explanation of the law, the Department offers other publications, such as tax guides and pamphlets.

While the ITs do not have the force of law, they can generally be relied upon as reflecting the Department's interpretation of the law to be applied on a consistent basis by departmental staff. In cases where an IT has not yet been revised to reflect legislative changes, readers should refer to the amended legislation and its effective date. Similarly, court decisions subsequent to the date of the IT should be considered when determining the relevancy of the comments in the IT.

An interpretation described in an IT applies as of the date the IT is published, unless otherwise specified. When there is a change in a previous interpretation and the change is beneficial to taxpayers, it is usually effective for all future assessments and reassessments. If the change is not favourable to taxpayers, it will normally be effective for the current and subsequent taxation years or for transactions entered into after the date of the IT.

A change in a departmental interpretation may also be announced in the *Income Tax Technical News*.

If you have any comments regarding matters discussed in this IT, please send them to:

Director, Business and Publications Division

Income Tax Rulings Directorate

Policy and Legislation Branch

Revenue Canada

Ottawa ON K1A 0L5

Dividends.

The General Rules.

Subsection 82(1) requires that the trust include in its Division B income all taxable dividends received from Canadian resident corporations and, (where the trust is not a registered charity), and thereto an additional 1/4 of the gross received amount but only where the payor corporation is a taxable Canadian corporation as defined in Sec. 89(1)(i). "Taxable dividend", defined in Sec. 89(1)(j), includes any dividends other than a qualifying dividend, described in Sec. 83(1), or a capital dividend, defined in Sec. 83(2). In the case of non-resident corporations subsection 90(1) requires that all dividends be included in computing the Canadian resident taxpayer's income while similarly to Sec. 82(1) any amount received on account or in lieu of payment of or in satisfaction of the shares owned will be included however it will not be grossed up. Unlike Sec. 82(1) it is not just taxable dividends that will be includable in income under Sec. 90(1). "Dividend", defined in Sec. 248(1), includes a "stock dividend", which is also defined in Sec. 248(1), to be a dividend paid by a corporation to the extent that it is paid through the **issuance** (but apparently not distribution of previously existing shares) of shares of any class of capital stock of the particular payor corporation. A stock dividend is habitually fundamentally distinctive from a stock split in that it usually results from a capitalization of retained earnings of the corporation while a stock split simply increases the number of tradeable shares outstanding without altering the total residual ownership capital in the corporation. Subsection 84(1) provides that where the paid-up capital (P.U.C.) of a corporation, (conceptually similar to residual ownership capital), is increased in respect of a particular class of shares, **other than** by, amongst others, **a payment of stock dividend**, the corporation will be deemed to have paid a dividend equal to the amount of the increase in the P.U.C. in respect of that class of shares and the shareholders thereof will be deemed to have received a portion of the dividend paid equal to the proportion of the share of the class they owned that is of the total number of shares of the P.U.C. inflated class. An increase due to the payment of a stock dividend will not result in a deemed dividend however this does not preclude it from being a taxable dividend since the definition of that term clearly causes stock dividends to be captured. Subsection 82(1) includes in income of the recipient all "amounts" received as taxable dividends and the "amount" of a taxable dividend, including a stock dividend, is defined in the definition thereof in Sec. 248(1)(c) to be the amount by which the P.U.C. of the corporation, **of any class of stock**, is increased through the payment of the dividend, while in most other cases the "amount" means money or rights or things expressed in the value of money. Thus the amounts by which the increase in any class of shares P.U.C. of the payor corporation is attributable to stock dividends received by the trust will be included in the trust's Division B income, and if the stock dividend was received from a taxable Canadian corporation that amount will also be grossed up. Stock dividends are a property that under Sec. 52(3) have a cost to the recipient equal to the "amount" of the stock dividend, (the flat amount, not the amount grossed-up), plus the amount if any that was included in the recipient's income under Sec. 15(1.1). Subsection 15(1.1) is a recently introduced anti-avoidance provision that causes the fair market value **of the stock dividend**, (other than the "amount" described in Sec. 82(1)(a)), to be included in computing the income of the recipient if it may reasonably be considered (but not concluded) that one of the purposes of the stock dividend issuance was to **significantly alter the value** of the interest of a specified shareholder, in respect of the recipient, in the corporation. It is this amount that will be added to the cost of the dividend to be recognized. "Specified shareholder", defined in Sec. 248(1), means a taxpayer who owns directly and indirectly at least 10% of the capital stock of any class of a corporation, or any corporation related thereto, while non-arm's length person's shares will be deemed owned by the S.S. and if he is a beneficiary under a trust, he will be deemed to own that proportion of the shares owned by the trust that the fair market value of his interest therein is of the aggregate fair market value of all of the interests in the trust. The basis of the Sec. 15(1.1) inclusion is the purpose of significant alteration in the value of the S.S.'s interest in the corporation however **the only amount** that will be included in the recipient's income is the amount if any by which the fair market value of the stock dividends exceeds the Sec. 82(1)(a) inclusion amount.

If the stock dividends are received from a corporation other than a taxable Canadian corporation then the "1/4" gross-up in Sec. 82(1)(b) will not be applicable to their "amount" while if the stock dividend is received from a foreign affiliate, defined under Sec. 95(1)(d), for purposes of Sec. 52(3) it will have an "amount" equal

to nil as per Sec. 95(7) but only in the case of corporate recipients, but for purposes of Sec. 82(1)(a) its "amount" will equal its value in money. If the corporation is not a foreign affiliate then the stock dividend will have a cost to the recipient equal to that prescribed by Sec. 52(3).

The Case Law as to Entitlements to Alternate Forms.

Whether or not a dividend in stock, cash, or in kind when received by a trust or estate will fall under an income or capital beneficiary's claim is the immediate concern of the specific trust terms and there have been a considerable amount of cases where due to trust deed ambiguity a court has had to decide to whom and for whose benefit a dividend will be received. One of the earliest of these cases, and the landmark of all following modern, consists of *Ann Bouch & William Bouch v. William Bouch Sproule*¹³⁸⁸ where a company had the power to increase its shareholders' equity by setting out of profits a sum which when retained by the corporation resulted in the shareholders receiving stock dividends; "bonus" cash dividends were declared but the stock dividend was to be financed out of the retention of the bonus dividend, at the discretion of the shareholder, so that the shareholder could receive either the cash dividend or the stock dividend, **the latter having a far higher value**. The stock dividends were distributed to the trust in this case since the trustees exercised their discretion in respect thereof and the life tenant contended that her rights to interest, **dividends**, and annual income of the personal estate allowed her to be entitled to the stock dividend.¹³⁸⁹ Quoting Lord Justice Fry in *Irving v. Houstoun*¹³⁹⁰ Lord Herschell reiterated:

"When a testator or settlor directs or permits the subject of his disposition to remain as shares or stocks in a company which has the power either of distributing its profits as dividend or of converting them into capital, and the company validly exercises this power, such exercise of its power is binding on all persons interested under the testator or settlor in the shares, and consequently what is paid by the company as dividend goes to the tenant for life, and what is paid by the company to the shareholder as capital, or appreciated as an increase of the capital stock of the concern, inures to the benefit of all who are interested in the capital."

further adding:

"And it appears to me that where a company has power to increase its capital and to appropriate its profits to such increase, **it cannot be considered as having to intended to convert, or having converted, any part of its profits into capital when it has made no such increase, even if a company having no power to increase its capital may be regarded as having thus converted profits into capital by the accumulation and use of them as such.**"

Lord Watson on the issue provided:

"I do not doubt that the rule applied by this House in *Irving v. Houstoun*(2) must receive effect in all similar cases. But in a case like the present, where the company has power to determine whether profits reserved, and temporarily devoted to capital purposes, shall be distributed as dividend or permanently added to its capital, the interest of the life tenant depends, in my opinion, upon the decision of the company. I entirely concur in the observation made upon this point by Lord Hatherlay (then Vice-Chancellor) in *Re: Barton's Trust*, Law Rep. 5. Eq. 244: "The dividend to which a tenant for life is entitled is the dividend which the company chooses to declare. And when the company meet and say that they will not declare a dividend, but will carry over some portion of the half-year's earnings to the capital account and turn it into capital, it is competent for them, I apprehend, to do so; and when this is done everybody is bound by it, and the tenant for life of those shares cannot complain.""

The capitalized earnings, and thus the resulting paid up stock dividend inured to the capital beneficiaries only.

In *R. A. Hill and others v. Perm. Trustee Comp. of N. S. W. Ltd., and others*¹³⁹¹ the rights of income and capital beneficiaries in respect of corporate distributions on termination/wind-up were examined when a pastoral company wound up its affairs and distributed proceeds to its shareholders and some question arose

¹³⁸⁸ 1887 12 A.C. 385, (HL)

¹³⁸⁹ It must be recognized that the trustee exercised the option of either receiving the cash dividend, a distribution of liquid profits, or the stock dividend, a capitalized form of those profits.

¹³⁹⁰ 4 Paton, Sc. App. 521

¹³⁹¹ 1930 A.C. 720, (PC)

as to the entitlements of the trust shareholder beneficiaries to the dividends received, as indicated by the company, as a return of capital. Lord Russell of Killowen commented about the respective scope of the trust's beneficiaries' entitlements concerning the capital and earnings:

"The question which thus arises is one which may frequently occur when investments, representing a settled trust fund, include shares in a limited company which are not restricted to a fixed rate of dividend. So long as such a company is a going concern and is not restricted as to the profits out of which it may pay dividends, it may distribute as dividends to its shareholder the excess of its revenue receipts over expenses properly chargeable to the revenue account. The balance to the credit of profit and loss account may in many cases be divided as dividend even if the company's capital account is in debt; and such a distribution by way of dividend would, *prima facie*, be "income or profits" of the trust share, and belong to the tenant for life; it would not be "capital of my estate". On the other hand, if the company instead of distributing the same balance as dividends, resolved upon liquidation, the shareholder would be repaid his share capital and in addition the share of surplus assets in the liquidation attributable to this shares. The moneys received by the shareholder in the liquidation may be swollen by reason of the fact that the company has in its possession undivided profits, but no part thereof would belong to the tenant for life as income; it would all be corpus of the trust estate.

From this it would appear that moneys paid in respect of shares in a limited company may be income or corpus of a settled share according to the procedure adopted, i.e., according as the moneys are paid by way of dividend liquidation or are paid by way of surplus assets in a winding up. Each process might appear to involve some injustice, the former to the remainderman, the latter to the tenant for life.

In truth the only methods by which the rights of the respective cestuis que trust can be safeguarded and made incapable of being varied or affected by the conduct of the company, is by the insertion of special provisions in the trust instrument clearly defining the respective rights of income and corpus in regard to moneys received by the trustee from limited companies, in respect of shares therein held by him as part of the trust estate."

The latter paragraph's point is particularly relevant when a trust is to control a corporation or when the corporation, at the time of the share transfer to the trust, has substantial booked profits that are sunk into assets and the testator wishes some of those profits to be received by the income beneficiary, given that the corporation may be wound-up without interim distribution, in the near future.¹³⁹²

Lord Russell went on to ascertain three salient points concerning corporate distributions to trusts:

"(1). A limited company when it parts with moneys available for distribution among its shareholders is not concerned with the fate of those monies in the hands of any shareholder. The company does not and does not care whether a shareholder is a trustee of his shares or not. It is of no concern to a company which is parting with monies to a shareholder whether that shareholder (if he be a trustee) will hold them as trustees for A. absolutely or as trustee for A. for life only."

This comment can definitely not be considered applicable to instances where trustees are put in control of a corporation by virtue of the holding of the shares since in such a position they must maintain "even hand" impartiality and resulting procedures with respect to corporate earnings and distributions, (which may be negated by provisions in the trust deed).

"(2) A limited company not in liquidation can make no payment by way of return of capital to its shareholders except as a step in an authorized reduction of capital. Any other payments made by it by means of which it parts with moneys to its shareholders must and can only be made by way of dividing profits. Whether the payment is called "dividend" or "bonus", or any other name, it still must remain a payment on division of profits."

And a reduction in capital necessitates the trustee's recognition of a return of the trust's investment and not income from such an investment, while it would appear that the excess of the amount of the distribution over

¹³⁹² See also *Re: Northage*, 1891 60 L.J. Ch. 488, *Re: Joel*, 1976 2 All E.R. 962, *Re: Wright's Settlement Trusts*, 1945 Ch. 211, for similar dicta.

the carrying cost of the share is recognizable only as an accretion on account of capital and not as income.¹³⁹³

"(3) Moneys so paid to a shareholder (if he be a trustee) prima facie belong to the person beneficially entitled to the income of the trust estate. If such moneys or any part thereof are to be treated as part of the corpus of the trust estate there must be some provision in the trust deed which brings about that result. **No statement by the company or its officers that moneys which are being paid away to the shareholders out of profits are capital, or are to be treated as capital, can have any affect upon the rights of the beneficiaries under a trust instrument which comprises shares in the company.**"¹³⁹⁴

Subsequently his Lordship reiterated this point in a quote from *In Re: Bates*¹³⁹⁵; "Unless and until the fund was in fact capitalized it retained its characteristics of a distributable property...no change in the character of the fund was brought about by the company's expressed intention to distribute it as capital. It remained an uncanceled surplus available for distribution, either as dividend or bonus on the shares, or as a special division of an ascertained profit...and in the hands of those who received it it retained the same characteristics." The surplus was considered to fall under the scope of the remainderman's entitlement in *Hill*, once it was distributed, only because the company was being wound-up.¹³⁹⁶

In *Re: Keating Estate*¹³⁹⁷ a liquidation and wind-up of a Canadian company was of concern when some question arose as to the entitlements of the income and capital beneficiaries and to whom the terminal distribution of corporate cash would be payable. The corporation had received a considerable sum of money in respect of the appropriation of its sole asset and had passed it on to its shareholders and while a certain English court had provided that the compensation was to be returned to the shareholders on account of capital this did not affect the rights of the beneficiaries under the trust once it was received by the trust. The trustee, unsure of which account to credit, applied to the court for advice on the handling of the voluntary liquidation and resulting proceeds whereby the *Hill* case was considerably relied upon while the Court also paid attention to the precedent set in *In re Armitage; Armitage v. Garnett*¹³⁹⁸ whereby Hughes, J. quoting therefrom provided:

"The company was wound up, and the assets of the company were distributed amongst the registered shareholders...Those undivided profits of course could have been paid as dividends if the company had so thought fit...The moment the company got into liquidation there was an end of all power of declaring dividends and of equalizing dividends and the only thing that the liquidation had to do was to turn the assets into money, and divide the money among the shareholders...What does a man mean when he leaves shares to a tenant for life? He means that that tenant for life shall have the income arising from the shares in the shape of dividends or bonuses declared during the lifetime of the life tenant. He does not mean that the tenant for life shall receive profits in any other sense."

The return of capital in *Keating* inured exclusively to the benefit of the remainderman as decided by the Supreme Court of Canada while the apportioning rule found in *In re Earl of Chesterfield's Trusts*¹³⁹⁹ (where conversion is postponed at the demise of the life tenant), which provides some degree of equitable adjustment between life tenant and remainderman was held not to apply since the case did not concern conversions.

In *Re: Doughty*¹⁴⁰⁰ a corporate charter provision allowed the corporation to make resolutions as to the character of dividends the substance of which was realized from the disposal of capital assets and it resolved to distribute a particular amount as capital. The Chancery Division found that, on the basis of *Re: Bates* and *Hill* that the dividends inured to the life tenant under the recipient trust even though they weren't captured for

¹³⁹³ This (similar) excess would also be considered a deemed dividend under the ITA.

¹³⁹⁴ This was endorsed in *Bakewell v. Holme and others*, 44 S.R. (N.S.W.) 150.

¹³⁹⁵ [1928] Ch. 682

¹³⁹⁶ In *Knowles and Haslem v. Ballarant Trustees, Exors. & Agency Co. Ltd.*, 22 C.L.R. 212 (HCA), *Bouch v. Sproule* was called upon to support the dicta that if the company has the power to increase paid up capital out of accumulated earnings via the issuance of shares subsequent to which it can be reduced by the payment of "capital" dividends it can also eliminate the middle step by paying directly from the accumulated earnings account and if it intends that such should be a capital distribution the payment shall be received as capital.

¹³⁹⁷ [1934] S.C.R. 698

¹³⁹⁸ [1893] 3 Ch. 337

¹³⁹⁹ (1883) 24 Ch. D. 643

¹⁴⁰⁰ 1947 1 Ch. 263

income tax. In *Re: Sechiavi*¹⁴⁰¹ after the realization of principally all of its assets on a governmental expropriation a "capital profits" dividend was payable with in specie consideration received on the sale and the Chancery Division, again relying on *Hill*, held that the payment was to be treated as income of the trust recipient inuring to the life tenant¹⁴⁰² In *re: Armitage*¹⁴⁰³ a testator left shares in a company the "actual" income from which was to be paid to the life tenant while the company subsequent to the death underwent a winddown and reconstitution. The shares held realized 1.5 pounds more than their paid up capital and the Appeal Court held that the excess inured to the benefit of the remainderman since the will specified that the life tenant was to be entitled only to income (dividends and bonuses) and not capital realizations in respect of shares disposed of. In *Fisher v. Fisher*¹⁴⁰⁴ an Australian corporation wished to hive off its foreign operations and incorporated a subsidiary and distributed its preferred shares to its shareholders, one of which, was a residuary trust, in respect of their shares in the holding corporation. The life tenants contended that they were entitled to the shares, being entitled to all of the income from the original shares. The paid up capital of the preferred shares was financed with the foreign assets. *Barton J.* held that since the will gave the life tenant rights to income in specie from the shares and since the effect of the transactions was to increase the paid up capital of both the parent and subsidiary's shares aggregately, (there wasn't a reduction in the P.U.C. of the parent but the preferred shares were based on assets paid into the subsidiary), the preferred shares inured to the remainderman.¹⁴⁰⁵

One interesting case that should be addressed is *Re: Winder's Will Trusts*¹⁴⁰⁶ where a testator died prior to the actual payment of a dividend but subsequent to its declaration. It was held that the sum was received as capital by his estate: it accrued as income prior to his death.¹⁴⁰⁷

Tax consequences arising from distributions by corporations to trustees were the topic of arguments in *Re: Water's Estate*¹⁴⁰⁸ and *Re: Hardy Trust*¹⁴⁰⁹ both concerning the use by the corporations of section 95A of the 1952 Act so as to allow them to pay a 15% tax on accumulated earnings upon capitalization into redeemable preferred shares, thus sterilizing them so that when the paid up shares were distributed as stock dividends the substance of the capitalization would be received tax-free when the shares were redeemed. Unfortunately the actual process of the electing for section 95A treatment, whereby paid up shares were issued, caused the earnings to be capitalized thus permanently removing the earnings from distributable form. The shares were redeemed after being received by the trustee, whereby the life tenants applied to court contending that the scope of their income rights extended over the proceeds realized. In *re: Waters Rand, J.* recognized the relevance of both *Hill v. Permanent Trustee* and *Bouch v. Sproule* and provided:

"When earnings are 'capitalized' they cease, at that moment to be 'earnings'; they become part of the capital assets; and if the transaction has not the elements of dividend and purchase, the shares, *prima facie*, are not income. Mr. Henderson urged very plausibly that the company's intention was to release those earnings and pass them to the shareholders as such in a single act consisting of several parts. **The fallacy lies in overlooking what has taken place.** The company undoubtedly intends by its total act to pass money to the shareholder: but if what the company does converts the earnings into capital, the "intention" of the company must take account of that fact: it "intends" that fact; and to carry the intention to a conclusion it intends to distribute capital assets by means of an authorization reduction in capital stock. **Here form is substance; and the moment form has changed the character of the earnings as assets, the intention follows that change.**"

¹⁴⁰¹ 1950 1 All E.R. 417

¹⁴⁰² See also *Re: Kleinwart's Settlements*, 1951 Ch. 860, *Re: Rudd's Will Trusts*, 1952 1 All E.R. 254, and *Re: Tedlie*, 1922 126 L.T. 644.

¹⁴⁰³ 1893 3 Ch. 337, (CA)

¹⁴⁰⁴ 23 C.L.R. 337 (HCA)

¹⁴⁰⁵ See also the recent UK case of *Bessie Taube Discretionary Settlement Trust, Trustees of the v Revenue & Customs* (Rev 1) [2010] UKFTT 473 (TC) (07 October 2010) for an analysis of considerable jurisprudence when trust shares were refunded as "an extraction of capital".

¹⁴⁰⁶ 1951 Ch. 916

¹⁴⁰⁷ See also *Hughes v. Fripp*, 30 C.L.R. 508, for similar situation a partnership determined on death.

¹⁴⁰⁸ 56 D.T.C. 1113, (SCC)

¹⁴⁰⁹ 56 D.T.C. 1121, (SCC)

"...and in the absence of special directions in the will, we are not at liberty to disregard what the testator is to be deemed to have foreseen as the possible action of the company."

Kellock, J. further provided very similar reasoning, drawing relevant comment from the two landmark cases, finishing with:

"Even where redemption takes place out of profits, therefore, the capital paid up on the shares originally appropriated out of the profits remains as capital. This emphasizes, if emphasis be needed, that in the purview of the statute, profits which have been used to pay up an issue of shares becomes capital and remains so from the moment the shares are so paid up."

Re: Hardy concerned itself a little more with the intention of the company in making the section 95A election Rand, C.J., providing:

"While in the view that I take of the matter it does not assist in the determination of the question, it may be noted that at the meeting which authorised the stock dividend and the redemption of the preferred shares, the chairman stated that it had not been the intention of the company to make the preference shares part of its capital structure and that they had been created with the sole view of immediately redeeming them when they were issued in order to take advantage of the provisions of The Income Tax Act whereby the company might be paying a tax of \$47,109.51, distribute the tax paid surplus tax free in the hands of the shareholder. The motive or purpose is, however, irrelevant if it is made out that the accumulated profits have been capitalized. (Commissioner of Income Tax v. Mercantile Bank of India, 1936 A.C. at 495.)"

There are numerous ways by which profits can be distributed tax free under the present ITA, two of which are the election to treat them as distributions from the corporation's capital account, as described under Sec. 83(2), or as a reduction in paid-up-capital on a return of capital substantiated the shares. Both may take the form of cash dividends but the former does not constitute a reduction in paid up capital, in either the tax or corporate law sense of the term, and thus the former may usually be recognized as a distribution of profits to which life tenants and income beneficiaries would otherwise be entitled. This is in accordance with the reasoning in *Bouch v. Sproule, Hill, Waters, and Hardy* however it must be recognized, as it was in *Hill*, that the rights of trust beneficiaries to specific payments of dividends, be they basic income or capital payments, may be altered and specified by special adjustments in the trust deed.

Unfortunately there has been at least one instance where such explicit adjustments in the trust deed were not needed and instead the Court stretched the interpretation of a will, written in Everyman's speech, so that "the intention" of the testator was "found" to be that distribution of otherwise taxable dividends consisting of accumulating profits, that were elected upon as Sec. 83(1) 1971 capital surplus on hand thus being received tax free, were to inure exclusively to the remaindermen and not the life tenant, when the shares were held by the residuary estate and the will provided that all of the income was to be payable to the life tenant.¹⁴¹⁰ In *Re: Welsh; Re Thomson and Morrison*¹⁴¹¹ the bulk of an estate consisted of 85 1/2 shares of a closely-held family corporation while the corporation paid dividends to the trust upon which it designated them as being paid out of its 1971 C.S.O.H., the amount being accumulations, as described under now repealed Sec. 89(1)(l), in respect of dispositions of capital properties of the corporation. Under Sec. 83(1)(c) the dividend was received tax-free by the trust while the ACB of the shares was reduced as per Sec. 83(1)(d).¹⁴¹² The will of the testator provided that the spouse life tenant was to use the house of the testator and that the trustees were to maintain the dwelling for her out of both income and capital resources. The trustees were also to invest and keep invested the monies of the estate and to pay the life tenant the income therefrom while they had the power in absolute and unfettered discretion to raise sums out of capital as they felt were necessary and pay it to or for the life tenant's benefit in respect of maintenance or in case of illness, sudden adversity or other emergency. They were not given the power to make good out of subsequent income receipts the amount of capital

¹⁴¹⁰ This is one instance where equity recognizing intention overcome the form rule.

¹⁴¹¹ 6 E.T.R. 257

¹⁴¹² The fact that the dividend was paid out of 1971 C.S.O.H. is practically irrelevant in that the capital property which produced the 1971 C.S.O.H. could have been purchased with accumulated profits which had not been capitalized into shareholder's equity and thus the C.S.O.H. balance must not be equated with any form of paid up capital in the form of shareholder's residuary claims. The fact that the notional account is termed "capital surplus on hand" does not cause it to be recognized paid-up capital in the corporate law sense.

previously used to supplement the life tenant's entitlement while they were also entitled to retain any investments formerly held by him notwithstanding that they may not have been authorized legal investments under the laws of Province of Ontario. They were also given the power to vary the investments of the estate and to sell, call in and convert the whole or any part of the estate property, as they saw fit in their absolute discretion, while the house could be sold but the proceeds were required to be used to purchase another one for the spouse life tenant's use. Upon the death of the spouse, the will provided that the residuary estate was to be divided up amongst the living offspring in equal shares per stirpes. There was not a minimum value of residuary estate needed to be maintained stated thus the remaindermen could technically be entitled to nothing if the capital was fully used to support the spouse's "station in life" in the two manners provided for, while in respect of both spousal capital uses the trustees were not given the power to carve out of income amounts to replace capital previously used, a fairly common power when minimal residue is attempted to be provided. The company's capital surplus balance (assumed equal to its 1971 C.S.O.H. balance), consisted of \$ 1,400,244 before the Sec. 83(1) elections, while also from the previous year it was carrying a negative "earned surplus" ("deficit") while the company paid C.S.O.H. dividends 5 times, in amount of \$ 272,023, from the date of the mentioned C.S. balance and the date of appeal. During this time the life tenant also received a similar amount of payments from the estate, which must have principally been received by the trust as normal dividends from the corporation on the shares.

J. Holland recognized that in not recognizing the C.S.O.H. dividends as capital the remaindermen would suffer considerably in that their benefits would be reduced to \$50,000 ultimately from what would otherwise be \$ 322,023 when the C.S.O.H. dividends were recognized as capital. He chose to extrapolate from the language of the will and fall back on natural justice attempting to substantiate and fulfil the testator's intention.

"The circumstances surrounding the execution of this will were that the testator, who had one asset only, namely his interest in Welsh Lumber Co. Ltd., represented about 85 1/2 shares of common stock of that company, wished to provide for two successive interests - that of his wife while she was living and on her death for his natural born children. The only way that he could provide for both of these interests was through the value of these shares..."

"I find that the intention of the testator as expressed in this will taken as a whole and in the circumstances which existed at the time when it was executed is quite clear. This testator intended that the value of his interest in Welsh Lumber Ltd. as represented by his shareholdings, (to include the break-up value which such shares would attract), to be the capital of his estate, and to be held as part of the residue of his estate after payment of specific bequests. It was this on which income was to be derived which income he intended to be paid to his wife. The source of the income to be paid to the widow was the interest earned from this capital sum and a limited power to encroach upon this sum given for the benefit of the wife supports this interpretation. Indeed, that is what was done during the lifetime of Opal and she received some \$200,000 without it being necessary to encroach upon capital in any way."

The life tenant was to be supported with income in the form of dividends from the shares and while Judge Holland considered that the testator could not foresee future methods of distributing "capital surplus" he did recognize that the life tenant was also to be supported with the capital if need be. No analysis was made of the origin of the "capital surplus" amounts nor were the form-over-substance arguments presented by estate's counsel, formed from cases such as *Re: Fleck*¹⁴¹³ *Re: McIntyre*¹⁴¹⁴ *Re: Hardy & Re: Waters, & Re: Fleming*¹⁴¹⁵, followed. Instead it was held:

"It is clear that the Court may look at the form of the transaction or at the substance, but that in any event the overriding consideration must be the intention of the testator as expressed by the words of his will and in the circumstances in which that will be executed."

"Whether or not this testator ever gave consideration to the vehicle by which these moneys would be received by his estate is very doubtful and, of course, we realize that the Income Tax Act was amended in 1972 in connection with this type of problem. He surely could not have had within contemplation that

1413 [1952] O.W.N. 260 (C.A.)

1414 [1953] O.R. 910

1415 [1973] 3 O.R. 588

such amendments would be made. Cases dealing with undistributed income and the method by which this money falls into the hands of the shareholders and the characterization of that money do not aid in the interpretation of the present circumstances where we are dealing with the main, perhaps only, asset of a company and an estate, which asset under the terms of the will is obliged to provide income for life and upon death of the life tenant to be divided amongst the remaindermen."

Royal Trust Co. & McMurray v. Crawford¹⁴¹⁶ is an excellent case to illustrate a valid application of the principle of equity when a testator's intention was to benefit successive interests with property owned and it also illustrates an application of the *Howe v. Dartmouth* rule of conversion where wasting or hazardous property is to be converted for the benefit of successive interests. In this case the property was a majority block of shares in a corporation which had a substantial accumulated surplus at the time of death and there was some concern as to how the executors were to exercise their control of the corporation and the form of the payments of the surplus to be made. The trustees also had uncontrollable discretion to resort to capital to maintain the widow. It was held that from the will on a whole the intention of the testator was to benefit both classes of beneficiaries and that a conversion of the investments was in order thus precluding the widow from enjoying the dividends in specie but shifting their constructive benefit to the remaindermen. In *Nat. Victoria & Grey Trust Co. Ltd. v. Baker et al.*¹⁴¹⁷ the courts had to be solicited for an opinion to ascertain to whom cash dividends received by the trust would be accredited to when the corporation made the section 83 capital gains dividend election. The settlor had not specified how such dividends were to be handled and although the deed did provide that the corpus was to be increased by all stock dividends and cash dividends distributed by way of return of capital a supplemental deed provided that **gains** and profits were to inure to the life tenant. The Queen's Bench did not find the remainderman's argument of the existence of the intention to preserve buying power of the capital persuasive but found that the fact that the fund was named the life tenant's fund expressed the intention that the benefits therefrom were to inure primarily to the life tenant thus the capital gains dividends were income to which the life tenant was entitled.

Given that income tax rules concerning corporate distributions to any shareholder will most likely continue to undergo transformation at the whim or capricious act of the Department of Finance and the foreign counterparts it compels the settlor/testator to give specific directions as to how the beneficiaries under the trust/estate will be entitled to corporate distributions as return of capital or distribution of earnings and in this respect the specific underlying value of the shares at time of transfer, inherent undistributed earnings and beneficiaries rights thereto must be specifically accounted for. It need not be important for the instrument to make specific tax treatments available, but it is clearly advisable that proposed treatment of undistributed earnings at time of transfer be fully described in detail. As per Hill; "...the only method by which the rights of the respective cestuis que trust can be safeguarded and made incapable of being varied or affected by the conduct of the company, is by the insertion of special provisions in the trust instrument clearly defining the respective rights of income and corpus..."

In *Re: Bronson*¹⁴¹⁸ a testator provided in his will that the executors of his estate would have the power to determine whether receipts in respect of payment on account of shares held in corporations would be either of a capital or income nature, regardless of the interference of the courts. Obviously the testator wished to give his executors the ability to make equalizing distributions to both capital and income beneficiaries regardless of the nature of the dividend received however the High Court of Ontario provided otherwise and supported appropriately that the Court's power in these matters cannot be reduced, and that in giving the power to the trustees the testator had shown the intent to make a gift but that through the existence of the power that gift could not be validly ascertained. The power was void. If the testator had given discretionary powers of appointment in respect of the receipts, rather than the power "to change their character", the intended results could have been attained.¹⁴¹⁹

1416 1955 S.C.R. 184

1417 24 E.T.R. 306

1418 14 D.L.R.(2d) 51, OHC

1419 *Re: Wynn*, [1952] 1 Ch. 271, also dealt with this issue while *Re: Fenwick, Fenwick v. Stewart*, [1936] 2 All E.R. 1096, dealt with dividends and interest in identical circumstances, all with the same result. See also *Terrill Estate v. M.N.R.*, 87 D.T.C. 504 (TCC), & *Re: Richards*, 1974 2 N.Z.L.R. 60 (SC).

If a testator formerly was in control of a corporation which had accumulated profits instead of attempting to specify meticulously defined rights with respect to the accumulated profits so as to allow the life tenant to be sure of benefitting from them he could designate her also as an executor of the estate, with respect to the shares which would also be transferred to the trust (which gave him control), so that the life tenant could not only receive the income when dividends were paid by the corporation but also allow her to control the form of distribution they would take, due to her being a major element on the Board of Directors. This was the case in *Re: Zacks*¹⁴²⁰ where a testator did the above through the will and the corporation distributed significant amounts from the realization of converted earnings. The life tenant controlled 50% of the voting shares through the trust and owned the other 50% directly and when the accumulated income was paid out as cash dividends (as part of a two fold distribution arrangement) which inured to the life tenant the Public Trustee in attempting to protect the capital of the estate which was to go to public charities in remainder contended that the actions were illegal. Judge Reid thought otherwise in providing:

"I accept that a trustee must hold an even hand between income beneficiaries and remaindermen and that the obligation to do so is not diminished by the fact that the trustee may be as well an income beneficiary. **Yet that obligation is subject to the terms of the will.** The will under consideration discloses a clear intention on the part of testator to give the widow an absolute or, at the very least, a dominant voice in the administration of the estate. That was done deliberately by the testator, an experienced and successful businessman, in the knowledge that his wife was the owner in her own right of one-half of the issued common shares of Conreal."

In *re: Fleming*¹⁴²¹ a corporation wholly owned by an estate realized a capital asset and wished to distribute the proceeds. The trustee-directors had a choice between paying it out as a taxable dividend whereby the life tenant would be entitled to it or redeem preferred shares which would benefit the remainderman ultimately. The Ontario High Court of Justice held that the executors should redeem the preferred shares since such would reduce the charge on income inuring to the life tenant and if paid out as a dividend to them would only cause a diminution of the income producing assets of the corporation. Judge Osler also held that they should apply even hand principles to the directorship and that since the sums substantiated the value of the shares for probate and succession duty purposes as capital property it would "seem" inequitable for the trustees to convert such into income subsequently.¹⁴²² In *Re: Campbell*¹⁴²³ it was held that trustees holding control of the corporation must vote their shares in such a way as to ensure impartiality concurring with the reasoning in *Hill v. Perm. Trustee Co. Ltd*¹⁴²⁴:

"It is not disputed that the duty of voting as shareholders of the company in respect of shares held as trustee is a duty in the nature of a trust, in the exercise of which the trustee must so far as possible maintain a strict impartiality between tenant for life and remainderman."¹⁴²⁵

Stock Dividends.

If the stock dividend doesn't enter the trust's income solely because it represents a capitalization (increase in P.U.C.) that doesn't preclude it from having a taxable dividend status and if the trust deed provides that the particular beneficiary shall receive all dividends in kind or in cash, or in stock then the particular beneficiary will have an enforceable right thereto. Subsection 104(19), providing a designation to the trust whereby dividend **income** flowing through to a beneficiary from a trust via Sec. 104(13),(14) or section 105 will retain its character, will not be needed in that there isn't any amount to be included in the beneficiary's (or trust's) income. If the stock dividend is precluded from being treated as taxable income solely because there is no increase in P.U.C. in respect of it, and the trust treats it as being exclusively earned for the benefit of the life tenant then once that life tenant becomes non-resident Sec. 107(5) will apply to its distribution since although the stock dividend has been received as income in a previous period it has been capitalized subsequently by not

¹⁴²⁰ 17 E.T.R. 206

¹⁴²¹ 1973 3 O.R. 588

¹⁴²² See also "Maintaining the Even-Hand Rule Through a Holding Company." by W.D. Goodman, E. & T. Q. 1982-84 pg 42.

¹⁴²³ 1973 2 N.S.W.L.R. 146

¹⁴²⁴ 33 S.R.(N.S.W.) 527

¹⁴²⁵ See also *Bakewell v. Holme*, 44 S.R.N.S.W. 150, for similar dicta.

transferring it out to the life tenant at that time. If the stock dividend is not expressly considered as income by the trust deed to which the life tenant has exclusive entitlement then regardless of if there hasn't been a capitalization, since it reduces the proportionate residual capital ownership in the class of shares in which it exists, (due to more shares being in a certain class per the same amount of corporate capital), it should be treated as a distribution of capital to the trust which is to the exclusive benefit of the capital beneficiaries. If it weren't then a stock dividend that was issued in shares of an existing class would reduce the proportionate P.U.C./capitalized earnings to the class, to the demise of the capital beneficiaries under the trust, since in effect a distribution to income beneficiaries would dilute the capital beneficiaries residual ownership.¹⁴²⁶

A "stock dividend" is a dividend in the form of a share of the payor corporation as per the definition thereof in Sec. 248(1), while a dividend in the form of a stock of different corporation paid by the payor corporation is a "dividend in kind" which is not defined in Sec. 248(1) but is a distribution, as a dividend, of any property the legal title of which was formerly owned by the payor corporation. As per subsection 52(2) a shareholder receiving a dividend in kind will be allowed to recognize a cost of the property received equal to its fair market value while the corporation will be deemed to have disposed of the property for proceeds equal to that fair market value. Understandably a dividend-in-kind is also a taxable dividend, the "amount" of which is includable in the recipient's income under Sec. 82(1) subject to the possibly applicable gross-up. The "amount" of the D.I.K. is equal to its value in terms of money as prescribed by Sec. 248(1) which will always equal its fair market value. Although the D.I.K. may be a distribution of property which was previously capitalized the D.I.K. will usually be treated as a distribution of income, for the benefit of the income beneficiaries under a trust while if the property distributed causes a reduction in the paid-up capital of the corporation it should be recognized as a capital distribution inuring exclusively to the benefit of capital beneficiaries as per the reasoning in *Waters and Hardy*.¹⁴²⁷ In either case in tax law as per the mechanics offered in Sec. 104(19) it can be designated as having been received by a beneficiary under a Sec. 104(13),(14) or section 105 inclusion even though the legal title to the D.I.K. property may not have been distributed. If the D.I.K. represents a distribution of capital then a Sec. 104(20) designation may only be made in respect of a capital beneficiary.¹⁴²⁸

Capital Dividends & Tax Free Dividends.

Subsection 83(2) provides that where a private corporation elects in respect of the full amount of a dividend in a prescribed form and manner a dividend will be considered to have been paid out of the corporation's "**capital dividend account**" to the extent of the balance thereof and no part of that amount will be includable in the shareholder's income upon receipt (while subsections 83(2.1), (2.2), (2.3), (2.4) provide anti-avoidance measures too complex to review here). Subsection 89(1)(b) defines "capital dividend account" to mean the aggregate of a composition of five different conceptually tax-free receipts that are not recognized in the corporation's income, net of capital dividends payable previously. The first item consists of the aggregate of the non-taxable portion of capital gains recognized by the corporation after 1971 since it last became a private corporation, net of the undeductible portion of capital losses recognized over the same period of time, (the computation of both items are specifically adjusted with respect the status of the corporation and who it was controlled by). The second item consists of the amounts of capital dividends received from other corporations. The third item consists of certain amounts in respect of the disposition or acquisition of eligible capital property of the corporation and should be reviewed in detail since they are too irrelevantly complicated to comment on here. The fourth item, and perhaps a more important one, consists of the proceeds of a life insurance policy,

¹⁴²⁶ If the trust deed specifies that stock dividends of this nature are to be distributable to the income beneficiaries then such a distribution from the corporation to the trust, to the beneficiary would cause an enrichment that the capital beneficiary having rights to the stock held by the trust could do nothing about since it is the corporation that causes a reduction in the residual value under his beneficial title, not the trustee. This isn't the case where the corporation is controlled by the trust. See *Re: Lee*, [1993] 3 All E.R. 926 ChD where it was held that the principle whereby a trust held corporation dividing profits through every means except a reduction in paid up capital was to inure to the income beneficiary was only a guideline and that can be displaced where it produces results manifestly in conflict with the settlor's/testator's intention read from the trust deed.

¹⁴²⁷ This is if the trust deed does not provide alternate indications adjusting income/capital beneficiaries rights thereto.

¹⁴²⁸ The subsection 104(19) designation allows for retention of character of specific sources of tax income flowing through the trust that were earned in respect of a particular beneficiary, even if they weren't received but were receivable by the particular beneficiary in the period.

of which the corporation was the beneficiary thereunder on or before June 28th, 1982 or was not a beneficiary thereunder on or before June 28, 1982 but received the proceeds after 1985, received in consequence of the death of a person but only those proceeds that exceed the policy's adjusted cost basis, (as defined in Sec. 148(9)(a)), immediately before the person's death.¹⁴²⁹ It is this inclusion in the capital dividend account, the substance of which can be paid out tax free to the shareholders that allows for some fairly interesting trust/estate planning. The fifth amount included in the C.D.A. consists of the corporation's life insurance capital dividend account balance immediately before May 24th, 1985, which was repealed, (as per the definition thereof in Sec. 89(1)(b.2)), effective that day.

As per Sec. 89(1)(j)(i) a capital dividend is not to be considered a taxable dividend which is to be included in computing the taxpayer's income however under Sec. 212(2) the capital dividend will be subject to a 25% withholding when it is distributed to a non-resident. As per Sec. 83(2.1) if one of the main reasons why a taxpayer acquired the share (or its substitute) upon which an otherwise capital dividend was paid was to receive the dividend then the dividend will be, for purposes of the Act **not including** the computing of the C.D.A. balance, deemed to be a taxable dividend will apply through testamentary or *inter vivos* spousal or non spousal transfers whether or not they received Sec. 73(1) or 70(6) relief.

A capital dividend consists almost exclusively of funds that were generated on the corporation's capital account, however a payment of a capital dividend to a trust will usually cause it to come under an income beneficiary's entitlement since the payment has not caused a reduction in the P.U.C. of the corporation, in either the tax or corporate law sense.¹⁴³⁰ In order for a capital dividend to be considered as falling under the scope of the capital beneficiary's entitlement the terms of the trust deed must specify such, (or possibly it may be drawn from the implicit intention of the testator), otherwise it is "income" as per the rules specified in Hill.¹⁴³¹

The counter part to the capital dividend in substance, is the taxable dividend the substance of which is generated, possibly as capital transactions, and taxed at the corporate level. As per Sec. 53(2)(a) the ACB of a share of a Canadian resident corporation upon which a taxable dividend or a capital dividend has been received will **not** be reduced by the two categories of amounts received, (taxable and capital dividends), but all other dividends will reduce the ACB of the share.

Qualified Dividends.

Subsection 89(1)(j) provides that a "taxable dividend" does not include a dividend in respect of which the corporation has elected under Sec. 83(1) as it read prior to 1979 or under Sec. 83(2). Under para. (ii) of the definition of "taxable dividend" qualifying dividends paid by public corporations on tax-deferred preferred shares, as described in Sec. 83(1), will also not be considered as taxable dividends.

Section 83, "Qualifying dividends", provides that where a dividend has been paid by a public corporation, (defined in Sec. 89(1)(g)), on a class of tax-deferred preferred shares that were outstanding on March 31st 1977, the dividend will not be included in computing the recipient's income but the ACB of the share will be reduced, as per Sec. 53(2)(a)(i), by the amount thereof. Subsection 83(6) defines "qualifying dividend" for purposes of Sec. 83(1), to be a dividend payable on certain prescribed tax-deferred preferred shares after 1978 and before Oct 2, 1991, (with certain exceptions), however the shares thereby described may lose the t.d.p. status if the terms of the particular class have been changed since March 31, 1977 or after that date the corporation issued more shares of the particular class. "Tax-deferred preferred shares" are described in Reg. 2107 to be certain issued shares of; Algoma Steel Corp., Alcan, Brascan, Canada Permanent Mortgage Corp., and Cominco Ltd.. The qualifying dividends from certain shares of these companies will thus not be includable in the trust's tax income, nor as per Sec. 108(3) income to which a spouse under a spousal trust must be entitled to, although in the latter case no one else but the spouse can be entitled to or to receive or obtain the

¹⁴²⁹ It does not include such dividends received **through** an estate/trust: and Sec. 104(19) **doesn't** change the character of the particular receipt. The beneficiary corporation must receive the proceeds **directly** from the plan and its rights to such must be **directly** enforceable against the policyholders.

¹⁴³⁰ Technically since the source of the funds that generated the account balance would have usually been accumulated profits the account balance shouldn't represent anything other than accumulated earnings. The fact that they have been capitalized through retention does not cause them to be recognized as capital for corporate or trust law purposes.

¹⁴³¹ If the corporation is winding down this may not be true however.

use of them before her death either as income or as capital.¹⁴³²

"Taxable dividends" do not include dividends received that were elected upon by a Canadian corporation as per Sec. 83(1), **as if it were read prior to 1979**, and this is the original use of the Sec. 83(1) "qualifying dividend" provision. Reading "the small print" will reveal that the provision allowed the corporation to pay out tax-free to its shareholders dividends the substance of which consisted of its balance of "tax paid undistributed surplus on hand" and/or its "1971 capital surplus".¹⁴³³ The 1971 C.S.O.H. conceptually represents accrued capital gains recognized after 1971 that accrued prior to that date, dividends received from other corporations out of their 1971 C.S.O.H., and certain amounts in respect of eligible capital amounts while an election in respect of the 1971 C.S.O.H. dividend can be made only when the corporation is being wound-up. The T.P.U.S.O.H. of a corporation represents effectively the undistributed pre 1971 income upon which the Part XI 15% tax was paid, (less the tax paid), the amount of dividends received out of the T.P.U.S.O.H. of other corporations as elected upon by them under Sec. 83(1), less the dividends payable or paid by the corporate recipient that were elected upon so as to drain the T.P.U.S.O.H.. The Sec. 83(1) T.P.U.S.O.H. and 1971 C.S.O.H. dividends can be elected as such by the corporation upon its wind-up. Unlike a capital dividend which also is not included in the recipient's income, as per Sec. 53(2)(a) and the way Sec. 83(1) is to be read, the ACB of **any** share of the corporation owned by the dividend recipient is to be reduced by the amount of the dividend. The T.P.U.S.O.H. and 1971 C.S.O.H. dividends are the subject of considerably complex provisions in the Act that should not be gone into in length in this work however in respect of trusts they will not be included in Division B income nor need they be subject to a spouse's entitlement under the statutory spousal trust setting. Effectively, as distribution of capitalized earnings, **unless specified to the contrary in the trust deed**, following the reasoning in *Waters*, once distributed (on a wind-up) they should be exclusively subject to the entitlement of the capital beneficiaries and not the life tenant.

Subparagraph 212(2) causes capital dividends to be subject to 25% withholding tax when paid to a non-resident and with the 1990 amendments Sec. 212(1)(c) was introduced to provide that amounts derived from a capital dividend when distributed by a trust or estate to a non-resident beneficiary will be deemed income from the trust so as to cause withholding tax to be applied to it. This arises only where it can reasonably be considered with regard to the circumstances including but not limited to the terms /conditions of the trust the payment has such a source and it only applies to capital dividends from Canadian resident corporations.

Subsection 104(19) Taxable Dividend Flow Through Designations.

Subsection 104(19) **allows** a trust that was resident in Canada throughout its tax year to designate as having been received by a beneficiary instead of itself a portion of taxable dividends it received on a share of a capital stock of a taxable Canadian corporation whereby for purposes of the entire Act **other than Part XIII** the portion designated will be deemed not to have been received, at all, by it, but instead received directly by the beneficiary, as a taxable dividend on the share in the year of the trust.¹⁴³⁴ The amount that may be designated must be capable of being reasonably considered to be part of the amount included in the particular beneficiary's income under Sec. 104(13), (14) or section 105 for the year, having regard to all of the circumstances including, but not limited to, the terms and conditions of the trust agreement, while the amount cannot have been designated in respect of another beneficiary. Two limitations are applied to the designatable

¹⁴³². Since such dividends reduce the a.c.b. of the t.d.p. share thus increasing the potential for the recognition of a capital gain upon its disposal the party for whom the share is held should have his entitlement increased by the expected taxes to be paid on that gain that was consequentially generated by the dividend. An amount should be withheld from the dividend amount, if not specified or implied in the deed to the contrary, to substantiate such entitlement, however this understandably isn't the case where the capital and income of the shares are to benefit the same person. If the dividends are distributable in respect of a capital interest in a personal trust acquired for consideration payable there will be an additional reduction in the a.c.b. of the interest thus doubling the tax consequences while if it is paid in respect of an income interest a Sec. 105(1) inclusion will occur. Such amounts are only receivable tax free from a personal trust in respect of a non-purchased capital interest.

¹⁴³³ T.P.U.S.O.H. and 1971 C.S.O.H. are defined in Sec. 89(1)(k) and (l) respectively.

¹⁴³⁴. Paragraph 4 of I.T. 372R provides that the Department will allow a non-resident trust to make the designation in respect of a resident beneficiary if sufficient documentation is provided indicating the amount and source of that received and distributed and the identity of the recipient. Part XIII tax paid on the dividend's way out of the country will not be applicable against the resident's Part I tax liability nor will it be eligible for section 126 foreign tax credit treatment.

amount, the first being the amount of trust income recognized by the beneficiary under the four subdivision K inclusion provisions net of other designations made in respect of it under the other subdivision K designation provisions, and, the amount of taxable dividends received by the trust, (not grossed-up), from taxable Canadian corporations, net of the amount of which was designated in respect of any other beneficiary. Although the trust is able to take the section 121 dividend tax credit deduction from its Part I tax payable, it can do so only up to the amount of tax payable while as per Sec. 108(5) the dividend character of the amount is otherwise lost when it flows through to a beneficiary thus unless the designation is made when a substantial amount of the trust income, of any source, is flowing through to a beneficiary the trust-beneficiary arrangement runs the risk of not allowing the beneficiary to recognize the amount as a dividend and denying the trust the ability to use the section 121 tax credit, due to the simple fact that it does not have sufficient Part I taxes payable.

Subsection 104(19) is not applicable with respect to Part XIII "Income of Non-resident Persons" hence a non-resident beneficiary will not obtain the treatment afforded direct payments of taxable dividends described under Sec. 212(2) but will instead recognize the amount as "estate or trust income" under Sec. 212(1)(c) but only where it was includable in his income under **Sec. 104(13)** had he been resident. Since the Sec. 104(19) designation can never apply in respect of non-residents and the Sec. 212(1)(c) provision applies only to Sec. 104(13) inclusions it would be beneficial to all parties to have the trust recognize the dividend income, take the section 121 tax credit, and in the following period distribute the dividend amount as capital, whereby if it is from a personal trust and in respect of a capital interest which wasn't acquired for consideration, a distribution may be made tax-free. This is manageable with a discretionary distributive power. If the dividend is received from a non-resident-owned investment corporation, and **all** of the property of the trust is owned for the benefit of non-residents or their issue then if the amount thereof is not deducted under Sec. 104(6) the trust will still obtain a deduction in respect of those particular dividends as per Sec. 104(10), although regardless of whether or not the deduction was in fact made, as per Sec. 104(11), the amount will be deemed paid to any non-resident person for purposes of Part XIII thus requiring the trust to remit withholding taxes. Since the section 121 D.T.C. is available only against Part I taxes payable, and since the Sec. 104(19) designation basis looks to all of the circumstances including the trust deed, in order to maximize the benefit of the Sec. 104(19) and section 121 provisions a trust deed should be structured, if possible, so as to allow entitlements to dividend income to always be situated in Canadian resident beneficiaries, and lost if the holder becomes non-resident whereby upon such time the particular beneficiary will gain an entitlement to another source of trust revenue. An accumulating power would also allow the Sec. 104(13) inclusion to be avoided preventing the Part XIII tax liability whereby previously, the capital net of Part I tax net of the section 121 credit, could be distributed subsequently.

It should be recognized that the designation by the trust may be made by the trustee regardless of the opinion of the designatee and is entirely voluntary.¹⁴³⁵ There also isn't any statutory authority that indicates that only the "net" taxable dividend, (net of expenses incurred to derive it), can be designated hence if the trust deed is specifically structured so as to cause the trustee to deduct such expenses the designatable amount is none-the-less restricted to that amount that is "reasonable" in the circumstances. On the other hand the trust need not designate in respect of any beneficiary allowing it to benefit from the section 121 D.T.C. in respect of its tax payable for the benefit of the capital beneficiaries, while in certain instances a beneficiary eligible for an excessive dividend tax credit following a Sec. 104(19) designation may use it to reduce the effective taxation of the other income. Subsection 104(19) refers to any "portion of a taxable capital dividend" received hence it's possible to have the trust deduct interest costs related to the shares and to designate the balance of the taxable dividend out to the beneficiary to get a gross-up and tax credit. Whatever amount wasn't designated out will be grossed up in the trust's hands hence to absorb interest expenses the trust would retain recognition of 80% of the interest expenses.¹⁴³⁶

The subsection 104(19) designation changes the character of the income received from the trust from

¹⁴³⁵ If the designation isn't made, and the D.T.C. is lost, the trustee may be exposed to a beneficiary's claim for damages due to inequitable treatment.

¹⁴³⁶ Taxable dividends are designatable; grossed up dividends are technically not taxable dividends.

"income of the beneficiary for the year from a property that is an interest in the trust and not from any other source,..." as described in Sec. 108(5)(a), to a "taxable dividend on the share received by the beneficiary in the particular year from the corporation" and with these specific statutory attributes in mind one has to review para. 74.3(1)(a) whereby a designation made under Sec. 104(19) will take the designated amount out from the scope of the Sec. 74.3(1) attribution provision and cause it to be generally exposed to the section 74.1 or 74.2 attribution rules by virtue of the fact that the shares have been transferred for **"the benefit of"** the particular taxpayer.

"Taxable dividends – Sec. 104(19)"

(19) Such portion of a taxable dividend received by a trust in a taxation year throughout which it was resident in Canada on a share of the capital stock of a taxable Canadian corporation as

(a) may reasonably be considered (having regard to all the circumstances including the terms and conditions of the trust arrangement) to be part of the amount that, by reason of subsection 104(13) or 104(14) or section 105, as the case may be, was included in taxation year of a beneficiary under the trust, and

(b) was not designated by the trust in respect of any other beneficiary under the trust is, if so designated by the trust in respect of the beneficiary in its return of income for the year, deemed, for the purposes of paragraphs 82(1)(b) and 107(1)(c) and (d) and section 112, not to have been received by the trust, and for the purposes of this Act (other than Part XIII),

to be a taxable dividend on the share received by the beneficiary in the particular year from the corporation.¹⁴³⁷

1437 July. 2010 FINANCE TECHNICAL NOTES (Part 1.- technical): Subsection 104(19) permits a trust to designate a taxable dividend received by it in a taxation year on the share of a taxable Canadian corporation. Where the designation is made in respect of a beneficiary under the trust, the dividend is treated, for the purposes of the Act (other than Part XIII), as a taxable dividend received by the beneficiary from the corporation, and is treated, for the purposes of the dividend gross-up in paragraph 82(1)(b) and stop-loss rules in paragraphs 107(1)(c) and (d) and section 112, as not having been received by the trust.

Subsection 104(19) is amended to clarify that where a designation, in respect of a taxpayer, is made by a trust in respect of a taxable dividend received by the trust in a particular taxation year of the trust, on a share of the capital stock of a taxable Canadian corporation, the portion of the dividend in respect of which the designation is made is

- for the purposes of paragraphs 82(1)(b) and 107(1)(c) and (d) and section 112, deemed not to have been received by the trust, and
- for the purposes of the Act other than Part XIII, deemed to be a taxable dividend on the share received by the taxpayer in the taxpayer's taxation year in which the particular taxation year of the trust ends.

These deeming rules do not apply, however, unless a number of conditions are met. One of these conditions - that a designated amount not be made in respect of more than one beneficiary under the trust - is replaced with a new requirement that the total of all amounts designated by the trust under subsection 104(19) for the particular taxation year of the trust not exceed the total of all amounts each of which is the amount of a taxable dividend received by the trust in the particular taxation year on a share of the capital stock of a taxable Canadian corporation.

The deeming rules under subsection 104(19) apply, in respect of a beneficiary under the trust, only to the portion of the amount, designated under that subsection, that may reasonably be considered (having regard to all the circumstances including the terms and conditions of the trust arrangement) to be part of the amount that, by reason of subsection 104(13) or (14) or section 105, as the case may be, was included in computing the income for a particular taxation year of a beneficiary under the trust. This condition is also amended and now provides that the portion of a taxable dividend designated by a trust is deemed to be a taxable dividend of a taxpayer who is a beneficiary of the trust (and not to be a dividend received by the trust) only if an amount equal to the amount of the designated portion may reasonably be considered (having regard to all the circumstances including the terms and conditions of the trust) to be part of the amount that, because of paragraph 104(13)(a) or subsection 104(14) or section 105, was included in computing the income of that taxpayer (i.e., the taxpayer in respect of whom the amount is designated).

The amended reference in the above rule to paragraph 104(13)(a), instead of subsection 104(13), applies to taxation years that end after July 18, 2005. This change clarifies that the deeming rules do not apply to taxable dividends, received by a trust governed by an employee benefit plan and paid to an employer under the plan. This is intended to ensure the appropriate characterization of such amounts for purposes of the rules relating to employee benefit plans. For taxation years that end after February 27, 2004 and on or before July 18, 2005, the referenced provision is subsection 104(13).

Taxable Dividends Received From Foreign Affiliates.

The subsection 104(19) designation is applicable only in respect of taxable dividends from **taxable Canadian corporations** which as per the Sec. 89(1)(i) definition of the term includes a "Canadian corporation" not including those exempt from tax under Part I while "Canadian corporations" include those resident in Canada that were incorporated in Canada or resided in Canada continuously since June 18, 1971, hence taxable dividends from foreign affiliates or controlled foreign affiliates of the trust described in Sec. 95(1)(d) or (a) respectively cannot be designated upon. Although the trust will be eligible to make certain deductions, (**and** be required to recognize certain arbitrarily derived inclusions, under the section 91 rules if the foreign affiliate is a C.F.A.), it will not be able to take the section 113 deductions in respect of the dividends if the payor is just a foreign affiliate, due to the fact that the trust is not a corporation. For this reason, if the trust is to hold considerable ownership of non-resident corporations (F.A.'s), (though limited to a portfolio nature), it could be more advantageous to do so through the incorporation of a wholly owned holding corporation into which the foreign corporation's shares would be transferred so that it could benefit from the Sec. 113(1), (and Sec. 113(2)), deductions in respect of the dividends received, thus cleansing their source when they are subsequently distributed out to the trust and then possibly to its beneficiaries.¹⁴³⁸

Part IV Tax.

Part IV Sec. 196(1) of the Act applies a tax on certain intercorporate dividend distributions, (which may be refunded given the existence of proper conditions), equal to "1/4 " of the amount of dividends received by a "particular" corporation that were **deductible** by it under Sec. 112(1), or 113(1)(a)(b), or (d), or (2), (other than those received from **connected** corporations), plus 4 times the amount of dividend refund¹⁴³⁹ received by a connected payer corporation in respect of the Sec. 112(1) deductible dividends received by the particular corporation that exceeds the aggregate of certain non-capital and farm losses of the recipient "particular" corporation deducted by it in the year. The tax is conceptually targeted to apply to intercorporate dividends so

Except as noted above, these amendments apply to taxation years that end after February 27, 2004.

March 2001 FINANCE TECHNICAL NOTES: Subsection 104(19) permits a trust to designate dividends received by it in a taxation year on shares of a taxable Canadian corporation to be taxable dividends received by a beneficiary of the trust, rather than by the trust itself, in the year from the corporation.

Subsection 104(19) is amended so that a trust will, except for the purposes of the dividend gross-up in paragraph 82(l)(b) and stop-loss rules in paragraphs 107(1)(c) and (d) and section 112, still be treated as having received the dividend even if it is designated in favour of a beneficiary. In most cases, the trust will be allowed a corresponding deduction under subsection 104(6) to offset the resulting income inclusion. However, as described in the commentary on amendments to subsection 104(6), there are certain restrictions under, amended subsection 104(6) on the deduction of amounts made payable from alter ego trusts, joint spousal or common-law partner trusts and post- 1971 spousal or common-law partner trusts.

1988 FINANCE TECHNICAL NOTES: Subsection 104(19) permits a trust to designate dividends received by it in a taxation year on shares of a taxable Canadian corporation to be taxable dividends received by a beneficiary of the trust in the year from the corporation. New subsection 104(19) is introduced to clarify that any dividend so designated by a trust shall be considered to have been received by the beneficiary on the share of the capital stock of the corporation on which the dividend was received by the trust. This measure thus ensures that where a dividend is received on a taxable preferred share or a taxable RFI share a beneficiary of a trust will be equally subject to tax under new Part IV.1 whether the dividend is received directly by the beneficiary or received by the trust and allocated to the beneficiary.

1982 FINANCE TECHNICAL NOTES: Subsection 104(19) provides that taxable dividends on shares of a taxable Canadian corporation that are flowed through a trust retain their character as taxable dividends in the hands of beneficiaries of the trust for the purposes of section 82. Such dividends are therefore eligible for the dividend tax credit where the beneficiary is an individual. The amendment to subsection 104(19) provides that such dividends will retain their character in the hands of beneficiaries for all purposes of the Act other than for the purpose of the non-resident withholding tax under Part XIII. Taxable dividends flowing through a trust to a non-resident beneficiary will continue to be treated as income from a trust rather than as dividend income for non-resident withholding tax purposes.

1438. In order for this to be beneficial the balance in the "exempt surplus" or "pre-acquisition surplus" accounts of the foreign affiliate described in Reg. 5907(1) would have to be reasonably substantial in order to allow the incorporation costs etc to be economically with regard also to the amount of section 121 deduction/tax reduction that will occur.

1439. described under Sec. 129(1)

as to cause the dividend to be exposed to, generally, a 25% tax rate if **it is deductible** in computing the recipient's income, thus it is to operate as a deterrent to taxpayers who transfer dividend producing shares into private corporations so as to allow the use of the section 112 or 113 deductions. The "particular" corporation can be, as per the preamble of Sec. 186(1), any and "every corporation...that was, at any time in a taxation year, a corporation resident in Canada and controlled whether by reason of a beneficial interest in one or more trusts or otherwise, by or for the benefit of an individual (other than a trust) or a related group of individuals (other than trusts)...or a private corporation..."¹⁴⁴⁰ If the recipient corporation is resident in Canada in order for Part IV to apply to it it must have been controlled through one of the various methods cited in Sec. 186(1) and although Sec. 186(2) provides that one corporation will be considered controlled by another for purposes of Part IV if more than 50% of its issued share capital having voting rights under all circumstances "belongs" to the corporation, persons with whom then corporation does not deal at arm's length or to both. This definition applies only for purposes of Part IV and prevents those in section 251 from having any effect. A private corporation can control a payer corporation through a trust when it can control the trustees' actions via removal/influence so as not to be at arm's length with the trust.¹⁴⁴¹

Subsection 186(1) applies to every corporation that was resident in Canada at any time in its tax year and that was controlled, at any time in its tax year by any of the above methods for the benefit of an individual other than a trust although these criteria apply only when the corporation isn't a private corporation. If the recipient corporation is a private corporation then it need not satisfy any of the above, (except of course residency), and will be exposed to Part IV tax on its appropriate dividend receipts.

Subsection 186(1), paragraph (b) requires the inclusion in the Part IV tax base of the amount equal to four times the amount of dividend refund the payor corporation realized in respect of a dividend paid that was **deductible** by the particular (subject) corporation under Sec. 112(1) but only where the payor corporation is **"connected"** to the recipient particular corporation. Subsection 186(4) provides a definition of "connectedness" whereby; two corporations will be connected if the payor corporation is controlled¹⁴⁴² by the recipient at the time of receipt **or** the recipient owned at the time more than 10% of the number of issued share capital of the payer having irrevocable voting rights and any shares of the corporation having a fair market value in excess of 10% of the fair market value of all of the payor corporation shares. In the former case subsection 186(2) provides that a corporation is controlled by another corporation if more than 50% of the issued share capital having irrevocable full voting rights "belongs" to another corporation or, **to persons not at arm's length with the other corporation** however the Sec. 186(4)(a) provision precludes the recognition of control when a person has a right under a contract, or an equitable right or otherwise either immediately or in the future, absolutely or contingently to, or to acquire, the shares in the corporation or to control the voting rights of such shares or to cause the corporation to redeem, acquire or cancel any shares of its capital stock owned by shareholders, as that described in Sec. 251(5)(b). Thus in order for a payor corporation to be controlled by a corporate beneficiary the beneficiary would have to control the payor outright either through the ownership of the required number of shares, or possibly through the reliance upon Sec. 186(2) where the trust would hold control of the corporation¹⁴⁴³ otherwise if the payer corporation pays a taxable dividend to the trust that then makes a designation under Sec. 104(19) in respect of the corporate beneficiary, Part IV tax will be applied to the dividend received but the corporate beneficiary will not have to include in its Part IV tax base the dividend refund the payer may otherwise have been entitled to receive. If the corporate beneficiary and trust are not at arm's length Sec. 186(2) will apply to allow control to possibly be recognized, but if not¹⁴⁴⁴ then Sec.

¹⁴⁴⁰ Part IV does not provide a definition of "private corporation" although Sec. 248(1), for purposes of the Act, provides that the definition in Sec. 89(1)(f) is applicable being, generalized, that a non-public corporation that is not controlled by a public corporation is a private corporation.

¹⁴⁴¹ The Sec. 186(2) control definition does not apply to "subject corporations": corporations other than private corporations resident in Canada that are controlled directly or indirectly by or for the benefit of an individual or related groups of individuals other than trusts. The Sec. 186(2) definition does apply to private corporations while the Sec. 256(5.1) & (6) definitions of control supplement the common law test of de jure ownership of a number of shares owned sufficient to elect a majority of the board of directors applicable to establish control of the non-private corporation.

¹⁴⁴² otherwise than by virtue of a right described in Sec. 251(5)(b)

¹⁴⁴³ The associated corporation rules in Sec. 256(1.2)(f) do not apply for these purposes.

¹⁴⁴⁴ such as the case where a trust company administers the trust

186(2) will not have any effect and the tax refund mechanism will not operate.¹⁴⁴⁵

The dividend refund mechanism allows the dividend refund to be received by a **private** corporation equal to the lesser of 1/4 of all taxable dividends paid by it in the year and its refundable dividend tax on hand for the particular year, the latter defined in Sec. 129(3) to include the aggregate of certain amounts one of which is the amount of Part IV tax payable or paid by the private corporation in respect of the receipt of certain dividends and thus, in general for purposes of this discussion, the section 129 mechanics in conjunction with Sec. 186(1)(b) effectively allow the Part IV tax to cascade through inter "connected" private corporations along with the dividends. If it were not for the effect of Sec. 186(2) then a corporate beneficiary under a trust could never be considered connected with an upstream payer corporation¹⁴⁴⁶ thus although the upstream private corporation would receive at least a partial dividend refund under Sec. 129(1)(a) when it paid taxable dividends, a corporate beneficiary would recognize only the initial Sec. 186(1)(a) Part IV tax based inclusions of the taxable dividend (assuming the Sec. 104(19) designation was made) and not the secondary one.

If the subsection 104(19) designation is not made in respect of a corporate beneficiary then the proceeds of the taxable dividends received by the corporate beneficiary will be, as per Sec. 108(5)(a), received as income from a property which is a trust interest and thus the payer corporation may obtain a partial or full Part IV dividend tax refund under Sec. 129(1) while the corporate beneficiary will be immune from Sec. 186(1) in respect of them, although it will not benefit from the Sec. 112(1) deduction and will be required to recognize an income inclusion under Sec. 104(13).¹⁴⁴⁷ If the trust holds 40% of a certain class of shares and the corporate beneficiary holds 20% of the same class of the payor it would appear that the Sec. 186(1) targeting provision is satisfied in that control is established to exist "by reason of a beneficial interest in one or more trusts...by or for the benefit of an individual...or private corporation". It must be recognized that where the trust's terms preclude the individual or private corporation from benefitting from the ownership of the shares the Sec. 186(1) charging provision can be avoided and in this particular instance trust is not considered an individual.

Subsection 104(20) Non-Taxable Dividend Designations.

Subsection 104(19) provides a provision by which a trust may voluntarily designate as having been realized by one of its beneficiaries the proceeds of any part of a taxable dividend from a taxable Canadian corporation that was received by it in the year and the amount of such a designation is thus treated as a taxable dividend received by the beneficiary. Subsection 104(20) **formerly** provided a virtually identical provision in respect of non-taxable dividends but this was repealed with the 1988 reform. Subsection 104(20) now provides that such portion of dividends, other than taxable dividends, received from a Canadian resident corporation by a trust that was resident in Canada throughout its tax year as may reasonably be considered, having regard to all the circumstances including the terms of the trust deed, to be part of an amount that became **payable** to a particular beneficiary in the year of receipt by the trust, **must be** designated by the trust in respect of the particular beneficiary, like the Sec. 104(19) designation, in its T.3 return for the year, for purposes of Sec. 53(2)(h)(i.1)(B)(ii), 107(1)(c), 112(3.2) and (4.3), and thus this provision altered is very different from former Sec. 104(20) which allowed for the recognition of the non-taxable dividend characteristic by the beneficiary but did not make the recognition mandatory. It also, more importantly, **doesn't** cause a flow through of its character

¹⁴⁴⁵ Question 26 of the 1990 Roundtable Discussions confirmed that a corporate beneficiary will also not be recognized to own the shares of the corporation owned by the trust upon which the dividends were paid, Part IV tax applied and Sec. 104(19) designation made even though it may have been the only beneficiary. The Department thus takes the position that it is the legal ownership of the shares that is to be concerned with and though the beneficiary may have beneficial ownership it doesn't make a difference. In such a case the corporate beneficiary's Part IV tax base will not include 4 times the dividend refund received by the payer corporation under Sec. 129(1) and holding the shares in trust failing the applicability of Sec. 256(1.2)(f) serves as an interesting method of disrupting the cascading of the Part IV tax through chains of private corporations. Q 6 of the 1991 Roundtables confirmed this position and it was opined that it also applied for purposes of Part IV.1 and VI.1 tax.

¹⁴⁴⁶ unless it controlled the payer directly

¹⁴⁴⁷ Pursuant to Sec. 129(4)(a)(ii) business income and capital gain flowing through a trust that is subject to Sec. 108(5)(a) causing it to be income from property (a trust interest) will retain its business or gain income character for purposes of computing the dividend payer's refundable dividend tax of hand, and thus be excluded from being "Canadian" or "foreign investment income". When the Sec. 104(19) designation isn't made the corporate beneficiary which then goes on to pay a dividend will be able to include in its RDTOH, as per the mechanics of Sec. 129(3)(a) possibly, a portion of the dividend received.

to allow the beneficiary to be considered to have received a capital dividend: this is not its purpose and nothing in the provision allows for such an interpretation.

Subparagraph 53(2)(h)(i.1)(B)(II) effectively disallows a distribution of capital in respect of a capital interest payable after 1987 to cause an ACB adjustment in respect of a capital interest in a trust¹⁴⁴⁸ if the capital was the amount that was subject to a Sec. 104(20) designation hence in this respect a Sec. 104(20) designation disqualifies the potential for a possible ACB adjustment in respect of a capital interest and is thus beneficial. Unfortunately since the payment has not been included in computing the recipient beneficiary's income and has not led to an ACB adjustment Sec. 105(1) will apply to it to cause its payment to be included as a benefit from the trust and fully included in income. It should be recognized however that Sec. 53(2)(h) does not apply in respect of capital interests in personal trusts that were **not acquired** for consideration payable, hence a designation under Sec. 104(20) in respect of a beneficiary holding a capital interest not purchased will **not lead** to an ACB adjustment **and** may not lead to a Sec. 105(1) inclusion by virtue of Sec. 105(1)(b)(ii) itself.

Subparagraph 53(2)(h)(i.1)(B)(II) prevents the substance of a Sec. 104(20) designation from causing an ACB reduction of the capital interest if it is paid in respect of the interest after 1987 but this is of concern when the interest **wasn't** an interest in a personal trust acquired for consideration payable or a Sec. 108(1)(j)(ii) to (v) trust capital interest. It must be noted that the Sec. 108(1)(c) definition of "capital interest" **in terms of personal trusts** is based on rights to trust law capital and the capital dividend, unless paid as a return of corporate legal capital, will be trust law **income** in the trust's hands and a beneficiary's right to receive it will be, in the case of a personal trust, (regardless of whether it was purchased), an **income interest** preventing Sec. 53(2)(h) from being relevant. The Sec. 104(20) designation is **mandatory** only when the current receipt of the non-taxable dividend is currently payable/paid hence it cannot be trust law capitalized in the trust's hands when the designation is made. If it is then the designation need not be made.

In the case of a personal a beneficiary holding a right to receive non-taxable (as well as taxable) dividends as they are received by the trust will **hold an income interest** and though the Sec. 104(20) designation is made the dividend will not be included in his income via Sec. 104(13) since it isn't Division B income and it isn't paid/payable in respect of a capital interest hence Sec. 105(1) is **not prevented** from applying to it by virtue of paragraph (b) therein and the non-taxable dividend will be fully included in the beneficiary's income reintroducing it to Part I tax. This stems from the abnormally weak implied definition of "capital interest", as mutually exclusive of an income interest based on Sec. 108(3), in that it is based on trust law capital - not tax law capital. Unless the capital dividend constitutes a reduction in paid up capital it will usually be received as trust law income and not payable in respect of a trust law capital interest.

Where the beneficiary under a personal trust has a right to receive the dividend after it has been held for one year by the trust, **and the right wasn't purchased**, Sec. 53(2)(h) will not apply to its payment while Sec. 105(1) will apply **as if it did** and the distribution of that dividend will be tax free. This is perhaps one of the only ways to realize non-taxable dividends from a trust in a tax free manner without extinguishing the interest.

If the income interest above was purchased its cost will not be deductible against the Sec. 105(1) income inclusion but the cost would usually cause a Sec. 106(2) income inclusion and thus a purchased income interest based on non-taxable dividend streams currently payable will not only reintroduce the dividends realized back into income but also cause an effective **double** income inclusion if the cost of the interest cannot be deductible against other income realized. If the capital interest is purchased than a capitalized distribution will cause an ACB reduction since the Sec. 104(20) designation wasn't made to activate the Sec. 53(2)(h)(i.1)(B)(II) exemption and capital gains potential is created without a Sec. 105(1) inclusion. In almost all cases the only safe way to handle a non-taxable dividend stream flowing through a personal trust is to have it capitalized and distributed in respect of a capital interest that wasn't acquired for consideration payable.

In the case of a non-personal trust all interests are capital interests and Sec. 53(2)(h) doesn't apply to the exclusion of Sec. 105(1). If the dividend is currently payable the Sec. 104(20) designation is made and pursuant to Sec. 53(2)(h)(i.1)(B)(II) the amount will **not** lead to an ACB reduction hence Sec. 105(1)(b) will **not** operate **to prevent** a Sec. 105(1) income inclusion from being in order due to the fact that the amount wasn't included in computing the beneficiary's income under Sec. 104(13). If the dividend is accumulated until the

1448. other than an interest in a personal trust which was not purchased by the beneficiary

next period after its receipt by the trust the Sec. 104(20) designation isn't in order, the trust doesn't recognize it in its income and when distributed the ACB of the capital interest will be reduced under Sec. 53(2)(h). The accumulation would then prove more beneficial in that a 3/4 income inclusion due to a capital gain caused by a reduced ACB is better than a full income inclusion caused by Sec. 105(1).¹⁴⁴⁹ If the beneficiary is non-resident Sec. 105(1) does not, at the time of writing, cause any tax consequences viz-a-viz Part XIII withholding but if the dividend is a capital dividend it will lead to a Sec. 212(1)(c) withholding liability whether it's accumulated or not.

"Designation in respect of nontaxable dividends – Sec. 104(20)"

(20) The portion of the total of all amounts, each of which is the amount of a dividend (other than a taxable dividend) paid on a share of the capital stock of a corporation resident in Canada to a trust during a taxation year of the trust throughout which the trust was resident in Canada, that can reasonably be considered (having regard to all the circumstances including the terms and conditions of the trust arrangement) to be part of an amount that became payable in the year to a particular beneficiary under the trust shall be designated by the trust in respect of the particular beneficiary in the return of the trust's income for the year for the purposes of subclause 53(2)(h)(i.1)(B)(II), paragraphs 107(1)(c) and 107(1)(d) and subsections 112(3.1), 112(3.2), 112(3.31) and 112(4.2).¹⁴⁵⁰

and "Loss Limitations."

The Sec. 104(20) designation also applies for purposes of Sec. 107(1)(c) which causes a corporate beneficiary's capital loss on the disposition of any part of a trust capital interest to be reduced by the amount of taxable dividends or non-taxable dividends received by the corporation through a Sec. 104(19) or (20) designation hence a designation under Sec. 104(20) in respect of a corporate beneficiary may have some consequence if the corporation has a capital interest in the trust, if the corporation is going to dispose of it, and if the consequences of such a disposition will be the recognition of a capital loss under the subdivision C rules by the corporation.¹⁴⁵¹ It should be recognized that the interest disposed of that is affected by Sec. 107(1)(c) need not be referenced to the shares producing the dividends or the dividend stream itself and thus any interest disposition, possibly of an interest based on foreign resource property income of the trust etc., that produces a loss, will be affected by a Sec. 104(20) designation. If the corporation does not have a **capital interest** in

¹⁴⁴⁹ The Sec. 104(2) designation may also reduce possible loss recognition on the disposition of the shares: a secondary consideration as will be discussed subsequently.

¹⁴⁵⁰ Dec. 1998 FINANCE TECHNICAL NOTES (trusts): For the purposes of certain loss limitation and other rules in the Act, subsection 104(20) requires a trust resident in Canada to designate the non-taxable dividends that are received by the trust and subsequently distributed to the trust's beneficiaries. Subsection 104(20) is amended so that it also applies for the purpose of the amended loss limitation rules in sections 107 and 112 and for the purpose of new clause 53(2)(h)(i.2)(B).

Dec. 1997 FINANCE TECHNICAL NOTES (technical): For the purposes of certain loss limitation rules in the Act, subsection 104(20) requires a trust to designate the non-taxable dividends that are received by the trust and subsequently distributed to the trust's beneficiaries. The amendment to this provision is consequential on the amendments to the loss limitation rules in section 112 and the addition of paragraph 107(1)(d) to the Act. The amended loss limitation rules and new paragraph 107(1)(d) are added to the list of purposes of the Act for which designations will be considered to have been made under subsection 104(20).

1988 FINANCE TECHNICAL NOTES: Subsection 104(20) ensures that the amount of capital dividends received by a trust in a year and flowed out to a beneficiary in that year will not be taxed when received by its beneficiaries. But for such a provision, it might be argued that such amounts received by the beneficiary were included in the beneficiary's income as a benefit under subsection 105(1). As a result of changes to subsection 105(1), it is no longer necessary to specifically exclude such amounts in computing income of a beneficiary. However, in order to allow such amounts to flow out to beneficiaries without a reduction in the adjusted cost base of their trust interests and to preserve the "stop-loss" rules found in subsections 112(3.2) and (4.3) in respect of shares held by trusts, amended subsection 104(20) provides that a resident trust must make a designation in respect of the capital dividends received and flowed out in a year to its beneficiaries.

¹⁴⁵¹ As previously discussed the capital interest in this case would have to be a right to receive income from a **non-personal** trust in that if the trust is personal the right to current non-taxable dividends would be an income interest.

the trust then a Sec. 104(20) designation in respect of it will not be possible.¹⁴⁵² The subsection 104(20) designation also applies for purposes of subsections 112(3.2) and (4.3), both of which may affect the loss recognizable by the trust, mutually exclusively, when the trust disposes of the dividend producing share. Subsection 112(3.2) and (4.3) are virtually identical provisions which caused the loss¹⁴⁵³ recognized by the trust (other than a prescribed trust) on the disposition of the dividend producing share to be reduced by the amount of designations made by the trust under Sec. 104(19) or (20) in respect of any corporate beneficiary unless the trust owned the share at least for a period of 365 days or longer before the disposition **and** the trust, the corporation, and persons with whom the corporation was not dealing at arm's length did not at the time the dividend was received own aggregately amongst themselves greater than 5% of the issued shares of **any** class of capital stock of the corporation from which the dividend was paid. If the shares were inventory to the trust then the loss recognizable will not be reduced by the Sec. 131(1) capital dividends received in respect of the shares, while it should be recognized that in both instances the amount of shares owned by parties not at arm's length **to the trust** but dealing at arm's length with the corporate beneficiary will not have any effect. If the shares are held by the trust as inventory then the designations that will have effect need not be those made only in respect of corporations but instead include those made in respect of any taxpayer. Subsection 112(3.2) and (4.3) affect the trust directly rather than through the beneficiaries, as do the other provisions cited in Sec. 104(20). Subsection 104(20) doesn't alter the character of the receipt in the beneficiary's hands as is the case with Sec. 104(19) taxable dividends and Sec. 104(21) taxable capital gains. It only specifies an amount in respect of a payment and that amount is consistently referred to as such, not a non-taxable dividend. In such a case then a shareholder could finance a trust's acquisition of an interest in trust which has non-taxable dividend producing shares and the financed trust's beneficiary could be a corporation. the trust will also remain personal if the settlor is an individual. the payer corporation would shell out non-taxable dividends and the top tier trust would make the mandatory Sec. 104(20) designation but the second tier trust would not have to since it isn't recognizing the receipt as a non-taxable dividend paid on a Canadian corporation's share but the amount would have to be recognized in income via Sec. 104(13) as income from a trust interest. If the top tier trust is personal, and the interest therein is a right to capitalized non-taxable dividends then the personal trust would not recognize income when it accumulates a non-taxable dividend and would not make a Sec. 104(20) designation and the corporate beneficiary could receive the capital tax free via Sec. 53(2)(h)-105(1)(b) if the interest was not acquired for consideration payable and when the trust disposes of the shares or the corporate beneficiary disposes of the interest any loss would not be cut back by Sec. 104(20) designations not made.

Given these possible effects that may occur upon a mandatorily imposed Sec. 104(20) designation, the majority of which may prove disadvantageous to the beneficiaries or trust it would seem prudent to attempt to insure that the trust deed is properly drafted so as to avoid the possible consequences and with this in mind one has to recognize that other than being "reasonable in the circumstances" the designation must be made in respect of an amount **received in the year** that was also **payable in the year** hence if the trust deed provides that non-taxable dividends are to be held until the next fiscal period, at least, by the trust upon receipt a Sec. 104(20) designation cannot be made in respect of them. This may cause the dividend amounts to cause a capital interest ACB adjustment, under Sec. 53(2)(h)(i.1) when they are distributed, **if** that provision applies.

The designation is **mandatory** in respect of amounts received as non-taxable dividends from Canadian resident corporations that were payable in the year of receipt **to the particular beneficiary**, and not payable on his behalf for his benefit, and although the Sec. 104(24) "amount payable" definition is expressly applicable, it applies only when the amount is payable **to a beneficiary**. If it is paid on a beneficiary's behalf to another person Sec. 56(2) will not apply, (since the dividend wouldn't have otherwise been income), while Sec. 105(1) will in that the payment wasn't made to the corporate beneficiary regardless of its possible effect on the ACB of its capital interest. Subsection 104(20) applies regardless of the residence of the beneficiary¹⁴⁵⁴. If the funds of the trust are to be mingled then there can be considerable debate as to the source of the amount received

¹⁴⁵² This is the case with personal trusts.

¹⁴⁵³ be it capital in the former instance, or income in the latter

¹⁴⁵⁴ while Sec. 105(1) doesn't apply to non-residents

by a beneficiary and whether any part of it is from a non-taxable dividend. In order to be payable to a beneficiary, the beneficiary need not have any particular character of beneficial interest in the trust in that the dividend could be treated as income or capital. Subsection 104(24) applies to determine whether an amount is payable and with respect to this it is possible to have powers of appointment/discretionary powers drafted into the trust deed to purposefully avoid the Sec. 104(20) provisions application. If the payment is made in respect of a trust law income interest Sec. 53(2)(h) could not apply to it however Sec. 105(1) may.

Income Tax Interpretation Bulletin

Losses on Shares on Which Dividends Have Been Received

IT-328R3

DATE: FEBRUARY 21, 1994

SUBJECT: INCOME TAX ACT

LOSSES ON SHARES ON WHICH DIVIDENDS HAVE BEEN RECEIVED

REFERENCE: SUBSECTIONS 112(3), (3.1), (3.2), (4), (4.1), (4.2), (4.3) AND (7) (ALSO SECTIONS 9, 113, 115, SUBSECTIONS 10(1), 40(1), 104(19) AND (20), 112(1), 131(1), 138(6) AND 248(6), AND PART IV AND PART VII)

APPLICATION

This bulletin cancels and replaces Interpretation Bulletin IT-328R2, dated May 27, 1985 and Special Release IT-328R2, dated August 19, 1988.

SUMMARY

The purpose of this bulletin is to explain the "stop-loss" rules in section 112 which may apply to reduce a taxpayer's loss on the sale of a share by the amount of certain dividends received on the share. The bulletin discusses the rules that apply to losses resulting from transactions in shares that are capital property and transactions in shares that are not capital property. It also discusses an adjustment to the value of a share held in inventory that may apply where certain dividends have been received on the share.

DISCUSSION AND INTERPRETATION

SHARES THAT ARE CAPITAL PROPERTY

1. Under subsection 112(3), where a corporation owns a share that is capital property and receives dividends described in 3 below on the share, it must reduce any loss arising from a transaction in respect of that share by the amount of those dividends, unless

- (a) the corporation owned the share for at least 365 days before sustaining the loss; and
- (b) the corporation, alone or with persons not dealing at arm's length with it, did not own more than 5% of the issued shares of any class of the capital stock of the payer corporation at the time the dividend was received.

2. Subsections 112(3.1) and (3.2) provide rules similar to those in 1 above where a share is owned as capital property by a partnership of which a corporation is a partner or by a trust of which a corporation is a beneficiary. Where such a partnership owns the share, the corporate partner's share of any partnership loss on a transaction involving the share is reduced by that corporation's share of dividends described in 3 below. Where a trust holds the share, the trust's loss on a transaction involving the share is reduced by the amount of dividends described in 3 below that have been designated, by the trust, as dividends deemed to be received by the corporate beneficiary under subsection 104(19), or for which the trust has made a designation under subsection 104(20) in respect of the corporate beneficiary.

3. The dividends which are taken into account in determining a corporation's loss under subsection 112(3) or a corporation's share of a partnership loss under subsection 112(3.1) on a share transaction are:

- (a) taxable dividends on the share which were
 - (i) deductible under section 112 or subsection 138(6) in computing the corporation's taxable income, and
 - (ii) not subject to tax under Part VII of the Act as it read on March 31, 1977;
- (b) capital dividends on the share; or
- (c) life insurance capital dividends on the share.

The dividends taken into account in determining the loss of a trust under subsection 112(3.2) are the same as above, except that the requirements in (a)(i) and (ii) do not apply and (a) would refer only to "taxable dividends on the share".

4. Subsection 112(7) provides special rules for applying the provisions of subsections 112(3), (3.1) and (3.2) to losses on a new share that had previously been acquired for an old share in an exchange transaction under section 51, 85.1, 86 or 87. Certain dividends (see 3 above) received or designated on the new share, plus such dividends received or designated on the old share, reduce any loss arising from a transaction involving the new share. If the number of old and new shares exchanged was not equal, the reduction in respect of dividends received or designated on the old share(s), as they apply to a new share, will be calculated as follows:

$$A \times B \div C = D$$

where:

A = dividends received or designated on all the old exchanged shares

B = adjusted cost base of a new share immediately after the exchange

C = adjusted cost base of all new shares immediately after the exchange

D = reduction in the loss on a new share

NOTE: If the draft legislation released by the Minister of Finance on August 30, 1993 is enacted into law as currently proposed, paragraph 112(7)(b) will be amended so that the amount of dividends on an old exchanged share that can be applied to reduce a loss realized on the disposition of a new share will be limited to the lesser of

a) the dividends (described in 3 above) received or designated on the old exchanged share, and

b) the adjusted cost base of the old exchanged share immediately before the exchange.

If the number of old and new shares exchanged was not equal, the reduction which relates to the old exchanged share(s) will be calculated as follows:

$$A \times B \div C = D$$

where:

A = total of all amounts, each of which is the lesser of a) and b) above for each old exchange share

B = adjusted cost base of a new share immediately after the exchange

C = adjusted cost base of all new shares immediately after the exchange

D = reduction in the loss on a new share

This proposed amendment will apply to losses arising in the 1992 and subsequent taxation years.

SHARES THAT ARE NOT CAPITAL PROPERTY

5. Subsections 112(4), (4.2) and (4.3), which apply to any taxpayer, operate in a manner similar to subsections 112(3), (3.1) and (3.2) except that they reduce the loss on disposition of a share that is not a capital property.

A loss arising in respect of a share transaction subject to the rules in subsection 112(4) (the share is owned by a taxpayer) or (4.2) (the share is owned by a partnership of which the taxpayer is a member) will be reduced as follows:

(a) if the taxpayer is an individual, the loss will be reduced by dividends (excluding capital gains dividends received from a mutual fund corporation) received on the share if the corporation that issued the share is a taxable Canadian corporation; and

(b) if the taxpayer is a corporation, the loss will be reduced by taxable dividends deductible under section 112, subsection 115(1) or subsection 138(6) in calculating the corporation's taxable income or taxable income earned in Canada, and any dividend other than a taxable dividend.

The loss reductions described above do not apply to any dividends which were subject to tax under Part VII of the Act as it read on March 31, 1977. These rules apply for taxation years after 1989. However, they also apply for the 1985 to 1989 taxation years if the taxpayer elected to have them apply by notifying the Minister in writing before December 11, 1993. Before 1990 (or before 1985 if the election has been made) a taxpayer's loss or a taxpayer's share of a partnership loss would have to be reduced by any dividends received on the share, excluding any capital gains dividends received from a mutual fund corporation and

any portion of taxable dividends on which the taxpayer was required to pay tax under Part VII of the Act as it read on March 31, 1977.

Subsection 112(4.3) applies if the taxpayer is the beneficiary of a trust (other than a prescribed trust) that owns a share that is not capital property and the taxpayer receives a dividend in respect of the share pursuant to a designation under subsection 104(19) or the trust has made a designation under subsection 104(20) in respect of the taxpayer for a dividend on the share. Subsection 112(4.3) requires that any loss of the trust arising from a transaction in respect of the share must be reduced by any dividends (other than a capital gains dividend received from a mutual fund corporation) designated under subsection 104(19) or (20).

NOTE: If the draft legislation released by the Minister of Finance on August 30, 1993 is enacted into law as currently proposed, subparagraphs 112(4)(d)(ii) and 112(4.2)(d)(ii) will be amended so that they also exclude a capital gains dividend received from a mutual fund corporation. As a result, (b) above would be revised to:

(b) if the taxpayer is a corporation, the loss will be reduced by taxable dividends deductible under section 112, subsection 115(1) or subsection 138(6) in calculating the corporation's taxable income or taxable income earned in Canada, and any dividend other than a capital gains dividend received from a mutual fund corporation or a taxable dividend.

This proposed amendment will apply to losses arising in the 1990 and subsequent taxation years; however, it will also apply to the 1985 to 1989 taxation years if the above-noted election has been made.

6. The stop-loss rules in 5 above do not apply if:

(a) the taxpayer, partnership or trust, as the case may be, owned the share 365 days or longer before the loss was sustained; and

(b) alone or with persons the taxpayer did not deal with at arm's length, the

(i) taxpayer,

(ii) partnership and the taxpayer (partner), or

(iii) trust and the taxpayer (beneficiary),

as the case may be, did not own more than 5% of the issued shares of any class of the capital stock of the payer corporation at the time the dividend was received.

7. The inventory value of a share which is not a capital property of a taxpayer (other than a prescribed trust) or a partnership which holds it is determined under subsection 112(4.1). This subsection provides that the fair market value of the share will be deemed to be its fair market value otherwise determined at the time the inventory is being valued plus:

(a) if the shareholder is an individual and the corporation paying the dividend is a taxable Canadian corporation, the total of all dividends (except a capital gains dividend received from a mutual fund corporation) received before that time on the share, or that would have been received if the Act were read without reference to subsection 104(19);

(b) if the shareholder is a corporation, any taxable dividend received on the share before that time that was deductible under section 112 or 113 or subsection 115(1) or 138(6) in calculating the corporation's taxable income or taxable income earned in Canada and any dividend other than a taxable dividend received on the share before that time; and

(c) if the shareholder is a partnership, the total of any dividends (other than a capital gains dividend received from a mutual fund corporation) received on the share before that time.

The additions to the value of shares held in inventory described above do not apply to any dividends which were subject to tax under Part VII of the Act as it read on March 31, 1977. These rules apply for taxation years after 1989. However, they also apply for the 1985 to 1989 taxation years if the taxpayer elected to have them apply by notifying the Minister in writing before December 11, 1993. Before 1990 (or before 1985 if the election has been made) the fair market value otherwise determined of the shares, held by any holder referred to above, would have to be increased by any dividends received in respect of the shares (determined without reference to subsection 104(19)), excluding any capital gains dividends from a mutual fund corporation.

Subsection 112(4.1) does not apply if the shareholder held the share for at least 365 days before the time of inventory valuation and the shareholder, alone or together with any non-arm's length person, did not hold more than 5% of the issued shares of any class of the payer corporation at the time the dividend was received.

Note: If the draft legislation released by the Minister of Finance on August 30, 1993 is enacted into law as currently proposed, subparagraph 112(4.1)(d)(ii) will be amended so that it also excludes a capital gains dividend received from a mutual fund corporation. As a result, (b) above would be revised to:

(b) if the shareholder is a corporation, any taxable dividend received on the share before that time that was deductible under section 112 or 113 or subsection 115(1) or 138(6) in calculating the corporation's taxable income or taxable income earned in Canada and any dividend received on the share before that time, other than a capital gains dividend received from a mutual fund corporation or a taxable dividend; and.

This proposed amendment will apply to the 1990 and subsequent taxation years; however, it will also apply to the 1985 to 1989 taxation years if the above-noted election has been made.

GENERAL COMMENTS

8. The loss referred to in subsections 112(3), (3.1) and (3.2) is a capital loss within the meaning of paragraph 39(1)(b) and calculated under paragraph 40(1)(b). The amount of the loss referred to in subsections 112(4), (4.2) and (4.3) is an amount calculated by reference to the aggregate of the costs of acquiring the share and other related costs used in determining income. Adjustments under subsections 112(4), (4.1), (4.2) and (4.3) are determinants of income or loss from a business or property within section 9.

9. The inclusion of the amount of a dividend in calculating the fair market value of a share under subsection 112(4.1) does not prevent the inclusion of all or any part of that dividend in the calculation of a loss pursuant to subsection 112(4), (4.2) or (4.3) at any subsequent time. The example in the Appendix illustrates this principle.

10. Part IV tax on a dividend received is applicable even though the dividend, or a part thereof, was applied to reduce a loss for purposes of subsection 112(3), (3.1), (3.2), (4), (4.2) or (4.3), or to increase the fair market value of a share under subsection 112(4.1).

11. For purposes of subsections 112(3) to 112(4.3), any reference to "5% of the issued shares of any class of the capital stock" should be interpreted as "5% of the issued shares of any series of a class of shares" when there is more than one series of the same class of shares.

If you have any comments regarding the matters discussed in this bulletin, please send them to:

Director, Technical Publications Division
Legislative and Intergovernmental Affairs Branch
Revenue Canada - Customs, Excise and Taxation
875 Heron Road
Ottawa, Ontario
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APPENDIX EXAMPLE ASSUMPTIONS

1. Cost to Corporation A of share of Corporation B acquired on June 28, 1991 as trading property	\$80
2. Taxable dividend received from Corporation B on August 15, 1991 and deducted under subsection 112(1) by Corporation A	\$ 4
3. Fair market value of share at 1991 fiscal year end November 30	\$78
4. Proceeds of disposition of share, March 5, 1992	\$75
5. Corporation A held more than 5% of the issued shares of Corporation B at all relevant times	

APPLICATION OF SUBSECTION 112(4.1)

Cost of share		\$80	
		=====	
Deemed fair market value of share determined under subsection 112(4.1):			
Fair market value otherwise determined	\$78		
Taxable dividend received	\$ 4	\$82	
	-----	=====	
Lower of cost and fair market value at November 30, 1991		\$80	
		=====	
Loss from inventory adjustments		NIL	
		=====	
APPLICATION OF SUBSECTION 112(4)			
Carried value of inventory December 1, 1991		\$80	
Proceeds of disposition, March 5, 1992		\$75	

Loss otherwise determined		\$ 5	
Less: Taxable dividend received		\$ 4	

Loss determined under subsection 112(4)		\$ 1	
		=====	

EXPLANATION OF CHANGES FOR INTERPRETATION BULLETIN IT-328R3 LOSSES ON SHARES ON WHICH DIVIDENDS HAVE BEEN RECEIVED

INTRODUCTION

The purpose of the Explanation of Changes is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised departmental interpretations.

OVERVIEW

This bulletin discusses the "stop-loss" rules in section 112 which may apply to reduce a taxpayer's loss on the sale of a share that is capital property, as well as the loss on the sale of a share that is not capital property, by the amount of certain dividends received on the share. It also discusses an adjustment to the fair market value of a share held in inventory that may apply where certain dividends have been received on the share.

We revised the bulletin to reflect changes in the Income Tax Act resulting from Bill C-18, which received Royal Assent on December 17, 1991. In addition, the proposed amendments in the August 30, 1993 draft legislation, which affect the bulletin, have been reflected in italics where applicable. The contents of this bulletin, however, are not affected by the proposed changes in Bill C-136. (Bill C-136 was tabled in the House of Commons in June 1993 and will be reintroduced, along with the August 30, 1993 draft legislation, in bills after Parliament resumes in January 1994, as indicated by the Minister of Finance in a news release dated December 20, 1993.)

LEGISLATIVE AND OTHER CHANGES

Throughout the bulletin, we have made minor changes for clarification or readability purposes.

In new # 3 (former # 4), the dividends which are taken into account in determining the loss of a trust under subsection 112(3.2) have been explained separately, since they differ slightly from those taken into account in determining the loss of a corporation under subsection 112(3), or the loss of a corporate partner under subsection 112(3.1).

The note at the end of new # 4 (former # 5) reflects the proposed amendment to paragraph 112(7)(b) in the August 30, 1993 draft legislation. This amendment sets a limit on the amount of dividends on an old

exchanged share that can be applied to reduce a loss realized on the disposition of a new share (acquired for the old share in certain exchange transactions).

New # 5 (first part of former # 6) reflects the amendments in Bill C-18 to subsections 112(4) and (4.2). These amendments relate to the dividends which reduce a loss on the disposition of a share that is not a capital property of a taxpayer (subsection 112(4)), or of a partnership of which the taxpayer is a member (subsection 112(4.2)). Determining the loss reduction will vary depending on whether the taxpayer is an individual or a corporation. Because subsection 112(4.3) was not amended in Bill C-18, we separated the discussion on this subsection from the discussion on subsections 112(4) and (4.2).

The note at the end of new # 5 reflects the proposed amendments to subparagraphs 112(4)(d)(ii) and 112(4.2)(d)(ii) in the August 30, 1993 draft legislation. The amended provisions would exclude from the "stop- loss" rules, therein, certain capital gains dividends.

New # 6 (second part of former # 6) lists the exceptions to the "stop- loss" rules in subsections 112(4), (4.2) and (4.3), with the former paragraph changed for clarification purposes.

New # 7 (former # 7) reflects the Bill C-18 amendments to subsection 112(4.1). These amendments relate to the dividends taken into consideration in determining the inventory value of a share that is not capital property. In addition, where the share is held by an individual, these amendments add a requirement with respect to the corporation paying the dividend.

The note at the end of new # 7 reflects the proposed amendment to subparagraph 112(4.1)(d)(ii) in the August 30, 1993 draft legislation. The amended provision would exclude certain capital gains dividends from the inventory valuation rule where the holder of the share is a corporation.

New # 8 replaces former # 8. The references to subsections 4(1) and 9(2), in the former paragraph, have been revised to section 9. The reference to subsection 4(1) is not required. In addition, subsection 9(2) refers only to losses, whereas the provisions referred to in the last sentence of new # 8 may be adjustments to income.

We have revised the Appendix to indicate that the dividends received were deducted under subsection 112(1), to comply with the requirements of revised subsections 112(4) and (4.1) (as explained in # 5 and 7 of the bulletin). In addition, we have changed the dates of the example to more current dates.

Capital Cost Allowance and Depreciation.

Under subsection 18(1)(b) a taxpayer will not be allowed to deduct, in computing his Division B income, a depreciation, obsolescence or depletion allowance, however under Sec. 20(1)(a) (and the accompanying Regulations in Part II, XI & XVII) a taxpayer is permitted to deduct such parts of the capital cost of property the legal title of which is owned by him, if he uses it to derive business or property income. The disallowance of depreciation deductions and the provision for the C.C.A. deduction in computing Division B income will automatically cause the trust law income recognizable to be different from the Division B income recognizable, (unless, by fluke, the depreciation rate implicit in the trust agreement is equivalent to the applicable C.C.A. rate).

"Depreciation", as described in *Goldman v. M.N.R.*¹⁴⁵⁵ "is applied to that inevitable wastage in the value of assets due to some cause inherent in the thing itself, as distinct from fluctuation in the value that arise from external causes...it is caused by wear and tear, natural decay and obsolescence", and thus not only to properly measure, on an accrual accounting basis, a meaningful representation of incremental economic worth increase, but also as a duty of the trustees to maintain an even hand unless otherwise directed, "depreciation" should be deducted from income from property or business realized in the trust.

Common Law Tests for Depreciation Deduction.

In *Re: Crabtree, Thomas v. Crabtree*¹⁴⁵⁶ a testator bequeathed certain businesses to his estate whereby the executors were to carry on the businesses and pay to the spouse the net income therefrom. Some difference of opinion arose as to if the executors were fulfilling their role correctly in deducting certain amounts of depreciation, as measured upon the value of the property, from the gross estate income and after the Master of the Rolls denied the beneficiaries' assertions, that depreciation was not to be deducted, he provided that the deduction amount was properly withheld. On appeal, the conclusion was the same being that when a business is left to trustees to carry on in the same manner as did the deceased/settlor, and to pay its profits to a beneficiary, a reasonable sum should be deducted, in computing such profits, to compensate for the wearing away of the machinery. This was the opinion of R.S.W. Fordham QC in *Goldman v. M.N.R.*. He also referred to two other cases being *Re: Rose*¹⁴⁵⁷ and *Re: Robertson*¹⁴⁵⁸ wherein the former case a general store (business) had been bequeathed and the trustee was to carry on the business and pay the "net income" to the spouse, however upon taking a depreciation charge the spouse inadvertently questioned its appropriateness and applied to the Court for its opinion. Heard in the New Brunswick Supreme Court, Harrison J., based his conclusion upon the clear evidence that the trust deed called for "net income" to be payable and the fact that there were at least two basic presumptions involved in the charging of depreciation; the first being profits should be calculated as a prudent man of business would calculate, and second, an allowance is necessary because with wasting property there is the constant consumption of capital (through the wear and tear) and its conversion into income and it ought not to enter "income". Harrison, J. provided that:

"In my opinion the business should be charged with depreciation on this building as a current expenditure payable out of income, because there is a consumption of capital to the extent which ought not to enter into profits. For the same reasons I consider the depreciation on "the furniture and fixtures and delivery equipment" used in the business is a proper charge against the income of such business. Replacement of such furniture, fixtures and equipment should be purchased out of the fund built up by charging depreciation, and should not be charged against capital."

In *Re: Robertson* the testator left to his trustees the business which they were to carry on and provided that they were to pay to the spouse the "net income" otherwise obtained although they were also given absolute control and management powers over the property and income with which they exercised and accumulated \$472,309 through depreciation charges the amount of which the life tenants contended to have rights to. They took the trustees before the Ontario High Court of Justice, (Gale J.), on the reason that they considered that

1455 53 D.T.C. 434
1456 [1912] 106 L.T. 49
1457 1940 1 D.L.R. 139
1458 1951 O.W.N. 332

the depreciation charge was erroneously applied and that "except to the extent that the trustees can show that part or all thereof is required to make good impairment of capital on the realization (of the assets)..." the amount accumulated was theirs. Judge Gale held that the two principle test previously mentioned was to be applicable and that:

"There did not appear to be any good reason for suggesting that executors who were directed to carry on a business might not allocate proper amounts for depreciation in computing the annual income from the business. A wise business man did this in his lifetime and his policy should be followed by his executors",

and thus allowed the depreciation to be deducted. One factor that is common to the two above depreciation cases is that they deal with the computation of income from a business and not from property which is held as an investment.

In *Re: Hunter*¹⁴⁵⁹ the question of whether or not a depreciation reserve was to be allowed to be taken on rental income produced through investments in property, (which did not constitute a business activity), was at issue. At the same time the question of the right or need to charge depreciation upon income from a business was at issue and the court found, (in the absence of contrary testamentary intention expressed in the trust deed), that the trustees could take depreciation on business income:

"One of the duties which falls upon him who carries on any commercial undertaking is to decide what provision should be made out of each year's revenue, by means of a depreciation fund or reserve to be set up, to compensate for the loss of capital assets which has resulted from the year's working.

If a trustee is directed to carry on a business (as per the trust deed), this duty must fall upon him..."

Obviously the above comment cannot apply to instances where a commercial activity is not carried on as in the case where an investment in real estate produces passive rental income. The Court in *Hunter*, in this instance, held:

"Where real property and personal property are devised and bequeathed together (as in the will before me) as a residue for a direction for sale and conversion, the proceeds to form one fund settled for persons in succession, the tenant for life of the proceeds is entitled to the rents and profits of the real property until the time of conversion where the sale is properly postponed by the trustees: in *Re Searle*, *Searle v. Baker*, (1902) 2 Ch. 829; In *Re Darnley*, *Clifton v. Darnley*, (1907) 1 Ch. 159; etc. When this rule is applied to the city properties referred to...it appears that Lady Hunter (life tenant), as the person entitled to the income from residue, a mixture of real and personal property in which the city properties are included, is entitled to the actual net rents received from the properties."

The fact that the rental of the city properties did not constitute a business (or adventure in the nature of trade) that was to be carried on by the trustees and that the property was treated as residuary property rather than assets the trustees could utilize to actively create business income resulted in the inability of the trustees to deduct depreciation. If the trustees had been given the power to carry on the activity as a business, or more directly, the power to charge depreciation there would have been little question however in *Hunter* they were only given the power to convert as soon as possible and not to carry on the activity as a business in the interim.

In *Re: Zive*¹⁴⁶⁰ the above principle was altered significantly in that Hart J., for the Nova Scotia Supreme Court, considered the factors of business and investment source to be practically irrelevant in that he examined the substance of the charge of depreciation as to ascertain whether the remainderman suffered a disadvantage in comparison to the life tenant who was receiving the entire actual rental income of the estate. The estate in this instance was comprised of substantial real estate investments that were to be held over an extended period of time thus if depreciation was not to be taken the loss (if any) in the value of the property would cause a disadvantage to the remainderman for the benefit of a life tenant, and thus on those grounds (effectively) depreciation was allowed on rental property income. The important note to be made about *Zive* is that the trust deed did not specify the nature of the income to be paid to the life tenant, and that the property,

¹⁴⁵⁹ 1958 N.Z.L.R. 654
¹⁴⁶⁰ 1977 77 D.L.R. (3d) 669

held as an investment to benefit both separate parties, was sustaining a decrease in value, which had it not been corrected with a depreciation provision would have caused the even-handed rule to be offended. In *Re: Katz*¹⁴⁶¹ it was held that unless the testator directs his trustees to carry on a business (or the rental activities of the trust could constitute a business unrestricted by the trust deed), the trustees cannot deduct depreciation from "net income" realized on residual rental property which as per the trust deed they are to pay over to the life tenant. It was also held in that case that the mere power given to the trustees to make repairs did not constitute the right to deduct depreciation nor, more importantly, did the fact that the trust deed referred to "net income" payable when the trust was not operating a business, nor when the testator did not operate "a business" in respect of the activity, previously.

Thus it would appear that unless the trust deed explicitly grants the power to do so or provides that income should be computed net of depreciation, generally, a trustee will be able to deduct depreciation only from business activity revenue and only when the trust deed refers to "net income" payable to the beneficiaries. The amount of depreciation charge that can be applied can be argued to be directly derived from the actual decrease in the value of the depreciating property since if some arbitrary write off caused depreciation funds to be accumulated in excess of the decrease in the value of the property, the capital beneficiaries would benefit at the expense of the income beneficiaries. If the trust holds property until conversion as an investment then unless the trust deed specifies that depreciation is to be charged, the income payable to a beneficiary will be net income, without provision for depreciation.

The ability of the trustee to charge accounting depreciation against revenue being realized for the benefit of beneficiaries is so important and subject to the lengthy discussion due to the fact that if a depreciation charge is levied so as to reduce trust law income payable it will also cause less inherent corresponding Division B income to be recognizable as payable to the particular effected beneficiaries under Sec. 104(13). By increasing the accounting depreciation charge, more Division B income will be recognizable in the hands of the trust and will not be taxed in the hands of the beneficiary, who regardlessly may have an interest in the accumulating fund anyway.

In *Toba Goldman v. M.N.R.*¹⁴⁶² the appellant was the beneficiary of an estate wherein a partnership interest was held and the trustees carried on the partnership. "Net income" of the estate was to be paid to the beneficiary, however the Minister assessed the beneficiary as having received pre depreciation income when in fact she did not have a right to the capital of the estate and only received the revenue net of depreciation.¹⁴⁶³ *Fordham Q.C.* on the Income Tax Appeal Board held that the depreciation was properly deducted by the trustees and that the resulting income was the only amount to which the particular beneficiary's income right pertained. He also provided:

"It follows, of course, that in such circumstances a beneficiary cannot successfully make any claim in respect of funds set aside for depreciation purposes. In the instant appeal, as the appellant not only did not receive any part of the depreciation allowance deducted, but also was not entitled thereto in law, the assessment made by the Minister was in no way supportable."

Trust law income payable is completely different from tax law (Division B) income payable, unfortunately, in respect of the criteria which are used to allow depreciation and capital cost allowance deductions to be taken. Under trust law, the depreciation charge can be applied against the income to accrue to the life tenant regardless of whether the particular beneficiary is entitled to receive the property eventually from the trust or not. The ability to deduct C.C.A. from Division B income otherwise payable to a beneficiary has had varied treatment in the past, both in respect of the common and civil law, and while presently after the 1988 reform C.C.A. can only be taken on the trust level, there have been times in the past where it was allowed to be deducted by the beneficiary of his level, (as was the effect of former Sec. 104(16)). Subsection 104(13)(a) provides that the income payable to a beneficiary will be (effectively) equivalent to the Division B income of the trust, computed as per the computational definition of "income" in section 3, prior to any Sec. 104(6) or (12) (P.B.Election) deductions, but unlike the pre 1988 reform Sec. 104(13) provision, after any deductions

¹⁴⁶¹ 1980, 29 O.L.R. (2d) 81

¹⁴⁶² 53 D.T.C. 434, ITAB

¹⁴⁶³ The relevant provisions in the case, under the 1952 ITA, are basically equivalent to Sec. 104(13)(a) and 104(24).

for C.C.A. however in deciding whether the trustee can in fact deduct C.C.A. in deriving the Division B income payable to a particular beneficiary under Sec. 104(13) one should examine the historic context of the C.C.A. deduction and its effect on beneficiary - trust relationships.

In many instances a testator may give a direct life interest in the ownership of property rather than have a third party testamentary trustee hold all the immediate ownership rights. Whether or not the life interest holder can deduct capital cost allowance on the property was of concern in *J. Bruce Enstone v. The Queen*¹⁴⁶⁴ where the Fed. Appeal Court held:

"[16] It was argued for Mr. Enstone that, as the holder of only a life interest in the rental properties, he is not entitled to claim capital cost allowance under paragraph 20(1)(a) for the cost of capital improvements made to the properties. It is true that if paragraph 20(1)(a) does not apply, then no tax relief is available for expenditures made for capital improvements to the rental properties unless the application of paragraph 18(1)(b) is barred by characterizing the expenditures as current expenses.

...

[22] In any event, counsel for the Crown argued that even if the *Johns-Manville* case stands for the broad principle propounded by counsel for Mr. Enstone, that principle is not applicable in this case. He said that the expenditures made by Mr. Enstone to make capital improvements to the rental properties are within the scheme of paragraph 20(1)(a). According to counsel for the Crown, Mr. Enstone can claim capital cost allowance in respect of those expenditures because his life estate is a sufficient ownership interest in the rental properties.

[23] In response to that point, counsel for Mr. Enstone argued that the estate is the owner of the rental properties during the lifetime of Mr. Enstone and therefore only the estate is in a position to claim capital cost allowance. That is obviously not the case. The will did not establish a trust to hold the properties and then grant Mr. Enstone a life interest in the trust. The terms of the will granted Mr. Enstone a life estate in the properties themselves.

[24] **No jurisprudence was cited to suggest that capital cost allowance cannot be claimed by the owner of a life interest in an income earning property. There is no provision of the *Income Tax Act* or the *Regulations* that would preclude such a claim. I conclude that there is no basis for denying Mr. Enstone the right to claim capital cost allowance on the costs he incurs to make capital improvements to the rental properties in which he has a life interest.** Therefore, the principle for which the *Johns-Manville* case was cited has no application to this case.

[25] For these reasons, I agree with the Tax Court Judge that the expenditures made by Mr. Enstone to improve and repair the rental properties in which he has a life interest must be classified as on capital or income account according to the well established principles. The expenditures he made for capital improvements to the rental properties were capital expenditures, the deduction of which is prohibited by paragraph 18(1)(a), except to the extent that paragraph 20(1)(a) applies."

Usufructuaries.

One of the early cases where C.C.A. was denied deduction by a "beneficiary" was in *No. 234 v. M.N.R.*¹⁴⁶⁵ where under the former Act a deduction was usually allowed to a beneficiary of the trust, if he was "beneficially interested in a trust or estate who is entitled, either contingently or absolutely, to the property of the trust or estate or some part thereof at some future time", limited by the amount of C.C.A. that would otherwise be deductible by the trust directly, (in effect, the predecessor system equivalent to the now repealed Sec. 104(16)). In that case the appellant was the usufructuary, (the civil law equivalent of a legal life tenant, simplified), and the beneficiary also had a power to draw on capital only to offset the loss that may be realized in income from the trust. Chairman Fabio Monet Q.C. relied upon the reasoning in *Brodie v. C.I.R.*¹⁴⁶⁶ to find

1464 A-594-98
1465 55 D.T.C. 115, ITAB
1466 17 T.C. 432,

that the usufructuary's capital drawings were equivalent to income in her hands and that she did not have any absolute or contingent right to capital, as capital, of the trust thus she was not allowed the C.C.A. deductions on her portion of the estate income. In a Memorandum provided by the Bilingual Services and resource Industries Division to District Offices in Oct. 1989 it was provided correctly that a usufructuary has no right to the capital and since his usufruct right is not a capital property he cannot claim C.C.A.. Neither can the proprietor possessing the balance of the ownership rights since he doesn't realize income from the property. upon the disposition of the property, it was held, the recaptured C.C.A. must be included in the usufructuary's income and any gain would be included in the proprietor's income.¹⁴⁶⁷

New subsection 248(3)(a) provides that a usufruct shall be deemed to be a trust and property subject thereto shall be deemed held in trust, (while substitutes are treated the same way). This provision could allow for the deduction of C.C.A. against a usufructuary's income entitlement so as to reduce his Sec. 104(13) inclusion. If the property is statutorily deemed to be property held in trust and not otherwise the usufructuary, by virtue of paragraph (d) therein, is the beneficiary recognizing a Sec. 104(13) income inclusion. The deduction of depreciation under a civil law usufruct is not allowed but this isn't necessarily the case in respect of the deduction of C.C.A. by the usufruct-trust under the Income Tax Act and the proprietor and usufructuary could agree to deduct C.C.A. to reduce the latter's Sec. 104(13) inclusion provided he is also responsible for the liability arising out of the possible recapture.

In *Hebert v. M.N.R.* 1468 some question arose as to whether a usufructuary, entitled to "net income" of the estate was required to recognize the amount of C.C.A. deduction taken by the trustees, which also reduced the actual amount of funds paid to her. The I.T.A.B. recognizing the usufructuary, held:

"I am of the opinion that when a beneficiary-as is the case of the appellant here-is given a right to the "net income" of property, without further qualification, he is entitled to the gross income less such expenses only as are chargeable to income, without any deduction of a capital nature." but it must be recognized that this quote refers only to the rights of usufructuaries.

Common Law C.C.A. Tests

In *Rose Kanee v. M.N.R.* 1469 the reasoning in No. 234 was followed and extended to the trust level. Under the provisions of the will in that case the life tenant was entitled to the "net income" of the estate, (consisting of income producing property), and the trustees paid it to her, after deducting the appropriate expenses including capital cost allowance. The Minister added the C.C.A. deduction taken back to her income realized from the trust on her level due to the fact that since she did not have a right to any of the trust's income producing property, C.C.A., taken by the trust at its level, could not reduce the Division B income payable to her. *Fabio Monet Q.C.* of the I.T.A.B., noting that the appellant did not receive the substance of the C.C.A. deducted by the trustees, also considered the fact that, as contended by the appellant, the trustees had a duty to retain and deduct C.C.A. for the benefit of the remainderman, and that the appellant was not ever entitled to the funds representing the deductions. The Chairman relied entirely upon the reasoning in No. 234 v. M.N.R. previously stated being that, under the ITA at that time, the life tenant did not have an absolute or contingent right to capital of the trust, thus in no circumstances could C.C.A. reduce the Division B income recognizable by the life tenant.

The requirement that the beneficiary had to have an absolute or contingent interest in the capital of the trust in order to claim C.C.A. on his level, was incorrectly applied in the *Rose Kanee* case in that it could not be extended to the trust level as per the reasoning in *Harold Ernest Manning v. M.N.R.* (No. 184 v. M.N.R.)¹⁴⁷⁰ which was finally decided at the Exchequer Court level after having being dismissed unfavorably at the I.T.A.B. level (in 54 D.T.C. 366). In this case the appellant and his three sisters were to receive the

¹⁴⁶⁷ This latter opinion is questionable when at the same time the usufructuary is disallowed C.C.A.: the asset he holds is not being disposed of since a new proprietor acquires the ownership rights subject to the usufructuary. the asset that causes the recapture is the residual ownership rights and given that a usufructuary can't deduct C.C.A. upon that property the only way recapture can be generated is where the **proprietor** has previously deducted C.C.A. prior to the granting of the usufruct. He should recognize the recapture.

1468 55 D.T.C. 305, ITAB
1469 56 D.T.C. 97, ITAB
1470 56 D.T.C. 1099,

revenue (apparently not restricted to "net income") of the estate while the trustees deducted C.C.A. at the estate level so as to reduce the tax income to which the beneficiary would be entitled. The life tenants did not have an absolute nor contingent interest in the property of the trust but had a power of appointment over it only exercisable by will. The Minister added to the appellant's taxable income his portion of the C.C.A. taken at the trust level and the appellant had to go through the I.T.A.B. to have the assessment corrected. He contended that he should only be taxed on the amount of income so received from the trust by him, under what was then equivalent to present Sec. 104(13)(a). In closing comments of the Exchequer Court Hyndman, D.J. held that:

"Furthermore it seems to me that there was a duty or obligation on the part of the trustees to maintain or preserve the "corpus" in the interest of the residuary beneficiaries, whoever they may be following the exercise or the non-exercise of a power of appointment provided for in the will...it seems to me therefore that it is most important that the property should be kept intact for the residuary beneficiaries, and to insure that, reasonable early depreciation would be necessary."

After quoting from *Re: Robertson*¹⁴⁷¹ concerning the appropriateness of a depreciation charge to maintain capital he went on to close:

"I am therefore of opinion that net revenue in this instance is that which is left after payment of taxes, interest, licenses, if any, insurance, and other lawful expenses, and reasonable depreciation. In other words the four children of the deceased were not entitled to claim more than the revenue remaining after first deducting the said charges. If I am correct in this, then it follows that the appellant was never entitled to receive any part of the amount set aside for depreciation. He never did receive it, and in my opinion never was entitled to such. It therefore never became part of his personal income, and consequently not taxable in his hands."

Thus he relied upon the substance of what could be equated now as being the Sec. 104(13)(a), (or (c)), provision in that regardless of whether the taxpayer has an interest in the trust property or not, the amount of taxable income made available to him, (to which he is entitled), after C.C.A. is deducted by the trustees, will be the only taxable income to which he is entitled, thus taxed upon.¹⁴⁷²

In *Harris v. M.N.R.*¹⁴⁷³ a testator provided that the trustees were to pay the "net income" from the estate, (consisting of apartment and commercial buildings), and the I.T.A.B. recognized the *Crabtree*, *Rose*, *Robertson*, and *Goldman* cases in arriving at whether or not C.C.A./depreciation deducted was still to be taxed in Mrs. Harris' hands (life tenant), concluding:

"It seems that the best test of Mrs Harris' tax ability in this particular case is not whether a business is carried on as some of the cases seem to indicate but rather it is whether the trustee has a right to withhold depreciation having in mind his duty towards the remainderman as well as his duty towards the life tenant."

Equitably Compelled to Deduct C.C.A.

The ability of the trustee to deduct accounting depreciation in computing the amount of actual income to which a life tenant is entitled should not be confused with the trustees' ability to deduct tax C.C.A. on the income so as to reduce the exposure to tax that income will sustain when paid to the beneficiary: the former reduces the amount of income that is paid to the life tenant and is accumulated for the remainderman while the latter does but exposes the remainderman, unless some equitable adjustment in the entitlements isn't forthcoming, to a tax liability that doesn't nor hasn't been sustained for his benefit. This assumes that the C.C.A. recapture potential is real and that the trust for sale or distribution will cause the recapture of the amount to reduce the extent of the remainderman's benefits. If the fair market value of the property is dropping at such a rate and the property is held in trust for sale and there isn't any chance that the terminal loss could

¹⁴⁷¹ 1953 2 S.C.R. 1, 7

¹⁴⁷² From another point of view subdivision K provides the provision by which the recognition of taxable income is transferred to a trust's beneficiaries from a trust, but it is every other provision in Part I other than those in subdivision K that determines how that taxable income is to be computed, and thus C.C.A. can be deducted from a revenue stream by a trust regardless of whether that Division B income is payable to a beneficiary.

¹⁴⁷³ 55 D.T.C. 446, ITAB

be offset against realizations of other trust property to confer any benefit on the remainderman does the life tenant have any equitable rights to compel the trustees to deduct C.C.A. so as to reduce his exposure on the income realized? If C.C.A. isn't deducted the terminal loss is wasted since the trust doesn't realize income on its disposition and wind-up and could it be argued that the C.C.A. must be deducted in such an instance rather than wasted so as to at least prudently provide the benefit to the life tenant?

Two Ways to Reduce Taxable Income Inclusions

There are two effective ways of reducing the Division B income of a trust that a beneficiary may be required to recognize under Sec. 104(13)(a), the first, an accounting equity adjustment will reduce the trust law income to which an income beneficiary will be entitled, thus reducing the shadow Division B income streams recognizable as receivable by the beneficiary. This will also cause the balance not recognizable as receivable by the beneficiary to be taxed in the hands of the trust, but only to the extent that it has not deducted C.C.A.. If the trust has deducted C.C.A. (which with the reform only it can do in respect of its income) not only will the income beneficiary's Division B income recognizable as payable under Sec. 104(13)(a) be reduced but the trust will also not be taxed on the "tax depreciation" deducted. Accounting depreciation taken may thus lower the income beneficiary's entitlement to income to an amount less than his corresponding Division B income entitlement recognizable under Sec. 104(13)(a) 1474 although the trust will be taxed on the excess of Division B income over shadow Division B income recognized as payable, the income beneficiary will not recognize the full Sec. 104(13)(a) inclusion.

A classic example of depreciation charged on income which reduced trust law income payable, (and which also ran afoul of the rules), can be found in *Cooper v. M.N.R.* 1475 wherein a life tenant was entitled to the net income of the estate but the executors had reduced the realizable amount by a book entry for depreciation. Unfortunately, although she was not entitled to any of the corpus of the estate in a particular year, the executors paid to her the amount of funds that were in respect of the depreciation charge, as a capital distribution and *Cameron, J.* of the Exchequer Court of Canada found that she could only receive the distribution as income as per the reasoning in *Brodie v. C.I.R.* 1476. The appellant had maintained that she was entitled to a depreciation charge on her level against the net income, if the trust had not deducted it, however the judge provided:

"In the case of *Davidson v. The King*, (1945) Ex. C.R. 160, the President of this Court came to the conclusion that the beneficiary of an estate, in so far as he is entitled to income from it, is not entitled to deduct any amount for depreciation in respect of such income, in as much as it is not his assets but those of the estate that are used in the production of such income."

thus accounting depreciation taken by the beneficiary was nonsense in that the particular party did not legally own the assets, (nor was she entitled to them), that produced the income. A particularly illustrative example of a constructive application of depreciation charges can be found in *Ida E. Brown v. M.N.R.* 1477 where depreciation charges against income realized by an estate were used to accumulate capital with which to provide an annuity to a spouse, while in fact the charge eliminated any trust law income payable in one of the particular years. The charge would under the present law cause the representative Division B income to be taxed in the hands of the trust, and without going into detail it was held by the Income Tax Appeal Board that the payment of the annuity was out of the capital of the trust, (being the capital produced by the depreciation charge), and was thus not taxable in the hands of the annuitant. The inherent Division B income in respect of that depreciation charge however would have been taxable in the hands of the trust, after which it would become capital. 1478 This would be the same result if today capital derived through capital cost allowance deductions was used to pay an annuity, (exclusive out of the tax capital), which would enter the annuitant's income under Sec. 56(1)(d) and be entirely deductible under Sec. 60(a) resulting in no taxation in the hands of the recipient. It would also be particularly useful in the case of non-resident trusts since Sec. 104(13)(c)

1474 whereby the trust may claim greater C.C.A. to thus reduce

1475 50 D.T.C. 720, ExC.

1476 17 T.C. 432

1477 50 D.T.C. 218, ITAB

1478 The beneficiary in *Cooper v. M.N.R.* previous had only an income interest under the trust.

does not cause income inclusions in respect of distributions of capital by personal trusts and the accounting depreciation charge could change the otherwise includable income into capital for the purposes of this paragraph. It would appear that the tax treatment of such an accounting charge in respect of the foreign jurisdiction is irrelevant.

Possible Effective Double Income Inclusions

Although the deduction of C.C.A., (or depreciation), may operate to reduce the amount which the income beneficiary is required to recognize under Sec. 104(13)(a) or (c), the amount representing the deduction will remain in the trust although it need not be retained permanently. If the trust is personal trust and the income beneficiary also has a capital interest, which may be partly referenced to the accumulated depreciation/C.C.A., a distribution thereof may proceed, tax-free, through the Sec. 53(2)(h) or 105(1) mechanics however if the C.C.A. is distributed other than in respect of a capital interest held by the beneficiary Sec. 53(2)(h) cannot hypothetically apply to it and thus Sec. 105(1) will cause it to be included completely in income. The C.C.A. must be "capitalized". In such a case there could be double taxation of the C.C.A. if Sec. 105(1) captures it; under that subsection and subsequently due to recapture. The accumulated(ing) funds may also be used to finance annuity payments which when received would have a nil income inclusion due to the mechanics of Sec. 60(a)(ii). In the instance that accounting depreciation causes Division B income to be considered taxable in the hands of the trust a tax cost to the trust will result while if a C.C.A. deduction is taken the amount will be removed from Division B income, and tax exposure altogether. However once the depreciable capital property of a prescribed class is disposed of it may cause the recapture of C.C.A. previously taken, which would cause the recognition of income upon which tax would be payable, which would reduce the capital available to the remaindermen hence if C.C.A. is to be deducted, and distributed, to a dual capital-income beneficiary at least a portion of the substance of the deduction should be retained to extinguish possible tax liabilities that may be incurred. Even when the fair market value trend of the particular property would cause recapture on its disposition it would be favorable to deduct the C.C.A. in the interim since the present value of the tax benefits would exceed the present value of the tax liabilities they create in the future however the ability of the trust to maintain a lower marginal tax bracket in respect of that recapture is also a factor to consider.

Provisions/clauses in the trust deed, concerning depreciation or C.C.A. will have to be followed if explicitly expressed thus the trust deed that provides for depreciation or C.C.A. on an arbitrary basis is extremely inflexible and will hinder tactical planning. It would prove to be a far more prudent exercise just to grant the trustees the power to make depreciation or C.C.A. charges as they see fit in their absolute discretion since unforeseeable events might occur that may require excessive charges to be made. The Courts have been silent on whether or not a trustee must charge depreciation or C.C.A. in arriving at the net income to which a life tenant (income beneficiary) is to be entitled; habitually it has been the life beneficiary and not the remainderman who has acted when depreciation was taken. Thus it would appear possible that a discretionary power to determine depreciation/C.C.A. would not be restricted, in that it was the testator's intention for it to exist. If on the other hand the trust deed prescribed that the trustees are to carry on the business that the testator did, then they may be restricted to the quantum of depreciation charges that he normally would have taken.

The trust deed, as an expression of the intention of the testator, would have to be examined and properly scrutinized in order to ascertain whether a depreciation charge is to be made against rental income or other income from property, while if the matter has to be resolved by a court judgment, it may not be resolved favorably. Depreciation on business property is generally accepted.

It would appear possible for the trustee to deduct C.C.A. against a particular income stream without doing so in respect of another however is it possible for him to apply all of the C.C.A. taken against one particular income beneficiary's taxable income liability otherwise recognizable under Sec. 104(13) while allowing another income beneficiary to recognize the gross amount of taxable income when they both have equal rights to the same income stream? It appears that there is no restriction in the form of allocating of C.C.A. such as was the essence of former Sec. 104(17.1) however inter-beneficiary agreements may be needed to ensure that only the particular beneficiary benefitted is exposed to possible subsequent recapture and that

the value of their income entitlements is adjusted accordingly to reflect equal after tax values. The terms of the trust deed may also be structured to allow the trustee the absolute discretion of adjusting realizable and recognizable trust law and tax law income payable of various beneficiaries with depreciation and C.C.A. charges.

Interest Income.

Subsection 12(1)(c) provides that any amount received or receivable in a tax year by a taxpayer as a payment on account of interest shall be included in computing his Division B income but only to the extent that it was not included in computing his income for a preceding tax year. Interpretation Bulletin 396R, dated May 29th 1984, provides a fairly in-depth discussion of how the Department will apply the interest recognition provisions and since the topic is practically exhausted therein only the general concepts will be discussed here.

Interest income can be reported in one of three methods, "cash" or "received", "receivable" or "accrual", under Sec. 12(1)(c) however the ability to utilize the cash method extends only to individuals¹⁴⁷⁹. As per Sec. 12(1)(c) the method to be used by the taxpayer will depend on the method regularly followed by the taxpayer in computing his income, hence if the trust recognizes interest from a particular form of investment contract on a receivable basis it will be bound to utilize that method consistently in respect of investment contracts of the particular character. Under subsection 12(3), where the taxpayer is a corporation, partnership, unit trust, or any trust of which a corporation or partnership is any form of beneficiary, any interest that accrued to it, or became receivable or was received by it, prior to the end of its tax year, to the extent that it wasn't previously included in its income for a previous year, will be included in its Division B income for the current tax year.¹⁴⁸⁰ If the trust has as a beneficiary a trust under which all of the beneficiaries are corporations or partnerships then the interest earning trust may thus choose any recognition method, as per Sec. 12(1)(c) However such **may** produce a Part XII.2 tax liability as per paragraph 210(e) depending on the characteristics of the ultimate beneficiary corporation or partnership.

The "cash" or "received" method causes the inclusion in the taxpayer's income of interest payments received or credited to the taxpayer before the end of the period and thus the basis of the inclusion is the fact that the payment was constructively received within the tax period. If the payment of the interest can be deferred to the next period obviously so too will the recognition thereof under the cash method. Under the "receivable" method the taxpayer recognizes an income inclusion in respect of the interest only when he has a clear legal right to receive it that is enforceable within the tax period. If interest is to be credited upon a certain date only upon the favorable exercise of a certain power of distribution then it will not be until the time at which the power is exercised that the interest would be subject to an immediately enforceable right to receive thus although the interest may have accrued and may have been recognized as such by both parties its payment or provision for payment is still to be recognized. The "accrual" method causes interest to be recognized in income as it accrues on a daily basis, regardless of whether or not it is received or receivable, thus the method may cause early recognition of tax liabilities in that recognition of interest can occur in a period prior to that in which the interest is received or receivable. As commented on previously this will be the method to which a "corporate or partnership" trust will be limited to utilizing thus the advantage (generally) of maintaining the trust character as having exclusively individual beneficiaries is clearly recognizable.

If the trust has as its beneficiaries only individuals it may avail itself of the choice in reporting methods¹⁴⁸¹ as per para. 7 of I.T. 396R, which could lead to beneficial tax deferral, especially when one considers that a beneficiary recognizing trust income under Sec. 104(13) does so only in the year in which the trust's tax year ends. If the accrual or receivable method is employed the trust may be forced to recognize the income in that the beneficiary will not have an enforceable right of distribution since the income hasn't been gotten in yet thus avoiding a Sec. 104(13) inclusion.¹⁴⁸² The choice of method to utilize in respect of a particular character of interest bearing instrument depends on the method which has been regularly followed with respect to that type of instrument, e.g.; a trust may have previously reported the interest on a C.S.B. on a receivable basis, however it will not be precluded from using the received basis in respect of non-coupon government bonds, hence where one method has been continuously used in respect of a particular type of investment then the trust has

¹⁴⁷⁹ and trusts, the beneficiaries of which are exclusively individuals

¹⁴⁸⁰ This does not apply to interest from income bonds, income debentures, small business development bonds or small business bonds defined in Sec. 248(1).

¹⁴⁸¹ depending however on the method previously followed and the need for its consistent application

¹⁴⁸² A preferred beneficiary election can be made in this instance to shift the tax liability though its ability to resolve any inequities is severely limited by the mechanics of the Sec. 104(15) accumulating share.

established a "method regularly followed" and must adhere to it. Obviously the trustees should evaluate the most favorable reporting method in respect of a particular form of investment not previously owned when it is purchased since once one method is used it must be used consistently.

Alterations in Reporting.

The Department allows taxpayers¹⁴⁸³ to change from the "received" to the "receivable" or "accrual" method or from the "receivable" method to the "accrual" method **if** they have a valid reason and obtained prior approval, however alterations towards the "cash" method will not be entertained for the obvious reasons. Under Sec. 12(8), which doesn't apply in respect of those parties described in Sec. 12(3), a taxpayer who holds an interest in a debt obligation may elect in his return to have the accrual method apply to its interest regardless of which method it previously used however in order to change from the "received" method to the "receivable" method the taxpayer must still obtain the proper approval. Once such an election is made it applies in respect of that particular debt obligation for all subsequent tax years, while in the year of election the interest recognized will be that not recognized in any previous tax year.

The Three Year Rule.

Subsection 12(4)¹⁴⁸⁴ provides that where a taxpayer holds an interest in an "investment contract", and where he has not elected in favor of the accrual method under Sec. 12(8) in respect thereof, interest will be recognized on any third anniversary of the issuance of the investment contract, regardless of how long he owned it, to the extent that it was not already recognized in income in any previous tax year and to the extent that it accrued to him after Dec. 31st 1981.¹⁴⁸⁵ If at any time the investment contract is disposed of the third year anniversary will be recognized and all accrued interest will be recognizable, while if interest is received/receivable within the three year period Sec. 12(1)(c) will cause its recognition.

The ability of the trust to qualify for the third anniversary recognition rules or the "received" or "receivable" methods of reporting interest depends upon whether or not it has as any one of its beneficiaries¹⁴⁸⁶ a partnership or corporation. The fact that a partnership beneficiary may be composed exclusively of individuals is of no consequence.¹⁴⁸⁷ Failing the maintenance of the particular character the trust will mandatorily utilize the "accrual" method as prescribed by Sec. 12(3) however it will not apply in respect of the specific instances described in Sec. 12(5) or (6) or in respect of the four different debt instruments described in Sec. 12(3).

Subsection 12(6) provides that the mandatory accrual method in Sec. 12(3) will not apply if the debt obligation was acquired prior to Oct. 29th, 1980 and the trust could not, after Oct. 28th, 1980, and before the end of the particular tax year, enforce a payment of the accrued interest, (other than by reason of failure or default of the terms of the contract), where the maturity date of the instrument was not extended after Oct. 28th 1980 and the terms/conditions relating to the **payment** only have not been changed since that time, and the obligation was issued by a person with whom the trust was dealing at arm's length, (at the time of issuance). It would appear that an issuer can become a beneficiary of the trust after the time of issuance and/or increase the rate of interest without consequence while since no legal right enforceable in respect of the distribution of the interest exists the receivable method cannot be used and instead the "cash" method can prevail.¹⁴⁸⁸ Subsection 12(5) provides that Sec. 12(3) is not applicable with respect to, amongst others, trusts the principal

1483. other than those described in Sec. 12(3): "corporate or partnership trusts"

1484. which isn't available to "corporate or partnership trusts"

1485 "Investment contract", defined in Sec. 12(11)(a), includes any debt obligation other than a salary deferral arrangement, income bond, or debenture, or small business bond or development bond, while "third anniversary", defined in Sec. 12(11)(b), is the end of the day that is three years after the end of the calendar year of the issue of the contract, and the day every three years successively after that, and the day on which the contract is disposed of. There was certain grandfathering amended with the 1988 reform which effectively operates to provide that where before 1989 the interest has not been disposed of and it was acquired prior to 1982, the contract will be deemed to have been issued on Dec. 31st 1988 hence the initial third year anniversary will be Dec. 31st 1991, whereby interest accrued since Dec. 31st 1981, (if not previously included in income), will be recognized.

1486 regardless of whether or not they hold a technically defined "income" or "capital interest"

1487 There is however a difference between a taxpayer who subjects the earnings from an interest in a trust to a partnership agreement turning the right thereto into joint estate and the instance where the interest in the trust is in fact turned into joint estate.

1488 The arrangement will not qualify for the third anniversary method.

business of which was the making of loans or that borrows money from the public in the course of carrying on such a business in respect of debt acquired before Oct. 29th, 1980 unless it was issued by a corporation/trust/partnership which was not at arm's length with the trust.

Section 12.1 provides that where a taxpayer has received an amount as a cash bonus from the Government of Canada in respect of a Canada Savings Bond he shall be required to include only one half of the bonus amount received in his income, and this is applicable to all trusts.

Formerly, the trust could avail itself of the subsection 104(26) provision which would allow it to designate as having been received by an income beneficiary as part of its Sec. 104(13) or (14) income inclusion certain amounts of interest it received and thus allow the beneficiary to take the investment income deduction however this was reformed in the 1988 amendments. Now all interest income must be recognized by the trust and as per Sec. 108(5) when the beneficiary receives it he will recognize it as income from a property which is a trust interest.

If interest is to flow through a Canadian resident trust to a non-resident beneficiary excessive withholding tax may result. The interest will **not** retain its source characteristic due to Sec. 212(11) and Sec. 212(1)(c) will apply while the Sec. 212(1)(b) exemptions may have applied to prevent withholding tax had the amount been payable directly to a non-resident.

Under both the Canada - United Kingdom Income Tax Convention (1978) and the Canada - U.S. Convention (1980) interest is defined as income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attached to such securities, bonds, or debentures, as well as income assimilated to income from money lent by the tax law of the State in which the income arises. Under both Conventions if the **beneficial owner** of the interest is resident in the contracting state other than in which the interest arises tax charged by the state in which the interest arose cannot exceed 10% or 15% (U.K. or U.S. respectively) of the gross interest amount, while the "resident" state may charge tax thereupon as it pleases. In the case of the U.K. Convention the above will not apply where the beneficial owner does not bear tax in respect thereof in Canada **and** sells (or contracts to sell) the investment upon which the interest was realized within three months of the date at which it was acquired. In respect of the U.S. Convention interest will be exempt from the above withholding if; it is beneficially owned by the contracting state or some political subdivision **and** is exempt in the contracting state, is beneficially owned by a resident of the contracting state and is paid by the other state, or, some political subdivision therein, and is otherwise exempt from taxation in that other state.

In the case of both conventions if the beneficial owner of the interest resident in one state carries on a business in the other state, through a "permanent establishment" situated therein, or performs in that other state independent personal services from a fixed base situated therein, and the debt-claim giving rise to the interest is "effectively connected" with that fixed base or permanent establishment, withholding will not apply **but** the Business Profits or Independent Personal Services Articles will apply so as to cause taxation of that interest to be solely in that other state due to the fact that the "business income" or "independent personal service income" is attributable to the fixed base/permanent establishment.

An interesting aspect about the Convention is that there is no expressed criteria that define "beneficial ownership" and although para. 2 and 3 of I.T. 437 describe instances of "beneficial ownership" it can be said that if the trust agreement grants a discretionary power to trustees allowing them to ascertain which beneficiary may ultimately receive the interest income or accumulated capital therefrom, "beneficial ownership" may not be easily ascertained. If the trustees have the ability to accumulate certain interest revenue for the ultimate benefit of certain non-resident beneficiaries then in the act of accumulating such the lower withholding rate will apply, however, since the foreign resident beneficiary hasn't received the interest, nor has an enforceable right to such due to the deferred exercise of the discretionary power, the beneficiary will not be subject to tax under the foreign jurisdiction.¹⁴⁸⁹ The jurisprudence of the country of residence of the purported beneficial owner

¹⁴⁸⁹ In the extreme, if **all** of the possible discretionary objects are resident in the foreign state, even though they do not have individually fully ascertainable beneficial ownership, **as a class** they could, and since the exercise of the power could only result in a foreign resident beneficiary being entitled to that accumulating interest, beneficial ownership can be recognized to be in a person resident in the foreign state.

could conflict with that of the state of source's jurisprudence as to the term "beneficial owner".

Interest Deductions – Inside, and Outside the Trust.

Interest expenses incurred to produce taxable income are generally currently deductible¹⁴⁹⁰ however there must be a valid and immediate connection between the use of the funds borrowed and their application in the taxable income producing activity in order for the interest to be deductible. Under subsection 20(1)(c) there may be deducted in computing income from business or property the amount paid or payable pursuant to an enforceable legal obligation to pay interest on borrowed money used for the purpose of either earning income from a business or a property, or amounts that were payable for property acquired for gaining or producing income therefrom or from a business, except, in neither case can the deduction be taken in respect of money used to acquire property the income of which would be exempt or to acquire a life insurance policy. Under paragraphs (iii) and (iv) the amount paid by the taxpayer on certain amounts paid to him under an Appropriation Act or Northern Mineral Exploration Assistance Regulations under an Appropriation Act, or, borrowed funds used to purchase an annuity contract to which section 12.2 applies, (or would apply if it had a third anniversary in the year), except that where the payments have actually commenced from the annuity in a preceding year, will not be deductible to the extent that it exceeds the amount which will be included in the taxpayer's income for the particular year under section 12.2 or Sec. 56(1)(d.1). In the latter case it should be apparent that if debt is to be used to acquire an annuity contract, the contract should be a virgin issuance and not acquired from a third party, otherwise there is a strong possibility that the total amount of interest payable or paid may not be deductible. The income inclusions under Sec. 12.2(3) or Sec. 56(1)(d.1) may depend upon either an annual or third anniversary recognition hence where income is recognized every third anniversary it will only be in those years that interest will actually be deductible while in the two other years interest paid will not be deductible.

Under subsection 20(1)(c) interest expenses may be deductible up to the amount that is reasonable hence even when the expenses have been incurred to produce taxable income in the proper conditions, if they are not reasonable in magnitude or relatedness, they will be, in their entirety, non-deductible. Subsection 20(1)(d) provides that compound interest on charges legitimately incurred, as described in Sec. 20(1)(c), will be deductible if they are pursuant to a legal obligation to pay. Subsection 20(1)(e) allows for certain interest costs, connected with financing unit trusts, partnerships, corporations etc., that weren't otherwise deductible, to be deductible with certain limitations while subsection 18(2) provides that no deduction will be permitted in respect of interest on debt relating to the acquisition of land against the income from business or property, unless having regard to all the circumstances, the land can reasonably be considered to have been, in the particular year, used in the course of business, other than the primary business of resale or development, or producing income from the land in that year.¹⁴⁹¹ Understandably interest paid in respect of debt assumed or incurred with respect to land by the trust/estate may or may not be deductible however the debt itself, whether or not in the form of a mortgage on the land, can serve a useful purpose when the land¹⁴⁹² is distributed and as a condition of such distribution the beneficiary must assume that debt since under Sec. 107(2)(c)¹⁴⁹³ such an assumption will lower the beneficiary's recognizable proceeds of disposition from his interest, thus increasing the potential for the sustaining of a capital loss if the interest has an ACB.¹⁴⁹⁴

Alternately, if the trust assumes/contracted the debt in respect of an activity/property that did not allow the interest to be immediately deductible or capitalized into the cost of the property, by rolling out the debt, in accompany with property, to a capital beneficiary who does carry on a qualifying activity with respect to the debt loaded property the interest may become deductible by him, or he may be able to capitalize it, since in both cases the debt was incurred to produce taxable income from the particular property. If the debt had been assumed initially by the beneficiary in respect of the activities/property of the trust whereby the trust would

1490. or in some cases may be capitalized into the tax cost of the property to which they relate

1491 Paragraphs (e) and (f) provide further limitations while Sec. 18(3)(b) defines "interest on debt relating to the acquisition of land."

1492 or any type of property

1493 in respect of personal trusts

1494 For a method of executing a tax free cost bump using powers of appointment do a key-word search..

receive funds and the beneficiary would be charged with the extinguishment of the obligation, interest incurred would not be deductible by the beneficiary unless the trust terms provided that essentially all of the income/gain from the activity/property was to immediately, (or possibly ultimately), inure to the particular beneficiary.

There must be maintained, as per the requirements of Sec. 20(1)(c), a **direct** connection between the borrowing of the funds and **their use** for the purpose of producing income or gain which is taxable however just how direct this connection must be was the topic of at least one major series of court actions.

In #185 v. M.N.R.¹⁴⁹⁵ the appellant estate attempted, through various means, to persuade Chairman Fabio Monet, Q.C. of the Income Tax Appeal Board that interest paid on borrowed money used to extinguish succession duties was tax deductible. The appellant's first line of argument was that the loan allowed the estate to retain income producing property thus allowing it to maintain the production of taxable income. They also contended that the tax payment had been made to enable the estate to obtain absolute title to the property, which the Minister had placed a lien upon so as to collect the succession duties. The opinion of the Board was expressed in its closing comment:

"The Court acknowledges that the borrowing of money to pay the succession duties, thus preventing the estate to dispose of some of its income producing assets, is only an **indirect** cause to the producing of income. Section 11(1)(c) of the Canadian 1948 Income Tax Act, - the only section which, in my opinion, could afford relief to the appellant - makes it clear that a **direct relationship of cause and effect between expenditure and the income earning process must exist in order that a taxpayer may claim the deduction it provides for...**"

The same reasoning was followed in #228 v. M.N.R.¹⁴⁹⁶ with the same result.¹⁴⁹⁷

In 1969-70 the trustees of the Phyllis Barbara Bronfman Trust¹⁴⁹⁸ decided to make capital distributions to some of its beneficiaries however they were "kinda-short-on-the-bucks" at the time and instead decided to borrow funds to distribute, since all of the capital of the trust was invested in income-producing assets. The income-producing properties were subsequently sold so as to obtain funds to extinguish the loan however the trustees attempted to claim an interest expense deduction, which was flatly denied by the Minister on the grounds that the interest had not been incurred to produce income/(gain). Before the Income Tax Appeal Board the trustees relied heavily upon the reasoning *Cochrane Estate v. M.N.R.*¹⁴⁹⁹ which was heard before only the Tax Review Board, and resulted in the erroneous opinion that interest incurred on loans made to extinguish estate and succession duties was tax deductible.¹⁵⁰⁰ In the Bronfman instance the trust obtained loans of approx. \$2,200,000 to make capital distributions because the trustees believed that selling the income-producing assets at that time was not a sound business decision. In 1970-72 it racked up interest charges of a little over \$120,000 which it tried to deduct, while it subsequently sold some income producing property and extinguished the loans, but only after the value of the property (Gulf Oil Canada shares) had supposedly increased.

At the Tax Review Board level the case was dismissed in that although the Board concurred with the reasoning in *Cochrane v. M.N.R.*, the appellant had not satisfied the Board that a loss in the revenue of the trust had been avoided. The trustees appealed to the Federal Court-Trial Division¹⁵⁰¹ where Marceau J. held, on the same argument, that:

"The money was not borrowed here to redeem a debt previously incurred to acquire the income producing property of the trust. The series of transactions entered into by the trustees - ie; the capital allocations, the borrowing of money, the payment to the institution, and by so doing the retaining of securities which otherwise would have been disposed of - did more than simply change the composition

¹⁴⁹⁵ 54 D.T.C. 395, ITAB

¹⁴⁹⁶ 55 D.T.C. 39,

¹⁴⁹⁷ See also *Begg v. Dep. F.C.T.*, 1937 S.A.S.R. 97, & Case 11, 1950 1 T.B.R.D. 23 (Aust.).

¹⁴⁹⁸ 78 D.T.C. 1752

¹⁴⁹⁹ 76 D.T.C. 1154

¹⁵⁰⁰ In that case the only property of the estate was an income-producing term deposit, the disposition of which would drastically reduce the income of the estate. In fact there was a substantial amount of accrued interest in respect of that term deposit that would be reduced if the instrument had been disposed of to secure liquid funds hence the trustees were held to have almost an obligation to protect that income,...though how relevant this was in a tax case was obviously over-emphasized.

¹⁵⁰¹ 79 D.T.C. 5438

of the income earning property of the trust; that property was definitely reduced by some \$2,500,000 ...the decision here sought by the Plaintiff would mean that without doing anything that could enhance the value of its property, not even anything that could change the composition of its assets, the trust could nevertheless render non-taxable part of its income."

"If assets had been sold, these would have remained income producing and tax producing, and the borrowed money would have been added to the total amount of income and tax producing capital."

The appeal was thereby dismissed however fortunately the trustees appealed to the Federal Court of Appeal¹⁵⁰² whereunder Thurlow, C.J., Pratte, J., and Hyde, D.J., found (with Pratte dissenting), that the interest expense was deductible. Chief Justice Thurlow held:

"Had the trustees sold income yielding investments to pay the allocations, the income of the trust would have been reduced accordingly. Had they given the beneficiary income yielding investments in lieu of cash, the income of the trust would have been reduced accordingly. By not doing either, by borrowing money and using it to pay the allocations, the trustees preserved intact the income yielding capacity of the trust's investments. That, as it seems to me, is sufficient, in the circumstances of this case, to characterize the borrowed money as having being used in the taxation years in question **for the purpose** of earning income from the trust property."

He then went on to effectively comment that the fact that the actual purpose of the borrowed funds was not as important as the effect they had.

The Minister appealed to the Supreme Court of Canada¹⁵⁰³ whereby the Court analyzed the purposes of subsection 18(i)(a) and (c) in reaching its conclusion, and after a slight review of the previous judgments of the lower courts the Supreme Court held that the relevant aspects to recognize in deciding the question of deductibility were that it is not just the **purpose** of the borrowing of the funds that matters but the purpose in **using** those funds borrowed was the issue hence it eliminated the maintenance of income production reasoning and cut directly to how the funds were **actually used**. The Court further provided that a natural limitation on the applicability of the relevant provisions is that the borrowed funds, either directly or indirectly through the acquisition and disposition of property, **must remain in the hands of the borrower in order to allow the interest charges incurred to be deductible**.¹⁵⁰⁴ The Court acknowledged that the borrowing was used to make a distribution whereby the trust did not receive consideration or property of any kind. As a concluding comment Chief Justice Dickson¹⁵⁰⁵ provided that:

"The taxpayer in such a situation has doubly reduced his or her long-run income-earning capacity; first, by expending capital in a manner that does not produce taxable income, and second, by incurring debt financing charges. The taxpayer, of course, has a right to spend money in ways in which cannot reasonably be expected to generate taxable income but if the taxpayer chooses to do so, he or she cannot expect any advantageous treatment by the tax assessor. In my view, the text of the Act requires tracing **the use of borrowed funds to a specific eligible use**, its obviously restricted purpose being the encouragement of taxpayers to augment their income-producing potential. This, in my view, precludes the allowance of a deduction for interest paid on borrowed funds which **indirectly** preserve income-producing property but which are **not directly** "used for the purpose of earning income from property.""

The Court also concluded that although the trust would have been eligible for the interest deduction if it had sold the property, distributed the proceeds, and then borrowed the funds to reacquire the property, however the Court "must deal with what the taxpayer actually did, and not what he might have done" and it is the substance of this closing comment that can allow so much flexibility to the executor/trustee.

If the immediate capital rights of a capital beneficiary or income tax liability must be extinguished the trust could dispose of income producing property for proceeds which are then distributable while immediately

1502 83 D.T.C 5243
1503 87 D.T.C. 5059

1504 If the funds are reloaned at a higher rate of interest the debt collectable will be the "property acquired". This automatically precludes a trust from borrowing to acquire an income producing property, and then rolling that property out to a beneficiary under Sec. 106(3) or 107(2), (2.1), etc.,....and retaining the liability for the debt at its level and expecting to deduct the interest charges since the use of the borrowed funds will not produce taxable income in its hands but in that of the beneficiary's. If the beneficiary must assume the debt the interest expense should be deductible by him.

1505 concurring with Beetz, McIntyre, Lamer, Wilson, and LaForest

thereafter the trust could obtain loans to reacquire the property or similar property, whereby the interest charges could be deductible if the property produced or eventually was to produce income or gain.¹⁵⁰⁶ In the case of a personal trust the capital interest of which wasn't purchased a capital distribution in respect of the interest that does not satisfy it will be effectively tax free. On the sustaining of debt the capital beneficiaries would be in a better position to possibly recognize a capital loss on the distribution - satisfaction of capital interests, as per Sec. 107(1)(c), if the debt must be assumed as a condition of receiving the property and the beneficiary has had the opportunity to inflate the a.c.b of his capital interest.

In the previously cited case the interest paid would have been recognizable as income by the recipient but would not be deductible by the payor. If the property was distributed to a beneficiary under Sec. 106(3) or 107(2) etc. in satisfaction of his income/capital interest, and then the beneficiary loaned the property back to the trust, the beneficiary could have charged "rent/interest" on the loan equal to the minimal under Sec. 74.5(2) and thus realize income, have the trust deduct the payments and thus allow the trust to continue to realize income for other beneficiaries without the possibility of having it attributed to the beneficiary. If the beneficiary loaned funds to the trust and the trust turned around and distributed the funds out as capital, tax free in some instances, the trust would have incurred a debt which could be used in a Sec. 107(2)(c) distribution setting, advantageously however the interest paid thereupon would not be deductible.

If the trust incurred debt so as to inflate its working capital which would operate to the benefit of the income beneficiaries, then the trustees could exercise their discretion in timing the payment and level of payment of the debt **out of the revenue** of the trust that directly affect the income entitlements of the income beneficiaries which would thus reduce the income amount recognizable as payable and includable in the income beneficiaries under Sec. 104(24) & (13), thus causing the balance of trust's Division B income to be recognizable by the trust.

If the trust is testamentary its tax rates may be lower than the borrowing beneficiary so that the tax on the revenue in the hands of the trust is lower than the tax relief on the interest deduction in the hands of the income beneficiary. In such a case it could prove beneficial to have a beneficiary take out a loan and pay interest and then inject a contribution into the trust which is used to buy business property which is rent or rent-free back to the beneficiary, or, support the beneficiaries interest which can be used to collateralize a loan. In the case of rental of a business-property rent paid into the trust is tax-deductible and is taxed at lower rates than that of the payor paying it. And the taxed rental revenue can then come back out to a beneficiary. The variations of sinking revenue into a testamentary trust subjecting it to lower rates are numerous though one must be concerned with the multiple trust rules as well as the definition of "testamentary trust" itself. The connection of why the loan was received and its use for taxable income production is intact.¹⁵⁰⁷

If the working capital debt carries interest charges then the net amount of trust income recognizable will be reduced, since the interest was incurred to produce taxable income and the beneficiary will recognize less Sec. 104(13) income.

This could also be of use in avoiding the Sec. 74.3(1)(a) income attribution and Part XII.2 targeting. If a beneficiary loaned the trust the funds then interesting splitting of income, adjustments in accumulating income, etc, can be obtained.

¹⁵⁰⁶ The reacquisition might cause the recognition of a superficial loss if loss property is luckily on hand otherwise the tax consequences on the disposition by the trust may prove self-defeating.

¹⁵⁰⁷ See *Fed. Cmmr of Tax v. ANZ Savings Bank*, 194 C.L.R. 328, HCA for an instance where a beneficiary partnership was slipped into the mix on the realization of Aust. exempt annuity income through an *inter vivos* trust and interest incurred by the partnership to buy the interest was recognized deductible: the taxpayer had acquired an income interest in the trust with the loan which produced income. See also *Riverside Road Pty Ltd v FCT*, 91 A.L.R. 565, FC Aust, for instance where interest on beneficiary borrowing to buy property which was transferred to a bare trust with lease-back from trust for business use by beneficiary was allowed deduction. Again, the taxpayer had an interest in the trust which owned the property and the trust's property was effectively given back to the beneficiary for a business use. And, see also *Forrest v Commissioner of Taxation* [2010] FCAFC 6 for an instance where the taxpayer borrowed to buy interests in a trust that allowed the interest to be deductible. See also *FCT v. Janmor* 75 A.L.R. 15 FC Aust for a reverse flow of rental income into a trust to off-set interest expense on mortgages incurred to give the beneficiary a place of business.

Limited Deductibility: Interest on Succession Duties.

Subparagraph 60(d) allows a deduction from a taxpayer's income equal to the amount of interest accruing during the tax year in respect of succession duties, inheritance or estate taxes while I.T. 203 essentially provides that whoever is liable for the payment of the taxes may deduct the amount. Federal and provincial estate/succession taxes no longer exist as such in Canada but the U.S. still has such legislation. Only the amount of **interest** on such taxes is deductible,, not the taxes themselves. Interest on debt incurred to actually extinguish the liabilities will not be deductible as per #228 v. M.N.R.¹⁵⁰⁸, Cutten v. M.N.R.¹⁵⁰⁹ and Begg v. D.F.C.T.¹⁵¹⁰.

Subject: Interest on Death Duties

IT-203 Date: February 24, 1975

1. The deduction under paragraph 60(d) applies to interest accruing on estate taxes under the Estate Tax Act (repealed as to deaths after 1971), interest on provincial succession duties, foreign death duties and inheritance taxes. The deduction must be taken every year for the interest 'accruing within the taxation year'.
2. The taxpayer referred to in paragraph 60(d) is the person who is primarily liable or the person upon whom the incidence of death duties and accrued interest falls. Generally either the executor or the successor to an estate may claim the deduction provided for in paragraph 60(d).
3. Where the executor who is not a beneficiary to the estate claims the deduction under paragraph 60(d), he may deduct the interest accrued in the taxation year of the estate from the income of the estate. If the income of the estate is insufficient to cover the amount of the accrued interest, a non-capital loss occurs and may be carried forward under section 111.
4. A successor who claims the deduction under paragraph 60(d) may deduct the accrued interest from the income of the estate, from his personal income, or from both. There is no priority as to which income the deduction must be applied against first. However, if a successor wishes to deduct the interest from his personal income, the amount deductible is the interest accrued within the calendar year and referable to his succession duty payable. Where the amount of the deductible interest exceeds the income of the estate, the excess may be carried forward under the provisions of section 111 or may be applied against the personal income of the successor. The principles set out in this paragraph apply equally to an executor who is also sole beneficiary of an estate.
5. Where a taxpayer borrows money to pay succession duties or estate taxes, interest paid thereon is not an allowable deduction under paragraph 60(d), nor under paragraph 20(1)(c) nor any other provision of the Act.

Thin Capitalization.

Subsection 18(4)-(5) severely restrict the amount of interest that a corporation resident in Canada can deduct against income from property or a business where the debt upon which it is paid is held by a non-resident and the amount of debt, defined in Sec. 18(5), exceeds three times the corporation's retained earnings exclusively from the corporation and its contributed surplus. The rules prevent the minimal Sec. 212(1)(b) Part XIII taxation of interest to be the only tax applied to the income generated that would otherwise be captured under Division D had the non-resident carried on the business in his personal capacity without a corporate shell when an alteration in the economic character of the income would result.

There are no thin capitalization rules in respect of trusts realizing income from business or property and thus it is possible to use a trust to alter the character of the income flowing through it with beneficial Part XIII consequences by "lending" the trust funds or possibly creating it with a loan and realizing the economic benefits as interest. The interest deduction would have to be legitimately arranged for to be deductible while the Sec. 104(7) restriction would not need to be concerned with since the income is not being paid to the recipient quo beneficiary: the Sec. 104(6) deduction is not being claimed. Though there have been instances in the U.S.

1508. 55 D.T.C. 39
1509 56 D.T.C. 454
1510 4 A.T.D. 257

where beneficiaries of a trust have been held liable for the trust's debt such is not the case in Canada - nor is it expected to develop as such given the present juristic climate. While in common law a trustee is personally liable for the debt of the trust nothing prevents the trustee from being a corporation which has limited liability. In such a case the beneficiaries would not be liable for the trust's debt - unless they acted as guarantor, surety, etc. - and the corporate trustee would protect its shareholders-directors from liability. A trust is almost as functional as a corporation in creating limited liability while allowing for an alteration in the character of income flowing through it to non-residents so as to gain lower Part XIII rate treatment.

Withholding Tax and Alternate Income Elections.

The Basic Charges

Part XIII of the Income Tax Act, as per subsection 212(1), requires that every non-resident person shall pay a tax of 25% on every amount that a person resident in Canada pays or credits, or is deemed by Part I to pay or credit to him as on account or in lieu of payments of a certain character described in section 212. Subsection 212(1)(c) requires that withholding tax apply to "income of or from an estate **or** trust" that would be included in computing the income of a non-resident person by reason of Sec. 104(13), if that person had been resident in Canada, except such amount designated by mutual fund trusts as taxable capital gains under Sec. 104(21). In 1990 the provision was amended to also include under Sec. 212(1)(c)(ii) subject to withholding tax amounts received that may reasonably be considered to be a distribution or, or **derived** from, an amount received by the trust or estate as a non-taxable dividend but only if the payor corporation was resident in Canada.¹⁵¹¹ All the circumstances including, but not limited to, the terms and conditions of the trust/estate arrangement will be examined in ascertaining this and one should note that the targeting includes amounts derived from non-taxable dividends being that such receipts will lose their character when passing through an estate being administered. The amendment is to ensure that the payment of withholding tax on capital dividends otherwise required under Sec. 212(2) cannot be avoided by flowing them through a trust/estate, however if they are they may still benefit from favorable rates available under the applicable treaty as income from an estate or trust. Subsection 212(11) was amended to delete references to payments or distributions of capital and provides that all payments made by a trust or estate to a non-resident will be deemed as income of the trust or estate. The "**person**" in this case must be a beneficiary under the trust which would otherwise recognize Sec. 104(13) income had he been resident in Canada and the provision is broad enough to include any person to whom an amount representing Division B income **in specie** has been paid or to whom it is payable under the Sec. 104(24) definition of income payable. Subsection 212(11) provides that an amount paid or credited by a trust or a state to a beneficiary or person beneficially interested **regardless** of the source from which it arose in the trust's hands, will be **deemed** to have been, for the purpose of Sec. 212(1)(c), credited or paid as income of the trust. Subsection 212(11) was significantly amended with the 1990 amendments to delete the preclusion of distributions or payments of capital from withholding tax however as per the commentary on pg. 315 of Explanatory Notes to Draft Income Tax Amendments (circa July 1990) such was consequential upon capital dividends being targeted under Sec. 212(1)(c)(ii). The Sec. 212(1)(c)(ii) provision still refers only to amounts that would have been includable in the recipient's income under subsection 104(13) only had he been resident. Capital distributions are not includable in income under Sec. 104(13) since they do not represent any part of the trusts Division B income. The nature of the receipt in the trust's hands may not be that of the nature in the recipient's hands when paid to him.¹⁵¹² If the trustees can deduct non-tax deductible expenses from the trust law income then those amounts cease to be trust income and by result are trust capital.¹⁵¹³ Depreciation, interest provisions, sinking funds charges, etc can thus be deducted and be retained by the trust as capital. When they are paid or distributed they will fall outside of the effect of Sec. 212(11) and 212(1)(c).

"Estate or trust income – Sec. 212(1)(c)"

(c) income of or from an estate or a trust to the extent that the amount

- (i) is included in computing the income of the non-resident person under subsection 104(13), except to the extent that the amount is deemed by subsection 104(21) to be a taxable capital gain of the non-resident person, or**
- (ii) can reasonably be considered (having regard to all the circumstances including the terms and conditions of the estate or trust arrangement) to be a distribution of, or derived**

¹⁵¹¹ This has changed substantially since T.I. 5-7609 rendered June 1989 by the Reorganizations and Non-Resident Division and File 7-3249 from the Specialty Rulings Directorate to the Source Deductions Division in Oct. 1989.

¹⁵¹² In re: Bronson, 14 D.L.R. (2d) 51, a testator gave his trustees the power to determine whether a receipt was capital or income. The High Court of Ontario found that such a power **could not alter the nature** of the receipts.

¹⁵¹³ If they are distributed as capital the trust still has to recognize the Division B income.

from, an amount received by the estate or trust as, on account of, in lieu of payment of or in satisfaction of, a dividend on a share of the capital stock of a corporation resident in Canada, other than a taxable dividend;

Subsection 212(1)(c) refers only to income of or from the trust or estate that would be included in computing the non-resident's income by virtue of Sec. 104(13) only, had he been resident while Sec. 214(3)(a) causes deemed dividend payments to have been received by the non-resident from a Canadian resident corporation where section 15 or Sec. 56(2) would have been applicable to the non-resident and since there is not a single mention of Sec. 105(1) or its substance or effect, anywhere under Part XIII, indirect benefits may be realized by a non-resident from or in respect of the trust or estate without tax effect. Subsection 108(5) does not apply for purposes of Part XIII hence such a benefit will not be considered/deemed to be income from a property which is an interest in a trust.

Under subsections 215(1) and (2) a trustee/executor will be required to deduct, withhold, and remit an amount of tax on the payment credited or paid or deemed to have been credited or paid to the non-resident or his agent and should he not he will become personally liable therefore under Sec. 215(6). Subsection 215(3) extends this obligation to the non-residence agent or other person acting and collecting for and on behalf of the non-resident .

Subsection 212(9) offers an exception to Sec. 212(1)(c) if the amount paid to a non-resident can be reasonably regarded as having been derived from dividends or interest received by the trustee from a non-resident-owned investment corporation or amounts received as a royalty in respect of a copyright in respect of the production or reproduction of a literary, dramatic, artistic, or musical work, but only where no tax would have been payable under Part XIII on the amount if it had been paid directly to the non-resident instead of the trustee.

Eliminating the Conduit Principle

The conduit principle as it applies to economic benefits flowing through Canadian resident trusts and estates to non-resident beneficiaries is supposedly eliminated by virtue of Sec. 212(11) and instead every payment made by the trust/estate to the non-resident is to be recognized for subsection 212(1)(c) purposes to be a payment of income of the trust or estate.¹⁵¹⁴ It's important to recognize that new Sec. 212(11) causes the payment to be deemed to have been paid "as income **of** the trust or estate, regardless of the source from which the trust or estate derived it.", however it doesn't state expressly, as it does in Sec. 108(5), that such a payment is to be deemed as income **from** an interest in a trust. Whether or not this can be of use to extrapolate the draftsman's intentions to interpret the Part XIII provisions isn't known.

"Payment to beneficiary as income of trust – Sec. 212(11)"

(11) An amount paid or credited by a trust or an estate to a beneficiary or other person beneficially interested therein shall be deemed, for the purpose of paragraph (1)(c) and without limiting the generality thereof, to have been paid or credited as income of the trust or estate, regardless of the source from which the trust or estate derived it.

An Example Of Recent Case On "Paid Or Credited" Vs. "Payable"

In Richard Lewin Re: The J.J. Herbert Family Trust # 1 and Her Majesty the Queen¹⁵¹⁵ the TCC had to consider an instance where a preferred share dividend had been paid to a trust however, in the particular year of assessment, it had not been paid to the trust's non-resident beneficiary. The Minister took the

¹⁵¹⁴. See para. 6 of T.I. 465R as well as T.I. 910108 provided in March 1991 by the Reorganization and Non-Resident Division. T.I. 5-3792 of Sept. 1987 by the same came to a similar conclusion.

¹⁵¹⁵ 2011 TCC 476

argument that merely being payable allowed Part XIII to apply to it. The TCC held:

Brief Answer

[4] The appeal should be allowed for the following reasons:

- a. **The Trust was not liable for Part XIII tax in 2001 because the Resolution did not result in the dividend amount being paid or credited to the Beneficiary in that year. It resulted rather in the amount becoming payable. However, payable should not be held to be equivalent to paid or credited.**
- b. **The appellant should not be held to be personally liable for the unremitted Part XIII tax because the Resolution did not authorize that the dividend amount be paid. At the time the amount was paid — in 2002 — the appellant was no longer a trustee of the Trust and was not in a position to directly or indirectly cause the amount to be paid to the Beneficiary.**

The Respondent's Position

[5] The respondent contends that:

- a. Part XIII tax was payable by the Trust by virtue of paragraph 212(1)(c) of the *Act*, and that, therefore,
- b. the appellant was personally liable for that tax amount by virtue of paragraphs 215(5) and 227(5) of the *Act*.

[6] Subsection 104(13) of the *Act* applies to residents of Canada and requires that any amounts that have become payable to a beneficiary during the taxation year be included in the beneficiary's income. Furthermore, when an amount becomes payable to a beneficiary (resident or non-resident) during a particular taxation year, the trust may deduct it from its income for the year.^[1] Subsection 104(24) of the *Act* provides that an amount is not payable to a beneficiary unless either it was paid to the beneficiary during the year or the beneficiary acquired the right to enforce its payment during the year.

[7] The respondent refers to subsections 104(13) and 104(24) of the *Act* in arguing that the dividend amount was payable to the Beneficiary during the 2001 taxation year.^[2] The appellant does not dispute this. In fact, the Trust filed its 2001 tax return on the basis that the amount had become payable to the Beneficiary in 2001.

[8] The respondent submits that due to two facts, namely, (1) that the Trust had an obligation to pay the amount, and (2) that the Resolution is [TRANSLATION] "more than a simple accounting entry", the conditions for the application of paragraph 212(1)(c) of the *Act* have been met^[3]. In other words, because of these two facts, the Resolution amounted to a payment or credit.

[9] Paragraph 212(1)(c) of the *Act* reads as follows:

Every non-resident person shall pay an income tax of 25% on every amount that a person resident in Canada pays or credits, or is deemed by Part I to pay or credit, to the non-resident person as, on account or in lieu of payment of, or in satisfaction of,

...

- (c) income of or from an estate or a trust to the extent that the amount
 - (i) is included in computing the income of the non-resident person under subsection 104(13), except to the extent that the amount is deemed by subsection 104(21) to be a taxable capital gain of the non-resident person, or
 - (ii) can reasonably be considered (having regard to all the circumstances including the terms and conditions of the estate or trust arrangement) to be a distribution of, or derived from, an amount received by the estate or trust as, on account of, in lieu of payment of or in satisfaction of, a dividend on a share of the capital stock of a corporation resident in Canada, other than a taxable dividend;

(Emphasis added.)

[10] The respondent gives two very specific meanings to the verbs “to pay” and “to credit”, as used in the legislation.

[11] According to the respondent, “to pay” means to disburse an amount of money in fulfilment of an obligation.^[4] In addition, the respondent contends that “to credit” as used in subsection 212(1) of the *Act* refers to a situation where a creditor has the right to enforce immediate payment of a sum but grants the debtor deferral of the payment until some future date.

[12] In support of this interpretation of “to credit”, counsel for the respondent relies on Judge Rip’s decision in *Wenger’s v. M.N.R.*^[5] In that case, Judge Rip was required to interpret the effect of import and sales contracts between a Canadian company and a Soviet business entity. The issue before Judge Rip was a question of fact. The overall issue in the case involved determining the nature of payments made between the entities and whether those payments constituted interest. Thus, Judge Rip needed to determine the moment at which the Canadian company became the owner of the imported goods. At that moment, interest would have begun to accumulate, since payment for the goods was not made until later. It was in this context that Judge Rip made the following comments with regard to sales made on “credit” at paragraphs 71-73 (CarswellNat):

71 At least two of the contracts produced declare the interest to be paid by the purchaser is for “credit”. The payment clauses in other contracts produced refer to a period after the goods are withdrawn from consignment for the goods to be “fully paid” and indicate an interest rate to accrue until payment is “fully” made by the purchaser.

72 The *Shorter Oxford Dictionary on Historical Principals* defines the word “credit” as “... confidence in a buyer’s ability and intention to pay at some future time, for goods, etc., entrusted to him without present payment”.

73 The word “credit” assumes that the grantor of the credit, the creditor, is entitled to receive immediate payment but grants the debtor the right to pay at some later date. A creditor may receive interest because of the relationship he has with the debtor, such as vendor and purchaser. In general, a vendor is entitled to interest on the unpaid purchase money until actual payment (Volume 42, paragraph 200).

[13] According to the respondent, the fact that, in *Wenger’s*, Judge Rip reiterated his interpretation of “credit” from *Gillette Canada Inc. v. The Queen*,^[6] lends credence to the assertion that “to credit” for the purposes of subsection 212(1) of the *Act* means the granting of a deferral of payments immediately due.

[14] In *Gillette*, the issue was whether a debt restructuring gave rise to an amount “paid or credited” to a non-resident. Judge Rip wrote:

13 . . . If, on the other hand, an analysis of the facts with regard to subsection 212(13.1) leads to the conclusion that an actual payment or credit has occurred, then other provisions of Part XIII, including paragraph 214(3)(a), must be considered to determine whether the character of that payment or credit requires a tax to be paid.

[15] He then went on to reproduce dictionary definitions of the word “credit” and adopted the definition provided in *Cie minière Québec Cartier v. M.N.R.*^[7] In that case, the verb “to credit” was interpreted, with respect to subsection 212(1) of the *Act*, to mean that an amount has been made “available to” or placed “at the disposal of” a non-resident beneficiary. Judge Rip continued, in *Gillette*:

16 The definition of the word “credit”, however, by its very name suggests a creditor-debtor relationship. Funds or goods must either have been received by the debtor or be available to the debtor with the understanding that the debtor may defer immediate payment. An extension of a loan by a creditor to a debtor

comes within the meaning of the word "credit". The word "credit" in paragraph 212(13.1)(b) refers to something more than a mere accounting entry. . . .

...

26 I agree with the respondent that the conversion of the Oral-B debt to the Gillette France debt constituted a payment. The conversion created a debt. As part of the debt conversion the appellant delivered money's worth to the Partnership in order to discharge its obligation. In any event, there was at least a credit since on the conversion of the "Oral-B note" to the Gillette France debt the appellant made available to the Partnership funds to repay the note with the understanding that the repayment was deferred.

[16] The respondent inferred from these passages, particularly paragraph 16, that: La notion de « porte à son crédit » étend la portée de « paie » que l'on retrouve à l'article 212 de la *Loi de l'impôt sur le revenu*. Le paiement d'une somme implique l'exécution d'une obligation alors que le fait de porter au crédit d'une personne présuppose qu'une personne (le créancier) a droit immédiatement à la somme, mais qu'elle consent, à la personne qui doit effectuer le déboursement (le débiteur), à ce que la somme soit payée à un moment futur.^[8]

[17] To reiterate, according to the respondent, "credits" in section 212 of the *Act* means the act of a creditor in permitting a debtor to pay at a later date an amount due immediately.^[9]

[18] Applying this definition to the facts herein, the respondent contends that the Resolution had the effect of making the amount payable immediately.^[10] In the respondent's view, the fact that the Beneficiary consented to it being paid at a future date meant that the amount was credited to the Beneficiary.^[11] Therefore, counsel concludes that as of September 11, 2001 — the date of the Resolution — the amount was credited to the Beneficiary and the conditions for the application of subsection 212(1) of the *Act* were met.^[12]

[19] The respondent maintains that the appellant is personally liable for the unpaid Part XIII tax of the Trust. In support of this position, counsel relies on subsection 227(5) of the *Act*. That provision reads as follows:

Where a specified person in relation to a particular person (in this subsection referred to as the "payer") has any direct or indirect influence over the disbursements, property, business or estate of the payer and the specified person, alone or together with another person, authorizes or otherwise causes a payment referred to in subsection 135(3), 135.1(7) or 153(1), or on or in respect of which tax is payable under Part XII.5 or XIII, to be made by or on behalf of the payer, the specified person

...

(b) is jointly and severally liable with the payer to pay to the Receiver General

(i) all amounts payable by the payer because of any of subsections 135(3), 135.1(7), 153(1) and 211.8(2) and section 215 in respect of the payment, and

(ii) all amounts payable under this *Act* by the payer because of any failure to comply with any of those provisions in respect of the payment; and

[20] It is the respondent's position that the appellant had a direct or indirect influence over the disbursements, property or business of the Trust and caused the amount to be paid to the Beneficiary.^[13] Counsel contends that by adopting the Resolution the appellant caused the amount to be paid. The respondent accordingly urges the Court to hold that the appellant is liable for the unpaid Part XIII tax.

Analysis

[21] The respondent's position is largely based on a misreading and misapplication of the

provisions in question. Specifically, the respondent is conflating the concepts of an amount “payable” (within the meaning of subsection 104(13) of the *Act*) and an amount paid or credited (within the meaning of subsection 212(1) of the *Act*).

[22] Additionally, the respondent’s interpretation of the word “credited” is necessarily wrong since it would lead to the absurd result that an amount is “credited” to a beneficiary (by a trust) at the moment when the *beneficiary* “credits” the *trust* by deferring payment of an allocated benefit. In other words, it leads to a perfectly upside-down result.

[23] Furthermore, because the respondent’s position conflates the concepts of “payable” and “paid”, when viewed in the light of paragraph 214(3)(f) of the *Act*, it leads to an equally absurd interpretation of that provision, as I shall demonstrate below.

[24] The respondent rightly asserts that the legal obligation to pay that was created by the Resolution was unconditional.^[14] Article 1497 of the *Civil Code of Québec* (the “CCQ”) explains the concept of a conditional obligation:

An obligation is conditional where it is made to depend upon a future and uncertain event, either by suspending it until the event occurs or is certain not to occur, or by making its extinction dependent on whether or not the event occurs.

[25] Baudouin explains suspensive conditions in the following terms:

. . . La condition suspensive fait dépendre la naissance de l’obligation de l’arrivée de l’événement ou de la certitude qu’il ne se produira pas; elle retarde donc la création du lien entre les parties (article 1497).^[15] . . .

[26] The appellant pointed to three conditions that prevented the immediate payment of the amount: (1) the deposit of the treasury bills; (2) the redemption of the preferred shares; and (3) the issuance of the certificate required by subsection 159(2) of the *Act*. However, none of these uncertainties is of the sort that would render conditional the legal obligation to pay the amount. If it were argued that they are legal conditions, they would likely be in the nature of a “*condition purement potestative*”, that is, a condition which is not upheld by the courts as a legally effective condition.^[16] As Baudouin explains, these kinds of conditions are not valid in law:

614 – Introduction - Toute condition doit, pour être valide, remplir certaines exigences fixées par la loi. Elle ne doit pas engager le débiteur de façon purement potestative, être impossible, ou encore pécher contre la loi ou l’ordre public.

A. La condition potestative

615 – Condition purement potestative - La condition « casuelle », dont la réalisation dépend uniquement d’un événement extérieur, s’oppose à la condition « potestative » (ou « facultative »), dont la réalisation dépend de l’exercice discrétionnaire de la volonté d’une des parties.

Il y a, à première vue, antinomie complète entre l’élément d’imprévisibilité de la condition et l’élément discrétionnaire de l’acte d’une des parties. On ne saurait donc admettre comme valable la condition qui dépend, pour sa réalisation, du seul acte de volonté du débiteur, c’est-à-dire de l’exercice de son seul pouvoir discrétionnaire. La personne qui accepte d’exécuter une obligation « si elle le veut » ne s’engage pas véritablement et sérieusement, puisqu’elle a le pouvoir d’acquitter l’obligation selon son bon vouloir ou son caprice. Cette condition est connue classiquement sous le nom de condition purement potestative et entraîne la nullité de l’obligation qui en dépend (article 1500).^[17]

[27] Clearly, the kinds of conditions invoked by the appellant would fall under the category of “*conditions purement potestatives*” since their fulfilment depends entirely on the discretionary exercise of the will of one of the parties. That is, so long as the appellant undertook the actions listed, the conditions would be fulfilled. Even the third condition — the obtaining of the certificate — depends solely on the will of the appellant since the Canada Revenue Agency (“CRA”) has taken the position that it is not necessary to obtain this certificate if the payer withholds sufficient funds to discharge any debts owing to the CRA.^[18]

[28] However, the above analysis is moot. The respondent portrays the appellant as asserting that

the three conditions are legal conditions that prevent the Resolution from making the amount payable, but this is a straw man version of the appellant's real argument. The appellant never argued that the three conditions set out above render the obligation to pay the amount conditional in the sense referred to by the CCQ, article 1497. Counsel for the appellant clarifies as follows:

... L'appellant n'a jamais prétendu et ne prétend toujours pas que l'obligation résultant de la résolution du 11 septembre 2011 [sic] était « conditionnelle » au sens des articles 1497 à 1507 du Code civil du Québec. Selon nous, l'Intimée fait erreur et ne veut que semer la confusion en faisant de l'obligation créée par la résolution une obligation dite « conditionnelle » sous prétexte que la somme de 2 200 003 \$ n'était pas « mise à la disposition » de J.J. Herbert « inconditionnellement ».^[19]

[29] Since there is no genuine disagreement between the parties on this point, the Court should conclude that the Resolution created an unconditional obligation on the part of the Trust to pay the amount to the Beneficiary.

[30] Since an amount payable is defined in subsection 104(24) of the *Act* as including any amount whose payment a beneficiary was entitled to enforce during the year, the creation of an unconditional obligation to pay an amount of money is the essence of an amount that has become payable under paragraph 104(13)(a) of the *Act*. That being so, at the moment that the Resolution was passed the amount became payable to the Beneficiary for the purposes of paragraph 104(13)(a) of the *Act*.

[31] The respondent placed a great deal of emphasis and relied heavily on the decision in *Wenger's*.^[20] She relied on paragraphs 16 and 26 of that decision to argue that "credited" means the creation of a debtor-creditor situation where the creditor permits the debtor to defer payment of the amount owed.

[32] However, the facts in *Wenger's* are very dissimilar to the facts currently before the Court. The question before Judge Rip related to the legal characterization of import/sale contracts between a Canadian company and a Soviet entity. Because payment and delivery of the goods were not concurrent, it was necessary for Judge Rip to determine if certain amounts paid (over and above the actual purchase price) were in the nature of "surcharges" or were actually interest paid on goods provided on credit. Judge Rip therefore had to determine whether the sale of the goods was a sale on "credit". He did not have to determine the meaning of "credited" for the purposes of subsection 212(1) of the *Act*.

[33] The word "credit" in the *Wenger's* context has a much different meaning than "credits" in the phrase "pays or credits" in subsection 212(1) of the *Act*. In *Wenger's*, the term has the meaning of a loan or financing. On the other hand, in subsection 212(1) of the *Act*, "credits" is paired with "pays" and implies the fulfilment of an obligation.^[21]

[34] The respondent gave too broad an application to *Wenger's*. That decision interpreted the noun "credit" in a particular context, it cannot be seen as having defined the verb form "credits" as used in subsection 212(1) of the *Act*.

[35] The respondent relies on the *Gillette* case to support her contention that a creditor-debtor relationship arises from the fact that an amount is "credited" for the purposes of subsection 212(1) of the *Act*. In his decision, Judge Rip said the following:

[16] The definition of the word "credit", however, by its very name suggests a creditor-debtor relationship. Funds or goods must either have been received by the debtor or be available to the debtor with the understanding that the debtor may defer immediate payment. An extension of a loan by a creditor to a debtor comes within the meaning of the word "credit". The word "credit" in paragraph 212(13.1)(b) refers to something more than a mere accounting entry. . . .

[36] Judge Rip was of the opinion that the conversion of one debt instrument into another debt instrument constituted a "credit" for the purposes of paragraph 212(13.1)(b) of the *Act*. However, he did not state that every time a debtor-creditor relationship is created an amount is "credited" for the purposes of subsection 212(1) of the *Act*. In fact, the reason he felt that the debt conversion constituted a credit was that the repayment of the original loan followed by the issuance of another placed funds at

the disposal of the non-resident.^[22] He wrote:

[26] I agree with the respondent that the conversion of the Oral B debt to the Gillette France debt constituted a payment. The conversion created a debt. As part of the debt conversion the appellant delivered money's worth to the Partnership in order to discharge its obligation. In any event, there was at least a credit since on the conversion of the "Oral B note" to the Gillette France debt the appellant made available to the Partnership funds to repay the note with the understanding that the repayment was deferred.

(Emphasis added.)

[37] This is, in fact, an application of the definition of the verb "to credit" that this Court adopted in *Cie minière*. It was therefore the fact that the Canadian resident permitted a novation — which entailed the placing of funds at the disposal of the non-resident — that constituted a credit.

[38] Moreover, Judge Rip expressly accepted the definition of the verb "to credit" from *Cie minière*, namely, that an amount is "credited" by someone (here, the trust) to someone else (here, a non-resident beneficiary) if the former puts a sum of money at the latter's disposal.^[23] This definition fits perfectly with the interpretation adopted by the CRA and with the meaning that I propose at paragraph 50 below.

[39] Furthermore, the granting of credit in the sense in which it occurs in *Wenger's* takes place from the point of view of the creditor — or, in *Wenger's*, of the seller of the goods. As must always be the case, the creditor grants credit to the debtor. However, in the context of subsection 212(1) of the *Act*, the crediting takes place from the point of view of the debtor. It is the debtor — i.e., the Trust — that pays or credits an amount to the creditor (the Beneficiary of the Trust). This clearly implies that "credited" should be treated as a near synonym of "paid" — that is, it refers to the fulfilment of the obligation to pay the amount to the Beneficiary.

[40] Thus, the two senses of the word "credit" are incompatible. It is difficult to see how the respondent can suggest that the noun "credit" as defined in *Wenger's* should be treated as synonymous with the verb "to credit" as used in subsection 212(1) of the *Act*. With one the situation is seen from the point of view of the creditor while with the other it is seen from the point of view of the debtor. If the respondent's argument and definition were to be accepted, the result would be that the creditor of the Trust — that is, the Beneficiary — would be the only entity or person in a position to credit the amount since it is the creditor who must grant the debtor the right to defer payment. The beneficiary would thus be determining, for the purposes of subsection 212(1) of the *Act*, whether to credit the amount to himself. This is clearly an unintended and absurd application of the provision. This reason is sufficient to reject the respondent's definition of "credited" as involving a situation where the creditor has permitted a payment to be deferred.

[41] However, there is yet another reason for rejecting the respondent's definition. That definition would mean that an amount "payable" (under subsection 104(13) of the *Act*) would always be an amount "credited" under subsection 212(1) of the *Act*. The reason for this has to do with the definition of an amount payable in 104(24) of the *Act*. An amount payable includes any amount whose payment the beneficiary was entitled to enforce. If the beneficiary could enforce payment but did not, then (if we accept the respondent's definition) the amount would also have been "credited" to the Beneficiary. Thus amounts "payable" and amounts "credited" would always be equivalent.

[42] This conflation of amounts "payable" and amounts "credited" is also troubling when one considers the existence of paragraph 214(3)(f) of the *Act*. That provision reads as follows:

Deemed payments -- For the purposes of this Part,

...

- (f) where subsection 104(13) would, if Part I were applicable, require any part of an amount payable by a trust in its taxation year to a beneficiary to be included in computing the income of the non-resident person who is a beneficiary of the trust, that part shall be deemed to be an amount paid or credited to that person as income of or from the trust on the earlier of
- (i) the day on which the amount was paid or credited, and

(ii) the day that is 90 days after the end of the taxation year
and not at any subsequent time when the amount was actually paid or credited;

[43] The effect of paragraph 214(3)(f) of the *Act* is therefore to deem a. amounts payable to beneficiaries to be b. amounts paid or credited to beneficiaries, once certain conditions are met. However, there is no point in deeming these two types of amounts to be equivalent if they are already equivalent on their own. To put it another way, if they were already equivalent concepts then there would be no need to use different words to describe them. They must therefore, of necessity, be different concepts that may be deemed to be equivalent in certain circumstances. There is no reason to deem “b” to be “b”. If the respondent’s definition were accepted, paragraph 214(3)(f) of the *Act* would become futile.

[44] The presumption against useless legislative provisions is a long-standing principle of Canadian law. In 1949 the House of Lords said the following:

. . . it is to be observed that though a Parliamentary enactment (like parliamentary eloquence) is capable of saying the same thing twice over without adding anything to what has already been said once, this repetition in the case of an Act of Parliament is not to be assumed. When the legislature enacts a particular phrase in a statute the presumption is that it is saying something which has not been said immediately before. The rule that a meaning should, if possible, be given to every word in the statute implies that, unless there is good reason to the contrary, the words add something which would not be there if the words were left out.^[24]

[45] And Lamer C.J. of the Supreme Court of Canada wrote in *R v. Proulx*:^[25]

. . . It is a well accepted principle of statutory interpretation that no legislative provision should be interpreted so as to render it mere surplusage. . . .

[46] If this principle of legislative interpretation endorsed by the Supreme Court is to be taken seriously, it is difficult to see how this Court could endorse an interpretation that would render paragraph 214(3)(f) of the *Act* completely superfluous.

[47] The McCarthy Tétrault Commentary states the following regarding the function of paragraph 214(3)(f) of the *Act*:

Income from a Trust (paras 214(3)(f) and (f.1))

Several provisions of Part XIII deal with the imposition of non-resident withholding tax in respect of income from a trust. See paragraph 212(1)(c) and subsections 212(9), (10) and (11). Paragraph 214(3)(f) deals in particular with the determination of the time when income from a trust is to be regarded as having been paid or credited to a non-resident beneficiary. The provision states that where subsection 104(13) would require an amount payable by a trust in a particular taxation year to be included in computing the income of a non-resident beneficiary, the amount shall be deemed paid or credited on the earlier of the day on which it actually was paid or credited and 90 days after the end of the taxation year, and not at any subsequent time when it was actually paid or credited. In effect, unless the amount payable by the trust to the non-resident beneficiary has already been paid, a 90-day grace period is added to the end of the taxation year in which the amount has become payable.^[26]

[48] If the respondent’s interpretation were accepted, this 90-day grace period would be judicially written out of the legislation.

[49] The way in which the provisions of the *Act* are structured suggests that the legislator intended certain tax consequences to attach at the time of the creation of a trust’s obligation to pay an amount to a beneficiary, and other tax consequences to attach at the time that the obligation is actually discharged and funds leave the trust (particularly in the case of non-resident beneficiaries). I would suggest that subsection 104(13) of the *Act* refers to the point in time at which a trust incurs the obligation to pay a beneficiary, while both the terms “pays” and “credits” in subsection 212(1) of the *Act* refer to the moment when the obligation is discharged — that is, when the trust essentially gives up possession of the funds necessary to pay the obligation.

[50] Paragraph 104(13) of the *Act* attaches certain tax consequences to the creation of an unconditional obligation on a trust to pay an amount to a beneficiary. These include, among other things, the inclusion of the amount in the income of the beneficiary and the ability to deduct from the trust's income the amount that has become payable during the year. Part I of the *Act* does not create tax consequences that apply at the moment that the obligation is created and different tax consequences that apply at the time that it is fulfilled. Rather, it mandates both that the taxpayer include the amount payable in his income and that the trust be permitted to deduct it from its income at the same moment in time, that is, the moment at which the obligation to pay is created.

[51] However, because Part I deals with beneficiaries that are resident in Canada while Part XIII deals with non-resident beneficiaries, the Minister must be assured of being able to collect from the latter category of beneficiaries. Subsection 212(1) of the *Act* therefore imposes a withholding tax on the (resident) trust at the time that funds actually leave the country. Thus, subsection 104(13) of the *Act* has consequences at the time the obligation is created, while subsection 212(1) of the *Act* creates further consequences at the time that it is fulfilled.

[52] Even though she applied it incorrectly to the facts of the case, the respondent recognized this dualism, as shown by the following excerpt:

22. La Résolution a eu pour effet de créer une obligation juridique de la Fiducie à l'égard de J.J. Herbert. L'obligation se définit de la façon suivante :

Elle est le lien de droit, existant entre deux ou plusieurs personnes, par lequel une personne, appelée débiteur, est tenue envers une autre, appelée créancier, d'exécuter une prestation consistant à faire ou à ne pas faire quelque chose, sous peine d'une contrainte juridique.

23. L'exécution de l'obligation se traduira par le paiement de la somme de 2 200 003 \$ lorsque J.J. Herbert en aura choisi le moment. Conséquemment, le 11 septembre 2001, la somme de 2 200 003 \$ était à la disposition de J.J. Herbert^[27].

[53] The respondent recognizes that the Resolution created an obligation on the Trust towards the Beneficiary. However, it is curious that the respondent states only that payment of the amount would constitute fulfilment of the obligation. Subsection 212(1) of the *Act* refers to amounts either paid or credited; it therefore seems odd for the respondent to omit amounts "credited" when referring to how the obligation may be fulfilled. It would appear that the legislator envisaged two ways in which the obligation to pay could be fulfilled and therefore result in funds leaving the country and therefore create the need to impose Part XIII tax: the amount could be either paid or credited to the non-resident beneficiary.

[54] The respondent is referring to one but not the other method of fulfilling the obligation to pay leads to confusion.^[28] The respondent wishes to ascribe to the verb "to credit" in subsection 212(1) of the *Act* a meaning relating to the *creation* of an obligation. However, by placing the verb form "credits" in the same provision as "pays", the legislator, it would appear, intended both terms to refer to the *fulfilment* of the obligation.

[55] On the other hand, the courts have clearly stated that "credits" and "pays" are not synonyms. In the *Berry*^[29] case, M. J. Bonner of the Tax Review Board wrote the following on the subject of section 212 of the *Act*:

The arguments advanced on behalf of the appellant seem to have been based on the unstated assumption that the word "credits" as used in section 212 of the *Income Tax Act* means the same as the word "pays" as used in that section. As I read that provision the words are used disjunctively and, in the absence of any argument directed towards showing that the words "or credits" should be regarded as surplusage and that the section should be read as restricted to the imposition of tax on payments alone, I can find no reason for accepting the unstated assumption.

[56] However, the fact that "credited" and "paid" are not synonyms does not mean that "credited" should refer to the creation of the obligation. As I stated above, the respondent's argument ends up confusing the concepts of an amount "credited" and an amount "payable".

[57] Interestingly, a more appropriate interpretation of “credited” has already been advanced by the CRA, and it is in fact its long-standing position:

5. The words “credits” and “credited” cover any situation where a resident of Canada or, in certain cases, a non-resident (see 8 below) has set aside and made unconditionally available to the non-resident creditor an amount due to the non-resident such as where

- (a) a tenant or agent deposits rents in a bank account on behalf of a non-resident landlord;
- (b) a bank credits interest to the savings account of a non-resident;
- (c) an insurance or trust company deposits a pension or annuity payment in the bank account of a non-resident; or
- (d) the amount due is applied by the resident (or deemed resident) against an amount owing by the non-resident. . . . ^[30]

[58] It is likely that this interpretation of “credited” is the correct one. The examples provided by the CRA in its Information Circular are ones that refer to the fulfilment of the obligation to pay. They are situations where sums of money have actually been put aside or deposited in an account of the beneficiary. In those examples, the funds have therefore been unconditionally placed at the disposal of the beneficiary. Practically speaking, the beneficiary is in “possession” of the funds.

[59] These kinds of practical considerations are of the same nature as the three unfulfilled “conditions” enumerated by the appellant that prevented the payment of the amount to the Beneficiary in 2001. Because the appellant was not actually in possession of the necessary funds, those funds could not actually be paid or credited to the Beneficiary until the treasury bills were cashed and the preferred shares redeemed. Thus, the appellant is correct in pointing to the taking of these steps as being necessary before the amount could have been paid or credited.

[60] Furthermore, the examples provided by the CRA involve to situations where it is the debtor that has credited the amounts to the creditor. As I decided above, this is the only interpretation that does not lead to the absurd result of the beneficiary being able to credit an amount to himself.

[61] It is therefore my contention that the Court should adopt the definition of “credited” suggested by the CRA and interpret it as meaning: the unconditional placing of funds — on a practical level — at the disposal of the Beneficiary in fulfilment of the Trust’s obligation to pay. This definition is consistent with both the scheme of the legislation and the leading case of *Cie minière*.

[62] The respondent also argues that subsection 227(5) of the *Act* applies to the appellant in view of the fact that he authorized the payment of the amount. Counsel submits that the Resolution “authorized or otherwise caused” the amount to be paid to the Beneficiary. However, this is simply not tenable given the facts of the case. The Resolution created the obligation on the part of the Trust to pay the amount to the Beneficiary. It did not authorize its payment. It is not an accurate statement to say that a resolution creating an obligation is the same thing as a resolution authorizing the fulfilment of that obligation.

[63] Therefore, even if the Court accepted the respondent’s argument that the Resolution “credited” the amount to the Beneficiary (which I am of the opinion is incorrect), the Resolution clearly did not authorize the payment of the amount. Unfortunately for the respondent’s position, subsection 227(5) of the *Act* attaches liability for unremitted Part XIII tax only to trustees who authorized a payment to a non-resident beneficiary or otherwise caused such a payment to be made. Unlike subsection 212(1) of the *Act*, which applies to amounts paid *or* credited, subsection 227(5) of the *Act* clearly states that it applies only to amounts paid.

[64] The Latin maxim “*expressio unius est exclusio alterius*”, also known as the principle of implied exclusion, states that where the legislator causes a provision to apply to a number of categories but fails to include one that could easily have been included, one may infer that the legislator intended to exclude that category from the application of the provision. As Noël J.A. of the Federal Court of Appeal stated:

[96] The rule is that the expression of one thing in a statute usually suggests the

exclusion of another (*expressio unius est exclusio alterius*). Pursuant to this maxim, if a statute specifies one exception (or more) to a general rule, other exceptions are not to be read in. The rationale is that the legislator has turned its mind to the issue and provided for the exemptions which were intended.^[31]

[65] One should therefore assume that the legislator intended subsection 227(5) of the *Act* to exclude from its application situations where a trustee has credited an amount to a non-resident beneficiary. Subsection 227(5) of the *Act* applies to trustees who directly or indirectly cause a *payment* to be made to a non-resident beneficiary of a trust.

[66] For these reasons, the appeal is allowed with costs.

Beneficial Ownership and the Treaties

In *Pan-American Trust Co. v. M.N.R.*¹⁵¹⁶ a Canadian resident company received from a N.R.O.I.C. dividends during the Second World War and rather than remit them immediately to the Swiss resident **beneficial owners** they were held in trust and deposited in a bank account to be accumulated. The Exchequer Court had to decide, under the Income War Tax Act, when the trust company received the dividends, whether it had to deduct withholding tax and remit it or whether the amounts accruing to the benefit of non-residents under a trust were exempt since their source was a N.R.O.I.C.. Subsection 9(B)(2) of that Act required that withholding tax be paid on "all income for any taxation period received from a Canadian estate or trust which income shall be deemed to include all income accruing to the credit of non-resident beneficiaries whether received by them or not during such taxation period...". Subsection 9(B)(12)(a) of that Act offered a saving provision in respect of dividends received from N.R.O.I.C. allowing them to be exempt from taxation. When the amounts were being received the trust company was required to make withholding remittances in respect of them as income accruing under a trust for the benefit of non-residents, as contended by the Minister, while the trust company maintained that they were exempt. Thorson, P. held, following an examination of the fundamentals of beneficial ownership and income of and from trusts realized by beneficiaries:

"Similarly, it should be held in the present case that when the dividends were paid to the appellant and credited by it to the Swiss Company the latter became the beneficial owner of such dividends and entitled to the amounts thereof in their character as dividends and not as income received or accruing from a Canadian estate or trust by reason of the fact that the appellant credited them to the Swiss Company and paid them into a separate bank trust account for it. In my opinion, the intervention of the appellant as trustee for the Swiss Company did not cause the amounts received by it to lose their character as tax exempt dividends..."

"...It seems to me that the term "income received or accruing from a Canadian estate or trust" must mean something other than the income from property which a settlor has transferred to a trustee for himself and of which he has **never ceased to be the beneficial owner**."

"Beneficial ownership" as compared to "beneficial interest" and the distinction between the two is of critical importance obviously.¹⁵¹⁷

Subsection 212(1) opens with the preamble charging a 25% withholding tax on the described payments made to non-residents while subsections 212(2) and (5) provide the same with respect to taxable and capital dividends and royalties in respect of motion pictures. Income Tax Application Rule 10(6), however, provides that where an agreement or convention between the Government of Canada and the other country has the force of law in Canada the tax rate applicable to the payment as per Part XIII will be that designated in the agreement or convention and not that under Part XIII. Under Article X of the Cdn.-U.K. Tax Convention 1978

¹⁵¹⁶ 49 D.T.C. 672, ExC.

¹⁵¹⁷ See also *TransCanada Investment Corp. v. M.N.R.*, 53 D.T.C. 1227 (ExC.), for similar case of **beneficial ownership** when a non-resident could enforce the distribution of shares in specie on a whim. Dividends paid were received as such through the trust. In T.I. A-0400 provided in Oct. 1984 by the Non-Corporate Rulings Division it was held that interest paid to a non-resident by a Canadian law firm acting as bare trustee for capital held was to be treated as trust income and not interest.

dividends paid by a Canadian resident company to a resident of the U.K. will be taxed in the U.K. and also in Canada but the Canadian rate will be limited to 15% of the "gross" amount and 10% if the recipient is a company which controls, directly or indirectly, 10% of the voting power in the payor. The same holds true in respect of dividends paid to a non-residents residing in the U.S. as per Art.X of the Canada-U.S. Tax Convention 1980. In both instances the gross amount of the dividend is the basis of the calculation and this does not mean "grossed-up dividend" since gross-up mechanics only occur under Part I. In both instances the rates will be obtained only, in the former case, if the beneficial **owner** of the dividends was resident in the U.K. while in the latter instance, only if the beneficial owner of the dividends is non-resident with respect to the payor. In both instances the recipient of the dividends, in specie, must be resident in the other relevant state and if the recipient is resident in a third country with the beneficial owner resident in the second country the rates will not be available.¹⁵¹⁸ Article XI of the Can.-U.K. Convention provides that interest income will attract original country withholding tax of not greater than 10% if the recipient non-resident is the beneficial owner thereof while if the beneficial **owner** isn't the immediate recipient thereof the 25% Sec. 212(1)(b) rate will apply. Under Art. XI of the Can.-U.S. Convention the recipient need only be resident in the relevant foreign state, and need not be the interest's beneficial owner in order to benefit from the low rate of 15% of the gross amount of interest.

Whether or not a beneficiary under a trust, let alone an estate, is a beneficial **owner** of income received by the trust/estate or is merely beneficially interested therein is of critical importance for purposes of the treaties. Beneficial ownership can be differentiated from being beneficially interested by virtue of the fact that under the former, powers of sale, mortgage, etc. are virtually exclusively held by the beneficiary who has proprietary interests in respect of the trust property while the mere holding of the legal title, (bare of any dispositive powers), is the function of the trust while a "beneficially interested" person will have no such dispositive/administrative powers and capacities to sell/mortgage/alter etc. will be held exclusively by the trustee making the beneficiary dependent on the actions of the trustee. The beneficiary then takes income from the trust regardless of how its wealth is increased or created. If a beneficiary is merely beneficially interested then actual beneficial **ownership** of the trust property will reside with the trustees as a result. In *Pan-American Trust Co.* cited earlier the trustees had no power over the dividend other than to accumulate them and distribute them as per the directions of the beneficiaries. If the trustees could accumulate them and distribute them as they saw fit, or, as per the terms of the trust agreement, then the beneficiaries would have no control over the dividends and although they would be beneficially interested therein they would not be in a position of beneficial ownership.¹⁵¹⁹ In respect of the U.K. Convention, Art. X does not require that the beneficial **owner** of the dividend actually be the in specie recipient, only that both be non-resident, in order for the 15% rate to apply however it is only when **the recipient** is a company that, acting indirectly or directly, controls 10% of the voting stock of the payor will the 10% rate be available. If the trustee recipient is such a company it receives the payment in the capacity of trustee and unfortunately not on account of the company and thus even if the trust is the beneficial owner of the dividends the 10% rate will not be available. This is not the case in respect of the U.S. treaty in that under Art. X para. 2(a) if the beneficial **owner** of the dividends is a company owning at least 10% of the voting stock of the payor the 10% rate will apply to the payment, even though the intermediary recipient may have been a trust. The U.K. Convention requires the recipient to be the beneficial owner in order to obtain the 10% rate. (In respect of receipt of both forms of income under both treaties there are exceptions that should be gone into in more detail than that can be afforded here however a general overview consists of that above.)¹⁵²⁰

Information Circular 76-12 R4, para. 5 describes a certificate that is required to be obtained from recipient agent/nominees of foreign residence beneficial **owners** if the Department is not satisfied with the proof provided by the payor that the beneficial owner is resident in that particular country. **Supposedly**, if some

¹⁵¹⁸ See *Hilton v. M.N.R.*, 63 D.T.C. 336 TAB, for an example of an inequitable treatment in respect of foreign tax credits but not to treaty treatment.

¹⁵¹⁹ See *Jodrey Estate v. Min. of Fin. (N.S.)*, [1980] C.T.C. 437, *MacKeen Estate v. M.N.R.*, 1977 C.T.C. 230.

¹⁵²⁰ For an excellent article covering various treaties between a majority of the industrialized countries and problems encounterable where income is realized in one source state, paid to a trust in another state, and then distributed to a beneficiary in a third state see "The Treatment of Trusts under the O.E.C.D. Model Convention." *Taxation in Aust.*, June 1989, 686, J.F.A. Jones (U.K.)... D.A. Ward (Canada).

question of the applicability of lower treaty rates arises concerning this instance, and the certificate isn't remitted the higher rate will be applied. Subsection 215(3), acting in concert with Sec. 215(1), requires that the agent or nominee receiving taxable amounts beneficially owned by the foreign resident taxpayer shall deduct and remit the appropriate amount of taxes thereupon but it would appear that the agent/nominee can be resident in Canada and in the foreign jurisdiction and in this way the collection/remittance mechanics/duties filter through to the agent from the payor. There is no statutory requirement that the above mentioned certificate be obtained, (nothing in the body of the Act nor in its accompanying regulations), and with this in mind one only has to review *MacMillan Bloedel Ltd. v. M.N.R.*¹⁵²¹ where such an administrative policy was found to be of no force and it was found that the payor need not ascertain the residence or identity of the beneficial owner of the amounts paid before deducting the minimal tax as specified by the treaty. In that case the payor company was making interest payments to the registered holders of debentures and when the Minister pushed to have the maximum tax withheld (25%) the payor contended that under company law it had no right to look beyond the nominal registered holder of its debentures to ascertain residence or identity of the beneficial owner, and what was more, they didn't have the obligation to do so under the ITA. The Tax Review Board found for the taxpayer providing that the payor is not required to ascertain the residence of the beneficial owner in order to deduct the lower treaty rate and since the agent recipient was resident in the U.S. it could be reasonably concluded that so too were the beneficial owners. Essentially the tax applied was to be based on **the country of residence of the nominee**, and if the capital Minister wanted more information he could contact the foreign taxing authority. This case has the obvious interesting ramifications on the ability to structure holdings through three or more countries. The trustee-agent-nominee must however file the prescribed form NR4, NR4A Summ., or NR4A Supp., as per Reg. 202(3), with respect to the payment.

The Part XIII withholding mechanics apply where an amount is paid or credited, or is deemed to have been paid or credited to a non-resident however the term "credits", used in conjunction with "pays" need not be exclusively treated as the action taken by an accountant in adjusting books of account. This was the issue in *La Compagne Miniere Quebec Cartier v. M.N.R.*¹⁵²² where as per the terms of a loan contract interest in arrears was credited to the principal amount owed to the creditors, who were non-resident. The Tax Court of Canada found that the term "credits" refers only to actions which make a sum available to a recipient, and not where interest has been credited to the loan account. In such an instant the company would not receive the Sec. 20(1)(c) interest deduction while the non-resident person would receive the sum as a return of capital eventually.¹⁵²³

The above concerns trust arrangements serving as recipients of payments from the Canadian resident payor. Under Art. XX of the U.K. Convention income received from a Canadian resident trust or estate by a U.K. resident beneficial **owner** thereof will be exposed to a maximum of 15% withholding tax on the gross amount. If the beneficial owner is not the immediate recipient, but possibly the beneficial owner of the payment received by an intermediary trust then the 15% rate is not available and the amount will be subject to the 25% rate applicable to Sec. 212(1)(c) payments. (Subpara. XX (2) provides certain exceptions to the above requirements.) Art. XX refers only to "income received" from the trust and if the payment cannot be classified as "income" then Art. XX does not apply to it. If the amount arose as a payment or distribution of capital it should not be subject to Art. XX, **unless** it can be recognized as income of the beneficiary from the trust/estate and not as a capital distribution **in the hands of the beneficiary**. Subsection 212(11) has no effect in this case.

Under the U.S Convention the taxable income recognition methods are different owing to the effect of Art. IV of the Canada-U.S 1980 Convention, para. I, which provides that an estate or trust shall be resident in a country to the extent that income derived by it is liable to tax in that country, in its hands, or in the hands of its beneficiary. If a trust all of the trustees of which are resident in Canada derives income from an American source, and as per its terms distributes it to the U.S. resident income beneficiaries as income then that particular income will not be taxed on the way out of the country to the trust at U.S. marginal rates, while the

1521 79 D.T.C. 297

1522 84 D.T.C. 1348, TCC

1523 See *East Finchley Pty. Ltd. v. F.C.T.*, 90 A.T.C. 457.

trust will make the Sec. 104(6) deduction eliminating marginal tax on it under the Canadian regime. The U.S. beneficiary will recognize the payment in his U.S. income. Under Art. XXII, para. (2), the rate applicable to the distribution will not be greater than 15% if the payment thereof is made to the U.S. beneficiaries, but only when that income can be recognized by Canadian domestic tax law, to be income arising from the trust and not from underlying sources. The treaty goes on to provide "however such income shall be exempt from tax in the first-mentioned State to the extent of any amount distributed out of income arising outside that State" when the State is Canada in this case. If the income arose in the U.S. Canadian withholding would not apply to it and thus the income would be taxed in the hands of the U.S. beneficiary only, the appropriate result. If the income arises in the U.K. and is paid to the U.S. beneficiary through the Canadian resident trust then the U.K. treaty will cause 15%-25% withholding on payment to the Canadian trustee and the trustee will deduct withholding tax on payment to the U.S. beneficiary. The U.S. beneficiary will include the amount in his regular income but may not receive a foreign tax credit in respect of the U.K. withholding as per the reasoning in *Hilton v. M.N.R.*¹⁵²⁴ while the U.K. tax will not be applicable against the Canadian Part XIII tax to reduce it. If the income substantiating the payment arose in Canada then the Canadian 15% withholding rate would be applicable. The general scheme of the Act allows withholding tax to be applied on payments of an income nature to non-resident trustees notwithstanding that the income paid to a Canadian resident beneficiary of that trust will be exposed to Part I tax. There is no provision for tax credits to be allowed to the Canadian beneficiary in respect of income having a source in Canada (or anywhere for that matter) that suffered a Part XIII tax on the way out of the country to the trust. Additional to this is the possibility that the income paid to the trust will suffer a Part XII.2 tax liability while section 94 or 94.1 may impute an additional liability directly to the beneficiary¹⁵²⁵. Planning which treaties and which jurisdictions' provisions effect the taxation of a particular stream of income flowing through two or more countries is obviously important.

Alternate Reporting re: Rents and Royalties

Under subsection 216(1) a non-resident taxpayer, when receiving payments in satisfaction of rent on real property, or timber royalties, may within two years following the end of the relevant tax year elect for Part I tax treatment in respect of those two sources of payments only whereby he will not be entitled to any deductions in computing the taxable income, while all of the tax credits/deductions available from section 118 to 118.9 inclusive will not be deductible. The system also implies in respect of partnerships in which the non-resident is a partner and recognizes the income from the particular two sources. The non-resident will be allowed to deduct all appropriate expenses in arriving at the Division B income, (which will be the net taxable income), and included in these deductions is C.C.A., interest/rental payments made to a trust for the use of its property etc.. If capital cost allowance is deducted and the property is disposed of by the non-resident then recapture of C.C.A. will be included in the non-resident's income under the form that the taxpayer must file when the particular real property, timber resource property etc is disposed as per Sec. 216(5). This was the case in *M.N.R. v. Bessemer Trust Co. and Ogden Phipps*¹⁵²⁶ where the non-resident trust took C.C.A. deductions through what was then the Sec. 216(1) election and argued that the Canada-U.S. tax treaty could negative the recapture in that it didn't make the election in the year however the Federal Court of Appeal found that in making the election in the prior year, the taxpayer had chosen to recognize income on the marginal rates in respect of the income for those years and since the recapture occurred with respect to C.C.A. taken in those years it constituted rental income for purposes of the tax treaties. In *The Queen v. Amos et. al.*¹⁵²⁷ a non-resident trust with non-resident beneficiaries settled property on trust for itself whereunder a Canadian resident corporation was the trustee. Capital cost allowance was deducted by the top tier trust through the Sec. 216(1) election and after the property had been distributed to the non-resident trust it was sold for proceeds well in excess of its Canadian recognized U.C.C.. The Minister attempted to charge the non-resident trustees with recapture recognition. The taxpayer contended that Art. XIII A of the Can.-U.S. Tax Convention exempted him

¹⁵²⁴ 63 D.T.C. 336

¹⁵²⁵ though as described there is a considerable degree of ability to reduce a liability if the income is being paid out of the trust.

¹⁵²⁶ 73 D.T.C. 5045

¹⁵²⁷ 82 D.T.C. 6165

from treatment, being enacted prior to Sec. 216(5). The Trial Court had found that the recapture had the characteristic of rental income in the hands of beneficiary trust, but, it was not **that** particular trust which had filed the election, but instead the trust from which the property was received was the trust(taxpayer) which had filed the election. The electing trust **beneficiary** could thus not be captured under **former** Sec. 216(5) in respect of recapture of C.C.A. deducted by the trust. Present subsection 216(5) is amended to counter the above situation and applies to persons who have elected for Sec. 216(1) treatment thus if the rental property is rolled out to the beneficiary who later disposes of it the trust (or the beneficiary) will still be subject to Sec. 216(5). It should be recognized that the provision refers to "persons", being trusts, and persons who are "beneficiaries" thereunder while Sec. 108(1)(b) defines a beneficiary as including but not exclusively meaning a person beneficially interested in the trust. Taking another technical "leap of faith" and giving note to the underlying spirit of the provisions involved Sec. 74.5(10) or 94(7) defines "beneficially interested", albeit for very restrictive purposes, as a taxpayer who has a right to receive income or capital of the trust directly or indirectly through one or more trusts and in the latter instance the second tier beneficiary must have a right directly enforceable against the top tier trustees in order to satisfy the definition.¹⁵²⁸ Even if, in this case, the provision read so as to include rights to the income/capital and not just to receive it the result would be the same. A partner in a partnership which is itself a partner in a larger partnership may not be a partner directly in that larger partnership due to the nature of the partnership form however is a beneficiary under a trust which is itself a beneficiary under another trust a beneficiary under that other trust? Can the bottom most beneficiary's rights be enforceable in court against the top most trust, or should the measure of being "beneficially interested" be indicated, as in Torrance Estate, Jodrey Estate or Mackeen Estate, as a status that will allow the taxpayer to ultimately or alternatively resort to any effective cause of payment or conferment of benefit including but not limited to the enforcement of direct rights. Notwithstanding the spirit of the specific though inapplicable provisions of the Act the above mentioned latter status could be easily argued to be the more valid and thus in the instance of the Sec. 216(5) targeting even a second tier beneficiary would cause application of the provision if he disposed of property which was received from a trust which itself received it from a top tier trust under which the Sec. 216(1) election was taken.¹⁵²⁹ On the other hand a beneficiary is a person beneficially interested in a trust and if the beneficial ownership of the trust interest in the top most trust, held by second tier trust, doesn't reside with the second tier beneficiary then it can be argued that the second tier trust which is executed by the trustees being uninfluenced by any outstanding beneficial ownership powers. The distinction between being generally beneficially interested in a trust and how it operated and having beneficial ownership of the property (trust interest) held by the trust is fine but does cause, in the author's opinion the former to be recognized only as being interested in the immediate trust, and the latter, in the top most as well.

Subsection 216(5) applies where the beneficiary under a trust which has deducted C.C.A. through Sec. 216(1) has disposed of the subject property regardless of whether that taxpayer was a beneficiary under the trust at the time that the Sec. 216(1) election was made by the trust. The subsection also requires that the person disposing of the property file the appropriate documentation if he was the person who elected for Sec. 216(1) treatment or is or was a beneficiary under the trust which elected for Sec. 216(1) treatment and deducted C.C.A. at the trust level and thus there is no advantage to be obtained in waiting for the trust to be wound-up, for example, for a period of six years, before the beneficiary disposes of the property since he will still be liable under Sec. 216(5).

The answer to Question 32 of the 1989 CRA Roundtable Question confirmed the Department's opinion that if beneficial ownership of property is retained after common law legal ownership thereof has been transferred to a trustee the bare trustee will be recognized to exist and will be subject to all of the subdivision K rules while the disposition will not be recognizable by the taxpayer under Sec. 54(c)(v). In concluding that opinion the Department provided that, appropriately, the contributor-trust relationship would be subject to Sec. 75(2) income/loss attribution. In this context Sec. 75(2) **isn't applicable** to a **non-resident** taxpayer beneficiary who also contributes to a second trust, and if the trust has been deriving rental income and made the Sec. 216(1)

¹⁵²⁸ That definition must be applied from his point of view ie; does he himself hold a right enforceable against the top tier trust.

¹⁵²⁹ See *M.N.R. v. Bessemer*.

for previous years taking C.C.A. then the beneficiary is in an interesting position with respect to that property with inherent tax liabilities. Could he not transfer only legal ownership of the property to a bare trustee who would subsequently dispose of it? In para. (4) of I.T. 170R the Department is of the opinion that for the purpose of computing "proceeds of disposition" of a depreciable property, as per Sec. 13(21)(d), which determines whether a "disposition" for recapture purposes has occurred, (as per Sec. 13(21)(c), all transfers of legal ownership with retention of beneficial ownership will be disregarded and thus as to the above question it would seem that on a transfer to a bare trustee the non-resident beneficiary would not recognize any tax consequences. When the property is subsequently disposed of by the trust, only upon the consent and with the direction of the contributor, the trust will be the party disposing of the property, not the beneficial owner.¹⁵³⁰ If the taxpayer or beneficiary transfers legal ownership to a bare trust and the trust doesn't make the Sec. 216(1) election and obviously wasn't a beneficiary under the initial operative trust which took the C.C.A. through the Sec. 216(1) election when the trust disposes of the property, especially since Sec. 75(2) can't apply, there would appear to be the avoidance of the tax liability. The party disposing of the property is not the party who took the Sec. 216(1) election, nor is it a beneficiary under a trust which did. If this isn't the case, and the beneficial owner will recognize the disposition, it could prove favorable to have the bare trust become resident in Canada so as to allow Sec. 128.1(1) to bump the tax cost of the property. If subsequently sold the tax consequences therefrom would be substantially reduced.

Income Tax Interpretation Bulletin

Election Re: Tax on Rents and Timber Royalties Non-Residents

IT-393R2

DATE: February 21, 1994

SUBJECT: INCOME TAX ACT

Election Re: Tax on Rents and Timber Royalties Non-Residents

REFERENCE: Section 216 (also sections 3, 115, 118 to 118.9 and 219, subsections 2(3), 104(7), 107(2), 120(1), 124(1), 126(1) and 215(3), and paragraphs 13(21)(d.1), 111(1)(a), 111(8)(c), 212(1)(d) and 212(1)(e) of the Income Tax Act and section 400 and subsection 2602(1) of the Income Tax Regulations)

APPLICATION

This bulletin replaces and cancels Interpretation Bulletin IT-393R dated August 12, 1983.

SUMMARY

Certain rent and timber royalty payments from sources in Canada that are made to a non-resident person are subject to non-resident withholding tax at a rate of 25% (unless reduced by a reciprocal tax treaty) of the gross amount of the payments. However, the non-resident may be able to save tax by subsequently electing to file a Canadian income tax return and instead be taxed on the net income derived from these payments in a manner similar to that in which a resident of Canada would be taxed.

This bulletin discusses the types of income that qualify for the election, the required separate return, the unavailability of certain deductions and of the non-refundable tax credits, and certain provincial income tax implications. Also discussed are the provisions for the recapture of capital cost allowance and the non-deductibility of a loss reported under the election against income for the year reported on any other return or against income of other years. The Canadian resident payer or an agent must still withhold and remit the non-resident tax in the first place on the gross rents or royalties, but the tax return subsequently filed by the non-resident can result in some or all of the tax so remitted being refunded. Also, there is an election available which allows an agent receiving the rents or royalties to withhold and remit tax on the net amount available from those rents or royalties.

DISCUSSION AND INTERPRETATION

1. Non-resident corporations and individuals (including estates and trusts) that receive rent from real property situated in Canada, or that receive a timber royalty on a timber resource property or a timber limit

¹⁵³⁰ The Act provides a provision, Sec. 75(2), especially for assigning tax liabilities ie income recognition, out to the beneficial owner, and apparently, as per the answer to Q. 32 above, the Department is willing to rely on it to tax the beneficial owner.

in Canada, are generally subject to Part XIII tax under paragraphs 212(1)(d) and (e), respectively, on the gross amount received. Subject to any relevant tax treaty, the rate of withholding tax is 25%. Alternatively, an election may be made under subsection 216(1) to file an income tax return and pay tax under Part I on that income as though the taxpayer were resident in Canada. This alternative is also available to a non-resident member of a partnership which receives such income.

2. Where the renting of real property by a non-resident is a business carried on in Canada by the taxpayer, the provisions of Part XIII and the alternative treatment under section 216 are not applicable. Income from a business carried on in Canada is taxed pursuant to Part I of the Act and is also subject to the relevant income taxes of any province or territory in which such business is carried on. In this situation, the taxpayer is required to file a return reporting the taxable income earned in Canada as determined under section 115. For more details on this subject, see the current version of IT-420, Non Residents - Income Earned in Canada, and of IT-171, Non-resident Individuals - Computation of Taxable Income Earned in Canada and Non-refundable Tax Credits.

3. A person who elects under subsection 216(1) to report Canadian source real property rent or timber royalty income as though resident in Canada must file the appropriate income tax return within two years (within six months, in the situation described in 9 below) from the end of the taxation year in which the income was received. It is not necessary for the person to have been a non-resident throughout the year. Thus, for example, an individual who immigrated to or emigrated from Canada during the year may elect under subsection 216(1) to report such income received during the part of the year in which he or she was a non-resident. A subsection 216(1) return must include all Canadian source real property rent and timber royalty income that would otherwise be taxable under Part XIII for the taxation year (or part of the year in which the person was a non-resident).

Furthermore, the subsection 216(1) return must be filed

(a) as though the non-resident had no income other than the above- mentioned rent and timber royalty income, and

(b) without affecting the liability of the non-resident person for tax otherwise payable under Part I.

As a result, the subsection 216(1) return is separate from any other return required for the year. For example, a non-resident would report section 115 taxable income earned in Canada from a business or employment in Canada on a Part I return separate from the return for subsection 216(1) income. If the non-resident had a loss from sources described in section 115, that loss could not be applied against income reported on the subsection 216(1) return.

4. Except as noted in 5 below, an election under subsection 216(1) permits a non-resident to claim those Part I deductions available to a resident in computing income under section 3. Thus, the non-resident can deduct those expenses (including capital cost allowance) incurred in earning the subsection 216(1) income, as well as any applicable amounts in subdivision e of Division B. For example, although the income reported on a subsection 216(1) return does not qualify as "earned income" for purposes of claiming a registered retirement savings plan premium, the non-resident might nevertheless, in limited circumstances, be able to claim such a premium on a subsection 216(1) return, such as in a situation where the non-resident was a resident in the immediately preceding year and had "earned income" for that year. A "subdivision e" deduction cannot, of course, be claimed twice (e.g., once on a section 115 return and again on a subsection 216(1) return). By virtue of paragraph 216(1)(c), no deductions are allowable in computing taxable income on a non-resident's subsection 216(1) return. Thus, Division C amounts such as non-capital losses are not deductible. Also, by virtue of paragraph 216(1)(d), the non-refundable tax credits described in sections 118 to 118.9 (such as the basic personal credit or the medical expense credit) are not deductible in computing the tax payable on a subsection 216(1) return.

5. Subsection 216(8) provides that, for greater certainty, no deduction is allowed in computing the income or the tax payable of a person who elects under subsection 216(1) if that deduction is not permitted under Part I for a non-resident. For example, a non-resident would be denied a foreign tax credit under subsection 126(1) and a non-resident trust would be denied a deduction by virtue of subsection 104(7) for distributions to a non-resident beneficiary, since those provisions are specifically dependent upon actual or deemed residency in Canada.

6. A non-resident's rent from real property in Canada can be reported under section 216 only if it is not income from carrying on a business in Canada (see 2 above). As a result, rent that can be reported under section 216 does not represent "income earned in the year in a province" by a non-resident individual or "taxable income earned in the year in a province" by a corporation, since these terms as defined in subsection 2602(1) and section 400 of the Income Tax Regulations, respectively, include only the income from a business. Rent reported under section 216 by an individual is therefore subject to the additional tax under subsection 120(1) and is not subject to tax by any province or territory whose individual income taxes are collected by the Government of Canada. Similarly, rent reported under section 216 by a corporation is not eligible for the deduction from tax provided by subsection 124(1) and is not subject to tax by any province or territory whose corporate income taxes are collected by the Government of Canada. Income reported under section 216 by a corporation is also not subject to "branch tax" under section 219 (the branch tax is discussed in the current version of IT-137, Additional Tax on Certain Corporations Carrying on Business in Canada).

7. Where capital cost allowance has been claimed (or deemed by subsection 107(2) to have been claimed) by a taxpayer on a particular property situated in Canada for purposes of calculating the rent or timber royalty income from that property under section 216, any recapture of that capital cost allowance arising on the disposition of the property (or an interest in the property) in a subsequent taxation year will be taxable under subsection 216(5). Similar to a subsection 216(1) return, a subsection 216(5) return is separate from any other return filed for the year such as a return to report section 115 taxable income earned in Canada. In addition to the capital cost allowance recapture (or the non-resident's share of the recapture), the subsection 216(5) return must also include all Canadian source real property rent and timber royalty income that occurs in the year of the recapture (or in such part of the year in which the taxpayer is a non-resident) and that would otherwise be taxable under Part XIII. The other rules that apply for purposes of filing a return under subsection 216(1), as described above, generally also apply for purposes of filing a return under subsection 216(5). However, a subsection 216(5) return is filed because it is required when that provision applies, rather than because the non-resident elects to do so. Also, the two year filing period mentioned in 3 above does not apply, i.e., a subsection 216(5) return must be filed by the deadline that would apply if the non-resident were a resident.

8. In certain cases, it may be that what is reported on a section 216 return is a loss from rents or from timber royalties. In such a case, the taxpayer may not set off such a loss against income for the same taxation year reported on any other return required under Part I, since to do so would conflict with the rule in 3(b) above. Of course, if a taxpayer has a loss for the year from one section 216 property and income for the same year from another section 216 property, the loss would be set off against the income. For example, if the loss from the one property was \$5,000 and the income from the other property \$2,000, the net income reported on the section 216 return would be nil. However, a section 216 loss may not be deducted in other years under paragraph 111(1)(a) because, by virtue of paragraph 111(8)(c), such a loss does not qualify as a non-capital loss.

9. Even though the non-resident payee may elect to file a section 216 return (which, as indicated in 3 above, can be done within two years from the end of the year in which the income is received), the Canadian resident payer or an agent, as the case may be, is nevertheless required by section 215 to withhold at the appropriate rate (see 1 above) and remit an amount to the Receiver General in payment of Part XIII tax on the gross amount of the non-resident's real property rents or timber royalties. In most cases, the difference between the Part XIII tax so remitted and the Part I tax liability resulting from the section 216 return will result in a subsequent refund to the non-resident. Where certain conditions are met, an election under subsection 216(4) may be made by an agent or other person acting on behalf of the non-resident who would otherwise be required by subsection 215(3) to remit the Part XIII tax on the gross rents or royalties. This election is available where the non-resident (or each non-resident who is a member of a partnership) has filed with the Minister an undertaking in prescribed form (Form NR6) to file a return of income under Part I for a taxation year as permitted by subsection 216(1), but within six months (rather than the two years described in 3 above) from the end of the relevant taxation year. The subsection 216(4) election allows the agent or other person to withhold and remit at the applicable rate on "any amount available" out of the rents

or royalties received for remittance to the non-resident. The expression "any amount available" describes the excess of rents or royalties collected over any disbursements deductible in computing income by virtue of the election under subsection 216(1). Such disbursements would include non-capital outlays relating to repairs and maintenance, property taxes, property management fees and interest and service charges relating to the financing of the property in question. Non-cash items, such as capital cost allowance, are not deductible for this purpose. Further particulars on the subsection 216(4) election may be found in the current version of Information Circular 77-16, Non-Resident Income Tax.

If you have any comments regarding the matters discussed in this bulletin, please send them to:

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Explanation of Changes for Interpretation Bulletin IT-393R2

Election re Tax on Rents and Timber Royalties - Non-Residents

INTRODUCTION

The purpose of the Explanation of Changes is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised departmental interpretations.

OVERVIEW This bulletin discusses the section 216 election that is available to a non-resident to pay Part I tax on Canadian source rents from real property and timber royalties. We have revised the bulletin primarily as a result of changes to the law under Bill C-139 and to expand the bulletin to include a discussion on the subsection 216(4) election available to an agent receiving section 216 rents or royalties.

The comments in the bulletin are not affected by proposed amendments to the Income Tax Act contained in Bill C-9, which received first reading in the House of Commons on February 4, 1994, or in the draft legislation released on August 30, 1993 (a Bill for this legislation will likely be introduced in the House in the current session of Parliament).

LEGISLATIVE AND OTHER CHANGES

CLARIFICATION CHANGES: Throughout the new bulletin, there are some additions and changes to the text which we have made solely to clarify or elaborate on the information given, without changing the substance of what was said in the old bulletin. Also, the order of some paragraphs has been changed.

Old No. 4: This has been discontinued for the reason stated below under "New No. 5".

New No. 4 (replaces old No. 5: The words in parentheses in the first sentence of old No. 5 are discontinued in new No. 4 for the reason stated below under "New No. 5". The example regarding a deduction for an RRSP premium has been modified to reflect the amendments to the RRSP rules which became law in 1988 by the enactment of Bill C-52. The last sentence of new No. 4 indicates that the non-refundable tax credits cannot be claimed by the non-resident (on a return filed under subsection 216(1)). This restriction is contained in paragraph 216(1)(d), which was added to the law under Bill C-139 (as a result of the introduction of the non-refundable tax credits under the same Bill C-139).

New No. 5: This paragraph describes the "for greater certainty" provision, subsection 216(8), which was added under Bill C-139, preventing a non-resident who files a return under section 216 from claiming any deduction that is not permitted to a non-resident under Part I of the Act. Because of this "for greater certainty" provision, old No. 4 and the words in parentheses in the first sentence of old No. 5 are no longer necessary and have been discontinued in the new bulletin.

Old No. 7: This paragraph is not continued in the new bulletin. As the paragraph indicates, the general averaging provisions were repealed for years subsequent to 1981. Forward averaging is being phased out and cannot be used for income reported after 1987 by virtue of amendments to sections 110.4 and 120.1 under Bill C-139.

New No. 7 (replaces old No. 8: New No. is similar to old No. 8, but has been modified to restrict the discussion on CCA recapture to that reported on a subsection 216(5) return in respect of CCA originally claimed on a section 216 return. (The discussion on recapturing CCA claimed on a section 150 return is outside the scope of this bulletin.) The last sentence of old No. 8 is discontinued in new No. 7 because the current tax treaty between Canada and the United States does not contain a relieving provision like Article XIII A(2) of the old treaty.

New No. 8 (replaces old No. 9: The last sentence in old No. 9 indicates that a loss reported by a non-resident under section 216 cannot be deducted under paragraph 111(1)(a) in the previous or a subsequent year in which the taxpayer was a resident. In *Pandju Merali v. The Queen*, 88 DTC 6173, (1988) 1 C.T.C. 320, the Federal Court of Appeal found that there was nothing in the Act to prevent such a loss application in the 1981 taxation year. However, the law was then amended to nullify the application of this decision after the 1982 year: the last sentence of new No. 8 discusses paragraph 111(8)(c) the effect of which, as amended under Bill C-2, is that a loss reported under section 216 cannot qualify as a non-capital loss for the 1983 and subsequent taxation years.

New No. 9: We have added this paragraph to the bulletin to provide additional information to non-residents filing under section 216, regarding:

- the requirement that the Canadian resident payer or agent withhold and remit Part XIII tax on the gross rents or timber royalties; and
- the subsection 216(4) election that permits the agent or other person acting on behalf of the non-resident to withhold and remit on the net amount available out of the rents or royalties.

Non-resident Trusts.

Sections 94 and 94.1 contain provisions that cause

- certain beneficiaries, be they capital or income,
- under certain trusts that are non-resident to;
- recognize components of the trust's income as if it were their own, or
- become jointly liable for taxes applied on the trust's income as if it were resident in Canada, or
- cause them to recognize minimal levels of income from the trust, which are based on the "designated cost" of their interest in the offshore fund.

The former section is particularly broad in scope and is designed to encompass a vast array of arrangements that taxpayers resident in Canada attempt to initiate so as to detach themselves from the foreign (or Canadian) income earning process and place responsibility of it with a receptive ownership base in a foreign jurisdiction thus avoiding the imposition of Canadian taxes. The latter applies in a similar manner but ensures that investment income of the foreign situated tax base (trust), that will or can ultimately be expected to inure to the benefit of the Canadian resident taxpayer, is taxed at a minimal arbitrarily derived effective tax rate.

“Application of certain provisions to trusts not resident in Canada – Sec. 94(1)”

(1) Where,

(a) at any time in a taxation year of a trust that is not resident in Canada or that, but for paragraph 94(1)(c), would not be so resident, a person beneficially interested in the trust (in this section referred to as a “beneficiary”) was

(i) a person resident in Canada,

(ii) a corporation or trust with which a person resident in Canada was not dealing at arm’s length, or

(iii) a controlled foreign affiliate of a person resident in Canada, and

(b) at any time in or before the taxation year of the trust,

(i) the trust, or a non-resident corporation that would, if the trust were resident in Canada, be a controlled foreign affiliate of the trust, has, other than in prescribed circumstances, acquired property, directly or indirectly in any manner whatever, from

(A) a particular person who

(I) was the beneficiary referred to in paragraph 94(1)(a), was related to that beneficiary or was the uncle, aunt, nephew or niece of that beneficiary,

(II) was resident in Canada at any time in the 18 month period before the end of that year or, in the case of a person who has ceased to exist, was resident in Canada at any time in the 18 month period before the person ceased to exist, and

(III) in the case of an individual, had before the end of that year been resident in Canada for a period of, or periods the total of which is, more than 60 months, or

(B) a trust or corporation that acquired the property, directly or indirectly in any manner whatever, from a particular person described in clause 94(1)(b)(i)(A) with whom it was not dealing at arm’s length and the trust was not

(C) an inter vivos trust created at any time before 1960 by a person who at that time was a non-resident person,

(D) a testamentary trust that arose as a consequence of the death of an individual before 1976, or

(E) governed by a foreign retirement arrangement, or

(ii) all or any part of the interest of the beneficiary in the trust was acquired directly or indirectly by the beneficiary by way of

(A) purchase,

(B) gift, bequest or inheritance from a person referred to in clause 94(1)(b)(i)(A) or 94(1)(b)(i)(B), or

(C) the exercise of a power of appointment by a person referred to in clause 94(1)(b)(i)(A) or 94(1)(b)(i)(B), the following rules apply for that taxation year of the trust:

(c) where the amount of the income or capital of the trust to be distributed at any time to any beneficiary of the trust depends on the exercise by any person of, or the failure by any person to exercise, any discretionary power,

(i) the trust is deemed for the purposes of this Part and sections 233.3 and 233.4 to be a person resident in Canada no part of whose taxable income is exempt because of section 149 from tax under this Part and whose taxable income for the year is the amount, if any, by which the total of

(A) the amount, if any, that would but for this subparagraph be its taxable income earned in Canada for the year,

(B) the amount that would be its foreign accrual property income for the year if
(I) except for the purpose of applying subsections 104(4) to (5.2) to days after 1998 that are determined under subsection 104(4), the trust were a non-resident corporation all the shares of which were owned by a person who was resident in Canada,

(II) the description of A in the definition "foreign accrual property income" in subsection 95(1) were, in respect of dividends received after 1998, read without reference to paragraph (b) of that description,

(III) the descriptions of B and E in that definition were, in respect of dispositions that occur after 1998, read without reference to "other than dispositions of excluded property to which none of paragraphs (2)(c), (d) and (e) apply",

(IV) the value of C in that definition were nil, and

(V) for the purposes of computing the trust's foreign accrual property income, the consequences of the application of subsections 104(4) to (5.2) applied in respect of days after 1998 that are determined under subsection 104(4),

(C) the amount, if any, by which the total of all amounts each of which is an amount required by subsection 91(1) or (3) to be included in computing its income for the year exceeds the total of all amounts each of which is an amount deducted by it for that year under subsection 91(2), (4) or (5), and

(D) the amount, if any, required by section 94.1 to be included in computing its income for the year exceeds

(E) the amount, if any, by which the total of all amounts each of which is an amount deducted by it under subsection 91(2), (4) or (5) in computing its income for the year exceeds the total of all amounts each of which is an amount included in computing its income for the year because of subsection 91(1) or (3), and

(ii) for the purposes of section 126,

(A) the amount that would be determined under subparagraph (i) in respect of the trust for the year, if that subparagraph were read without reference to clause (i)(A), is deemed to be income of the trust for the year from sources in the country other than Canada in which the trust would, but for subparagraph (i), be resident, and

(B) any income or profits tax paid by the trust for the year (other than any tax paid because of this section), to the extent that it can reasonably be regarded as having been paid in respect of that income, is deemed to be non-business income tax paid by the trust to the government of that country, and

- (d) in any other case, for the purposes of subsections 91(1) to 91(4) and sections 95 and 233.4,
- (i) the trust shall, with respect to any beneficiary under the trust the fair market value of whose beneficial interest in the trust is not less than 10% of the total fair market value of all beneficial interests in the trust, be deemed to be a non-resident corporation that is controlled by the beneficiary,
 - (ii) the trust shall be deemed to be a nonresident corporation having a capital stock of a single class divided into 100 issued shares, and
 - (iii) each beneficiary under the trust shall be deemed to own at any time the number of the issued shares that is equal to the proportion of 100 that
 - (A) the fair market value at that time of the beneficiary's beneficial interest in the trust is of
 - (B) the fair market value at that time of all beneficial interests in the trust.

"Obligations – Sec. 94(2)"

- (2) Where paragraph 94(1)(c) is applicable to a trust, each person described in clause 94(1)(b)(i)(A) or 94(1)(b)(i)(B) shall jointly and severally with the trust have the rights and obligations of the trust by virtue of Divisions I and J and shall be subject to the provisions of Part XV, but no amount in respect of taxes, penalties, costs and other amounts payable under this Act shall be recoverable from any such person except to the extent of
- (a) amounts paid to the person by the trust or the payment of which from the trust the person is entitled to enforce; and
 - (b) amounts received by the person on the disposition of an interest in the trust.

"Deduction in computing taxable income – Sec. 94(3)"

- (3) In computing the amount of taxable income of a trust to which paragraph 94(1)(c) applies for any taxation year, there may be deducted such portion of the amount that would, but for this subsection, be included in computing the taxable income of the trust for the year by virtue of clauses 94(1)(c)(i)(B) and 94(1)(c)(i)(C) as may reasonably be considered as having become an amount payable in the year within the meaning of subsection 104(24) to a beneficiary.

"Deduction from foreign accrual property income – Sec. 94(4)"

- (4) In computing the foreign accrual property income of a trust to which paragraph 94(1)(d) applies for any taxation year, there may be deducted such portion of the amount that would, but for this subsection, be the foreign accrual property income of the trust as may reasonably be considered as having become an amount payable in the year within the meaning of subsection 104(24) to a beneficiary.

"Adjusted cost base of capital interest in trust – Sec. 94(5)"

- (5) In computing, at any time in a taxation year, the adjusted cost base to a taxpayer resident in Canada of a capital interest in a trust to which paragraph 94(1)(d) applies,
- (a) there shall be added any amount required by subsection 91(1) or 91(3) to be included in computing the taxpayer's income for the year or any preceding taxation year (or that would have been so required to be included but for subsection 56(4.1) and sections 74.1 to 75 of this Act and section 74 of the Income Tax Act, chapter 148 of the Revised Statutes of Canada, 1952) in respect of that interest; and
 - (b) there shall be deducted any amount deducted by the taxpayer by reason of subsection 91(2) or 91(4) in computing the taxpayer's income for the year or any preceding taxation year (or that would have been so deductible by the taxpayer but for subsection 56(4.1) and sections 74.1 to 75 of this Act and section 74 of the Income Tax Act, chapter 148 of the Revised Statutes of Canada, 1952) in respect of that interest.

“Where financial assistance given – Sec. 94(6)”

(6) For the purposes of paragraph 94(1)(b), a trust or a non-resident corporation shall be deemed to have acquired property from any person who has given a guarantee on its behalf or from whom it has received any other financial assistance whatever.

(7) [Repealed, 1994, c. 7, Sch. VIII, s. 39(1)]

“Beneficially interested – Sec. 248(25)”

(25) For the purposes of this Act,

(a) a person or partnership beneficially interested in a particular trust includes any person or partnership that has any right (whether immediate or future, whether absolute or contingent or whether conditional on or subject to the exercise of any discretion by any person or partnership) as a beneficiary under a trust to receive any of the income or capital of the particular trust either directly from the particular trust or indirectly through one or more trusts or partnerships;

(b) except for the purpose of this paragraph, a particular person or partnership is deemed to be beneficially interested in a particular trust at a particular time where

(i) the particular person or partnership is not beneficially interested in the particular trust at the particular time,

(ii) because of the terms or conditions of the particular trust or any arrangement in respect of the particular trust at the particular time, the particular person or partnership might, because of the exercise of any discretion by any person or partnership, become beneficially interested in the particular trust at the particular time or at a later time, and

(iii) at or before the particular time, either

(A) the particular trust has acquired property, directly or indirectly in any manner whatever, from

(I) the particular person or partnership,

(II) another person with whom the particular person or partnership, or a member of the particular partnership, does not deal at arm's length,

(III) a person or partnership with whom the other person referred to in subclause 248(25)(b)(iii)(A)(II) does not deal at arm's length,

(IV) a controlled foreign affiliate of the particular person or of another person with whom the particular person or partnership, or a member of the particular partnership, does not deal at arm's length, or

(V) a non-resident corporation that would, if the particular partnership were a corporation resident in Canada, be a controlled foreign affiliate of the particular partnership, or

(B) a person or partnership described in any of subclauses 248(25)(b)(iii)(A)(I) to 248(25)(b)(iii)(A)(V) has given a guarantee on behalf of the particular trust or provided any other financial assistance whatever to the particular trust; and

(c) a member of a partnership that is beneficially interested in a trust is deemed to be beneficially interested in the trust.

Beneficially Interested Taxpayers.

Section 94 applies to cause certain "beneficially interested" parties to either, recognize a certain amount of a foreign resident trust's income as foreign accrual property income whereby they will be directly taxed on it, or, to become jointly liable for a tax computed on the adjusted trust income as if the trust were resident, where four conditions exist:

- if certain parties were "beneficially interested" in the non-resident trust,

- the trust or a controlled foreign affiliate **in respect of the trust** has acquired property from certain parties,
- and the trust itself was of a certain character arising at a certain time,
- or the interests held in the trust were acquired in a certain way.

Where a person resident in Canada, a corporation or trust (and ostensibly a partnership by virtue of Sec. 248(25(c)), with which a person resident in Canada does not deal at arm's length, or a controlled foreign affiliate of a person resident in Canada, was "beneficially interested" in the trust at **any time** in the tax year of the trust the first condition will be satisfied, the term "beneficially interested", given a meticulous and unique meaning in Sec. 248(25). (The corporation or trust which is not dealing at arm's length with the Canadian resident **person** and which is "beneficially interested" need not be resident in Canada hence even if the corporation isn't a **controlled** foreign affiliate but is a foreign affiliate or simply a non-resident corporation, or trust, it will satisfy the criterion.)

For purposes of the Act a Sec. 248(25) "**beneficially interested**" person in a trust has a broad net of various arrangements that is based on **that person** has any right¹⁵³¹ **to receive** any income or capital of the trust either directly from the trust or **indirectly through** one or more other trusts or partnerships even if a discretionary power that can give him that right has not yet been exercised.

The right described under the "beneficially interested" definition includes both that to receive income or capital directly from the trust and that to receive income or capital from the primary trust indirectly through one or more trusts and thus if the person doesn't have a right **to receive** the income or capital from the secondary trust he isn't "beneficially interested". A right to income or capital is enforceable by its holder only against the trust and one wonders how a trust which holds a capital or income right enforceable by the trust only can be considered as also giving its beneficiary an enforceable right under the primary trust.¹⁵³² Since the provision is very meticulously worded e.g. "**that**" person must hold the right, obviously one of the only instances that a person can be "beneficially interested" in a primary trust in a two-tier trust arrangement is where **his** right is enforceable to cause the primary trust to distribute the income or capital to the second trust from which he **receives it**.¹⁵³³ If the second trust **itself** has no right enforceable in respect of the primary trust, but is only a recipient upon the right holder's action, it cannot be termed "beneficially interested" itself. If a corporation which isn't at arm's length with a Canadian resident has a right to have capital or income paid to the Canadian resident but not itself neither it nor its beneficial recipient can technically be considered "beneficially interested" as per the definition in Sec. 248(25).

Given the definition of beneficially interested in Sec. 248(25) it's important not to have a general power of appointment that would allow its exerciser to be a recipient of an interest since even if the power isn't exercised the power holder would still be considered beneficially interested. This being said, vary it in after the fact.

Foreign Resident Trust Acquirors: The Primary Target.

The second condition that must be satisfied for the provision to apply is that at any time in or before the end of the current tax year of the trust, the trust, or non-resident corporation that would be a controlled foreign affiliate in respect of the trust, has "**acquired**" property directly or indirectly from certain parties¹⁵³⁴ but only if the trust is of a certain character.

Loans of property¹⁵³⁵ where legal title has not been transferred would not satisfy the "acquired" criterion and thus represent an interesting way by which the lessee/borrower will avoid being subject to section 94 while at the same time allowing the lessor/creditor to realize income, which may be deductible by the lessee/borrower.¹⁵³⁶ A renter of property to a trust does have a right to receive income or capital as a

¹⁵³¹ whether immediate or future, whether absolute or contingent, or whether conditional on or subject to the exercise of a discretionary power by any person or persons

¹⁵³² See F.C.T. v. Totledge, 1982 12 A.T.R. 830.

¹⁵³³ The other instance is where the second tier trust beneficiary is the beneficial **owner** of the income right in specie held by the intermediary trust.

¹⁵³⁴ and it would appear that "acquired" is wide enough to include instances where the property was acquired for fair market value consideration

¹⁵³⁵ other than that of **financial assistance**

¹⁵³⁶ The attribution provisions, and particularly Sec. 56(4.1) may apply to reduce the favorableness of this deficiency

beneficiary of the trust however, and the capacity in which he holds such a right does **not** preclude him from being "beneficially interested" therein as per the Sec. 94(7) definition, however the rented property has **still not been acquired** from him which **is the targeting**.¹⁵³⁷ The property the foreign subject trust acquires, such as an interest in a head trust **created by the same settlor**, need not be the same property in specie that the settlor owned. If a settlor creates a head trust and the non-resident trust is a beneficiary that sub-trust will have acquired property from the settlor via the dicta in *Sachs v. The Queen* and *Murphy v. The Queen*. If both head trust and sub-trusts are created by a non-resident and the reactive taxpayer contributes property to the head trust via sale or gift the same will result.

The persons from which property acquired would cause application include those "beneficially interested" described in para. (a) just commented upon or

- any person related thereto or who was the uncle, aunt, nephew, or niece of that beneficiary, or a person that was resident in Canada at any in the 18 month period before the end of the trust's tax year, (or where that person has ceased to exist, was resident in Canada at any time within the 18 month period before it ceased to exist),
- while in the case of an individual, such an individual who had been resident in Canada before the end of the trust's year for a period or aggregate period of more than 60 months.

If a person related to the "beneficially interested" party transfers property to the trust or corporation, it would appear that he need not have been resident in Canada at any time in the proceeding 18 month period in order to cause the trust to be subject. (Subparagraphs 94(1)(b)(A)(II) through (III) operate **jointly**.¹⁵³⁸)

If the related person is an individual then he must have also been resident in Canada before the end of the trust's year for a period or periods of time aggregately in excess of 60 months hence this provision limits considerably the scope of the previous one, however, both may still be satisfied at times causing the section to apply.

Since the provision refers to acquisitions of property, "directly or indirectly in any manner whatever," a transfer of property by a targeted contributor to a person who doesn't have the avoided characteristics whereafter that person transfers it to the trust, will still be caught under the provision.¹⁵³⁹

The second possible contaminated transferor can consist of any **person** who was resident in Canada at any time within the 18 month period prior to the end of the trust's tax year while again, if an individual, he must also have been resident for an aggregate of 60 months prior to that time. The 60 month exception obviously allows some flexibility in that only transfers from 5 year individual residents of Canada will be caught, regardless of the individual's residence at the time of the transfer.¹⁵⁴⁰ If an intermediary trust or

however not where the legal owner doesn't reside in Canada.

¹⁵³⁷ It would appear that all of the otherwise targeted beneficially interested persons listed in subparagraph (1)(a) can loan property to a trust and take back the sole interests therein, in this case capital, whereby the excess income (revenue net of rental expense) will accumulate. His interest in the trust has not been acquired via a gift from himself, nor has it been purchased, and the trust has not **acquired** the property from him, although he may be recognized as a beneficially interested person as per Sec. 94(7). If the trustee of the trust is not the beneficially interested contributor the trust cannot be ignored. Technically, Sec. 94(1) could not apply to this unique arrangement.

¹⁵³⁸ This was also the opinion of the Non-Corporate Rulings Division in March 1981 in a T.I..

¹⁵³⁹ If the intermediary **substitutes** the property (disposes of it) then gifts the proceeds to the trust the rules don't apply to the proceeds. The same occurs where the intermediary uses its earnings to create the trust.

¹⁵⁴⁰ This was the topic of Question 41 of the 1989 CRA Roundtable Discussions where the Department held that Sec. 75(2) may apply to attribute income from property held in a non-resident trust which received it from an individual prior to him becoming Canadian resident. They were not of the opinion that such a transaction would be an avoidance transaction subject to Sec. 245(3), however, they did not preclude it from being attacked where the terms of the trust were phrased so that Sec. 75(2), and "other provisions", could apply.

Subsection 75(2) seems to be a favoured second weapon with which to capture non-resident income. technical interpretation 5-7012 provided in March 1989 by the Reorganization and Non-Resident Division provided that the provision could be used when the investment income of the trust is otherwise attributable as F.A.P.I. to a beneficiary but it was overlooked that Sec. 75(2) does not negate the continued recognition of the income by the trust. In Technical Interpretation 5-6939 provided by the same Division in March 1989 it was held that Sec. 75(2) "overrides" subsection 94(1). Is it reasonable to assume that the 60 month period exemption was enacted to allow immigrating individuals to shelter their income from Canadian taxation? In evaluating the possible application of section 245 it was provided in T.I. 5-6939 that the immigrating individual's financial position, occupation, usual source of income, degree of control over the trust, what he brought to Canada himself as well as the extent of the trust's investment in Canada are to be scrutinized. The same was opined in T.I. 5-7012.

One would rarely want to become resident in Canada while holding the legal title to taxable Canadian property since the Sec. 128.1(1) bump would be forfeited. Instead it could prove far more beneficial, depending on the foreign jurisdiction's tax

corporation, (but apparently not a partnership), had acquired directly or indirectly the property from any of the above qualifying persons **with whom it was not dealing at arm's length** the primary trust or corporation which ultimately acquired the property from these two intermediary entities would also be caught.¹⁵⁴¹ These qualifying criteria only apply if the trust was not an *inter vivos* trust created before 1960 by a non-resident person or a testamentary trust that arose as a consequence of the death of an individual before 1976.

Subsection 94(6) expands the definition of "acquired" for purposes of the above to provide that a trust or a non-resident corporation shall be deemed to have acquired property from any person who has given a guarantee on its behalf or from whom it has received any other **financial assistance** whatever. If the loan consists of a property that isn't a financial instrument, and if the loan is entered into so as not to give the recipient "financial assistance" but instead the income earning power available to any taxpayer, then the rental property/investment property loan will not be caught by the Sec. 94(7) provision. If a loan etc. is guaranteed by one party on the trust's behalf, and a second person guarantees the first person's performance of the counter signing and thus becomes jointly and severally liable with the person, but not with the trust, has he given a guarantee on the trust's behalf?¹⁵⁴² The Sec. 94(6) provision refers to parties from whom the trust has received any other financial assistance thus if such a provider is of a character just described the Sec. 94(1) provision could apply to the trust.

The above descriptions of the qualifying transferrers must be read individually while the qualification in respect of individuals may cause otherwise subject transferrers to be exempt. If the contributor was an individual then he also must satisfy the criteria of being before the end of the trust's tax year resident in Canada for any combination of periods exceeding in length 5 years thus if the transferor is a Canadian resident residing in Canada for two years only he will satisfy the second criterion but not the latter, thus avoiding application on those specific grounds.¹⁵⁴³

Certain Exempt Trust Acquirors.

Satisfying the conditions of the provision described above will not cause it to apply where the ultimate recipient trust was an *inter vivos* trust created before 1960 by a person who at that time was non-resident or a testamentary trust that arose, at any time, as a consequence of the death of an individual before 1976, regardless of his residence and it is here where powers of appointments and variations of trusts can be extremely useful. If possible, it could be advisable to find these two types of trusts of trusts to receive property through direct contribution or sale and then have an interest held by the Cdn. resident taxpayer.

Both kinds of trusts need not be non-resident since their creation, however, if they were created as being Canadian resident in becoming non-resident deemed dispositions would be recognizable under section 128.1, however, where a **special** power of appointment creates a non-resident sub-trust, by virtue of the fact

laws, to transfer the property to a non-resident trust prior to becoming resident; realize the Sec. 128.1(1) bump in the interest cost in the trust and then have the trust distribute the property via Sec. 107(2) without tax consequences **except** so as to cause a bump in the property's cost. Likewise the interest could actually be disposed of with its relatively high "f.m.v." a.c.b.. Section 94.1 would also not apply to the trust during the 5 year period since the trust is not in fact captured by section 94.

1541 Where a non-resident trust with non-resident beneficiaries acquires from a Canadian resident (or any foreign resident) taxpayer property and then **lends** it to the subject trust with Canadian resident beneficiaries Sec. 94(1) will not apply since the latter step **isn't** an **acquisition**. With a general power of appointment and interests vesting in the non-resident beneficiaries well in the future the rental income can reduce the head trust's income, be accumulated, and then be appointed to the Canadian resident beneficiaries subsequently. Sections 74.1, 74.2 and Sec. 56(4.1) don't apply to non-residents. Subsection 94.1(1) may cause some problems here however though they may be structured around.

1542 If a non-resident, otherwise inert party provides "other financial assistance" to the trust and then receives financial consideration from an otherwise reactive party, has the trust received "financial assistance" from the reactive party in the **absence of any "indirectly or directly" specification?**

1543 Unfortunately if the tax year of the trust is the calendar year 1991-1992 and the individual transferor became resident in Canada on Nov. 30, 1986 the income for the **entire** tax year of the trust would be attributable, not just that of the month of December. This was effectively provided in Technical interpretation 5-3406 provided by the Reorganization and Non-Resident Division in July 1988. Subsection 249(1) deems an individual's taxation year to be a calendar year, regardless of whether that individual is a taxpayer. In the case of immigration trusts income could be accumulated during the five year period and instead capital could be distributed to the resident beneficiaries. Upon the termination of the exempt period the trust could become resident obtaining the Sec. 128.1(1) cost bump in respect of its "non taxable Canadian property".

In Question 4 of the 1991 Roundtables the Department also held that it could use Sec. 56(4.1) to access an immigrating taxpayer who, in consideration being a note receivable not bearing interest, has sold income producing property to a non-resident trust who has avoided Sec. 94(1) treatment by virtue of the Sec. 94(1)(b)(i)(A)(III) 60 month grace period.

that the power was special the non-resident trust will be read back into the original settlement as part thereof in ascertaining whether there has been a violation of the rule against remoteness of vesting of the gift, however, if the trust in which the special power exists is irrevocably wound-up so that the sub-trust can never again rely upon the former's terms then although a new trust has been created, even by virtue of the fact that it is to be read back into the original settlement deed, it may still not be considered as having been created at the time of the original trust.¹⁵⁴⁴ If a Canadian resident trust, containing a special power of such scope, is

¹⁵⁴⁴ There may be a problem with the recognized time for the fiscal creation of the trust where a special power (and definitely a general power) is used to create a sub-trust. In *Perp. Trustee Co. Ltd. v. Commr. of S.D.*, 1977 A.C. 525, Lord Wilberforce speaking of the timing of the exercise of a special power of appointment well after a death to effect a specific devise which would gain preferable death duty rates at the time of death held:

"... The executor sought to answer the argument by reliance upon cases concerned with special powers of appointment which decided that **for certain purposes**, for example for applying the rules against perpetuities, an exercise of a special power is read back into the instrument creating the power. Reference was made to the well-known authorities in Australia and the United Kingdom, *Pedley-Smith v. Pedley-Smith*, 1953 88 CLR 177, and *Muir or Williams v. Muir*, 1943 AC 468. **But these cases do not establish more than that an exercise of a special power is read back for the purpose of determining the source and the validity of the gift to the appointee: as was said in the High Court it is the instrument creating the power which has the operative effect: cf *Pedley-Smith v. Pedley-Smith*, at 191. They do not establish, as to avail the executor they would have to establish, that in point of time the instrument exercising the power is to be dated back. Indeed Lord Hardwicke LC decided the contrary in *Duke of Marlborough v. Lord Godolphin*, 1750 2 Ves Sen 61, 78 and on this point the decision has not been displaced: see *Pedley-Smith v. Pedley-Smith* at 190 and *Muir or Williams v. Muir* at 485."**

Dixon C.J. in *Pedley-Smith v. Pedley-Smith* was more to the point on the matter providing:

"As the assurance of the interest appointed by a special power is formed of the two instruments the principle thus illustrated cannot make it wrong to say that the interest is acquired under both instruments together.

.....
The operation being thus combined, it is to be expected that, where for the purposes of some provision, whether contained in a statute or another instrument, **a reference is made to the creation of proprietary interests**, there will be a question on the interpretation of the statute or instrument as to which of the elements together forming the assurance the statutory or other provision should be taken to apply.

.....
Attorney-General v. Chapman, 1891 2 Q.B. 526, shows that for the purpose of the stamp duties imposed by the Customs and Inland Revenue Act ... upon "property passing under" a voluntary settlement, whereby an interest for life was reserved to the settlor, property appointed under a power contained in a settlement reserving such a life estate "passed under" the settlement. Wills J. said, "if the House of Lords on three several occasions has applied in respect of succession duty the principle that the interest created by the power must be treated as arising under the deed creating the power, there would be abundant justification for our applying it to a question arising under" the Customs and Inland Revenue Act, 1881. The decisions to which Wills J. referred to are *Lord Braybrooke v. Attorney-General*, 1891 11 E.R. 685, *Attorney-General v. Floyer*, 1862 11 E.R. 814, and *Charlton v. Attorney-General*, 1879 4 App. Cas. 427. **They are decisions which turn very much on the interpretation of the not over simple statutory provisions which governed succession duty. But the point to be made is that in the end the question whether, for the purpose of a particular provision in a statute or in any other instrument, you are to take the power or the appointment depends very much on the scope and purpose as well as the language of the statute or other instrument.**

.....
The latest examples of such a question of interpretation are found in two decisions of Vaisey J. The first is *Re: Batty*, 1952 Ch. 280. The question for decision was whether or not the power of advancement which s.32 of the Trustee Act 1925-1950 ... gives to trustees was applicable to certain trusts appointed by deed under a special power of appointment. The power of appointment was created before the commencement of that Act, but the exercise of the power took place after its commencement. Sub-section (3) of s.32 provides that the section does not apply to trusts **constituted or created before the commencement of the Act**. His Lordship took the view that the trusts were **constituted or created before the commencement of the Act** because the power was then created. The decision, although not uninfluenced by *Muir v. Muir*, 1943 A.C. 468, depended on the view Vaisey J. took of the purpose of the sub-section. **It may be suggested, with great respect, that the subsection was concerned with the effect of trusts which had come into existence and, so to speak, were fixed before the commencement of the Act, and it was for that reason the word "constituted" was used. The trusts were defined and made effective, and in that sense "constituted" by the appointment.** His Lordship distinguished this case in the second of the two, *Re: Leigh's Marriage Settlement: Rollo v. Leigh*, 1952 2 All E.R. 57,. The question there was whether s. 161 (1) of the Law of Property Act 1925-1950 ... which abolishes the rule in *Whitby v. Mitchel*, applied to limitations made after the commencement of the Act by the exercise of a power of appointment created before its commencement. Sub-section (2) of s. 161 provides that the section only applies to limitations or trusts **created** by an instrument coming into operation after the commencement of the Act. The word "created" told in favour of the view that the deed of appointment was the instrument to be regarded. On the other hand the policy of the sub-section evidently was to preserve proprietary rights arising or capable of arising by reason of instruments already in existence, and the rule in *Whitby v. Mitchell* controlled the scope and ambit of the power of appointment, and in that way defined the future children who might be made objects. Moreover

drained through the power's exercise whereby a foreign resident trust is created and recognized as distinct subpara. 54(c)(v) will cause the recognition of the disposition of all property that was subject to the power but the unfortunate factor to recognize is that the trust will be created once the special power is exercised even though the validity of its dispositions will be based on the time of the power's creation: there is no relation back to the pre 1976 or 1960 tax years when the head trust may have been created.

An *inter vivos* trust **created** before 1960 by a non-resident will not be caught by section 94 hence all a taxpayer has to do is "obtain" the shell of such a trust, have it varied to his purposes and stuff it with property through sale, gift, etc.. Subsequent gifts or sales of property to a previously constituted trust do not "create it", but only expand its application to different property.¹⁵⁴⁵ If the *inter vivos* trust is created by the non-resident, it need not be "taken over" by other parties making contributions and variations; it may only be varied so as to add a beneficiary for the receipt of certain property. This cannot be done with testamentary trusts since contributions other than on and as a consequence of death will cause the "testamentary" status to be lost. If there isn't a change in beneficial ownership of the property, where the taxpayer beneficiary contributes the legal title to the property but retains the entire beneficial title he will not recognize a disposition but under Sec. 75(2) all income, gain, or loss will be attributed to him, if he retains a reversionary interest or dispositive right or veto. If a beneficiary is added under the trust in response to the contribution of property to it, the trust's personal status will be lost and this could prove disadvantageous to any potentially subsequent Canadian resident capital beneficiaries when the trust distributes capital, as per Sec. 107(2.1).¹⁵⁴⁶

The provision also doesn't apply to testamentary trusts, as defined in Sec. 108(1), that arose at any time as a consequence of the death of an individual before 1976 regardless of his residence hence if a variation occurs to add on a beneficiary for the receipt of property, such a receipt must be in the form of a contribution by an individual on or after and as a consequence of his death, in order for the testamentary status to be maintained.¹⁵⁴⁷ If property is sold for fair market value consideration then the status will not be jeopardized.

Interest Acquisitions: The Secondary Target

All of the above qualifying arrangements **related to property transfers** which cause the trust/beneficiary relationship to be subject to the Sec. 94(1) provision may not exist, but the trust/beneficially interested person relationship may **still** be caught due to the "beneficially interested" party having at any time in the tax year of the trust an "interest" in the trust all or part of which was acquired by the beneficiary, as a purchase,¹⁵⁴⁸ as a gift, bequest or inheritance from the above qualifying contributors or disposers of property to the trust, or by way of the exercise of a power of appointment by any of **those** persons. Such is not the case where the interest is the subject of a writ of foreclosure executed by the taxpayer against its former holder or where the interest is simply loaned or assigned to the taxpayer by an otherwise exempt party such as a non-resident. One must not overlook the critical structuring of para. (b) of Sec. 94(1) which causes application where conditions described under subpara. (i), (property transfers), **or** (ii) (interests), exist. Thus it is this sub-provision that will be, most likely, the more common reason for the application of the provision.

the rule that the appointment must be read into the power had a specific and well known application to the very rule abolished. Vaisey J., however, preferred the view that as the appointment was the immediate cause of the trusts or limitations coming into existence, s. 161 applied. **Again the decision necessarily turned on the meaning ascribed to the provision.**"

When is the 1960 trust "created" within the context of Sec. 94(1)? The intention of the legislators could arguably be to exempt those fiduciary environments that existed prior to 1960 and if such is the case wouldn't trusts rising out of such fiduciary environments also be exempt? The particular trust interest may not have been in existence before 1960 but does the fact that the trusts attached to the particular property, which is subsequently appointed out to a newly created sub-trust, existed prior to 1960 not make the sub-trust exempt since the trust attached thereto is an extension of that existing prior to 1960?

1545 There are limits to this procedure, however.

1546 It may also cause problems when the trust is paying its taxable income earned in Canada to a Canadian resident since the Sec. 104(6) deduction may be restricted by Sec. 104(7.1).

1547 as provided in Sec. 108(1)(i)(iii)(A). The **testamentary** trust arising as a consequence of the death of an individual before 1976 **must satisfy the Sec. 108(1)(i) definition of a testamentary trust** and thus it couldn't have been created by an individual other than the deceased, even though it may have been created as a consequence of his death, while if any post 1982 *inter vivos* contributions are made to it will cease to be "testamentary", as per subpara. (i) and (iii). Likewise the Sec. 108(1)(i)(iii)(B) distributive "balancing act" must occur with respect to pre 1982 *inter vivos* contributions to ensure that the testamentary status isn't tarnished.

1548 regardless of the relationship between the acquiror and disponent or the terms of the transaction

And, if neither paragraph (a) or (b) apply to the trust arrangement then the section 94 in its entirety doesn't apply.

The trust in which such an "interest" may be enforceable in respect of can be **any trust** regardless of the time at which it was created or from whom it received contributions or sales of property. Consequentially, if the trust/contributor arrangement isn't caught under the primary application criteria by virtue of the fact that the trust is of the character just described as being exempt, the arrangement **will still be caught if the interest in such a trust was obtained in the above ways.**

If the interest was purchased from the trust then automatically the trust would lose its "personal trust" status, (assuming it had it to begin with), and if the interest was a right to income, income realized by the beneficiary under Sec. 104(13) would not be able to be negated by a write-off of the cost of the capital interest under Sec. 106(1). If the interest is a right to receive capital of the trust then Sec. 107(2.1) would apply to deny favorable treatment when capital is distributed in satisfaction of that interest unless the proceeds of disposition of the interest are equal to its legitimate ACB. If the interest was purchased from a party who made a contribution to the trust then the trust will lose its "personal" status as well the disponent will have to recognize taxable events of varying consequences subsequently.

One must question whether the second qualifying acquisition, the "gift, bequest, or inheritance" is to be read as acquiring the beneficial interest in form or in substance as well. If the person contributed property to a trust upon his death, which resulted in a trust interest being granted to the beneficiary will this qualify as a "gift, bequest or inheritance" of a interest when the property which was devised by the deceased was not an interest in the trust, (since he did not own any), but only the legal title of the property which upon being contributed to the trust, caused an interest to be granted to the beneficiary? The former had a right to receive the income or capital of the property by virtue of holding the legal title and beneficial title of the property while the latter holds only the beneficial right to the property the legal title of which is held by a trust. In common law, it has been held that a gift impressed with a trust in the interim transfer of legal title is still a gift of the property held in the trust. In the author's opinion, for the purposes of this provision, a contribution of property to a testamentary, (or *inter vivos* trust), upon death, whereby a trust interest is granted to the beneficiary can be equated as a gift, bequest or inheritance of the trust interest itself. Whether or not the interest in a testamentary trust is acquired by way of bequest or inheritance is of critical importance in this instance and it would appear that the provision was phrased so as to cause both interests arising under a will and interests passing under a will to be captured.¹⁵⁴⁹

Where any part of the interest was received upon the exercise of a power of appointment, special or general, by any of the otherwise qualifying contributors or disposers of property to the trust (or corporation) described in subpara. 94(1)(b)(i), the provision will apply hence upon a contribution of property to a trust one would want to ensure that the party who grants the beneficiary the interest through a power of appointment isn't of the character of that described in Sec. 94(1)(b)(i)(A) or (B).¹⁵⁵⁰

¹⁵⁴⁹ If the interest in the non-resident trust is given to a non-resident beneficiary Sec. 94(1) will not apply if the creator is a Canadian resident: none of the beneficiaries cited in para. (a) exist. If that non-resident **individual** gifts the interest, several years later after income has accumulated, to a para. (a) beneficiary then para. (b)(ii)(B) isn't satisfied if the individual was never resident in Canada or doesn't satisfy the para. (i) requirements. (Even if the non-resident individual and contributor are related it doesn't matter.) Of course the primary targeting provision in para. (a) would have to be avoided on some other grounds in order for this arrangement to be of value.

¹⁵⁵⁰ It is not yet settled whether R.C. can assess the value of the interest received as a Sec. 105(1) benefit: as per former Sec. 105(1) such was the case though with the present mechanics of the subsection it is possible to realize the value via Sec. 53(2)(h) hypothetical advances without leading to a Sec. 105(1) inclusion. The basis of the inclusion is the benefit, not the prospect of the benefit.

In T.I. 5-7507 given in June 1989 by the Reorganization and non-Resident Division of the Specialty Rulings Directorate a two tier trust situation was scrutinized where the first non-resident trust, settled by a non-resident, settled a second non-resident trust as a beneficiary who had has a beneficiary an immigrating taxpayer who also received a power of appointment over the second trust's property. after being resident in Canada 6 years the power was exercised in the taxpayer's will and a resident taxpayer became directly interested in trust number 2. The Division held correctly that both trusts would be subject to Sec. 94(1) since the beneficiary was interested in both of them. Whether or not the second trust becomes "transparent" for purposes of measuring whether a second tier beneficiary is beneficially interested **within the context of Sec. 94(7)**, in a top tier trust is contentious issue however.

The exercise itself would not cause the trust to lose its "personal" nature unless there could be proven a payment of consideration to any person who contributed to the trust or to the trust itself. Technically, friends of the contributor could serve as power holders, however, they must not be related to the beneficiary while joint powers could be used to ensure that they don't exercise them unfavorably solely.¹⁵⁵¹

Discretionary Trust Income Tax Liability.

Under paragraph (c), **if the amount** of the income or the capital of the trust **to be distributed to any** "beneficially interested" person is subject to the exercise of a discretionary power the trust will be deemed to be resident in Canada and not exempt from tax under section 149. (The "beneficiary", as referred to in subsection 248(25), includes only those who have a right **to receive** income or capital from the trust or through one or more trusts hence where a discretionary power can affect the amount to be distributed for the indirect benefit of a taxpayer¹⁵⁵² para. (c) will not be applicable on those grounds. It should be noted that the limited scope of the "beneficially interested" status¹⁵⁵³ is fully supported by the diction in para.(c) in that it refers to "the income or capital of the trust to be distributed at any time **to any beneficiary of the trust...**")

As a result of falling under the para. (c) conditions, the trust's taxable income, (being net Division C taxable income), will be deemed to be the aggregate of its otherwise **taxable income earned in Canada for the year**, the amount of its foreign accrual property income for the year, (had it been computed as being a controlled foreign affiliate), and any net section 91 inclusions, (being themselves foreign accrual property income inclusions recognized by the trust in respect of controlled foreign affiliates in respect of the trust net of reserve, dividend, and foreign tax deductions in Sec. 91(2), (4), and (5)).¹⁵⁵⁴ CRA has confirmed in a Technical Interpretation provided in Feb. 1980 that the tax rates applicable to the trust would those described under section 122 while the trust could also suffer additional tax under Sec. 120(1) if the income isn't earned in a province. Subsection 94(2) deems the parties that draw the focus of the application of the provision as contributors jointly and severally liable for the tax on the income of the trust though only to certain limits.

An Interesting Deduction.

Under subsection 94(3), a deduction is available in computing the taxable income of the trust in respect of amounts that became payable as per the meaning in Sec. 104(24), to **a beneficiary** but only where they would otherwise be included in computing the trust's income under **section 91 or in its F.A.P.I.**, however, one must examine the definition of "beneficiary" for purposes of section 94 to ascertain the implicit limitations and dangerous misapplications that are inherent in this deduction.

A "beneficiary" as per the opening preamble in Sec. 94(1) is a person "beneficially interested" in the trust which as per Sec. 248(25), includes only those persons having a right **to receive** income or capital of the trust thus a deduction under Sec. 94(3) is not available in respect of beneficiaries who hold a right to have applied for their benefit, other than through an actual receipt, the capital or income of the trust.

Perhaps an even more interesting technicality is the fact that this "beneficiary" need not be resident in Canada, nor need it actually recognize the amount payable in its/his Part I tax **nor realize** the amount subsequently. The Sec. 94(3) provision allows a deduction in respect of income that "may reasonably be considered as having become an amount payable in the year **within the meaning** of subsection 104(24) to a beneficiary". In the author's opinion, if the substance of the trust's F.A.P.I., or net section 91 income were

¹⁵⁵¹ Non-resident **individual** power holders, even if they are related to the beneficiary, can serve a purpose if they don't satisfy the para. (b)(i)(A)(II) or (III) conditions. "Inert" resident or non-resident trusts or corporations (not related to a beneficiary described para. (a) or was itself a beneficiary) also can serve as power holders. Apparently the result of the exercise is not a "gift" for these purposes.

¹⁵⁵² **(other than distribution to him directly)**

¹⁵⁵³ i.e. it doesn't include rights to have trust property indirectly applied for the benefit of without direct receipt

¹⁵⁵⁴ The nature of the "discretionary power" is not specified however in the author's opinion the phrase is broad enough to cover powers of appointment, advancement, and encroachment as well as allocation powers the exercise of which determines or creates the beneficiaries' entitlements. Could it be argued that trust powers compelling exercise in certain instances are not discretionary powers for these purposes since a discretion isn't absolute. If the description "dispositive powers" would have been used true discretionary and trust powers would have been captured. Technical Interpretation 5-4117 provided in June 1982 by the Corporate Rulings Division provided that the power to determine the timing of the distribution but not its magnitude did not cause the trust to be discretionary.

contingently payable to non-resident and otherwise "sheltered" beneficiaries when the qualifying beneficiary was not resident in Canada, the trust would obtain the deduction under Sec. 94(3) thus severely reducing its taxable income. The Sec. 94(3) provision does not require that the income be recognized by any beneficiary under Part I and thus the deduction represents an very large "hole" in the tax base. This does not apply with respect to taxable income earned in Canada as per the section 115 rules hence if there's a choice available to the trust by which it can either recognize certain income as due to, 1, Sec. 115(1) or, 2, F.A.P.I. inclusions, it could be more beneficial to recognize the income under the F.A.P.I. rules and then as being payable to a non-resident since it could be reduced by the Sec. 94(3) provision and thus cause less "taxable income" to be recognized.¹⁵⁵⁵

The deduction is available in respect of any amount that has become payable but the provision does not state that rights to that payment be indefeasibly vested during the year. If "the beneficiary" becomes entitled in the year to sue for the distribution of the income but doesn't, and in a subsequent period that income, then capitalized, becomes payable to another person through the loss of the enforceability of the income beneficiary's right thereto, then the Sec. 94(3) deduction would have been taken while the substance of the deduction would have been redirected in payment, possibly to a Canadian resident beneficiary. That Canadian resident beneficiary would, of course, cause the trust to be captured by the section 94 rules however if its income is reduced to nil through the manipulative use of Sec. 94(3) what will be the trust's tax bill or amount of income that the beneficiary will become liable for? Nil.¹⁵⁵⁶ In the case where a captured trust is recognizing taxable income earned in Canada double taxation will not result, in the Department's preliminary opinion, if the income is payable to a beneficially interested person subject to Part I. Subsection 94(3) would not offer a deduction to reduce that beneficiary's Sec. 94(2) ultimate liability but as per the Department the trust could take a deduction under Sec. 104(6) which it considers available to non-resident trusts paying income to a Canadian resident beneficiary while he'd also have to recognize the income under Sec. 104(13)(c).¹⁵⁵⁷

Deemed Double Residency.

The trust deemed to be resident in Canada is not deemed to be not resident in the other jurisdiction for tax treaty purposes and this creates a substantial danger since technically both jurisdiction's internal tax laws may apply. The O.E.C.D. Model provides that the residence of the trustee for purpose of tax conventions settles the question of residency as per the internal law of the relevant state but in this case Canadian law **deemed** the trust, for purposes of Part I, to also be resident in Canada, regardless of what basis of ascertainment of residency prevails applicable to trusts resident in the other state. If for treaty purposes, the trust as an individual has a residence in Canada then for Part I purposes this is also true and no question of the applicability of section 94 arises while if not the trust is resident in the other state causing both internal laws to apply. Not only must the internal law of Canada be concerned with but so too how the relevant tax treaties are applicable. The relevant treaty may allow for settlement of the application of the treaty in the case of trusts/estates by mutual agreement procedure so as to reduce double taxation.

¹⁵⁵⁵ There is no qualification placed upon the amount payable requiring it to be recognized under Part I thus attracting alternate exposure to Canadian taxation!

¹⁵⁵⁶ Y'er Uncle Jed, the professional kravalley fisherman resident in the Caymans long time retired to playing chicken with Edsel Hawks could recognize all of the income however this may clearly be labeled an abuse of the provisions of the Act qualifying for section 245 treatment...if the Department has the resources to ascertain the nature of the arrangement and give pursuit. If you haven't "an Uncle Jed" of course any non-arm's length party will do.

¹⁵⁵⁷ It would appear from the need for Sec. 104(7) disallowing a Sec. 104(6) deduction in respect of beneficiaries who were designated beneficiaries within the meaning of the Part XII.2 rules if the trust wasn't resident throughout its tax year in Canada that Sec. 104(6) is a deduction available to non-resident trusts in respect of Canadian resident beneficiaries though it's to be noted that Sec. 104(6) applies to reduce the trust's "income for a taxation year" and not its "taxable income earned in Canada". If the trust has loss carry-forwards they may reduce the beneficiary's Sec. 104(13) inclusion and increase the Sec. 94(1)(c) tax base thus creating a liability for the Canadian beneficiary in respect of possibly a non-resident's frustrated entitlement. (The trust law carry-forward could prevent FAPI from being payable to a non-resident.) The trust deed should attend to such instances to prevent them from occurring since as per *Re: Liberal Pet. Trust*, 39 Alta. L.R. (2d) 357, common law doesn't allow for equitable adjustment in respect of the tax if the trust deed doesn't express such an intention.

The Beneficiary's Liability.

Where the certain character discretionary power exists the trust is deemed to be resident in Canada and under Sec. 94(2), each subject contributor, intermediary or beneficiary¹⁵⁵⁸ listed in Sec. 94(1)(b)(i)(A) or (B) will jointly and severally with the trust have the rights and obligations of the trust by virtue of Divisions I and J (Returns, Assessments, Payments and Appeals, and Appeals to the Tax Court of Canada and the Federal Court), and shall be subject to the provisions in Part XV, (Administration and Enforcement), and in this respect, the specified qualifying contributors and beneficiaries listed in Sec. 94(1)(b)(i)(A) and (B) will become jointly and severally liable with the trust for the payment of its Part I tax on its deemed taxable income, (net of the foreign tax credits), and shall also be obligated to make the necessary filings and extinguish any penalties, interest etc. as if they were the trust. Since they also become subject to Part XV (Admin. and Enforcement) they may also become exposed to garnishments, property seizures, books and records retention requirements, etc.. Generally speaking, CRA will attempt to collect the trust's tax liability through its beneficiaries or contributors in the absence of, or accompanying to, property of the trust which is seizable, however, there is, fortunately, one restriction.

No amount in respect of taxes, penalties, costs or other amounts payable will be recoverable from any person except to the extent of amounts paid to him by the trust, or the payment of which from the trust he is entitled to enforce, or amounts **received** by him on the disposition of an interest in the trust.

Under the former case, it would appear that amounts paid by a primary trust to a second tier trust which then distributes the payments to the ultimate beneficiary, will not be subject since the amounts were not "paid to him by **the** trust" while if the person does not hold the legal title of the equitable right to enforce the distribution from the primary trust, but instead, the secondary trust holds it, the payment will still not be caught. There is provision in the phrase structure of course to catch instances where the right the beneficiary has allowed him to enforce a payment from the trust though not necessarily to him, however, since the Sec. 94(1) charging provision applies only to beneficiaries who have the right **to receive** the payment one must infer that the phrase "payment of which from the trust he is entitled to enforce..." must indicate entitlement to enforce a distribution **to himself**. (It thus attempts to capture instances where the beneficiary caused the income or capital to be maintained under the trust at his discretion).¹⁵⁵⁹ The provision applies to contributors and beneficiaries alike: proceeds realized by a Canadian resident on a FMV sale will be targeted.

Since the provision is applicable only to the current year's tax liability of the trust, and not in respect of any previous periods, it can be entirely possible for the trust to apply loss carry forwards, (as described under Sec. 95(1)(b)(v) or 115(1)(d) and (e)), so as to reduce its "taxable income" for the period in which the Sec. 94(1)(c) provision applied thus reducing the Sec. 94(1)(b)(i)(A)&(B) parties' tax liabilities.¹⁵⁶⁰ If the trust can book substantial losses and not apply them, their controlled subsequent application, when a "beneficially interested" person becomes resident in Canada, will allow the trust to recognize less taxable income thus reducing the potential tax liability. While booking the losses, subsection 94(1) need not apply, (when the "beneficially interested" persons are non-resident, etc.).¹⁵⁶¹ Such losses include those recognized to be deductible in Sec. 115(1)(e) in respect of computing the trust's "taxable income earned in Canada", and those deductible losses described in Sec. 95(1)(b)(v) and technically described in Reg. 5903(1) while in respect of the latter loss the carry forward period of five years is equal to the time period during which a formerly non-

¹⁵⁵⁸ the beneficiary, related person, residents over certain minimum periods, etc. see T.I. 5-8972 of Feb. 1990 by the Reorganizations and Non-Resident Division for this opinion.

¹⁵⁵⁹ If the trust is varied to require a non-resident beneficiary to extinguish an equitable charge through the payment of cash conditional upon receipt of property to a targeted beneficiary the interests of whom have been nullified by the variation not only will the beneficiary recognize a disposition and deemed proceeds of disposition under sec. 69(1)(b) upon which the Sec. 94(2) provision can apply but the subsequent payment may be captured by Sec. 105(1) and fully includable in income; a very harsh result.

¹⁵⁶⁰ Subsection 94(2) opens with "where paragraph (1)(c) is applicable" but subsection 94(1)(c) applies on a year by year basis in respect of income earned in those years.

¹⁵⁶¹ If the trust already has a tax liability imputed against it for previous periods then Sec. 94(2) will apply in respect of it when the beneficiary becomes resident regardless of the loss position. Of course if the trust in which the newly resident taxpayer is interested isn't the same as the former Sec. 94(2) wouldn't apply: a variation to the extent of changing the trust to a distinct other is then obviously beneficial.

resident beneficially interested person can remain resident in Canada without having section 94 apply to his offshore holding trust.¹⁵⁶² If Sec. 95(1)(b)(v) losses are to be incurred they would be most beneficially recognized starting in the sixth year of that taxpayer's residency so as to allow them to be deducted and reduce his section 94 liability. The losses themselves could be incurred within the first five years of residency but they should not be incurred prior to the beneficiary becoming resident unless they can be deducted so as to reduce a Canadian tax liability in some form. The most beneficial deduction of booked losses will depend on how long the beneficially interested person's "tax free" period is after he first becomes resident.¹⁵⁶³

Only up to the level of the amounts **received by the beneficiary** as a disposition of an interest in the trust will be subject to possible collection hence if the right holder skips the country, although Sec. 128.1(1) will apply to cause him to recognize a deemed disposition of the interest, the provision does not deem him to have **received** proceeds of disposition unlike Sec. 69(1)(b) hence Sec. 94(2) cannot be applied **in that instance**.

In conclusion it is to be noted that this provision is very dangerous in that no mechanism exists by which it can't apply to a multitude of discretionary beneficiaries all residing in Canada in which case a multitude of equivalent liabilities would be created out of a singular trust. It is hoped that CRA would not fully take advantage of this however it's unnerving to note that the whole purpose of the imposition of the complete tax liability of the trust upon a mere discretionary capital or income interest holder is that the quantum of benefits to be derived from such rights cannot be accurately measured, in comparison to those to be described where the trust isn't discretionary, and thus all of the trust's property could be for the benefit of any particular beneficiary. Given that this is the underlying policy of the provision, unlike that in paragraph (d), if one is foolish enough to have two discretionary beneficiaries reside in Canada under a discretionary trust one should expect to have duplicate liabilities created.

Non Discretionary Trusts.

Subparagraph 94(1)(c) applies only where **the amount** of income or capital of the trust **to be distributed** at any time to **any** beneficiary depends upon the exercise of or failure to exercise a discretionary power.¹⁵⁶⁴ Where it doesn't then para. (d) applies which may cause the beneficiaries to which the provision is applicable to recognize their respective share of F.A.P.I. of the trust as per the rules embodied in sections 91 and 95.¹⁵⁶⁵ The provision refers to "any discretionary power" but what exactly constitutes a discretionary power for these purposes? Since the provision refers to the effect this power has on the amount of capital or income to be distributed it would appear that regardless of Sec. 94(7), such a power could include powers of appointment or advancement which could create beneficial interests or adjust their equitable standings.¹⁵⁶⁶

F.A.P.I. Inclusions: Who Recognizes the Tax Consequences.

Under subparagraph (d)(i) in respect of any "beneficiary" under the trust the fair market value of the interest of whom exceeds 10% of the aggregate fair market value of all the trust's beneficial interests the trust will be deemed to be a non-resident corporation controlled by that beneficiary and thus the trust will be a controlled foreign affiliate of the beneficiary. All existing "beneficial interests" are to be evaluated in this prorating process, however, do "beneficial interests" include those recognizable under common law principles other than those forming the basis of the "beneficially interested" status defined in Sec. 94(7)? In the author's opinion, they shouldn't since that definition defines a state based upon the ownership of a beneficial interest and the rest of the Sec. 94(1) provision operates very exclusively with respect to that form of a right. Obviously,

¹⁵⁶² Subsection 75(2) can also be used to double losses with respect to Canadian resident contributors.

¹⁵⁶³ Losses in the tax free five year period can be carried over and applied in the first five years the beneficiary is subject to section 94 while losses sustained during the post five year period will be directly deductible. Where the trust is to become resident prior to a wind-up to obtain the maximum Sec. 128.1(1) bump in respect of its non-taxable Canadian property care must be exercised to ensure there are not implicit income accruals waiting to be recognized by the trust since such would be subject to Part I tax.

¹⁵⁶⁴ It does not apply where the discretionary power affects the timing of the payment.

¹⁵⁶⁵ The substance of which is exceedingly complicated and should be reviewed in depth

¹⁵⁶⁶ If the power is contracted to be terminally unexercisable a disposition thereof will not be recognizable and para. (c) targeting can be avoided.

there are a multitude of ways by which the fair market values of income and capital interests may be severely altered, artificially or otherwise, so as to adjust the implementation of this provision and they range anywhere from the mortgaging of property with distributing of proceeds to selected capital beneficiaries to the extinguishment of income interests through a Sec. 106(3) transfer. If the FMV of the particular beneficiary's interest can be reduced to below 10% of the aggregate then the trust will not be considered a C.F.A. in respect of him and he will not have to recognize arbitrarily derived F.A.P.I. every year.¹⁵⁶⁷

The provision then goes on to provide that the trust will be deemed to be a non-resident corporation having a single class of capital of 100 shares and that each "beneficiary" will be deemed to own at any time the proportionate number of those shares that the FMV of his interest in the trust is of the aggregate FMV of all of the interests in the trust. Under Sec. 95(4)(a), the beneficiary's "direct equity percentage" in the trust will equal this ownership percentage and where the beneficiary is a corporation the shares of which are held by another holding corporation etc., the holding corporation's equity percentage will be determined under Sec. 95(4)(b), which includes "indirect" equity percentages. Under Sec. 95(1)(d), if a beneficiary's "equity percentage" exceeds 10% then the "corporation" will be deemed a foreign affiliate thus under Sec. 94(1)(d)(i), since the "non-resident corporation" is deemed to be controlled by a beneficiary holding 10% of the FMV of all of the interests, the trust will be deemed to be a controlled foreign affiliate, as per the definition thereof in Sec. 95(1)(a), of that beneficiary. Any beneficiary holding an interest the FMV of which exceeds 10% of the fair market value of all of the interests in a subject trust will be caused to recognize section 91 F.A.P.I. of the deemed controlled foreign affiliate (trust) on a year by year basis regardless of if he actually realizes it or has rights to receive it, while any beneficiary not holding such an amount may still have to recognize the trust as a "controlled foreign affiliate" when his "equity percentage" exceeds 10%¹⁵⁶⁸ and he is in the position, with other **related** beneficiaries to "control" through the amount of deemed shares the non-resident corporation (trust) as per Sec. 95(1)(a)(ii) or (iii). If he is not in the position to be considered as controlling the foreign affiliate as per Sec. 95(1)(a) since he isn't related to the other beneficiaries etc., or if his equity percentage isn't 10% or greater, (thus causing the "corporation" to be unrecognizable as a foreign affiliate in Sec. 95(1)(d)), he will not have to recognize trust F.A.P.I. on a year by year basis. Instead he may be hit by the application of section 94.1 which computes arbitrary income inclusions.

Under Sec. 91(1), a taxpayer **resident in Canada** must recognize as income from a share in a controlled foreign affiliate a percentage of the C.F.A.'s F.A.P.I. equal to the taxpayer's "participating percentage" thereof at the affiliate's year end. "Participating percentage" is defined in Sec. 95(1)(e) to be, where the F.A.P.I. for the corporation is less than 5,000\$; nil, and where greater than 5,000\$, for these purposes, the equity percentage of the beneficiary hence if the F.A.P.I. is less than 5,000\$ for the year the beneficiary will not have to recognize a Sec. 91(1) inclusion.

If a series of trusts are constituted, each with slightly different beneficiaries so that Sec. 104(2) will not apply to cause them to be recognized as one, this principle could be used to allow them to each realize slightly less than 5,000\$ of F.A.P.I. thus causing none of it to be subject to the Sec. 91(1) inclusion at the beneficiary level. This would not preclude section 94.1 (nor 245) from applying.

Subparagraph 94(1)(d) applies only for purposes of subsections 91(1) to (4) and section 95 hence where a corporation, trust, or controlled foreign affiliate is beneficially interested, it will either be exposed to the section 91 F.A.P.I. mechanics or the section 95 intercorporate exempt-taxable-preacquisition surplus accounting mechanics as well as the general F.A.P.I. determination rules in Sec. 95(1)(b) and (2). If the "beneficially interested" person is a foreign affiliate not dealing at arm's length with a Canadian resident or a C.F.A. of a Canadian resident, income it realizes from the trust will be included in its F.A.P.I., (usually) as income from property.¹⁵⁶⁹ If the recipient is a C.F.A., the income as F.A.P.I. in the year, will be subject to the section 91 inclusions in respect of the Canadian resident shareholder. If the recipient of the trust income is a

¹⁵⁶⁷ A general power of appointment isn't a beneficial interest and its Canadian resident holder may avoid the provision's effect while exercising the power to receive some of the trust's property. It is the inability to value a discretionary trust's interest that has been the underlying reason for the entirety of the trust's hypothetical tax liability being imposed on each singular beneficiary. Each may be able to benefit exclusively from the trust.

¹⁵⁶⁸ due to indirect holdings through corporations which are themselves beneficiaries

¹⁵⁶⁹ Subsection 108(5) doesn't apply for this purpose hence there may be instances where due to the underlying activity the CFA realizes business income through a trust.

foreign affiliate of the Canadian resident, the income will be included in its "taxable earnings" as per Reg. 5907(1)(i)(ii)(B) and will not immediately affect the Canadian resident, but will when distributed as dividends. (The F.A. rules should be reviewed in detail.) If a non-resident second tier trust, which being administered uninfluenced by a trust company, is beneficially interested in another top tier non-resident trust earning income, accumulating it and distributing it as capital to the second tier trust, and the second tier has Canadian resident capital beneficiaries, then the top tier trust couldn't have received the particular income producing property from those subject contributors listed in Sec. 94(1)(b)(i)(A) or (B) in order for those parties not to be subject to the liabilities imposed by Sec. 94(2). If the second tier trust is administered by a trust company, making it at arm's length with its Canadian resident capital beneficiaries, the top tier trust can receive property from the Canadian residents, (**as long as they have no rights under the top tier trust**), earn income, distribute it down as capital which is excluded from the second tier trust's F.A.P.I. or "adjusted taxable income" and then the second tier trust could distribute it, tax free as capital under the section 107 rules, to the Canadian resident capital beneficiaries.¹⁵⁷⁰ Since the Canadian resident beneficiary-second tier non-resident trust arrangement **will be caught** by the Sec. 94(1)(a)(i) mechanism directly, it's crucial to reduce the second tier trust's F.A.P.I. or "adjusted taxable income", as the case may be, by as much as possible.¹⁵⁷¹

Another Similarly Interesting Deduction.

Under subsection 94(4), there is a deduction virtually identical to that in Sec. 94(3) whereby the F.A.P.I. of a trust may be reduced by the amount that can reasonably be considered as having become payable in the year (as per the meaning in Sec. 104(24)), to **any** beneficiary and thus it suffers from the same weaknesses as that in Sec. 94(3) commented on previously. Even if the substance of such a deduction is conversely recognized in Part I income under Sec. 104(13) by Canadian resident beneficiaries, it may still reduce the F.A.P.I. to below the 5,000\$ amount whereby Sec. 91(1) inclusions would not apply. Foreign accrual property income is to be computed via the provisions in Sec. 95(1)(b) and 95(2) etc.. If the trust carries on only active business activities, it may not even have any F.A.P.I. to recognize.¹⁵⁷²

Subsection 91(1) causes yearly recognitions of income **from a share in a foreign affiliate** not as income from a property which is a trust interest as normally applicable to the subdivision k inclusions via Sec. 108(5), and the "share" in this case arises by virtue of the interest which is entirely subject to the attribution rules when transferred. Even though a deduction is allowed to reduce the F.A.P.I. in respect of Sec. 104(24) amounts payable out of it, there may be "double taxation" from an Canadian resident income beneficiary's point of view when he's recognizing income under Sec. 104(13) and suffers a Sec. 91(1) inclusion in respect of FAPI being accumulated for someone else while, obviously, capital "beneficiaries" can be hit excessively hard in having to recognize income that may not accrue to their benefit and which the trust would have recognized had it been resident in Canada.¹⁵⁷³ The trust deed should be structured to provide equitable adjustment in entitlements in respect of these aspects.¹⁵⁷⁴

Subsection 91(2) offers a reserve to the beneficiaries where the Minister is satisfied that by reason of the operation of monetary or exchange restrictions of a country other than Canada the inclusion of the whole Sec. 91(1) amount would cause "undue hardship" on the taxpayer but the deduction is limited to what the Minister considers reasonable, and under Sec. 91(3) must be included in income in the following year. Subsection

¹⁵⁷⁰ The second tier trust can transfer **the substitute** of the property contributed to it by the Canadian resident thus disallowing the top tier trust from being subject: Sec. 94(1)(b)(i)(B).

¹⁵⁷¹ This procedure was one of the reasons underlying the introduction of section 94.1.

¹⁵⁷² A substantial number of Part XIII payments make up FAPI. If major amounts of F.A.P.I. can be recognized to be payable to a non-resident, but never actually paid, then they could be accumulated and distributed out as capital to the Canadian resident, in respect of a capital interest he has in the personal trust, so as to avoid the recognition of a Sec. 105(1) inclusion while at the same time reducing the taxation of it, in his hands, under Sec. 94(1). This will prove very effective at reducing Sec. 94(1) taxation if the "other" beneficiary, in respect of whom the income is recognized as payable under Sec. 104(24), is resident in a jurisdiction whereunder only trust income **paid** is taxed in the hands of its recipient, if it is taxed at all. Once again, while adjusting "your water wings in shark infested waters", this doesn't preclude section 94.1 from applying.

¹⁵⁷³ however, under subsection 94(5), the a.c.b. of their capital interest will be adjusted upwards and downwards by the amount of Sec. 91(1) or (3) income or Sec. 91(2) or (4) deduction they recognize respectively (or would have recognized had it not been for the application of the attribution rules in Sec. 56(4.1) and sections 74 to 75)

¹⁵⁷⁴ The harsh treatment was recognized in Technical Interpretation 5-0390 provided in Feb. 1986 by the Bilingual Services and Resource Industries Division.

91(4) offers a deduction against the amount included under Sec. 91(1) in respect of "foreign accrual tax applicable" to that F.A.P.I. and can be examined in more detail under Sec. 95(1)(c), (f), etc..

Dealing in Foreign Affiliate Trust Interests.

There is a pronounced disadvantage in dealing in capital interests in foreign affiliate trusts cited under Sec. 94(1)(d) caused by Sec. 108(1)(d) and 107(1). The former prevents any attribution of the tax cost of the trust's property to the capital interest held by the Canadian resident beneficiary and even if the trust is personal, as a consequence of this the Sec. 107(1)(a) paragraph will operate to cause the beneficiary to recognize a capital gain on the disposition of that interest via to a third party or with a commutation based on his historical legitimate ACB.¹⁵⁷⁵ To counter this however the trust could become resident after incorporating its assets offshore thus allowing Sec. 107(1)-(2)-108(1)(d) to operate favourably in the year of the disposition of the interest while if a commutation with the shares occurs the beneficiary will benefit from them having a Sec. 128.1(1) bumped cost.

The closing amble of Sec. 107(1) provides that Sec. 107(1)(a) will not apply to a capital interest disposed of it was purchased and is in a non-resident *inter vivos* trust except where the interest is being commuted with a Sec. 107(20) distribution. the concern here is not whether the trust is described under sec. 94(1)(c) or (d) but whether it is an *inter vivos* trust and whether the interest was purchased. Where the trust is a foreign affiliate of the beneficiary due to his deemed equity percentage in it by virtue of the rules in section 95 and 94(1)(d) the amble will not have any benefit since Sec. 108(1)(d) will simply not operate to attribute the tax cost of the trust's property to the interest and Sec. 107(1)(a), even if applicable, would not prevent a potentially massive capital gain on the interest's disposition. Where the trust is testamentary and is not a foreign affiliate Sec. 107(1)(a) and 108(1)(d) will apply fully to reduce any capital gains exposure. where the trust is *inter vivos* but the interest was gifted, (and the trust isn't a f.a. in respect of the particular beneficiary), Sec. 107(1)(a) will again apply to reduce capital gains exposure with an attribution of tax cost to the capital interest. Where the interest is purchased **from anyone** and the trust is *inter vivos* regardless of whether or not it's a f.a., it will only be if the interest is disposed of through a commutation that Sec. 107(1)(a) will operate to reduce tax consequences and though the interest may have a substantial Sec. 108(1)(d) cost amount, if disposed of to a third party, it will be its legitimate ACB that will form the basis of capital gains taxation. In such a situation in may be preferable to commute the interest with a distribution of funds obtained through a mortgage etc. so as to prevent tax consequences while if the interest is muled into Canada it will benefit from the Sec. 128.1(1) cost bump. The ACB of the interest will also not be adjusted with a tax liability the beneficiary has sustained via Sec. 94(1)(c) and 94(2) while in the case of a foreign affiliate trust the ACB will be fully adjusted to reflect section 91 inclusions/deductions but the inapplicability of Sec. 108(1)(d) will make the legitimate ACB the exclusive creator of tax consequences on the disposition via to a third party **or with a commutation**.

To be compared to these instances however is when an income interest is satisfied with distributions of property by the trust since it appear that Sec. 106(2)-(3) do not give rise to excessive tax consequences when cash is used. entitlements to income satisfied through cash distributions under Sec. 106(2)(a) could prove one method of avoiding possible tax consequences however such would be moderated by the possible applicability of Sec. 105(1) to excessive/abusive distributions.

On the acquiring side, when the trust is non-resident at the time of the interest's acquisition, Sec. 53(2)(i) materially adjusts the ACB of the capital interest acquired regardless of what amount was paid for it with a purpose of reducing the ability to bump the tax cost of the trust's taxable Canadian property.¹⁵⁷⁶ The lesser the percentage of the FMV of the trust's property attributable to taxable Canadian property the lesser the ACB reduction. The provision also doesn't concern whether the trust becomes a foreign affiliate or is an *inter vivos* or testamentary trust. A reduction in the ACB can materially affect subsequent tax consequences when property is advanced to Canadian residents as well as when the a.c.b becomes relevant in facing a disposition

¹⁵⁷⁵ This is to be compared to the treatment of the disposition of capital interests in resident personal trusts where there is full cost attribution and capital gains may be substantially reduced. In a T.I. provided in April 1984 by the Specialty Rulings Division the above was recognized.

¹⁵⁷⁶ This provision is commented on extensively in a subsequent chapter.

via to a third party or commutation.

Concluding, when dealing with non-resident trust structures it's not just important to evaluate the on-going tax consequences that arise during the arrangement but also those that arise when the arrangement is to be exited via a disposition of the capital interest to a third party or with a commutation.

Some Relevant Overall Considerations

Obviously, an all conclusive statement cannot be made concerning which resulting application (or misapplication) of section 94 may be more favorable, however, it may prove advantageous to alter one application for another through a variation in the trust's terms, if it proves impossible to avoid the charging provisions in Sec. 94(1)(a) and (b), however, one would have to examine all of the relevant factors including the amount of F.A.P.I. originating in Canada, residency patterns, (and their propensity to change), of the beneficiaries, and not only ability but economy of both trusts and beneficiaries in effecting a more "sheltered" arrangement. The possible application of section 94.1 is of critical importance.

Offshore Investment Funds.

It's quite easy to avoid the application of the section 94 non-resident trust rules by transferring money to a non-resident trust, and have the trust invest in property that doesn't produce taxable income that is the target of Sec. 94(1)(c)(i) or 95(1)(b) or 95(2). Such an investment can consist of the shares of a non-resident corporation which pays redeemable stock dividends (non-taxable) to the trust which are redeemed to purchase more shares or are transferred to the beneficiary under the Sec. 107(2) mechanics whereafter they are redeemed tax free. Section 94.1 was enacted to counter this and the strength of any non-resident trust arrangement to avoid Canadian taxation must be measured not only by how it circumvents the section 94 rules but also if it can do the same to section 94 **and** 94.1 acting in unison.

Subsection 94.1(1) applies to taxpayers, other than non-resident-owned investment corporations, where they hold an interest in a share of capital stock, an interest in or debt of, (or right to acquire such), a "non-resident entity" whereby should that interest derive its value from portfolio investments, and one of the main reasons for holding the interest in such an arrangement was tax motivated, they will be required to recognize income annually which will be determined from the "designated cost" of that property. since the non-resident entity doesn't obtain a Part I tax deduction nor in most cases any sort of deduction in the foreign jurisdiction in respect of the Canadian beneficiary's tax there will be significant effective taxation of the arrangement, perhaps close to double. There are three conditions that must exist in order for the provision to apply; the holding of the interest in property that represents some connection to the non-resident entity, (the offshore investment fund property), the value of such interest must be derived from "portfolio investments" in certain property held by the non-resident entity (or any others), and the tax motivation in which the taxpayer recognizes less taxation in holding the interest than if he received the income from the portfolio investments directly.

"Offshore investment fund property – Sec. 94.1(1)"

(1) Where in a taxation year a taxpayer, other than a non-resident-owned investment corporation, holds or has an interest in property (in this section referred to as an "offshore investment fund property")

(a) that is a share of the capital stock of, an interest in, or a debt of, a non-resident entity (other than a controlled foreign affiliate of the taxpayer or a prescribed non-resident entity) or an interest in or a right or option to acquire such a share, interest or debt, and

(b) that may reasonably be considered to derive its value, directly or indirectly, primarily from portfolio investments of that or any other non-resident entity in

(i) shares of the capital stock of one or more corporations,

- (ii) indebtedness or annuities,
 - (iii) interests in one or more corporations, trusts, partnerships, organizations, funds or entities,
 - (iv) commodities,
 - (v) real estate,
 - (vi) Canadian or foreign resource properties,
 - (vii) currency of a country other than Canada,
 - (viii) rights or options to acquire or dispose of any of the foregoing, or
 - (ix) any combination of the foregoing, and it may reasonably be concluded, having regard to all the circumstances, including
- (c) the nature, organization and operation of any non-resident entity and the form of, and the terms and conditions governing, the taxpayer's interest in, or connection with, any non-resident entity,
- (d) the extent to which any income, profits and gains that may reasonably be considered to be earned or accrued, whether directly or indirectly, for the benefit of any non-resident entity are subject to an income or profits tax that is significantly less than the income tax that would be applicable to such income, profits and gains if they were earned directly by the taxpayer, and
- (e) the extent to which the income, profits and gains of any non-resident entity for any fiscal period are distributed in that or the immediately following fiscal period, that one of the main reasons for the taxpayer acquiring, holding or having the interest in such property was to derive a benefit from portfolio investments in assets described in any of subparagraphs 94.1(1)(b)(i) to 94.1(1)(b)(ix) in such a manner that the taxes, if any, on the income, profits and gains from such assets for any particular year are significantly less than the tax that would have been applicable under this Part if the income, profits and gains had been earned directly by the taxpayer, there shall be included in computing the taxpayer's income for the year the amount, if any, by which
- (f) the total of all amounts each of which is the product obtained when
- (i) the designated cost to the taxpayer of the offshore investment fund property at the end of a month in the year is multiplied by
 - (ii) the quotient obtained when the prescribed rate of interest for the period including that month is divided by 12 exceeds
- (g) the taxpayer's income for the year (other than a capital gain) from the offshore investment fund property determined without reference to this subsection.

Definitions

(2) In this section,

“designated cost”

“designated cost” to a taxpayer at any time in a taxation year of an offshore investment fund property that the taxpayer holds or has an interest in means the amount determined by the formula $A + B + C + D$ where

A is the cost amount to the taxpayer of the property at that time (determined without reference to paragraphs 53(1)(m) and 53(1)(q), subparagraph 53(2)(c)(i.3), paragraphs 53(2)(g) and 53(2)(g.1) and section 143.2),

B is, where an additional amount has been made available by a person to another person after 1984 and before that time, whether by way of gift, loan, payment for a share, transfer of property at less than its fair market value or otherwise, in circumstances such that it may reasonably be concluded that one of the main reasons for so making the additional amount available to the other person was to increase the value of the property, the total of all amounts each of which is the amount, if any, by which such an additional amount exceeds any increase in the cost amount to the taxpayer of the property by virtue of that additional amount,

C is the total of all amounts each of which is an amount included in respect of the offshore investment fund property by virtue of this section in computing the taxpayer’s income for a preceding taxation year, and

D is

(a) where the taxpayer has held or has had the interest in the property at all times since the end of 1984, the amount, if any, by which the fair market value of the property at the end of 1984 exceeds the cost amount to the taxpayer of the property at the end of 1984, or

(b) in any other case, the total of

(i) the amount, if any, by which the fair market value of the property at the particular time the taxpayer acquired the property exceeds the cost amount to the taxpayer of the property at the particular time, and

(ii) the amount, if any, by which

(A) the total of all amounts each of which is an amount that would have been included in respect of the property because of this section in computing the taxpayer’s income for a taxation year that began before June 20, 1996 if the cost to the taxpayer of the property were equal to the fair market value of the property at the particular time exceeds

(B) the total of all amounts each of which is an amount that was included in respect of the property because of this section in computing the taxpayer’s income for a taxation year that began before June 20, 1996, except that the designated cost of an offshore investment fund property that is a prescribed offshore investment fund property is nil;

“non-resident entity”

“non-resident entity” means a corporation that is not resident in Canada, a partnership, organization, fund or entity that is not resident or is not situated in Canada or a trust with respect to which the rules in paragraph 94(1)(c) or 94(1)(d) apply.

“Interpretation – Sec. 94.1(3)”

(3) Where subsection 94.1(1) is applied with respect to an offshore investment fund property that was

- (a) held by the taxpayer on February 15, 1984,**
- (b) received as a stock dividend in respect of a share of the capital stock of a non-resident entity held by the taxpayer on February 15, 1984,**
- (c) received as a stock dividend in respect of a share of the capital stock of a non-resident entity that the taxpayer had previously received as described in paragraph 94.1(3)(b), or**
- (d) substituted for a property held by the taxpayer on February 15, 1984 pursuant to an arrangement that existed on that date, the reference to “1984” in the descriptions of B and in the definition “designated cost” in subsection 94.1(2) shall be read as a reference to “1985”.**

“eligible trust”

“eligible trust”, at any time, means a trust, other than a trust

- (a) created or maintained for charitable purposes,**
- (b) governed by an employee benefit plan,**
- (c) described in paragraph (a.1) of the definition “trust” in subsection 108(1),**
- (d) governed by a salary deferral arrangement,**
- (e) operated for the purpose of administering or providing superannuation, pension, retirement or employee benefits, or**
- (f) where the amount of income or capital that any entity may receive directly from the trust at any time as a beneficiary under the trust depends on the exercise by any entity of, or the failure by any entity to exercise, a discretionary power;**

“entity”

“entity” includes an association, a corporation, a fund, a natural person, a joint venture, an organization, a partnership, a syndicate and a trust;

“exempt trust”

“exempt trust”, at a particular time in respect of a taxpayer resident in Canada, means a trust that, at that time, is a trust under which the interest of each beneficiary under the trust is, at all times that the interest exists during the trust’s taxation year that includes the particular time, a specified fixed interest of the beneficiary in the trust, if at the particular time

- (a) the trust is an eligible trust,**
- (b) there are at least 150 beneficiaries each of whom holds a specified fixed interest, in the trust, that has a fair market value of at least \$500, and**
- (c) the total of all amounts each of which is the fair market value of an interest as a beneficiary**

under the trust held by a specified purchaser in respect of the taxpayer is not more than 10% of the total fair market value of all interests as a beneficiary under the trust;

Trust Interests.

Fiscal Hybrids.

There are countless references to "capital interests", "income interests", and "beneficial interests", contained in the Act but the common law concept of income and capital interests under trusts are much more technically defined in subsection 108(1). Capital and income interests as defined in the Act are two specific types of property that are "beneficial interests", but that they are not exhaustive of the term. Beneficial interest for purposes of the Act, carries with it the common law definition and in this case it is much broader than mere ITA "capital" or "income interests".

A trust/estate interest can be described as one of two possible forms of property; either it can be recognized as a right to cause the trust agreement/will to be administered as per its own terms thus causing legal title of property to be transferred to the right/interest holder, or, it can be recognized as a right to the property directly, or interest directly therein the legal ownership of the property held by a trustee. Subparagraphs 108(1)(c) and (e) provide the definitions of "capital" and "income interests" respectively for purposes of the ITA as provided for in Sec. 248(1), both of which depend directly upon the nature of a trust beneficiary's **rights** under the trust and the nature of the trust as recognized for purposes of the ITA. The "interest" is, in the case of a personal trust, defined as a right enforceable immediately or in the future¹⁵⁷⁷ which is vested absolutely or contingently that is held by the taxpayer in the capacity of a beneficiary under the trust while "beneficiary" is defined in Sec. 108(1)(d) to include a person beneficially interested in the trust.¹⁵⁷⁸ "Beneficially" would tend to carry a definition indicating an arrangement that results in an advantage being realized by the relevant person from some other thing hence as per a strict interpretation of the provisions; in order to be a beneficiary the taxpayer must hold a beneficial interest in the trust **as a beneficiary** hence the obvious circularity results. Since the nature of a creditor's/lender's right is not "beneficial" (in that he can gain no "advantage" from the relationship owing to the fact that what he has or will receive is approximately equal to what he has given up), rights held by creditors/lenders against a trust do not qualify as trust interests and it should be recognized as per the limited definitions of "interests" provided it is only this reasoning that disqualifies them.¹⁵⁷⁹

Pursuant to *Dunn v. C.I.R.*¹⁵⁸⁰ a settlor was contended by the tax authorities to be a beneficiary under a trust created when its terms were to be read with respect to a court order which was awarded against him requiring him to provide maintenance. The trust was created prior to the order and the court held that he wasn't a beneficiary by virtue of the advantage he would realize by having his obligations extinguished:

"He said that there is no distinction between the true and legal beneficiary and that the appellant as settlor answers both descriptions because by the deed the trustees are bound to apply the trust income first in discharge of his obligations under the Court orders... I think the short answer to that argument is that this settlor is not a beneficiary under the trust at all. Like many settlers, he may derive advantages from the creation of the trust, but that is not the same as being a beneficiary of or under a trust. To the extent that the trust is able to satisfy his maintenance obligations - a question which I express no opinion - he may derive an advantage. But that is not because he is a beneficiary: it is because he has made his first wife and the child of the marriage beneficiaries. Once it is accepted, as the Commissioner does accept, that the trust is valid, it seems self-evident that the true beneficiaries are the persons **designated** to receive the benefits under it."

¹⁵⁷⁷ See recently *Johns v. Johns* [2004] 3 N.Z.L.R. 202, CA NZ for a good definition.

¹⁵⁷⁸ "A beneficiary is one for whose benefit property is held by trustees or executors." as per *Malkin v. M.N.R.*, 1 D.T.C. 456 ExC. See also *Barton v. Cooke* (1800) 5 Ves. Jun 461/31 E.R. 682, *Noel v. Jones*, (1848) 16 Sim 309/60 E.R. 893, *Presant & Presant v. Goodwin*, 1860 164 E.R. 852, *Perp. Trustee Co. v. Hindmarsh*, 1948 48 S.R.N.S.W. 454, and *Sacks v. Gridiger*, 1991 22 N.S.W.L.R. 454 for the application of funds directly benefiting a taxpayer though not necessarily paid directly to them.

¹⁵⁷⁹ Of course it is possible for a creditor to become a beneficiary in respect of his claim through the acquisition of an interest in extinguishment of his creditor rights: *Levy v. Williams*, 1925 V.L.R. 615, *Murphy v. F.C.T.*, 1943 16 A.L.J. 371, *Gair v. F.C.T.*, 71 C.L.R. 388. Subsections 94(7) and 74.5(10) refer to the status of being beneficially interested for purposes of non-resident trust taxation and income attribution respectively but neither limit the capacity of the right holder to being a beneficiary as do the Sec. 108(1)(c) and (e) definitions.

¹⁵⁸⁰ 1975 1 N.Z.L.R. 465

An estate is synonymous with a trust **only under** subdivision k and it is only by virtue of this fact that a right the beneficiary has under an unadministered estate is treated as a capital interest for purposes of the Act as per para. (ii) of Sec. 108(1)(c). Even if the estate loses its personal character the right will still be a capital interest and will benefit from or bear all of the effects of provisions applicable thereto upon its disposition/commutation, etc..

The nature of the trust, as per its character assigned by the ITA, in accompany with the nature of the right as allowed for in light of the trust law principles will determine how the right itself will be regarded (sometimes very favourably) for purposes of taxation when it is disposed of. It is in this respect that the nature of the trust as described under the ITA in particular whether or not it is a "personal trust", becomes critical.

“capital interest” – Section 108 Definitions”

“capital interest” of a taxpayer in a trust means all rights of the taxpayer as a beneficiary under the trust, and after 1999 includes a right (other than a right acquired before 2000 and disposed of before March 2000) to enforce payment of an amount by the trust that arises as a consequence of any such right, but does not include an income interest in the trust;¹⁵⁸¹

“income interest” – Section 108 Definitions”

“income interest” of a taxpayer in a trust means a right (whether immediate or future and whether absolute or contingent) of the taxpayer as a beneficiary under a personal trust to, or to receive, all or any part of the income of the trust and, after 1999, includes a right (other than a right acquired before 2000 and disposed of before March 2000) to enforce payment of an amount by the trust that arises as a consequence of any such right;¹⁵⁸²

1581 March 1001 FINANCE TECHNICAL NOTES: Subsection 108(1) contains the definition "capital interest". In the case of a personal trust, a prescribed trust and certain "grandfathered" trusts, a taxpayer's capital interest encompasses all rights of the taxpayer to receive all or any part of the trust's capital. In any other case, a taxpayer's capital interest generally encompasses all rights of the taxpayer as a beneficiary under the trust.

The definition "capital interest" is amended to expressly provide that a capital interest does not include an income interest in the trust. With the exception of an income interest in a trust, a taxpayer's capital interest in a trust encompasses:

- all rights of the taxpayer as a beneficiary under any type of trust, and
- after 1999, a right (other than a right acquired before 2000 and disposed of before March 2000) to enforce payment by the trust that arises as a consequence of any such rights.

Note, in addition, that an amendment to subsection 104(1) has the effect of excluding a "bare trust" from the definition "trust" in the Act. One of the effects of this amendment is, that there will be no capital interests in a "bare trust" for the purposes of the Act

1988 FINANCE TECHNICAL NOTES: The definition of "capital interest" in a trust in paragraph 108(1)(c) ensures that beneficiaries cannot offset any portion of their cost of a capital interest in a trust by amortizing the cost of their trust interest under section 106. The amendment to the definition is strictly consequential on the proposed new definition of "personal trust" in subsection 248(1). Any interest in a trust other than in a personal trust or a prescribed trust will be a capital interest in a trust. In the application of the definition to subsection 107(2), a trust prescribed under subsection 107(2) will also be prescribed for the purposes of the definition. The amendment's of a relieving nature.

1987 FINANCE TECHNICAL NOTES: The definition of a "capital interest" in a trust is amended as a consequence of the amendment, described below, to the definition of an "income interest" in a trust. As amended, a "capital interest" is any right of a taxpayer as a beneficiary to, or to receive capital under a testamentary trust or an inter vivos trust in which none of the beneficial interests were purchased from the trust or a settlor thereof and any right of a taxpayer under any other inter vivos trust. Thus, where any interest in an inter vivos trust is purchased from the trust or a settlor of the trust, all interests in the trust will be treated as capital interests for the purposes of the Act. This amendment avoids the unintended result that may be obtained on the disposition of an interest in an investment trust under the former definitions, where the interest of a taxpayer could be regarded as two properties — an income interest and a capital interest. Under the amended definition, an interest in an investment trust will constitute a capital interest and the cost thereof will be taken into account in determining any gain or loss on the disposition of such an interest.

1582 March 2001 FINANCE TECHNICAL NOTES: Subsection 108(1) contains the definition "income interest". It is defined as a right as a beneficiary under a personal trust to income of the trust. Under subsection 108(3), "income" for this purpose is determined without reference to the provisions of the Act.

The definition is amended to provide that, after 1999, an income interest also includes a right (other than a right acquired before 2000 and disposed of before March 2000) to enforce payment by the trust that arises as a consequence of a right that is an income interest.

Under subsection 108(1)(e), an "income interest", for purposes of the Act as per Sec. 248(1), is a **right** of the taxpayer, whether immediate, future, absolute, or contingent, as a beneficiary under a **personal trust** to, or to receive, any part, including all of the **income** of the trust while under Sec. 108(3) "income" is defined, for purposes amongst others including this particular definition, to be "income" computed without reference to the Act, hence the trust law definition of income **rights** is implicit in the tax law definition of "income interests".

The Sec. 108(1)(e) definition applies only to "interests" created or **materially** altered after January 31, 1987 that were acquired by the taxpayer after February 6, 1987. If this condition does not apply by virtue of the lack of satisfying one of these conditions the former "income interest" definition applies being; an income right of the taxpayer held as beneficiary, with any combination of any of the four base characteristics, to or to receive all or any part of the income of the trust, **but** only where the trust is a "testamentary trust" or a trust in which no beneficial interest, be it capital or income, was acquired for consideration payable directly or indirectly to the trust or to any person who has made an assignment, transfer, or other disposition of property thereto.¹⁵⁸³ There are thus two mutually exclusive definitions of "income interest" and while the most recent was amended to apply to the new personal trust restrictions it was targeted only at income rights created/materially altered after January 31, 1987 and acquired after February 6, 1987. The "personal trust" definition was added in 1988, **applicable retroactively after 1984**, hence the former definition of "income interest" can apply when the personal trust rules also applied, (1984 to February 6, 1987). The former definition precludes the recognition of income interest status where any beneficial interest in the particular trust was acquired for consideration payable to either the trust or a person who has contributed to the trust, (as per the Sec. 108(1)(h)(ii)(a) use of the term), however the latter definition also essentially causes the same with respect to the personal trust rules, save for one instance, being the treatment afforded the creator/settlor of the trust. As per the former definition of "income interest", if the settlor takes back an interest on the settling of an *inter vivos* trust any possible income right existing thereunder will not gain "income interest" status in that "a beneficial interest had been acquired for consideration payable to the trust", while as per the latter definition a special exemption is afforded the creator, (of an *inter vivos* trust, if he's an individual), in such a situation so as to allow him not to taint the trust. The cause for alarm, (if the appropriate term), with respect to the legislative accuracy is that the personal trust definition applies all the way back to 1984, and the former "income interest" definition applies up to 1987, but **not based on the personal trust rules**, hence in the interim period between 1984 and February 6, 1987 if a **settlor** of an *inter vivos* trust takes back an interest in a trust created in that period all income rights under that agreement will not gain "income interest" status, ... unless each is created **after** January 31, 1987, or **materially** altered **after** that time, **and** were acquired **after** February 6, 1987, thus allowing the latter (new) definition of "income interest" to apply.¹⁵⁸⁴

Perhaps the most dangerous aspect about the definition of "income interest", before or after the 1988 reform, is that the status may be maintained only up until the trust receives a contribution in exchange for an interest granted, or until someone who has contributed to the trust receives consideration as a result of the acquisition of an "interest" therein by the interest acquiror. If one interest is sold by the trust/trustee for consideration which is received by the trust or contributor etc. all of the existing income rights under the

1988 FINANCE TECHNICAL NOTES: The definition of "income interest" in paragraph 108(1)(e) is no longer relevant in respect of commercial trusts since each interest in such a trust will fall within the definition of "capital interest", as described above. The amendment, strictly consequential on the proposed new definition of "personal trust" in subsection 248(1), has the effect of limiting an "income interest" to an interest in a "personal trust". The amendment is of a relieving nature.

1987 FINANCE TECHNICAL NOTES: The definition of an "income interest" in a trust is amended so that the only trusts in which there can be income interests are what might be referred to as "family trusts".— that is, testamentary trusts and *inter vivos* trusts in which none of the interests is purchased from the trust or a settlor thereof. This amendment will limit the deduction available under subsection 106(1) to the cost, of income interests in these family trusts. As described above, an interest of a taxpayer as a beneficiary under a trust which does not constitute an income interest is treated as a capital interest, and as a result the cost of such interest is taken into account in determining any gain or loss on its disposition.

¹⁵⁸³ Obviously the latter aspect of the former definition was used as the basis of the "personal trust" definition in Sec. 248(1).

¹⁵⁸⁴ The trust will be personal in respect of all of the other income interests but for purposes of describing the settlor's income right it doesn't really matter.

agreement will lose their status¹⁵⁸⁵. In the case of most trusts the possibility of this occurring simply doesn't exist since all beneficial interests may be privately held and not dealt in routinely, however this isn't the case whereunder a trust agreement the trustee has a power of appointment (which is general and non-restrictive) allowing him to transfer legal title of particular trust property(ies) to some (or any) person which isn't otherwise a recognized beneficiary (in the trust law sense of the term) for consideration receivable by the trust or a contributor. If such a power is exercised and the taxpayer instead of acquiring immediate legal title to the property acquires a beneficial right to have the agreement enforced thereby causing legal title to be transferred, eventually, to him he will have acquired an "interest" for the payment of consideration to the trust, thus causing it to be tainted.¹⁵⁸⁶ If instead of offering the consideration to the trust, the appointee offers it instead to the beneficiary the substance of the beneficial right of whom has been reduced, and assuming that that beneficiary hasn't made a contribution to the trust, the trust will maintain its "personal" status¹⁵⁸⁷. The same aspects are inherent in respect to the discretionary powers which are of the trust nature which must be exercised by the holder in respect of one of two or more possible candidates since in such an instance a distinctive interest is acquired by the beneficiary upon an exercise¹⁵⁸⁸.

Subsection 108(3) provides that for purposes of the Sec. 108(1)(e) definition of "income interest" the "income" of the trust to which the right is enforceable in respect of is that which is computed without reference to the Act; being that it is the income which is to be computed as per the settlor's expressed or implied direction or intention as evidenced in the agreement or failing the clarity thereof, some other appropriate method of accounting. A trust deed at its simplest is an agreement upon which the systematic transfer of legal title to property or its use is based and the settlor is in the position to determine how the income from the property, as a property itself, will be determined and in what manner and in what proportion the income computed will become the property of the stated beneficiary. These are factors that are laid out in the trust agreement and upon which the entire spectrum of possible beneficial interests and rights are based. The settlor may designate certain accounting methods that must be adhered to in computing the income and depending on other factors that form the purpose of the trust the settlor may also designate certain income recognition methods to be used to determine, individually, the substance of each beneficiary's income right. These designations can add considerable complexity to the trust deed however they are the base upon which the beneficiaries' rights are founded in that they are specific conditions imposed on the manner in which the gift (title to the income) is being given. The only major tax related problem with this environment, (the trust law income being the basis of an "income interest" in tax law), is that the settlor may provide that what are recognized as capital accretions for tax purposes form part of the trust law income that the beneficiary will be recognized as having an "income interest" in. If a trust agreement recognizes what are essentially capital gains under tax law as income then the beneficiary will have an "income interest" which effectively derives at least part of its substance from capital gains. When the capital gains are recognized by the trust, if they are payable to the beneficiary, their Division B tax character will carry through and the beneficiary will recognize the payable under Sec. 104(13)(a), as tax income and the trust will most likely make a Sec. 104(21) designation in respect of it allowing the beneficiary to recognize its source as a capital gain. The cost of an "income interest" can be deducted from Sec. 104(13) income recognized hence if the income interest has a cost, (that was arrived at without integrated taxation), then it can be beneficially applied to reduce taxation of the gain.¹⁵⁸⁹ Since the "income interest" (of a personal trust) is exclusively referenced to the trust law income, to be functional the "capital interest" described under Sec. 108(1)(c)(i) must be implicitly referenced to the capital of the trust as measured in **trust law terms** and it is here where the poor referencing of both "interests"

¹⁵⁸⁵ except where the *inter vivos* trust interest was taken aback by an individual creator, at the time of creation and only in limited cases

¹⁵⁸⁶ Powers over the legal title of the property so as to allow its actual conveyance instead of a creation of a beneficial interest therein **may** alleviate this problem; on the exercise and delivery the recipient will not receive a beneficial interest but instead actual legal title, while it may be possible to impress an additional trust upon the title. See Halsbury's Laws of England, 4th Ed., Vol. 36, para. 804.

¹⁵⁸⁷ though if resident that beneficiary will most likely recognize a Sec. 105(1) inclusion in respect of the benefit

¹⁵⁸⁸ See *Coggins v. Commr. of S.D.*, 1961 61 S.R. (N.S.W.) 639.

¹⁵⁸⁹ If the cost was arrived at through recognition of income by the previous holder obviously a tax benefit will result in applying the cost to reduce a capital gain recognized under Sec. 104(13) since the interest tax cost caused full income inclusion and the deduction thereof will only negate an effective 3/4 of this income inclusion.

becomes evident. If the "capital interest" refers to rights enforceable in respect of trust law capital, and the trust agreement provides that certain realizations of wealth are to be recognized as capital, then a serious inconsistency arises where such realizations are treated as income for tax purposes.¹⁵⁹⁰ As per Sec. 108(5)(a) these capital realizations, having a tax law income character will be recognizable only as income of a beneficiary when they are distributed being "deemed to be income of the beneficiary for the year from a property that is on interest in the trust and not from any other source". If they don't become "payable", as per Sec. 104(24), to the beneficiary then the trust will extinguish the tax liability while if they do become payable then the beneficiary will have to extinguish it. Since the respective beneficiary has a "capital interest" he will not be able to write off the cost thereof, as allowed in respect of "income interests" under Sec. 106(1), and equity will not exist simply because the trust agreement indicates that trust law income is to be computed in a certain way or that trust law causes the payment to inure to a particular class of beneficiary. Obviously when drawing up the trust agreement the draftsman should attempt to ensure that realizations of wealth that are to be treated as trust law income include all of those that will be recognized as Division B income, and such inclusions will be the basis of some of the beneficiaries' interests.¹⁵⁹¹ Where the trust isn't a personal trust then an "income interest" thereunder can not exist and all rights under the agreement are considered capital interest as per Sec. 108(1)(c)(ii) thus precluding the beneficiary from deducting his cost.¹⁵⁹²

Prescribed Trusts.

A taxpayer may hold a capital interest in a **prescribed** trust but income interests under such do not exist. Regulation 4800.1, finally added on May 10th, 1990, applicable after 1987, defines prescribed trusts, for purposes of Sec. 107(2), (4.1) and 108(1)(c), to be voting trusts, creditor trusts, and corporate employee ownership trusts. The latter may be a trust maintained **primarily**, (but not created solely), for the benefit of a corporation or two or more non-arm's length corporations where **one** of the main purposes is to hold **interests in** shares of the capital stock of the corporation(s). A "creditor trust" is a trust **established exclusively** for the benefit of a person who was, **at the time the trust was created**, either a person from whom the trust had received property or a creditor of such a person, where one of the main purposes of the trust is to secure payments required to be made by or on behalf of the person to the creditor. A definition of creditor isn't provided for these purposes while there are no parameters placed on the manner in which the "payments" may be made or the time over which they may be made or how the indebtedness arose.¹⁵⁹³ "The person" cited need not be the actual creator of the trust. The third type of prescribed trust consists of a trust the property of which all or substantially all consists of capital stock of a corporation which was established not necessarily by but pursuant to an agreement between two or more shareholders and one of the main purposes of the trust is to provide for the exercise of voting rights arising from those shares pursuant to the agreement. If the constituting agreement is altered after the trust is created the trust cannot technically be a prescribed trust. The trust and the corporation can be resident anywhere, (while the other prescribed trusts can be as well), while so too can the shareholders while all or substantially all of the property **owned** by the trust must be shares but this doesn't preclude the trust from borrowing income producing property however it must be noted that income therefrom will be hit with the highest tax rate if capitalized in the *inter vivos* trust, (unless the effect of Sec. 75(2) on loss producing property cannot be accessed), and if the income is distributed the beneficiaries will not be able to deduct the cost of the interest.

Regulation 4800.1

4800.1. For the purposes of subsections 107(2) and (4.1) and paragraph 108(1)(c) of the Act, the following are prescribed trusts:

¹⁵⁹⁰ Such is the case with mining income for instance in *Campbell v. Wardlaw*, 1883 8 App Cas 641 (HL).

¹⁵⁹¹ If a capital beneficiary in the trust law sense of the term is interested only in a particular property, and is not entitled to receive the gain portion of a disposition of that property then the gain will have to be recognized exclusively by the trust when the property is disposed of since the beneficiary will not be able to recognize, in respect of the particular (and only relevant) capital interest, income under Sec. 104(13) hence Sec. 104(21) designations will not be available.

¹⁵⁹² Capital interests are not depreciable property of a prescribed class.

¹⁵⁹³ #40. v. M.N.R. is an excellent example of such a trust.

- (a) a trust maintained primarily for the benefit of employees of a corporation or two or more corporations which do not deal at arms' length with each other, where one of the main purposes of the trust is to hold interests in shares of the capital stock of the corporation or corporations, as the case may be, or any corporation not dealing at arm's length therewith;
- (b) a trust established exclusively for the benefit of one or more persons each of whom was, at the time the trust was created, either a person from whom the trust received property or a creditor of that person, where one of the main purposes of the trust is to secure the payments required to be made by or on behalf of that person to such creditor; and
- (c) a trust all or substantially all of the properties of which consist of shares of the capital stock of a corporation, where the trust was established pursuant to the main purposes of the trust is to provide for the exercise of voting rights in respect of those shares pursuant to that agreement.

The definition of a prescribed trust is important, as indicated in the opening preamble of the regulation, in that it provides for tax free distributions of property to the holder from the trust under Sec. 107(2) or (4.1) while with the 1990 amendments the Sec. 107(1)(a) capital interest disposition provision was amended to allow for tax integrated dispositions of capital interests in such trusts, (while at the time of writing it can only be hoped that the Reg. 4800.1 targeting preamble will be amended as well to support this).¹⁵⁹⁴

Rights to Receive Indirectly.

Inherent in both the definitions of "income interest" and "capital interest" as they apply in respect of personal trusts is the entitlement of the beneficiary not to have the trust law income or capital distributed to him directly, (where he in is personal capacity received legal title thereto), but instead to have it applied for his benefit indirectly, either as he directs or as per the terms of the trust deed, without him realizing the legal title thereto. Where the trust agreement provides that a particular beneficiary cannot receive "the cash" from income or capital but instead allows him to direct it to be paid so as to extinguish his personal obligations as he pleases then obviously he benefits from the trust. Such an arrangement could be beneficially created, where the beneficiary does not have the prudence/discretion to favourably apply the money he could otherwise have received from the trust, in that it limits the amount of expenses (as per the trust deed) that the beneficiary can incur, and expect to be extinguished, to that consistent "with his station in life". The right he has in this instance

¹⁵⁹⁴ Voting trusts are but one of three methods by which a corporation may be controlled by a limited number of shareholders. The shareholders can transfer legal title of the shares, including voting rights appended thereto, to a trustee who is virtually bare of all dispositive powers whereby the trustee will be compelled to vote the shares in a manner set out by the trust deed. A voting contract can also be entered into whereby legal ownership of the shares remains in the shareholders' hands and they are bound to vote the shares in a specific manner described in the contract. Finally the corporation's residual ownership structure can be created in such a manner as to give differing voting rights to different classes of shareholders. It is to be noticed that a prescribed trust need only hold "interests in shares of the capital stock of the corporation" and it need not hold legal ownership of the shares themselves. Habitually a voting trust will hold full legal title of the shares and will issue "trust certificates", (as was the case in *M.L. McCreath Estate v. The Queen*, 1982 C.T.C. 36), however this isn't always the case and instead, as occurred in *Zeidler and Zeidler Holdings Ltd. v. Campbell*, 1989 63 Alta. L.R. (2d) 1, the shareholders may simply assign the voting rights to the trust and retain legal ownership of the shares. (See "Voting Trust Agreements and the Zeidler Case", D. Waters, E. & T.Q., Vol. 9, 1988-89, pg. 51 for an excellent discussion. For an example of a situation that appeared to be a trust but was instead a voting contract see *Birks v. Birks*, 1983 C.A. 485.) In such an instance the trust will still be a prescribed trust and if beneficial ownership of the voting rights doesn't change a disposition thereof will not be recognized. This was the opinion of the Technical Interpretations Division rendered in a T.I. in May 1978. By creating the trust out of the right to vote the shares' votes rather than the full legal ownership of the shares themselves the contributors have avoided a possible penalizing application of Sec. 75(2) if the shares pay considerable dividends. Subsection 75(2) would apply in most instances to such cases to cause exposure to double taxation of the dividends (unless they were paid out to their contributors who subsequently rely on Sec. 4(4) and the Sec. 104(19) designation). It is not clear if in the future the Department will not vicariously apply Sec. 75(2) in such a manner.

Voting trusts are not the most advantageous of creatures to execute certain arrangements when the associated corporation rules are examined; in particular Sec. 256(1.2) & (1.4). In *Hudson's Investment Co. Ltd. v. M.N.R.*, 68 D.T.C. 83, the Tax Appeal Board found that a taxpayer could control the voting of shares held in trust for some minors in that if the depositary and trustee (minor's father) would not follow the advice of and opinion of the taxpayer they would be removed, the trust terminated and resettled. Such a situation would clearly presently be subject to Sec. 256(1.4) equating control of the corporation for purposes of the associated corporation rules with the right to control the voting of the shares. Alternately Sec. 256(1.2) would apply to attribute the ownership of the entirety of the shares to the trust's beneficiaries proportionally on the value of their interests. The trust itself will continue to be recognized as owning the shares and thus there will be three ownership bases in such a situation.

is "to" the income or capital and not "to receive" it and although both rights are encompassed by the interest definitions the former will not result in the beneficiary recognizing the Division B income paid for his benefit under Sec. 104(13)(a) or (c), (not negated by Sec. 104(24)), in that they do not become payable **to the beneficiary** and thus the trust does not received a deduction under Sec. 104(6) in respect of them. Unfortunately the reformed Sec. 105(1) will usually operate to cause them to be included in the beneficiary's income, and thus double taxation may result.¹⁵⁹⁵ Even if the amount is paid to a non-beneficiary party in respect of the beneficiary's capital interest the beneficiary will have to recognize a Sec. 105(1) inclusion since Sec. 53(2)(h) could never apply to the payment by virtue of the fact that the payment wasn't made to **the beneficiary**.¹⁵⁹⁶

During Estate Administration.

The fact that in common law upon complete administration of an estate accumulated income is distributed to the beneficiaries as capital prevents their rights from being income interests described under Sec. 108(1)(e) since they are rights to what has become trust capital.¹⁵⁹⁷ If the right was to receive the property of the estate that was its income, where it remains as income, and hasn't been capitalized by the estate the right would be an income interest, as is the case with trusts. When the estate is administered however generally all income is capitalized since its last fiscal period and at that point when it becomes distributable it has ceased to be estate income but instead capital.¹⁵⁹⁸ This is also the case where the trust is to capitalize income and distribute it as capital: its source may be income, but when paid it is paid as trust capital and the related rights are based solely on this premise.

Five Basic Characteristics of Trust Interests.

There are at least five different broad attributes of rights held by beneficiaries under a trust/estate, four of which are specifically referred to in the tax law definition of the trust interest in respect of personal trusts, all of which derive their character from the intention of the settlor/testator as evidenced in the trust deed, while any particular existence of any one of them may have resounding effect upon the beneficiary's ability to realize the substance to which the right is referenced, by either affecting the time at which the right can be enforced or affecting whether the right is enforceable at all. First of all it should be recognized that the definitions of the interests, (with respect to personal trusts), consist of rights of the taxpayer as a beneficiary to or to receive capital or income of the trust and thus do not go as far as to advocate the premise that the holder has a legal interest in the particular property. Whether or not in trust law the beneficiary is regarded as having a right to enforce the trust agreement causing him to eventually realize legal title of the particular property or whether he has an interest in particular trust property directly, subject to a trust agreement, is of no concern here except that it would appear that the Act has taken the approach of the former. Where the trust agreement grants rights to its recognized beneficiaries these rights may take on four different characteristics, as rights, however the trust agreement may also grant choses in action that are not in fact rights "to or to receive" capital/income held by the beneficiary but are instead designations that allow him to acquire such rights (or have them defeated) subject to the discretion of someone described under the trust deed¹⁵⁹⁹. The difference between the latter form of trust law "interest" that the beneficiary may hold and the four former is that the latter, the "discretionary interest", is not a right to or to receive property until the discretionary power is exercised and is only a possibility while the former consist exclusively of rights of the beneficiary that can be fully ascertained at the moment of the trust creation and which draw their existence from the agreement at the initiation, and not, like the latter, from the exercise of a power subsequent to that time. The extent of the

¹⁵⁹⁵ The subsection 104(6) deduction isn't available in respect of a Sec. 105(1) inclusion if the beneficiary isn't the in specie recipient of the income.

¹⁵⁹⁶ This will not occur if the constructive recipient beneficiary is non-resident since neither Sec. 212(1)(c) nor 214(3) will apply to cause withholding tax to be collected when Sec. 105(1) applies.

¹⁵⁹⁷ See *Ansell Estate v. M.N.R.*, 66 D.T.C. 5508 (ExC.), *M.N.R. v. Trusts and Guarantee Co. Ltd.*, 1940 A.C. 138, 1 D.T.C. 499-64, *Burns Exors. v. M.N.R.*, 50 D.T.C. 748.

¹⁵⁹⁸ This isn't necessarily so in respect of specific bequests where the beneficiary is entitled to income from the property from the date of death subject to the executor's lien.

¹⁵⁹⁹ which need not exclude the particular beneficiary

involvement of the settlor/testator is the deciding factor to be recognized; if the settlor wanted a particular beneficiary to have a certain right he would have made provision for such in the agreement, (even though such a right could be defeated or fail to be granted due to the occurrence of an event specified by the settlor), while if he didn't wish the beneficiary to have the right but there was some doubt in his mind, he would have given the trustee the power to grant such a right at a time subsequent when it becomes apparent that that is what the settlor would have done himself.

Both subparagraph 108(1)(c) and (e) describe the right held by the beneficiary as "to or to receive" the substance of the trust and it is this right in respect of the substance of the trust rather than the holding of the title itself that the courts will protect should the right ever become enforceable, and it is upon the ability of the holder of the right to sue for the enforcement of such a right through court action that the four broad attributes have effect. The term "interest" in a trust/property etc. is capable of having a variety of meanings however for the purpose of the Act a trust "interest" is defined as **a right**, (in the case of a personal trust), **to income or capital or to receive such**¹⁶⁰⁰ and as such the right with its indisputable scope must have arose from somewhere, in this case the expressed intention of the settlor/testator or some other person, (in the case of a discretionary interest). In respect of personal trusts both Sec. 108(1)(c) and (e) provide that **a right** to receive or to income or capital of the trust whether it be "immediate or future and whether absolute or contingent" shall be an "interest" for the purposes of the Act if held by the taxpayer **as a beneficiary**, and it is these four basic attributes, all meticulously defined legal concepts, that apply to describe the specific manner in which a right may be enforced and specify circumstances which cause the right to lose its enforceability.

A right granted under a trust may be enforceable either "immediately" or "in the future" being that the right to enforce the trust agreement may have vested indefeasibly in the holder, (whereby it would not be defeasible at some later time), however due to the intentions of the settlor expressed in the trust deed the holder of the right cannot, before the specific time expressed in the deed, sue for the execution of the agreement causing the legal title to the particular property to be obtained by him. The effect of the impairment in the timing of the enforceability of the right allows the property to be held in trust, and utilized to produce income/capital, without causing the ultimate right to enforce the agreement (and receive the property) held by the taxpayer to be permanently impaired. On the constituting of the trust all of the beneficial interests must be known (ascertainable) and in the case of a future right the holder is recognized to be the relevant beneficiary only he cannot realize the benefits until a specified later time. Obviously an "immediate" right is one that is enforceable immediately however in order to do so the taxpayer must hold that right at the time and thus whether or not the right is "absolute or contingent" is the second dimension of such trust interests that relates directly to whether the taxpayer will always hold such a right or whether he can gain or lose it at some time as specified in the trust agreement. Some have advocated that future rights are those that can be obtained in the future regardless of whether or not the ownership thereof exists in the present even going as far to describe every possible taxpayer as owning every possible future right in every possible trust, however, such a literalist approach, demented as it may be, can simply not be supported by the context of the definitions. The property which is defined as a capital or income interest is a **right** held by the taxpayer in the capacity of a beneficiary and until such a right is held by the taxpayer he does not hold an income or capital interest.

A power of appointment cannot be recognized as a future right since until that power is exercised no beneficiary rights exist at all. The exercise of the power creates the right and until it is exercised the taxpayer ultimate recipient cannot be described as having a right enforceable in the future. Are power holders recognized as beneficiaries under a trust if they can appoint property out from under the trust to anyone, including themselves? They are beneficially interested to the extent that they have exercised their powers favourably in respect of themselves and until that time they simply have the power to determine the course of ownership of the property which cannot be equated to any sort of **right** to benefit from it. If this were not the case, as some have advocated, then there would be considerable administrative problems arising on the death or cessation of residency of any taxpayer since any taxpayer could be the potential recipient of a future right. The capital and income interest definitions were enacted initially at a time when the Estate Tax Act was in force and in that Act there is virtual statutory assimilation of powers of appointment with interests in trusts

¹⁶⁰⁰ while in the case of a non-personal trust a capital interest includes **any** right under the trust

from purposes of estate tax application. If Parliament recognized such in respect of the Estate Tax Act, and felt the importance to resultingly provide statutory law, why did they not do so in respect of the Income Tax Act?

In order to be enforceable at a particular time the right, at that particular time, must have vested in the holder and "vested"¹⁶⁰¹ can be defeasible at some later date or be indefeasible being that the holder can never lose the right due to some event or passage of time. An "absolute" right has the character of the latter, being that ownership thereof is absolute and is not dependent upon any other factors to cause ownership to be complete. When the right is absolute it is also indefeasible while if the ownership of the right is dependent upon the occurrence of an event/passage of time, which operates to cause it to be acquired absolutely or lost then the right is "contingent" and in being a contingent right it must first be a right that becomes enforceable or loses its enforceability upon the occurrence of an event/passage of time as described in the trust deed.

A right to, or to receive, trust property may be absolutely vested in the beneficiary whereby nothing remains to be done either by the beneficiary, the trustee, or any other person in order for the beneficiary to enforce his right. "Absolutely" vested may also be equated to, in general terms, "vested indefeasibly" which is a condition in respect of spousal trusts described in Sec. 70(6) to denote a vesting of beneficial title to property to be defeated. Effectively, in order to be considered absolutely vested, the beneficial title must have been granted without precondition nor subject to a power of revocation, and must have been complete in that no event subsequent could divest it from the holder while the beneficiary must be seen as not to be required to fulfill any condition in order for him to maintain its validity. "Contingent" rights are those that are vested subject to divestment, (or vice versa), with conditions subsequent or precedent that become effective (or lose their validity) upon the occurrence of an event that must be specifically and meticulously described in the trust agreement. A contingent right under a trust agreement is not simply a right that can be divested or vested upon any contingency arising after the constituting of the trust but instead is a right which is vested etc. upon a contingency specified in the trust agreement.

In *McCreath Trust v. The Queen*¹⁶⁰² a taxpayer reserved for herself through a series of transactions a contingent interest in a trust and Judge Addy provided:

"This interest so created by the deed of settlement was an interest in expectancy, a contingent interest in the corpus of the fund and not a vested interest subject to be divested by a condition subsequent."

As stated by Halsbury, Third edition, Volume 39, paragraph 1657 at page 1122. "Contingency in description of donee or subject matter of gift.":

"An estate or interest must remain contingent until there is a person having all the qualifications **that the testator requires** and completely answering the object of his bounty given in the will."

The rest of that definition, was also relied upon in *Fast v. Van Vliet*¹⁶⁰³ which provided:

"...Where the postponement of the gift is on account of some qualification attached to the donee, the gift is prima facie contingent on this qualification being acquired. Thus a gift to a person, "at", "if", "as soon as", "when", or "provided" he attains a certain age, without further context to govern the meaning of the words is contingent, and vests only on attainment of the required age, **this being a quality or description, which the donee must in general possess, in order to claim under the gift.**"

Although one continually encounters a bastardized use of the term "contingent" to describe rights which came into existence upon the exercise of a discretionary power or power of appointment, in the author's opinion, for purposes of the ITA, Parliament recognized the technical use of the term with respect to trust interests and referenced the Sec. 108(1)(c) and (e) interest definitions accordingly. If the term "contingent" is also meant to capture discretionary interests why do both Sec. 74.5(10) and 94(7), both defining states of being "beneficially interested" (albeit not necessarily solely in the capacity of a beneficiary), refer to **both** "contingent" rights **and** rights that are "conditional on or subject to the exercise of a discretionary power..."?

1601 being nothing more elaborate in this instance than an indication of ownership

1602 81 D.T.C. 5338 (FCTD)

1603 49 D.L.R. (2d) 616

Clearly the legislators felt that the former term did not encompass the latter instance and took steps to clarify and alleviate the deficiency in targeting¹⁶⁰⁴.

In order for the interest to be validly created the contingent event must be accurately described in that, if need be, a court must be able to ascertain how the divesting or vesting will occur. The contingent right is a right of the beneficiary to enforce the execution of a trust agreement that becomes enforceable or loses its enforceability only upon the occurrence of the event described, and while the enforceability thereof may be impaired until the event transpires the beneficiary can still be said to have a right, to or to receive, the property but only when that event transpires. The critical factor that only determines the enforceability is that of the occurrence of an event described in the trust deed and it has no bearing on the question of whether or not the beneficiary has a right, clearly given by the trust deed. A contingent right is essentially a gift made that requires a certain event to transpire or certain conditions to be maintained etc. before it is recognized to be complete, and while it is the settlor of the property in the trust who determines whom should have such a right and what the basis of its enforceability will be, they represent alternatives to absolute rights which offer a greater degree of flexibility. Examples of such "gifts from the grave" include beneficial rights that are contingent upon such things as the beneficiary's attaining of a certain age, (one of the more common forms), the pursuit and attainment of a particular form of education at a particular university etc., which will cause the beneficiary to be in no legal position to enforce the trust agreement until such events occur at the time of which the right will vest automatically, though possibly subject to an impairment in the timing of the enforceability. One must recognize that although the right may be subject to contingency terms that allow it to vest in the beneficiary at a certain time, there may be further contingency clauses that may cause it to divest subsequent to the date at which it initially vested. The classic "shifting clause" may operate to cause a particular trust right to vest in one person after divesting from another in a series of events such as the attaining of a certain age of parties described under the trust and thus the shifting clause transfers beneficiary status amongst several parties. The contingent event need not be related in any manner to the possible recipient of the right while if it is then the beneficiary may be in some position of control so as to control the possible vesting. The important aspect about contingent rights, be they under an estate, or *inter vivos* or testamentary trust, is that they are dependent upon the satisfying of conditions imposed by the settlor of the trust, and not by anyone else, and that the conditions must be clearly described in that the contingent event must be clearly ascertainable and the restrictions, if placed upon the occurrence of the event, must also be clear.¹⁶⁰⁵

Discretionary Interests.

A taxpayer may have an "interest" in/under a trust agreement but that doesn't necessarily mean that he has a right to or to receive some trust property and while such basic legal reality can be clearly ascertained for example from Article XX of the Canada-U.K. Tax Convention, paragraph 2 (where they made reference to both interests and rights under trusts and estates), it becomes extremely important when one attempts to ascertain whether an interest holder has a tax recognized capital or income interest in the trust as per the Sec. (108)(1)(c) or (e) definition thereof. Both definitions of "interests" offered by the Act in Sec. 108(1)(c) and (e) refer only to rights to, or to receive, capital or income in the case of a personal trust, that are either immediate or future, absolute or contingent but nonetheless are rights granted in the agreement that will ultimately cause vesting of legal title to the particular trust property in the right holder¹⁶⁰⁶. With respect to the four basic attributes of the rights the settlor has expressed the intention that the conveyancing of the legal title to the trust property or its use will occur as specified be it in the future, immediately or whether it will occur absolutely or contingently however in all cases the settlor will be the party who will determine to whom legal title will vest and how. Once the trust agreement is constituted¹⁶⁰⁷ the legal title to the property will eventually

¹⁶⁰⁴ though whether they did so completely is another question

¹⁶⁰⁵ See "The Nature of The Trust Beneficiary's Interest", D.W.M. Waters, 1967, C.B.R. 219, for an excellent article.

¹⁶⁰⁶ while in the case of a non-personal trust any right, regardless of whether or not it's to, or to receive property will be considered a capital interest

¹⁶⁰⁷ in the absence of a revocable power held by the settlor or where all of the beneficiaries thereunder decide to wind up the trust

vest in the beneficiary as per the specifications however it is in respect of this rigidity, (even when contingencies are expressed), that discretionary powers, and discretionary "interests" become attractive to the settlor in ensuring that the most advantageous disbursement of benefits, vesting of the title, occurs amongst any given group of beneficiaries. There are two broad categories of discretionary powers that when granted to trustees or other persons allow them to decide in their discretion or as per the fiduciary obligations attached thereto, to whom title will ultimately vest and/or when it will vest however as a requirement of certainty and subject the power can be exercised by the holder only in respect of the beneficiaries described, (or class of such), in the trust agreement/will. The power cannot be exercised in respect of **any** person but only those specified in the trust deed/will and while the settlor may go further and place additional limitations on the power such as validity only within a certain time period it should be recognized that the power can affect whether beneficiary rights are acquired by a particular party or when rights that are non-discretionary may be enforced. The discretionary power which affects whether beneficiary rights are acquired by a particular beneficiary can be either a mere power or a power in trust, the latter requiring an exercise¹⁶⁰⁸ while the former need not be exercised at all, instead allowing the trust to operate to its preconceived result. In the former case the property which supports the right that could result will not be recognized as intestate or an incomplete gift if the power isn't exercised in that usually a clear direction can be ascertained to activate the gift-over while in the instance where it is not exercised, no side effects will be realized. The trust deed will resultantly operate to redirect the benefits to the other specified parties.

In the Aust. case of *Scaffidi -V- Montevento Holdings Pty Ltd*¹⁶⁰⁹, a case well worth consuming on so many issues that is replete with sound jurisprudence, it was held:

24 The Trust Deed created a discretionary trust. **The term 'discretionary trust' does not have a constant, fixed normative meaning, in the absence of an applicable statutory definition. See *CPT Custodian Pty Ltd v Commissioner of State Revenue of the State of Victoria* [2005] HCA 53; (2005) 224 CLR 98 [15] (Gleeson CJ, McHugh, Gummow, Callinan and Heydon JJ).** It has been held that a discretionary trust, strictly so called, of its nature, confers on the beneficiaries no more than a right of due administration. See *Kent v SS 'Maria Luisa' (No 2)* [2003] FCFCA 93; [2003] FCAFC 93; (2003) 130 FCR 12 [59] (Tamberlin and Hely JJ). A beneficiary of a so-called discretionary trust will have an equitable proprietary interest in the assets of the trust fund only if the provisions of the trust instrument create that result. See *CPT Custodian* [15]; *SS 'Maria Luisa' (No 2)* [60].

25 In the present case, the Trust Deed does not confer on any of the beneficiaries a vested interest in the capital or income of the Trust Fund. The Trust Deed grants the Trustee a discretionary power, within prescribed limits, to distribute capital or income in favour of one or more of the beneficiaries, as determined from time to time by the Trustee in its discretion. None of the beneficiaries has any right or entitlement to any capital or income unless and until the Trustee exercises its power to make a distribution in his or her favour.

...

69 In the 1970s discretionary trusts flourished in Australia. They were a taxation avoidance device. **In addition to reducing the amount or incidence of income tax, and gift, estate and death duties, discretionary trusts offered flexibility and procedural simplicity.** See Hardingham and Baxt, *Discretionary Trusts*, 1975, chapters 7, 8 and 9; Grbich, Munn and Reicher (eds), *Modern Trusts and Taxation*, 1978, 1-2; GL Davies, 'Some Problems with Discretionary Trusts', (1974-75) 9 *Taxation in Australia* 415; DH Bloom, 'The Discretionary Trust - Some Practical Implications', (1974-

¹⁶⁰⁸ which may be required to occur within a specific time period. in a Technical Interpretation provided in Sept. 1978 the Non-Corporate Rulings Division Director opined that the word "contingent" in Sec. 108(1)(c) is broad enough to include a situation in which a trustee could exercise his discretionary powers to pay part of the capital to the beneficiary. The same Department provided a similar opinion in Aug. 1978.

¹⁶⁰⁹ [2011] WASCA 146 (7 July 2011), see also another Aust. case of *Cobden Lime Pty Ltd v Commissioner for State Revenue (Taxation)* [2010] VCAT 1278 (4 August 2010) for issues raised as to whether a party could stand as a beneficiary before a discretionary power was exercised to give beneficiary rights.

75) 9 *Taxation In Australia* 586; DKL Raphael 'Problems in Discretionary Trusts - What? Why? and How?', (1975-76) 10 *Taxation in Australia* 662; DG Hill, 'Comments on "Problems in Discretionary Trusts"', (1975-76) 10 *Taxation in Australia* 674; TW Magney, 'A Comparative Analysis of Estate Planning Vehicles', (1977-78) 12 *Taxation in Australia* 222.

The major difference between a trust "interest" described in Sec. 108(1)(c) or (e) and the "discretionary interest" is that the trust "interest" as defined for the purposes of the Act is a right to or to receive property of the trust, (in the case of a personal trust), while a "discretionary interest" is not such a right but is only a right to have the discretionary power exercised¹⁶¹⁰. The exercise of the discretionary power which affects whether or not creation of the right occurs is the event which gives rise to the right to or to receive trust property in that it is only at that time that a beneficial title, with its accompanying rights, is granted to the beneficiary. Until such a power is exercised the beneficiary has absolutely no right to or to receive any of the trust property via a right granted under the trust agreement that is enforceable but instead has only the right to be potential recipient of a favourable exercise of the discretionary power. That is as far as his "right" extends under the trust agreement.¹⁶¹¹ It should be recognized that the discretionary power may operate so as to impair or negate an already existing right to or to receive the property whereby if exercised divesting of the previously established right will occur and thus such a right is properly described as a contingent based on the exercise of the power. One cannot say that this applies vice versa since a right will not have been created prior to the exercise of the power. If the power is a trust discretionary power and in order for the beneficial title of the property to vest in anyone the power must be exercised, there will not be a corresponding contingent right in existence and in respect to subject property all of the potential beneficiaries will stand in otherwise equivalent positions.

In *Rispin*¹⁶¹² a will provided that the trustee was authorized in his discretion to pay trust income to a testator's offspring and it was held that the offspring had no rights to capital or income of the trust until such an exercise of power occurred. In *Cole Trust v. M.N.R.*¹⁶¹³ the type of right held by an infant under a trust agreement was the topic of litigation. Counsel for the Minister referred to *Re: Vestey's Settlement*¹⁶¹⁴ and commented on the trustee's discretionary power to pay rather than to allocate:

"...how could the beneficiary enforce the payment. The beneficiary's right was dependent upon the discretion of the trustee and the trustees could change the discretion...because something else might come to light and a trustee is not acting in the capacity where he makes one decision and then that decision sticks forever... I found no authority which would say that once the trustee has expressed an intention as to how he is going to exercise the discretion that there is any way that the beneficiary could enforce that declaration. The discretion given to the trustee is to make a payment and until that is done he could change his mind even if he had decided it, to make the payment to the beneficiary at sometime in the future. "

One of the issues in the case was whether the beneficiaries had rights to have the income payable to them and whether they existed prior to the exercise of the discretionary power, even when the beneficiaries had recognized the income in their returns. The Chairman thought otherwise.

Perhaps the most famous case concerning the nature of a discretionary "interest" is that of *Gartside and another v. I.R.C.*¹⁶¹⁵ where at pg. 574-5 *Salman L.J.* describes the nature of this property:

"*Snell's Principles of Equity* 25th ed. (1965) p.129 in my view correctly states the position thus:

"A discretionary trust is one which gives the beneficiary no right to any part of the income of the trust property, but vests in the trustees a discretionary power to pay him or apply for his benefit such part of the income as they think fit... The beneficiary thus has no more than a hope that the discretion will be exercised in his favour. "

¹⁶¹⁰ which makes it a capital interest in the case of a non-personal trust

¹⁶¹¹ See *Ontario v. Henson*, 36 E.T.R. 192.

¹⁶¹² (1912) 25 O.L.R. 663

¹⁶¹³ 81 D.T.C. 8

¹⁶¹⁴ [1970] 2 All E.R. 891 (C.A.)

¹⁶¹⁵ [1968] A.C. 553

...The only right which any discretionary object possess in addition to his chance or prospect is the right that the trustees shall honestly and fairly consider whether any, and if so what, part of the income shall be allocated to him. In a sense it may be difficult to appreciate how discretionary objects, who have only such a limited right and only such an uncertain chance or prospect of receiving anything, can be said to have any legally recognizable **interest** in the trust property. Once, however it is conceded as an authority it must be, that they have such an interest, it is even more difficult to see how that interest can properly be described as an interest in expectancy. They are in possession of the right and of the chance or prospect to which I have referred. The value of the right and of the chance or prospect no doubt depends upon how the trustees exercise their discretion. But the discretionary objects at all times enjoy the right and the chance or prospect whatever its value may turn out to be. A person who has a vested interest to receive money out of a trust fund on the happening of an event, his right becomes a right of possession. **The nature of his interest in the fund is determined by the nature of his rights.** When, however, a discretionary object is paid some of the income, it is not in my view accurate, having regard to the nature of the right, to say that his right is then vested in possession. **He has not even then and never has had any right to be paid any part of the income he receives. On the other hand, he has at all times enjoyed and been in possession of the right and chance or prospect which I have described. It may be tempting to say that a chance or prospect is something enjoyed in expectancy and that, when it comes off, it is enjoyed in possession. But this in my view is a fallacy, for when it comes it ceased to be a chance or prospect and is not as such enjoyed at all. By its very nature, as long as it exists it is in possession.**"¹⁶¹⁶

The definitions of "capital" and income interests for the purposes of subdivision k and as defined through Sec. 248(1), for purposes of the Act, in application to personal trusts are not wide enough to include discretionary "interests" in that they both refer quite precisely to "rights to, or to receive" trust property, and with this in mind one must also recognize that section 108 contains many particularly structural and meticulously defined concepts upon which the Act operates which deviate materially from those inherent in trust law.

This however was not the recent opinion of the Fed. Appeal Ct. in *Her Majesty the Queen and Propep Inc.*¹⁶¹⁷ where the court had to consider whether a discretionary beneficiary was "beneficially interested" in a trust for purposes of the associated corporations rules. It provided:

[18] Even assuming that Pierre-Marc Paquette's right was subject to a suspensive condition that had not yet been realized and that, according to the applicable civil law, Pierre-Marc Paquette was not a beneficiary of the trust—issues that this Court need not address and on which it expresses no opinion—the TCC judge seems to have lost sight of the fact that the trustees could, in exercising their discretion and at the time of their choosing, wind up 9059, thereby giving rise to Pierre-Marc Paquette's right as the sole beneficiary. I note that all of the capital stock of 9059 was part of the trust patrimony

...
[20] In any event, the TCC judge could not conclude that Pierre-Marc Paquette was not a beneficiary of the trust simply because his right was conditional on the winding-up of 9059. In so finding, the TCC judge failed to consider that, for the purposes of the Act, income interest in a trust, even when subject to a condition, is a right that is regarded as absolute. This follows from the definition of "income interest" at subsection 108(1) of the Act. It goes without saying that a person who has income interest in a trust is a beneficiary of that trust.

[21] By ignoring subsection 108(1), the TCC judge seems to have accepted the respondent's argument that this provision only applies for the purposes of Subdivision k (respondent's memorandum, para. 40). That is indeed the wording of subsection 108(1) ("In this subdivision" in the English version and "Les définitions qui suivent s'appliquent à la présente sous-section" in the French version). However,

¹⁶¹⁶ The substance of this quote should do away with the submission that a discretionary object has a "contingent" interest.

¹⁶¹⁷ 2009 FCA 274

subsection 248(1), which defines this same expression for the purposes of the whole Act, ("In this Act" in the English version and "Les définitions qui suivent s'appliquent à la présente Loi" in the French version), adopts the definition given at subsection 108(1). Pierre-Marc Paquette therefore had "income interest" in the trust for the purposes of the Act, even though his right was contingent.

[22] The TCC judge also failed to consider the expression "beneficially interested" ("droit de bénéficiaire" in the French version) as defined at subsection 248(25). A taxpayer is deemed to be "beneficially interested" when that taxpayer has a right, "whether absolute or contingent", to receive income or capital of a trust.

[23] The TCC judge seems to be of the opinion that this definition does not apply here because the expression "beneficially interested" is not used in either of the provisions dealing with associated corporations (256(1)(c), 256(1.2) and 256(1.3)) (reasons, para. 42).

[24] With respect, the expression "beneficially interested" does not have to be reproduced in each provision where it is likely to be applied. This concept applies each time the question arises whether a person is "beneficially interested" in a particular trust. A person who has a contingent right to the capital or income of a trust is "beneficially interested" for the purposes of the Act.

In *Lyrtech RD Inc. v. Her Majesty the Queen*¹⁶¹⁸ the Tax Court had to consider the same subsections and held:

[38] The respondent contends that the subsidiaries of Lyrtech, namely 4296621, 4296630 and 4296648, all had a future and conditional right, in equity or otherwise, to all the shares of the appellant's capital stock as beneficiaries of FFL's capital. Under paragraphs 9.1 and 9.2 of the trust deed, the trustees had absolute discretion to eventually distribute all the shares of the appellant's capital stock to one or more beneficiaries. Paragraphs 9.1 and 9.2 of the trust deed read as follows:

9. CAPITAL DISTRIBUTIONS

9.1 During the term of the Trust, the Trustees may, in their absolute and uncontrolled discretion, at any time, withdraw from the capital of the Trust and make payments of such withdrawal to one, the other or any combination of Capital Beneficiaries, in the proportions that the Trustees may determine in their absolute and uncontrolled discretion.

9.2 At the Time of Division, the Trustees shall deliver the remaining capital for the Trust and accumulated income of the Trust to one, the other or any combination of Capital Beneficiaries, in the proportions that the Trustees may determine, in their absolute and uncontrolled discretion.

[39] The CRA is of the opinion that paragraph 251(5)(b) of the Act applies to beneficiaries of a discretionary trust holding shares of the capital stock of a corporation, unless it is clearly shown in the trust deed that they will never be entitled to become owners of these shares or to control the voting rights attached to the shares. The CRA stated in the following terms, in external interpretation 2007-0246721E5 dated February 20, 2008, its position regarding related companies, at page 6:

[TRANSLATION]

There is no consensus, however, on the application of paragraph 251(5)(b) in a trust context. Some feel that discretionary beneficiaries of a trust have no right to trust property as long as the trustees' discretion is not exercised in their favour. On the other hand, others consider the wording of paragraph 251(5)(b) broad enough that it could in fact apply to a discretionary beneficiary of a trust's capital.

It should be noted that in a technical interpretation (F9730395), we have already stated that paragraph 251(5)(b) could apply to beneficiaries of a trust. We did

specify, however, that paragraph 251(5)(b) could not apply to beneficiaries of a trust who held shares in a corporation if, under the terms of the trust agreement, the beneficiaries could never obtain ownership of the corporation's shares or control the voting rights attached to these shares.

[40] The appellant for its part submits that the beneficiaries of an entirely discretionary trust do not possess a right referred to in paragraph 251(5)(b) of the Act as they do a right of first refusal or a right resulting from a forced purchase/sale provision ("shotgun arrangement") included in a shareholder agreement.

[41] The appellant's position is based on paragraphs 10.1 and 10.2 of the trust deed, which state that the persons designated as beneficiaries are only potential beneficiaries of the trust and that until they have received some part of the revenue or capital of the trust, they have no right, either pursuant to a statute or under the trust deed, as beneficiaries of the trust. Paragraphs 10.1 and 10.2 of the trust deed state the following:

10.1 For greater certainty, it is specified that the persons designated as Beneficiaries are merely potential beneficiaries of the Trust.

10.2 As a result, insofar as they shall not have received any part of the Revenue or the Capital of the Trust, a person designated in subparagraph 1.1(a) shall have no right, either by law or pursuant to the terms of the present Agreement, as a beneficiary of a trust, including, without limiting the generality of the foregoing, the right of supervision and control over the Trust, the right to examine the trust records, the right to require the Trustee to furnish any account, report or information, the right to examine the books and vouchers relating to the administration of the Trust and the right to ask for or to obtain a final accounting.

[42] FFL was created under the laws of Quebec and the respondent does not dispute its validity. The language used in paragraphs 10.1 and 10.2 of the trust deed is intended precisely to avoid the application of subsection 248(25) of the Act.

[43] In an article entitled "Strangers in Strange Lands: The Hidden Traps of Offshore Trusts", published by the Canadian Tax Foundation in the 1999 annual conference report at pages 40:1 et seq., Guy Fortin reviewed the doctrine and case law related to the application of subsection 248(25) of the Act to the interest of a beneficiary under a discretionary trust. His study showed that the two following conclusions were inescapable: (a) first, the right held by a beneficiary of a discretionary trust is in the nature of a limited personal right as opposed to a proprietary right in the trust property and only entitles the beneficiary to be considered as a potential beneficiary of the trust, the beneficiary's only recourse being against the trustee or trustees if they committed a breach of duty in exercising their discretion; (b) second, despite the legal nature of a beneficiary's right under a discretionary trust, the wording of a statutory provision may be very broad so as to include the personal right of a beneficiary under a discretionary trust. The following excerpt from page 40:12 of Mr. Fortin's article clearly sets out the findings of his study:

Under a discretionary trust, where the trustee is obliged to distribute the whole of the income (or capital or both) among the potential beneficiaries in the manner that he or she sees fit, the interest of the beneficiary cannot be described as a proprietary right. It is merely a limited personal right to be considered as a potential beneficiary that can be exercised only against the trustee. The right of a beneficiary under a non-exhaustive discretionary trust is even more limited in that, under such a trust, the trustee can choose whether and to what extent a distribution is to be made at all. However, it appears from an examination of the doctrine and jurisprudence on this issue that despite the legal nature of the interest of a beneficiary under a discretionary trust, in

practice the language of a particular statutory provision may be drafted in a manner that is broad enough to bring within its ambit the non-proprietary interest referred to above. In the context of tax law, the result may well be that the non-proprietary interest of a beneficiary under a discretionary trust could be covered by the definition.

...

[44] In an article entitled "Discretionary Trusts: Civil Law Perspectives", published in the *Canadian Tax Journal* (2003), Vol. 51, No. 4, pages 1647 et seq., Marilyn Piccini Roy describes the nature of the rights of a beneficiary of a discretionary trust governed by the *Civil Code of Québec* as follows, at pages 1670 and 1671:

The beneficiaries' rights are personal in nature and may therefore be exercised only against the trustees. . . .

...

It follows that the right of beneficiaries under a discretionary trust is not a right to receive income or capital under the trust. It is a limited right that entitles them to make a claim against the trustees if the trustees refuse to exercise their discretion or if the discretion is exercised improperly.

By contrast, the holder of a power of appointment is not subject to such control. The principal reason is that a power of appointment does not revolve around the notion of predetermined beneficiaries; it merely confers upon a potential appointee the opportunity to become a beneficiary. . . .

...

... The beneficiaries and the amounts of the entitlement are not fixed until the trustees have appointed the beneficiaries and indicated the extent of the benefit. . . . until their appointment, they have no claim or right except to force the trustees judicially to perform their obligation to exercise their discretion.

[45] In *Sachs v. Canada*, [1980] F.C.J. No. 611, paragraph 26, Heald J.A. of the Federal Court of Appeal described as follows the right of beneficiaries of a discretionary trust to receive trust capital:

...

... The situation of a beneficiary under a discretionary trust was described by Lord Wilberforce in the case of *Gartside et al. v. Inland Revenue Commissioners* as follows:

No doubt in a certain sense a beneficiary under a discretionary trust has an "interest": the nature of it may, sufficiently for the purpose, be spelt out by saying that he has a right to be considered as a potential recipient of benefit by the trustees and a right to have his interest protected by a court of equity. . . .

...

[46] Despite the personal nature of the right of the beneficiaries of FFL's capital and the precariousness of this right, it seems to me that subsection 248(25) is broad enough to apply thereto.

[47] In *Propep Inc. v. Canada*, [2009] F.C.J. No. 1155, Noël J.A. of the Federal Court of Appeal clearly states at paragraph 22 that a taxpayer is deemed to be "beneficially interested" when that taxpayer has a right, "whether absolute or contingent", to receive income or capital from a trust. In that case, the right of a beneficiary to receive income or capital from a discretionary trust was conditional on the winding up of a company.

[48] According to counsel for the respondent, a "conditional right" is broad enough to include cases where a discretionary power must be exercised in order for a fact to arise. The exercise of a discretionary power is a future and uncertain event that may or may not happen.

[49] Once it has been determined that each beneficiary of FFL's capital was "beneficially

interested" within the meaning of subsection 248(25), it should be considered whether they were also "beneficially interested" for the purposes of subparagraph 251(5)(b)(i).

[50] The expression "beneficially interested" does not appear in paragraph 251(5)(b), but in *Propep Inc.*, *supra*, Noël J.A. held that the expression "beneficially interested" applied for the purposes of provisions dealing with associated corporations, namely paragraph 256(1)(c) and subsections 256(1.2) and 256(1.3), even though the expression "beneficially interested" was not used in any of these provisions. At paragraph 24 of the decision, Noël J.A. stated the following:

With respect, the expression "beneficially interested" does not have to be reproduced in each provision where it is likely to be applied. This concept applies each time the question arises whether a person is "beneficially interested" in a particular trust. A person who has a contingent right to the capital or income of a trust is "beneficially interested" for the purposes of the Act.

[51] Moreover, it must be noted that the rights referred to in paragraph 251(5)(b) are not limited to those resulting from a contract. As Mahoney J. of the Federal Court indicated in *Lusita Holdings Limited v. The Queen*, [1983] 1 F.C. 439, paragraph 3, affirmed on appeal [1984] F.C.J. No. 414 (QL), they could also be, as in the present case, rights held "in equity or otherwise". Collier J. of the Federal Court also adopted this approach in *Rostal Sales Agency Ltd. v. Canada*, [1982] F.C.J. No. 153, at paragraphs 13 and 14.

[52] The wording of paragraph 251(5)(b) is very broad in scope such that a person who, under a contract or otherwise, has a future right to shares or to acquire shares, is deemed to be in the same position in relation to the control of the corporation as if the person owned the shares at that time.

[53] The fiction in paragraph 251(5)(b) relates to the concept of ownership of shares and not the concept of control of shares. Malone J.A. of the Federal Court of Appeal stated the matter in the following terms in *Sedona Networks Corp. v. Canada*, 2007 FCA 169 at paragraph 27:

In my analysis, the legal fiction created by the paragraph 251(5)(b) is directed at the concept of ownership, not control. Once it is determined that a person has an option to acquire treasury shares that falls within the scope of paragraph 251(5)(b), it is necessary to assume that the option is exercised and the related shares are actually acquired by the holder of the option. . . .

[54] The question to be determined at this stage is whether the beneficial interest of each beneficiary of FFL's capital is a right within the contemplation of paragraph 251(5)(b).

[55] I do not believe that the beneficial interest of each beneficiary of FFL's capital is a right within the contemplation of paragraph 251(5)(b), considering the wording, context and object of that paragraph. It seems to me that the nature of the beneficial interest of each beneficiary of FFL's capital is too aleatory, uncertain or indirect to be a right to the appellant's shares under paragraph 251(5)(b). The beneficial interest in question here does not confer any right on the holder of that interest to acquire shares in the appellant.

[56] I highly doubt that Parliament's intent was for subsection 248(25) to apply to paragraph 251(5)(b) because the concept of beneficial interest is far too broad in scope and much too vague for it to apply to the concept of *de jure* control for the purposes of the definition of "Canadian-controlled private corporation".

[57] If Parliament had intended that the beneficiaries of the income and capital of a discretionary trust be deemed owners of the shares that are part of the trust property, it would have clearly expressed that intent, as it did by introducing paragraph 256(1.2)(f) into the Act for the purposes of the rules concerning associated corporations. Paragraph 256(1.2)(f) reads as follows:

Control, etc. — For the purposes of this subsection and subsections (1), (1.1) and (1.3) to (5):

. . .

(f) where shares of the capital stock of a corporation are owned, or deemed by this subsection to be owned, at any time by a trust,

...

- (ii) where a beneficiary's share of the accumulating income or capital therefrom depends on the exercise by any person of, or the failure by any person to exercise, any discretionary power, those shares shall be deemed to be owned at that time by the beneficiary . . .

...

[58] To achieve such an end, Parliament could simply have reproduced the concept from paragraph 256(1.2)(f) for the purposes of subsection 251(2) and the definition of "Canadian-controlled private corporation", as it did in subsection 256(1.4), a provision similar to paragraph 251(5)(b).

[59] Parliament's inaction in not reproducing the concept from paragraph 256(1.2)(f) for the purposes of *de jure* control of corporations whose shares are held by discretionary trusts tends to confirm that the rule laid down by the Supreme Court of Canada in *M.N.R. v. Consolidated Holding Co.*, [1974] S.C.R. 419—i.e. that control of a corporation, the majority of the shares of which belong to a trust, is in the hands of the trustees who can bind the trust—is satisfactory and adequate.

Most obvious of this deviation in tax definition from common law definition is the case of the "settlor" of a trust, while another one consists of "testamentary trusts". In both cases the tax law definitions vary greatly with the recognized trust law definitions and it can be said that, consistent with Parliamentary intention as evidenced in those two cases, the definition of "capital" or "income interest" with respect to personal trusts was formulated so as to preclude discretionary interests from obtaining the Sec. 108(1)(c) or (e) status of the property. If the Act had instead been amended so as to provide that for its purposes a "capital" or "income interest" was an interest, held by taxpayer as a beneficiary under the trust, in the appropriate property then tax practitioners and authorities would have to rely on the common law definition of "interest" under a trust as opposed to rights under a trust to ascertain the nature of the beneficiary's property. In the *Minister of Revenue for the Province of Ontario v. McCreath*¹⁶¹⁹ the Supreme Court of Canada held that where a settlor had reserved herself a position of discretionary beneficiary under a trust created by herself in which she wielded the discretionary power she was considered to have an **"interest"** in the trust which caused her not to be recognized as having totally divested herself of the property for the purposes of succession duties. The Succession Duty Act R.S.O. 1969 operates upon the holding of an "interest" in a trust in the above respect which causes the trust property to be caught for succession duty, but the important note to be made is that the term **"interest"** was taken to include discretionary interests. The difference between that Act and the ITA is that the latter goes on to specify in meticulous terms and with narrowing effect, that a "capital" or "income" "interest" consists of a right to or to receive trust property, though subject to a discretion.

Some could argue that the above is far too narrow an interpretation of the intent of Parliament and that instead rights to obtain an income or capital right upon the exercise of a discretionary power are caught by the definitions. Upon an examination of two similar provisions in the Act, that may shed light on this phenomenon, subsections 74.5(7) and 94(7), one should recognize that this is not true. Subsection 94(7) provides, for purposes of section 94 only (similar to Sec. 74.5(10) in respect of sections 74.1 to 74.5), that a person is "beneficially interested" in a trust if he "has **any right** (whether immediate or future, whether absolute or contingent or whether **conditional or subject to the exercise of a discretionary power by any person or persons to receive** any income or capital of the trust...". Although the draftsmen of the provision made provision for instances where a trust right could be defeated by the exercise of the power of discretion, or be impaired by it, they failed to include as being "beneficially interested" those parties which had no right to receive the trust income or capital but could acquire such upon an exercise since the provision refers only

1619 [1977] 1 S.C.R. 2

to **holders of rights to receive** that are subject to the six possible attributes, not holders of rights to be considered as possible recipients of such rights under a discretionary power.¹⁶²⁰ It should also be recognized that the two "beneficially interested" definitions define a state of being rather than a category of property and thus one has to recognize that since there is no bridging interpretation definition offered in Sec. 248(1) for "beneficially interested" or "beneficial interest", they cannot be relied upon to identify holders of beneficial interests for other purposes other than the sections described.¹⁶²¹ The contingent-discretionary interest distinctiveness is inherent in the ITA but not in the provincial Trustee Acts where a "contingent right" is defined, **as applied to land** and for purposes of the relevant Act, to include "a possibility coupled with an interest, whether the object of the gift or limitation of that interest or possibility is or is not ascertained." This definition, if it is applicable for purposes of the ITA, (and it could easily be argued otherwise), applies only to land and by virtue of the fact that the definition makes the exception in respect of land it could be derived that the common law definition of contingent interest is accepted and recognized not to include possibilities. If it wasn't recognized as being restrictive then the definition would not be expressed only in respect of interests in land.

The exclusion of potential discretionary interests from the definition of "capital" or "income interest" for the purposes of the Act is automatic **when the trust is a personal or prescribed trust** in that the holder's right extends only to having the discretionary power exercised. This is true even when the power is a trust power and **collectively** the beneficiaries in respect of which it is exercisable can be ascertained to be entitled (although not individually specifically) to the property. Although they may have an "interest" in the trust as per the common law norms, they collectively and individually do not have **a right** to or to receive trust property until the trust discretionary power is exercised.¹⁶²²

Where the particular trust/estate isn't a personal or prescribed trust then not only can there not be any "income interests" in respect of it but every right that any beneficiary has under it will be recognized as a capital interest as per Sec. 108(1)(c)(ii) and this is particularly important for the provision does not operate on the referencing of that right. Discretionary interests, which are in substance rights to have a discretionary power exercised, thus become "capital interests" for the purposes of the Act under Sec. 108(1)(c)(ii) if the trust is not personal nor prescribed.¹⁶²³

Although under a personal trust a discretionary interest will not be considered as any particular form of trust "interest" for purposes of the Act, it will still represent a form of property in that it falls within the definition of such, being a "chose in action" and thus the character of the property, and the manner in which it was disposed of should determine whether it will be recognized as an income or capital transaction. If the discretionary power was exercisable so as to cause the particular disponent to realize trust income in respect of his position then the disposition of such potential right should receive income treatment, and vice versa in respect of trust capital, since if realized the benefits of such a trust interest would have been one or the other.

If a discretionary power exists so as to pay/allocate/apply the income to or for one of a class of beneficiaries those beneficiaries do not have income or capital interests in the trust (if it's personal) in respect of the power but if they are to participate fully in the case where the power isn't exercised they will have interests defined in Sec. 108(1). In effect they will have two rights; one of which will be recognized as a technical income or capital interest and the other merely a possibility.¹⁶²⁴

Whenever a reference to the holding of an "interest in a trust" is made in the Act it is read as a reference to the holding of any interest in the common law sense of the word and not only in respect of "interests" described in Sec. 108(1)(c) or (e). Subsection 248(1) provides that for the purposes of the Act "capital" and

¹⁶²⁰ If the discretionary interest is a contingent interest would there be redundancy in the Sec. 94(7) & 74.5(10) provisions?

¹⁶²¹ It should also be recognized that both definitions of "beneficially interested" refer to only rights **to receive** trust property and do not include those which can enforce a payment of trust property, for the holder's benefit, to another party.

¹⁶²² See McCreath for a discussion on collectively based rights.

¹⁶²³ Is there cost preservation when the discretionary interest (chose in action) becomes a technically capital interest on the loss of the personal trust status for instance? It would appear so.

¹⁶²⁴ See Re: Weir's Settlement Trusts, 1970 1 All E.R. 297. In Sainsbury & Others v. I.R.C., 1969 3 All E.R. 919, beneficiaries under an exhaustive discretionary trust were found not to have rights to trust property, only rights to have the trustees exercise their powers of allocation. See also Re: Beckett's Settlement, 1940 Ch. 279, A.G. v. Chettiar, 1957 A.C. 513, Re: Goldsworthy, 1969 V.R. 843, Spencer & Anor. v. Commr. of Taxn., 84 A.T.C. 4901.

"income interest" of a taxpayer in a trust has the definition assigned by Sec. 108(1) and while that subsection does not go on to define "interest in a trust" it cannot be solidly argued that what is implied is the holding of either an "income" or "capital interest", and nothing more. Discretionary interests (in personal trusts) do not have any advantages, in that they do not cause the relevant provisions to apply (which are generally unfavourable).

While a discretionary interest isn't a type of "interest" recognized under the Sec. 248(1) definitions it also cannot benefit from the Sec. 106(1) or particularly 107(1) disposition provisions that allow for reduction of income inclusions or increase of recognized ACB for disposition purposes, thus a disposition of a discretionary interest (property) may cause excessive taxation to occur if its FMV exceeds its ACB. By the same reason Sec. 69(1)(c) causes such to have a cost equal to its FMV at the time of its acquisition when it is gifted. If the discretionary power is exercised favourably, so that the discretionary interest takes on the required right character of a capital or income interest, just prior to a disposition, then the right may be disposed of with less tax consequences, even when favourable exercise is still required in respect of the discretionary interest in later periods. If this cannot be done then the taxpayer, CRA, and if need be the courts, may have to estimate a value that represents the interest's fair market value, if it is disposed of by a gift *inter vivos* or to a person with whom the disponent was not at arm's length with so as to apply Sec. 69(1), or, argue its application. Ascertaining that value could prove an interesting subjective exercise; eg, in *Gartside v. I.R.C.*¹⁶²⁵ Lord Wilberforce held in respect of the tax value of a discretionary interest, when measuring its value was of importance:

"It must follow that the discretionary beneficiaries under the settlement had no "interest" within the meaning of the section; no single member of this class had any right to income; even if one considers them collectively they had no right to any income because the trustees could accumulate the whole of it. This makes it unnecessary and indeed otiose to consider whether the beneficiaries had "interests in possession". No doubt in a certain sense a beneficiary under a discretionary trust has an "interest", the nature of it may, sufficiently for the purpose be spelt out by saying that **he has a right to be considered as a potential recipient** of benefit by the trustees and a right to have his interest protected by a court of equity. Certainly that is so and when it is said that he has a right to have the trustees exercise their discretion "fairly" or "reasonably" or "properly" that indicates clearly enough that some objective consideration, (not stated explicitly in declaring the discretionary trust, but latent in it), must be applied by the trusted and that the right is more than mere sides. **But that does not mean that he has an interest which is capable of being taxed by reference to its extent in the trusts income, (or capital): It may be a right with some degree of concreteness or solidity, one which attracts the protection of a court of equity, yet it may still lack the necessary quality of definable extent which must exist before it can be taxed.**"¹⁶²⁶

Also provided¹⁶²⁷ is the commentary of Lord Reid:

"But a right to require trustees to consider whether they will pay you something does not enable you to claim anything. **If the trustees do decide to pay you something, you do not get it by reason of having the right to have your case considered: you get it only because the trustees have decided to give it to you.**"

In *Leedale v. Lewis*¹⁶²⁸ the House of Lords had to ascertain whether the term "interests" in a taxing provision, Sec. 42(2) of the U.K. Finance Act, applied to discretionary interests and Lord Fraser of Tullybelton provided:

"The main question is what is the meaning of the word 'interests' in S. 42(2). It is a word that is capable of many meanings, **the appropriate meaning depending on the context.** In *Attorney-General v. Heywood*, (1887) 19 QBD 326, the settlor had provided that trustees had the discretion to apply the trust income for the benefit of himself and his wife and children or any one or more of them. It

¹⁶²⁵ 1967 2 All E.R. 173,

¹⁶²⁶ In that case the beneficiary was one of a class of discretionary beneficiaries.

¹⁶²⁷ [1968] A.C. at pg. 607,

¹⁶²⁸ 56 T.C. 501

was held that he had reserved an 'interest' within the meaning of the Customs and Inland Revenue Act 1881. But in *Gartside v. Inland Revenue Commissioners* [1968] AC 553 this house decided that a beneficiary under a discretionary trust did not have an 'interest' in the sense of s. 43 of the Finance Act 1940. Lord Reid expressed approval of the decision in *Heywood*, supra, but distinguished it because of the different context in which 'interest' was used in the 1940 Act. He said (at page 612) 'If so vague a word as 'interest' is used in different Acts dealing with different problems there is only, in my view, a slender presumption that it has the same meaning in both.' Lord Wilberforce, after referring to *Heywood* and also *Attorney-General v. Farrell*, [1931] 1 KB 81, declined to treat those cases as having settled the meaning of 'interest' in the different setting on the Finance Act 1940." Lord Wilberforce stated in that case, on page 539, that:

"The word 'interest' is one of uncertain meaning and it remains to be decided on the terms of the applicable statute which, or possibly what other, meaning the word may bear."

Powers of Appointment.

A power of appointment instilled in a person who need not be a trustee, through the trust agreement by the settlor/testator, may allow the person to determine to whom a particular trust property will be distributed, however it does not equal a right to or to receive trust property until the power is exercised but instead is limited to being a capacity to determine how the ownership of property will be dealt with. If the power is "general", (being that it can be exercised at any time in respect of any person by the holder), then only upon its exercise will a right to the property be granted to a particular recipient. Until that time the particular recipient may not have, as a beneficiary, any right to or to receive the trust property, and thus the substance of the trust property continues to substantiate the existing capital or income rights under the trust agreement, and thus when a power of appointment is exercised it can and usually operates to reduce the substance of a given trust right affected, though not the scope of the right itself. The power itself must be distinctively recognized from any equitable ownership rights under the trust agreement, (which would otherwise qualify as "capital" or "income interests"), since the power is restricted to being only the capacity to determine to whom the legal title of a particular property(s) will pass and until it is exercised the particular property is already the subject of equitable ownership rights, while the holder of an equitable ownership right to or to receive the property has the ability, subject to the previously discussed restrictions, to sue for the enforcement of the trust agreement thus causing legal ownership of the subject property to be vested in him, clearly exceeding the capabilities of the holder of the power of appointment.

A power of appointment exercisable so as to cause a beneficial right to be obtained by the power's holder **may** satisfy the common law concept of "trust interest" in its vaguest form in that the holder may be able to benefit from the particular property however the ITA gauges "capital" or "income interests" on the basis of whether or not they are rights to, or to receive trust property (in the case if a personal trust), held by the taxpayer as a **beneficiary**, while in the case of non-personal trusts any rights held under the agreement will be recognized as capital interests. The power of appointment is not a right to or to receive trust property as a **beneficiary** but is the catalyst and creator of such rights and thus until the power is exercised in favour of its holder, the holder hasn't a right to or to receive trust property as a beneficiary. (In the case of a non-personal trust the power holder has the right to exercise the power, but in order for that to be categorized as a "capital interest" the taxpayer must hold the rights **as a beneficiary**, being a person beneficially interested in the agreement. Is a power holder, where the power may be exercised favourably in respect of himself "beneficially interested", on those grounds alone or is he only after the favourable exercise has occurred?)¹⁶²⁹

In *Wanklyn et al. v. M.N.R.*¹⁶³⁰ the Supreme Court of Canada had to decide whether or not a taxpayer to whom a power of appointment had been given in a will so as to allow him to receive capital from an estate, could be assessed under the Dominion Succession Duty Act as, effectively, being beneficially interested in

¹⁶²⁹ Powers may be coupled with beneficial interests whereby they are referred to as powers appendant, retained after interests are disclaimed/disposed of, whereby they are referred to as in gross, or where no interest was held with respect to the subject property whereby they are collateral powers, however such terms are window dressing and do not indicate the true status of the power holder and his relationship to the trust.

¹⁶³⁰ 53 D.T.C. 1167

the capital of the estate in respect of which the power had not been exercised. The power allowed him to demand the payment of any portion of estate capital, (whereafter the executors could not be held accountable for it), and while the Minister contended that this could effectively be considered a general power of appointment over property, (allowing the taxpayer to be assessed for succession duty in respect thereof), the Court found in a majority, that he did not have a general power of appointment and that he wasn't beneficially entitled to the capital **until the power was exercised**. Cartwright, J. held:

"...and the question is therefore under her will upon her death, Dr. Chipman became beneficially entitled to that capital "either immediately or after any interval either certainly or contingently and either originally or by way of "substitutive limitation". It appears to me that he did not. I am of the opinion that upon the death of Mrs. Chipman, Dr. Chipman became beneficially entitled to the income from the residue and the residuary legatees became beneficially entitled to the capital thereof in remainder... The residuary legatees immediately on the death of Mrs. Chipman took not a contingent but a vested remainder in the capital, expectant on the death of Dr. Chipman, subject to be divested in whole or in part by his exercise of the power to take during his lifetime such portion or portions of the capital as he might wish. So far as the capital of the residue was concerned no part of it became vested in Dr. Chipman upon Mrs. Chipman's death or under any disposition made by her. **No doubt upon his exercising the power Dr. Chipman became entitled... but it is only to the extent that he exercised the power that he became beneficially entitled to any portion of such capital and it was conceded that he was liable to pay duty in respect of such portion. The respondent's argument depends upon the proposition that a person who is given a power over property thereby becomes beneficially entitled to such property but in my view this is not the law and no words in the Statute so provide. As is pointed out in Halsbury, 2nd Edition, vol.23 page 525:**

"The creation of a power over property does not in any way vest the property in the donee, though the exercise of the power may do so; and it is often difficult to say whether the intention was to give property or only a power over property."

In *Cossitt v. M.N.R.*¹⁶³¹ as a question of whether a general power of appointment over trust property caused the subject property to be caught and exposed to duty under the Dominion Succession Duty Act Judge O'Connor made an interesting quote concerning the exercise and result of the exercise of powers of appointment:

"What the appellant was given under (b) was not "property" but "power" and until he exercised such "power" in his own favour he was not "entitled to property" within the meaning of those words in section 2 (m). "Entitled" in section 2(m), in my opinion should be given the same meaning set out by Wynn-Parry, J., in *re Miller's Agreement*, *Uniache v Attorney-General*, (1947) 2 All E.R. 78, in which after discussing the word "entitled" in section 2 of the Succession Duty Act, 1853, he said at p. 83:

"The word "entitled" as used in this section appears to me necessarily to carry the implication that, for a person to be entitled to property under this section it must be capable of being postulated to her that she has a right to sue for and recover such property."

Until the appellant exercised the power in his own favour he would not have the right to sue for and recover the capital."

This was essentially also the opinion of the Chancery Division Court in *Vestey v. Inland Revenue Commissioners*¹⁶³² whence the taxman attempted to assess a taxpayer as having a right to trust capital and income when he had only power over them. That case involved the possible tax consequences to a power holder when he had the power to enjoy the income of property held in trust under what can be equated conceptually to Sec. 75(2). The charging provision of the Income Tax Act (British) 1952, read:

1631 49 D.T.C. 617
1632 [1979] 2 All E.R. 225

"by means of any such transfer, either alone or in conjunction with associated operations [have] acquired any rights by virtue of which he has, within the meaning of this section, power to enjoy... any income of a person resident or domiciled out of the United Kingdom."

The Commissioners contended a power of appointment held by the taxpayer constituted such a right while the taxpayer thought otherwise. Walton, J. held with respect to the power:

"The position therefore is that in each case we are dealing with a mere power (as distinct from a trust power) in the appropriate person enabling him to distribute among a class of beneficiaries as he thinks fit. What **'rights'** are by such a provision conferred on any individual potential beneficiary? In my judgment, the only relevant rights which are conferred on such a beneficiary are: (i) the right to be considered by the person exercising the power when he comes to exercise it; (ii) the right to prevent certain kinds of conduct on the part of the person so exercising the power, e.g. by distributing part of the assets to persons not within the class, and (iii) the right to retain any sums properly paid to him by the trustees in exercise of their discretionary powers. **But beyond that he has no relevant "right" of any description; and none of those rights is a right under which he has power to enjoy the income.** Indeed, no individual has any power over any part of the income whatsoever. The most relevant right is, indeed, the third; but a right to retain what is properly paid to you is simply the negative right of being afforded a complete defence to any claim for repayment, and no more. **Prior to actual payment, to which there is no right whatsoever, the recipient has no right to the money at all.**

One may, indeed, contrast the situation in the present case with a situation where trustees are obliged to distribute income year by year under the terms of their trust deed among a certain class in such shares and proportions as they may think fit, a case in which each potential beneficiary is very much more likely in ordinary parlance to have power to enjoy the income than the present case. Even in such a case no individual potential beneficiary has any relevant right whatsoever, although, collectively, they undoubtedly do have a right which, if they are all sui juris, they may collectively enforce: see *Nelson and Re Smith*; and compare *Gartside v. Inland Revenue Comrs* per Lord Reid."¹⁶³³

In respect of personal trusts it can surely be said that the exercise of the power of appointment is the event by which the ITA "capital" or "income interest" is acquired. This opinion seems to be supported by the implicit recognition of trust law provided by the Department in its opinion expressed in I.T. 286R2 para.4 (and 5), which provides that where the beneficiaries have the power to amend the trust deed so as to cause income to be payable to them the mere presence of the unexercised power is not to be the basis for treating income as being payable. Subsection 104(13) recognizes income as payable to a beneficiary when he has a right to enforce the payment, as per Sec. 104(24), while the Department goes on in I.T. 286R2 to provide that only after the exercise of the power and the amendment of the trust deed, will the income be considered payable. In the author's opinion the Department's opinion in I.T. 286R2 para. 4-5 is not precluded from applying to the five basic powers¹⁶³⁴ which may exist under any trust agreement as well as powers to vary the trust upon "unanimous" consent, (especially since the latter is more accurately described as a right). In the author's opinion by giving particular parties powers of appointment in respect of certain trust property which otherwise forms the substance of existing rights and allowing them to be exercised in respect of the power holders by expressly not excluding them from the class of parties in respect of which it is exercisable, a considerable degree of flexibility can be obtained although at a significant tax cost in that if circumstances call for it the power holder could exercise the power favourably in respect of himself and thus receive the legal title of the property, **but** in doing so he has received a benefit from the trust that isn't otherwise included in computing his income and isn't related to his capital interest in the trust, (which he doesn't have), thus Sec. 105(1) **could**

¹⁶³³ See also *Lord Romer v. Muir*, 1943 A.C. 468, providing "No statement of the principle that I have ever seen has suggested that the appointees under an appointment in their favour take any interest in the subject matter of the power until the appointment takes effect. It is, on the contrary, quite plain that they do not, ..." See also *Bowman v. Commr. of S.D.*, 1981 12 A.T.C. 446.

¹⁶³⁴ appointment, advancement, encroachment, maintenance, administration

apply, and the value of the property will be included in his income.¹⁶³⁵ This could occur with a **general** power of appointment. Unless the power holder is the contributor of the property to the trust, and resident, Sec. 75(2) will not apply to attribute income/gain/loss etc.

A **special** power of appointment is one which is restricted, as per the intentions of the grantor, so that it is exercisable only in respect of specific parties indicated in respect of it by the grantor, and/or exercisable only in certain conditions, and thus it significantly differs from a general power in that it is far more restrictive and far less dependant upon the exerciser's discretion. The general power effectively gives its holder an unrestricted ability to have legal title vest in any person, in any circumstance, as per the discretion of the power holder while the special power allows the holder to utilize his discretion in ascertaining whether legal title is to vest in a specific person (out of a specified class of persons), in a specific circumstance, both of which are decided by the grantor and not the exerciser thus the former gives a free hand in how it can be exercised and the latter only allows the holder to determine whether or not it is to be exercised and not, except for special situations, how it is to be exercised. The other major difference between the two is that the results of the general power draw their conclusion, (their validity) from the exercise of the power itself, being that the vesting of legal title in a particular person is not read as being an aspect of the trust deed which granted the power, but instead as a result of the power while the results of a special power draw their conclusion (validity) from the trust deed and/or the intentions of the settlor, being that the result of the exercise was consented to/determined by the grantor of the power and that the exercise thereof by the holder was secondary, due to the fact that the intention of the grantor is being acted upon, not that of the exerciser. The strategic importance of the difference in the two powers is more noticeable in the case of estates than trusts where the exercise of a general power will result in the realizing of a benefit from under the estate (trust) that isn't related to the will and cannot be read back into it, while an exercise of the special power of appointment will result in the realizing of a benefit from under the estate but that **is** related to the will and this should be recognized as a retroactive disposition to the recipient **by the deceased** (which would attract the application of Sec. 70(5)) not as a disposition by the estate of the deceased to the recipient, and thus should not attract the application of Sec. 105(1). The reason for the difference in treatment is that the special power of appointment results are to be read as those originating from the will, (the transfer of legal title), while the general power's results are to be read as originating from the exercise of the power, (and not the will), thus the benefit from the estate (trust) and not the deceased is recognizable. The results of the exercise of a special power will be read back for the purpose of ascertaining the validity of the gift in light of the rules against remoteness of vesting **but** the result is not to relate back nunc pro tunc to the time of the creation of the power: only from the time of its exercise.

A power of appointment, be it general or specific, is a chose in action and thus is a form of property as defined in Sec. 248(1), hence it will be subject to all of the applicable disposition rules if it can be and is transferred or disposed of by renunciation, however a disposition, for capital gains purposes, will not result when it is "canceled" or allowed to terminate upon the end of its life in that it is not a "right of a taxpayer to **receive** an amount" as described in the Sec. 54(c)(ii)(B) definition of "disposition".

"Capital interests" held by taxpayers in personal trusts represent rights of the taxpayer to or to receive trust law capital from the trust and as such they can be valued to their present value, given the scope of their enforceability with respect to the value of the trust property, the probability of their enforcement, and the timing of their enforcement, however the result of such a computation will represent a capital amount, if received upon the right's disposition to another person. This is primarily due to the fact that the nature of the property that satisfies the right, in the hands of the trust and in the way the right is enforceable, is the nature of the right.¹⁶³⁶ In the case of the income interest in a personal trust it too can be valued to its present value giving consideration to the three above factors, however the fact that it can be done does not result in the fact that such an amount received upon the disposition of the right is to be recognized as a capital receipt from the disposition of a capital property. In *Gladys Evans v. M.N.R.*¹⁶³⁷ the appellant spent about \$11,975 on legal

¹⁶³⁵ This isn't the case with non-residents if subsection 105(1) can apply in such a case.

¹⁶³⁶ The manner in which the right is held is also critical in the case of inventorial capital interests.

¹⁶³⁷ 60 D.T.C. 1047,

fees to convince the courts that she was entitled to a third share of the income of an estate, for life, of her father-in-law. The Minister refused to allow her to deduct the fees paid from her income realized contending that they were incurred on account of capital property, i.e. the trust interest. The taxpayer was entitled only to trust income. Taken the length to the Supreme Court, Taschereau, Cartwright, Fauteaux, Judson and Ritchie, J.J. found on a slim majority that the fees were deductible against her income. Cartwright J. provided:

"...the legal expenses paid by the appellant were expended by her for the purposes of obtaining payment of income; they were expenses of collecting income to which she was entitled but the payment of which she could not otherwise obtain. So viewed it could scarcely be doubted that the expenses were properly deductible in computing the appellant's taxable income...**I cannot agree that the fact that a bare right to be paid income can be sold or valued on an actuarial basis at a lump sum requires or permits that right while retained by the appellant to be regarded as a capital asset.**"¹⁶³⁸

If the taxpayer engaged in **the business** of "wheeling and dealing" in capital rights of estates/trusts then it cannot be argued that the interests are anything more to him than income producing inventory and thus realizations of benefits, either upon their disposition or from the respective trusts, should be recognized as income.¹⁶³⁹ One thus has to examine the actions and motivations of the right holder to ascertain whether the "capital interest" retains its statutory character in his hands. Though the property may be a right to trust capital and thus a capital interest it will be inventorial property and thus lead to income inclusions under subdivision b. Subsection 107(1)(a) will not apply to set up an artificial ACB of the interest since taxable capital gains are not being computed.

An income beneficiary has a right, under a personal trust, to or to receive income, from the trust while the trust deed may provide that transfer of legal title to the income realized in a period may be deferred to a later period and thus when the current period ends the income beneficiary obtains a right to or to receive capital of the trust representing the capitalized income to which he is entitled. If the capital is distributed to him under Sec. 107(2) then even though his capital interest hasn't an ACB greater than nil he will still not recognize any tax consequences. Since he was entitled to enforce in the year the payment of the income was realized the payment thereof, but possibly as per the trust terms, only in a subsequent period, he will be required to recognize the income under Sec. 104(13) and (24). In the author's opinion the right to the capitalized income is a capital interest held by the beneficiary, as a beneficiary, which may also constitute a lien, debt of the trust held by the beneficiary as a creditor against the trust as a liability/obligation to pay.

Options and Equitable Charges.

A "capital" or income interest" under a personal trust is defined as a right, held by the taxpayer **as a beneficiary** under the trust, to or to receive trust property having one form or another however while the beneficiary of the trust is beneficially interested, it does not mean that the taxpayer holds such a right to or to receive the property **absolutely gratuitously** in that in fact, to receive or to have access to trust property, the taxpayer may have to, with the exercise of his right, pay to the trust or to some person some amount of funds or execute some action that he otherwise would not have been required to. The reasons that the settlor/testator places such an equitable charge/condition on the execution of the right are in the multitudes and range from a simple desire to have his trust/estate have certain levels of liquid capital at certain times to the desire to spread the possible benefits realizable over as many people as possible, however in any case the fact that the taxpayer has to pay consideration or perform certain acts to enforce his right does not reduce it from being a capital or income interest as recognized under the Act.

¹⁶³⁸ The basis of the judgment seems to be that the expenses were incurred to produce income that was taxable in her hands. If they were to have been incurred in respect of trust property that could only have been taxable in her hands under Sec. 105(1), (due to the fact they were otherwise exempt income realized by the trust), but were not due to the fact that the beneficiary had a capital interest to which their distribution was related, then they may not have given rise to deduction. See *Gelinas v. M.N.R.*, 89 D.T.C. 117, for instance where legal fees not deductible when bequest was of capital property.

¹⁶³⁹ This doesn't prevent them, however, from being capital interests for certain purposes of the Act.

For Canadian income tax purposes there may be solid ground to argue that certain testamentary options to acquire estate property given by the will to a taxpayer constitutes a "capital interest" within the Sec. 108(1)(c) definition even though it has been questionably held in the lower courts that through its exercise the optionee acquires as a purchaser. The diction used by the testator and the particular situation may be conclusively indicative when there is a power to sell but gives the optionee a right to buy at a certain price or where the trustees are directed to make an offer of sale to the purported beneficiary.

In *Coleman Estate v. M.N.R.*¹⁶⁴⁰ a testator directed her trustees to "sell or transfer" farm property to one of her sons for total consideration of \$60,000, being equal to the V-day value of the property, whereby the consideration would be spread out amongst three other beneficiaries. The farm property was a major component of the estate and its value was greatly in excess of \$60,000 in 1982 (the year of death) hence clearly the "sale" was not one for valuable consideration. The Minister restricted the application of the Sec. 70(9) tax free roll-over provision on the grounds that the property had not been transferred or distributed to the acquirer by virtue of the death, but had been an estate sale, paying particular importance to the fact that the will contained the term "sell".

The Tax Court case of *Penner v. M.N.R.*¹⁶⁴¹ represents one of the more authoritative opinions on whether a "transfer or distribution" under Sec. 70(6)-(9) includes instances where a testamentary option is exercised to acquire property and it was held not to, however in the author's opinion the case was decided erroneously on what could be regarded as irrelevant reasoning based on the fact that only two Chancery Division English cases were cited, and they could be said to be an exception. *Tremblay T.C.J.* considered only *In re: Wilson*¹⁶⁴², *In re: Eve*¹⁶⁴³, in arriving at the conclusion that a taxpayer who is bequeathed a testamentary option to acquire estate property does so in the capacity of a purchaser, quoting from *Wilson*:

"On the language of this will, it is clear that the testator meant that Loughrey was to be a purchaser, and nothing else - a favoured purchaser no doubt, but still a purchaser. The element of bounty does enter into the matter; but the bounty conferred is the right to become a purchaser on advantageous terms, and not a devisee of the estate trust otherwise for sale."

From *re: Eve* he quoted:

"The question is where the benefits of the option stands in the hierarchy of assets for the payment of debts in a solvent estate. The option is a right to purchase 1,000 shares at par value, it involved a contract between the trustees as vending to sell and the purchaser to buy the shares at the stated price, free from incumbrances, and this is so, notwithstanding that there is a strong element of bounty in the transaction. The shares are not bequeathed subject to a charge or condition. An option to purchase cannot be a specific bequest of shares. If there is a specific bequest at all, it must be of the difference between the price stated in the will and the market value of the shares."

In *O'Neill v. O'Connell*¹⁶⁴⁴ certain restrictions were placed upon land sales though not on the devolution of land via testamentary dispositions and when the taxpayer exercised a testamentary option to acquire the land from the estate the authorities considered that it was purchased and was not acquired by a taxpayer in the capacity of a beneficiary. The High Court of Australia, upon a thorough review of a significant body of case law (including *Eve* and *Wilson*), held that the beneficiary acquired the land via a bequest and that until the option was exercised the optionee had an equitable interest in the property and that if it was disposed of he could still trace the proceeds for the amount of the benefit if it was exercised subsequently.¹⁶⁴⁵ Perhaps most fundamentally sound was the observations that the option doesn't necessarily create a contract between the testator and the optionee nor between the optionee and the executors; the rights of the optionee are acquired by testamentary disposition only and that the duty of the executor to honor them arises out of the terms of the will; the source of the option. The executor thus doesn't give effect to a contract entered into by the testator *inter vivos* nor does the testator bind the executor into the contract. The terms of the testamentary disposition

¹⁶⁴⁰ 87 D.T.C. 664

¹⁶⁴¹ 84 D.T.C. 1444

¹⁶⁴² 1908 1 Ch. 839

¹⁶⁴³ 1956 Ch. 479

¹⁶⁴⁴ 72 C.L.R. 101

¹⁶⁴⁵ See *Re: Fison's Will Trusts*, 1950 Ch. 394, and *Re: Armstrong's Will Trusts*, 1943 Ch. 400.

extend the option to the optionee and the executor is compelled **in equity** and not by contract to recognize the optionee's rights; since the will regulates both the option is a right of a beneficiary and recourse against the executor is governed by principles of equity and not contract.¹⁶⁴⁶ In *Perpetual Executors & Trustees Assc. of Aust. Ltd v. Commr of Probate Duties*¹⁶⁴⁷ the Supreme Court of Victoria had to ascertain whether there was to be a reduction of probate duty in respect of a testamentary transfer of property when the beneficiary exercised a testamentary option and acquired estate property. The relevant provision provided an exemption of duties when "property passes or is deemed to have passed to a person who is related by blood or marriage to the deceased", and the authorities contended that the property did not "pass" within the context required but was instead purchased. The Supreme Court of Victoria entirely concurred with the dicta in *O'Neill v. O'Conner* and found that the property had "passed" to the beneficiary within the context; it had not been sold pursuant to a contract for sale. The reasoning of the High Court of Australia as to how the option came into being and is enforceable was concurred with. It should be noted that there is a difference between a testamentary direction compelling the executors to offer to convey the property as a sale to a beneficiary for a certain price and the will providing the beneficiary with the option to acquire the property for a certain sum regardless of the actions of the executor. In the author's opinion the latter can be considered a right held in a beneficial capacity while the former will not be even when the executor executes the instruction. This jurisprudence arises out of Australia and it's important to note that both cases dealt with the applicability of testamentary exemption provisions, in one case very much like Sec. 70(6)-(9). Though English law apparently has not adopted the reasoning in these two cases and has clung to what could be argued to be less developed reasoning based on testamentary contract Canadian law, to the best of the author's knowledge, has not had to address the issue outside of the *Penner-Coleman* cases. The British tradition should be followed if there isn't strong reasoning to do otherwise and in this instance the author is of the opinion that the above two cases may prove formidable jurisprudence upon which to draw in future cases.¹⁶⁴⁸

It would seem that an option to acquire estate property given by will, when of the character that doesn't require the executor to make any offer, when exercised, will allow the subject property to gain Sec. 70(3)-(6)-(9) treatment as the case may be regardless of *Penner*. It should also be noted that this concerns only **testamentary** options granted by a will and should not be extended to *inter vivos* options granted by the testator or the executors themselves since in such cases the executor is compelled **by contract** to honor the right, and thus they are not capital interests within the Sec. 108(1)(c) context. Although it has been held that an *inter vivos* option to acquire property creates a beneficial interest in the holder, in the trust instance, this doesn't cause the holder to be a beneficiary since the trust deed may be framed so as to impose the fiduciary obligations in respect of the stated beneficiaries and not the option holder thus preventing the holder from being recognized as a true beneficiary.¹⁶⁴⁹ Equity would not be the source of the holder's protections; contract law would be and the Sec. 108(1)(c)-(e) definitions could be argued to apply only to the former.

Testamentary options, in the author's opinion, should cause Sec. 107(2)-(5) to apply if they are exercised and property is acquired by the beneficiary.¹⁶⁵⁰ Subparagraph 107(2)(c) seems to provide for such and they would operate in a manner similar to conditional bequests.¹⁶⁵¹ In *Phaneuf v. The Queen*¹⁶⁵² a taxpayer

¹⁶⁴⁶ See *Carter v. Hyde*, 33 C.L.R. 115, Re: *Busby*, 30 S.R. (N.S.W.) 399, *Cox v. Archer*, 110 C.L.R. 1, *Radnor v. Shafto*, 32 E.R. 1160, *Brooke v. Garrod*, 44 E.R. 911, *Oppenheimer v. Min. of Trans.*, 1942 1 K.B. 242, *Trustees, Exors. and Agency Co. Ltd. v. F.C.T.*, 69 C.L.R. 270, *Oliver v. Oliver*, 99 C.L.R. 20, Re: *Jolly*, 1901 17 T.L.R. 244, *Wright v. Morgan*, 1926 A.C. 788.

¹⁶⁴⁷ 1981 V.R. 91

¹⁶⁴⁸ The Tax Court judge in *Penner* was apparently ignorant of them or didn't consider them as applicable as general English jurisprudence but no reasons were given.

¹⁶⁴⁹ It seems interesting that Sec. 108(1)(b) offers a definition of "beneficiary" for purposes of the interest definitions, amongst others, that allows a taxpayer to be considered a beneficiary if he is beneficially interested **in the trust** not in the property and it is this that could be argued that prevents the *inter vivos* option holder from being a beneficiary. See also *Davidson v. Norstrant*, 61 S.C.R. 493, and *Commr. of Taxn. v. Camphin*, 57 C.L.R. 127, as well as "Options, Rights of Repurchase and Rights of First Refusal as Contracts and As Interests in Land.", Paul M. Perell, 1991 C.B.R. Vol 70 pg 1.

¹⁶⁵⁰ This assumes that the intent of the testator was that the beneficiary's claim was not to be ranked above others and that it could be abated with debt/liabilities.

¹⁶⁵¹ See *Mckendrick v. Lewis*, 1889 15 V.L.R. 450, *Belshaw v. Rollins*, 1904 1 Ir. R. 284, In re: *Nilsson*, 1920 S.A.L.R. 272, *Given v. Massey*, 1894 31 L.R. Ir. 126.

¹⁶⁵² 78 D.T.C. 6001 FCTD

extended in his will to his corporation's employees an option to acquire his shares at a reduced price and although the Minister was unsuccessful in convincing the court that the benefit was by virtue of or in the course of the employees' employment the court did find that the benefit was a **gift** made by the testator. In *Sweeney v. The Queen*¹⁶⁵³ an *inter vivos* option was held not to be a gift when the exercise price allowed the taxpayer to acquire the shares for a price approximately equal to their fair market value. The fact that the option was revocable by the optionor but wasn't revoked prior to his death did not make it a gift under Sec. 69(1)(c) the gift in that provision being interpreted to mean of the essence of an intentional, voluntary, and gratuitous transfer of property.¹⁶⁵⁴

Subparagraph 54(c)(ii)(D) provides that when an option expires the optionee will recognize a disposition while when it is extended subsection 49(1) provides that the optionor will recognize a disposition of property the ACB of which is equal to nil. This isn't the case with options to purchase principal residences while if it isn't the trust will recognize a disposition governed by Sec. 69(1) upon its creation. If the option expires the optionee may recognize a capital loss since the option has a cost equal to that governed by Sec. 69(1). If the option is to acquire the principal residence of the trust upon its expiry the optionee will recognize a capital loss without generating a capital gain for the trust when the option was extended. Repeating the extending of options to acquire the trust's principal residence may be an interesting way to get cash into the testamentary trust without causing the loss of its status while at the same time allowing capital losses to be created.¹⁶⁵⁵

If an option is to cease upon the death of its holder it will still be captured by Sec. 70(5) since that provision causes the deemed disposition of all property owned **immediately before death** however it may be possible to assign/transfer it to another taxpayer so as to avoid such.¹⁶⁵⁶ An option which terminates one week after the taxpayer's death, allowing his executors to exercise it, is far more preferable to one that terminates on death since the latter will cause full taxation under Sec. 70(5) upon the death but will not be able to generate a capital loss for the estate once it terminates since the estate doesn't actually acquire it. A spousal roll-over would also not be available in such a case. If however the option is canceled one day after the death the estate has acquired it and Sec. 70(5)(c) sets up the cost thereof so that once it expires **the full ACB** will be recognizable as a capital loss which will more than offset the capital gain potentially recognizable under sec. 70(5) via Sec. 164(6).¹⁶⁵⁷

A testamentary option to acquire property from the estate has been held to create a non-arm's length disposition within the context of Sec. 69(1)(b) as per *Sitler Estate v. M.N.R.*¹⁶⁵⁸ and any capital loss recognized by the estate as a consequence of the Sec. 70(5) bump in cost and subsequent reduced proceeds is undeductible.¹⁶⁵⁹ The application of Sec. 69(1) to the exercises of testamentary options is, in the author's

¹⁶⁵³ 90 D.T.C. 6507 FCTD

¹⁶⁵⁴ The termination of such an option can be recognized as "a benefit" in identical circumstances as was essentially the case in *Commr. of Probate Duties v. Wilson*, 1979 V.R. 592, where a shareholder's option to acquire additional shares of a corporation thus reducing the value of those held by others lapsed on his death and the cessation of the option was recognized as "a benefit" though understandably not a gift. In the context of the ITA the making of an option to acquire shares on a Sec. 85(1) incorporation instead of the shares themselves may amount to an attribution target given the relative income participation of the shares and the consideration for such provided by the shareholders.

¹⁶⁵⁵ As per *Turbo Res. Ltd. v. Paperny*, 11 E.T.R. 205, a power to sell/lease land does not infer a power to option it: the will should be specific with respect to this power.

¹⁶⁵⁶ See *Re: Ley*, 1932 S.A.S.R. 372, *Re: Zerny's Will Trusts*, 1968 1 All E.R. 686 (CA), *Skelton v. Younghouse*, 1942 A.C. 571, *Sharp v. Union Trust*, 69 C.L.R. 539, *Abbott v. Union Trustee*, 41 C.L.R. 375, *Wilson v. C.P.D.*, 78 A.T.C. 4278, for cases involving whether the option is assignable or is personal.

¹⁶⁵⁷ The same could be said about remainder interests in trusts that terminate upon death; Sec. 70(5) captures them but no one acquires them subsequently to create a loss.

¹⁶⁵⁸ 84 D.T.C. 1378, TCC

¹⁶⁵⁹ In the author's opinion this result may not always be the case, especially if the exercise is recognized as a purchase, since the optionee may be quite at arm's length with both the executors and the testator. It is to be noted that subpara. 69(1)(b) cites only **gifts inter vivos** and not those made by way of testamentary disposition. An option that operates to grant a gift testamentary at a severely reduced price is not an *inter vivos* gift and if the parties are/were at arm's length the loss may be fully deductible.

One particularly interesting testamentary option arrangement that can be instituted in respect of "non" taxable Canadian property is to have the will of a Canadian resident give a testamentary option to a non-resident residing in a tax free jurisdiction whereby estate property can be purchased for 50-75% of its f.m.v. The loss the estate recognizes on the sale, (since the cost of the property to the estate failing the availability of the spousal roll-over will be the property's f.m.v.) can be carried back and applied against the testator's terminal income under Sec. 164(6), while if the purchaser becomes resident in Canada subsequently the cost of the property will be inflated back to its f.m.v. as per Sec. 128.1(1). If the option provides that if

opinion, an incorrect interpretation of will law and its to be noted that in the above case Minister's counsel argued that the exercise was the realization of a testamentary gift, thus avoiding the application of Sec. 69(1) and causing Sec. 107(2) to apply.

A condition may be placed upon the right of the taxpayer to or to receive trust property so that the taxpayer can only receive/use the trust property if he performs some act or an equitable charge may be placed directly upon the property of the trust regardless of to which beneficiary it is ultimately distributed so that whoever receives the property must perform the act as a condition of accepting the property as such. In the former case a particular beneficiary having an otherwise contingent interest may also be required to pay an amount of funds to other specified beneficiaries if the contingent event occurs and his hence absolute right operates to preclude them from receiving large trust benefits that they otherwise would have received. An equitable charge is a the lien placed on property devised for the payment of a reoccurring or one time nature but does not create a trust itself since the devisee does not have any personal obligations to administer/hold the property for the benefit of the recipient. An equitable charge is however merely a security interest and remedy for breach in payment/fulfillment lies against the property not the party holding it. The devisee benefits personally to the extent that the benefits of the property are not used/needed to make the payments and the intermediary is under no obligation to supplement the payments if the income/benefits from the property are deficient. It is this latter aspect that principally distinguishes it from a trust.¹⁶⁶⁰

In *Joseph Harold Wilson v. M.N.R.*¹⁶⁶¹ a testator bequeathed a business and its premises to the appellant but on condition that he pay monthly sums to his mother for her life and upkeep her residence. Upon attempting to deduct such "rental" payments incurred to produce business income the appellant "hit the standard old brick wall" and had to go through the Appeal Board and Exchequer Court before appealing to the Supreme Court of Canada. The equitable charge had been placed only against the premises and not the business itself and as such, in the minds of the Supreme Court judges on April 5th, 1955, constituted a deductible expense, rental in nature, in computing the taxpayer's business income.¹⁶⁶² If the charge was instead against a personal property bequest then the same should not result for the obvious reasons.¹⁶⁶³

Whether or not an equitable charge placed upon an income recipient obliging him to support other people out of it can be described as a trust itself is an interesting topic however the parties to be supported by an immediate recipient of income under a trust or estate, as a condition of the bequest, may be found to have what is technically defined as a "capital" or in this case "income interest" if their rights to support by income or capital originating in the trust can be recognized and enforced in equity, regardless of the actions of the intermediary recipient. In *Bouck v. M.N.R.*¹⁶⁶⁴ a spouse was to be able to "dip" into funds provided in an "income account" made available by the trustees of a residuary estate, whereby she had sole control to use them "to maintain a home for herself and my children, for the maintenance of my wife and my children, for the proper education of my children, and otherwise for the benefit of my wife and my children as my wife in her sole discretion may from time to time determine". The Supreme Court of Canada felt that although the

exercised another Canadian resident will gain a right of first refusal in respect of the subsequent disposition of the property, then upon such a subsequent disposition the newly resident taxpayer will recognize marginal tax consequences and will have realized a net "bequest" equal to the "benefit" realized on the exercise of the option while the proceeds from the exercise of the option could be distributed by the estate to the secondary beneficiary acquiring thus allowing him to recognize a cost of the property equal to its f.m.v. while only effectively paying 25-50% of its f.m.v. for it. The testator will have his terminal capital gains reduced by the loss recognized and even if Sec. 105(1) could be applied to the benefit realized on the exercise of the option it wouldn't be applicable to non-residents. (See *Coolen v. Coolen & Smith*, 1981 43 N.S.R. (2d) 67, for an example of this arrangement.) This is an excellent reason why the Department would adopt the opinion that a testamentary option is a specific bequest: no loss could be created. *Inter vivos* options and those given by the trustees in their discretion could produce the same result. As mentioned above, subsection 105(1) can prove to be a substantial deterrent to the offensive use of testamentary options since any benefit realized on the bargain purchase of the estate property could be fully included in the purchaser's income and would thus lead to greater taxation than that reduced on the Sec. 164(6) carry-back.

¹⁶⁶⁰ See *Buhlman v. Nilsson*, 29 C.L.R. 417, and *Pearce v. Wright*, 39 C.L.R. 16.

¹⁶⁶¹ 55 D.T.C. 1065

¹⁶⁶² It is not mentioned in the report whether the Minister was subsequently successful in assessing the substance of the deduction as rental income in the hands of the appellant's mother or whether he assessed it as being a benefit under Sec. 105(1).

¹⁶⁶³ See *Re: Walker*, 13 D.L.R. (3d) 688.

¹⁶⁶⁴ 52 D.T.C. 1090

spouse had considerable discretionary power to apply the income the protection of the children's' benefits could be provided by the courts if the discretionary power was not exercised properly or where the creditors of the spouse were about to seize her interest. The children's' rights to maintenance, education, etc. through the discretionary application of trust income could be found to be trust interests in that the children were recognized as beneficiaries and that their right to income from the trust was restricted by the widow's discretion but could not be restricted where a court would intervene and overrule improper uses of the power. In this case the absolute entitlement of the widow to the income used and whether the gross amount used by her was to be included in her personal income was of concern and it was found that the part expended in respect of the children could be found not to be accessible in her hands, but in the hands of the children. In *Allen v. Furness*¹⁶⁶⁵ the Court of Appeal allowed for, for the purposes of this discussion, the protection of offspring's beneficial rights where a very similar situation existed. In *C.I.R. v. Simpson*¹⁶⁶⁶ the Court of Appeal held that income paid to a parent for an offspring's use was paid in trust for the offspring thus substantiating the offspring's rights, a special situation however, while in *Countess of Bective v. F.C.T.*¹⁶⁶⁷ an income trust was recognized to exist where an intermediary was required to maintain offspring and her involvement would be terminated upon the offspring's attainment of the age of 15 and the possibility of her personal benefit being remote, (if there was a gift over on the offspring's death).¹⁶⁶⁸ The intention of the testator is understandably critical in determining whether an equitable charge or a trust is created. If there is a planned reversion of any benefit from the property in excess of that paid to the third party the intermediary recipient is not to benefit personally and the conveyance creates a trust. The rights of the ultimate recipient can consequentially be "income" or "capital interest" under the ITA.

Where a trust power is instilled in the trustees, so as to compel them to exercise it if the conditions expressed arise it may be possible for the subject beneficiary to be recognized to have a technically defined income or capital interest by virtue of the fact that he can apply to the courts to have the trust power exercised however until the court enforces the action of the beneficiary does he not have only a right to have his conditions considered by the power holder with the power holder under a fiduciary obligation to respond to them as compared to a right to cause the power holder to exercise the power? In the author's opinion he merely is the object of the fiduciary power until it is exercised having no rights, per se, to the trust capital or income, even though the power holder may be compelled in equity to grant him such rights as per the expressed conditions in the trust deed.

"Beneficial Interests."

There are two types of specifically defined "interests" in a trust recognized under section 108 and these two types of property are given special consideration/treatment throughout the Act however they are but a subset of a larger category of property which are known under trust law as interests in the trust and as one flips through the Act it should become apparent that if Parliament had wanted a reference of "an interest in a trust" to be read as a specific type of interest, (either income or capital), as defined in section 108, they would have introduced the appropriate bridging definition in Sec. 248(1) or elsewhere. Obviously when one reads "an interest in a trust", the reference extends to include not just technically defined tax property forms of "capital" and "income interest" but also the other types of trust law "interests" that are not included in the definitions of these two, and in particular discretionary interests. The same can be said concerning references to "beneficially interested" or "beneficial interest" however one should recognize that in this case, if the Department furnishes a definition for the term as it is used in a particular instance then the "technical" definition supersedes that which could be extracted from common law, and in the case of Sec. 74.5(10) and 94(7) this may be advantageous in that those two definitions are not too well constructed.

"Beneficially interested – Sec. 248(25)"

1665 20 A.R. 34

1666 1989 2 N.Z.L.R. 704, (CA)

1667 47 C.L.R. 417

1668 See also *Hourigan v. Trustees, Exors., & Agency Co. Ltd.*, 51 C.L.R. 619.

(25) For the purposes of this Act,

(a) a person or partnership beneficially interested in a particular trust includes any person or partnership that has any right (whether immediate or future, whether absolute or contingent or whether conditional on or subject to the exercise of any discretion by any person or partnership) as a beneficiary under a trust to receive any of the income or capital of the particular trust either directly from the particular trust or indirectly through one or more trusts or partnerships;

(b) except for the purpose of this paragraph, a particular person or partnership is deemed to be beneficially interested in a particular trust at a particular time where

(i) the particular person or partnership is not beneficially interested in the particular trust at the particular time,

(ii) because of the terms or conditions of the particular trust or any arrangement in respect of the particular trust at the particular time, the particular person or partnership might, because of the exercise of any discretion by any person or partnership, become beneficially interested in the particular trust at the particular time or at a later time, and

(iii) at or before the particular time, either

(A) the particular trust has acquired property, directly or indirectly in any manner whatever, from

(I) the particular person or partnership,

(II) another person with whom the particular person or partnership, or a member of the particular partnership, does not deal at arm's length,

(III) a person or partnership with whom the other person referred to in subclause 248(25)(b)(iii)(A)(II) does not deal at arm's length,

(IV) a controlled foreign affiliate of the particular person or of another person with whom the particular person or partnership, or a member of the particular partnership, does not deal at arm's length, or

(V) a non-resident corporation that would, if the particular partnership were a corporation resident in Canada, be a controlled foreign affiliate of the particular partnership, or

(B) a person or partnership described in any of subclauses 248(25)(b)(iii)(A)(I) to 248(25)(b)(iii)(A)(V) has given a guarantee on behalf of the particular trust or provided any other financial assistance whatever to the particular trust; and

(c) a member of a partnership that is beneficially interested in a trust is deemed to be beneficially interested in the trust.

Most of the references in the Act to "interest in a trust" or "beneficially interested" are there as a matter of anti-avoidance/equity measure to ensure that certain rules are not taken advantage of or avoided by having a degree of legal ownership control through a trust arrangement in certain property (rather than directly) and thus the particular term serves as a maximal indicator of "connectedness", "association" etc. with the legal ownership of the property or with the trust activity. Under the formerly effective Estate Tax Act taxes were applied on property passing on the death of a person and such property included "interests" in trusts while the Ontario Succession Duty Act applied basically the same criteria on the same basis. Both of these Acts operated to include such property on the basis that if they didn't the taxpayer could simply transfer the property to a trust, taking back the interests and then have the interest exempt from succession duties while the property wouldn't have been if it had been owned instead. The Acts however had a different purpose than the Income Tax Act; (to collect duty on the value of property passing on death) but this does not preclude judgments in respect of those Acts, on the extent of the "connectedness", "association" of the taxpayer with the trust via his "interest" or whether or not he has one therein, from being relevant in determining whether a taxpayer has "an interest in a trust" for purposes of the ITA.

As well there is the secondary issue of to which property this "beneficial interest" is based: one can be beneficially interested in a trust as compared to having a proprietary emphasis of being beneficially interested in its property. Subsection 74.4(4) provides an example of beneficial interests in specific trust property (as well as Sec. 94.1(1) perhaps), as compared to merely being interested in the trust regardless of its property, (as described in the personal trust definition for example). The former implies the latter but not vice versa.

In *McCreath v. Minister of Revenue for the Province of Ontario*¹⁶⁶⁹ the Supreme Court held that the term "interest" for the purposes of The Succession Duty Act is to have "a meaning wider than that which it would have in a technical conveyancing context", and then pointed out an English case, *Attorney General v. Heywood*¹⁶⁷⁰:

"In *Heywood* the settlor created a trust fund of 43,000 pounds held on the following trusts; to pay income to such of the settlor, his wife and children for the settlor's life as the trustee should choose and on the settlor's death to hold the property in trust for the widow and children. It was argued that all that was reserved to the settlor was a mere possibility or contingency and not an interest. Stephen J. held that the settlor had retained an interest for life within the terms of the statute and Wills, J. stated, p. 331;

"The application of the word "interest" is not confined to a vested or a necessarily contingent interest.

The Act was meant to cast a wider net than such a construction would imply. The settlor here could only be deprived of the benefit he would otherwise get under the settlement by the exercise of the power of depriving him of such benefit which was vested in the trustees, and unless the trustees so deprived him he would necessarily get a benefit."

The same interpretation of "interest" was adopted in *Attorney-General v. Farrell*, [1931] 1 K.B. 81 (C.A.), where the settlor was also a discretionary object of income of a trust for his life with a gift over on his death..."

In *McCreath* the settlor retained a purely discretionary interest in the income of the trust: and her interest in the trust property was wished to be avoided for succession duty purposes. In *Gartside v. I.R.C.*¹⁶⁷¹ Lord Reid commented on the interpretation of the scope of a discretionary object's connectedness to a trust:

"It is always proper to construe an ambiguous word or phrase in light of the mischief which the provision is obviously designed to prevent, and in light of the reasonableness of the consequences which follow from giving it a particular construction. Here (in *Heywood*), if "interest" were given a narrow or technical meaning, it would be very easy to defeat the obvious purpose of the provision by setting up a discretionary trust and choosing trustees who might be expected to exercise their discretion in favour of the settlor. And on the other hand, no unreasonable consequences would

1669 (1977) 1 S.C.R. 2,
1670 (1887) 19 Q.B.D. 326
1671 [1968] A.C. 553 (H.L.)

follow if the word were given a wider meaning so as to include possible benefit that would come to the settlor in a certain event..."

In McCreath Judson J. held in conclusion:

"The fact that a discretionary object may have no interest in property law terms because she has no **"right" to a definable amount** of income is irrelevant. I do not believe that the niceties and arcana of ancient property law should be fastened upon with mechanical rigidity to determine the effect of a modern taxation statute whose purpose is plain."

Pursuant to Leedale v. Lewis and Gartside the character of the right the beneficiary possesses must be evaluated to establish if it is properly targeted by the particular statute that is contended to apply and if it can't because its scope or value can't be established etc., it does not fall to be subject to the provisions. Within the ITA "beneficial interest" is to have its broadest connotations and the established jurisprudence must be applied in light of this.

Following the above it would seem that where a taxpayer has a power of appointment, general or otherwise, over trust property, and the power can be exercised so as to have legal title of trust property vest in the taxpayer, the taxpayer could easily be found to have a "beneficial interest" in the trust following the reasoning in McCreath supra. Although in Wanklyn et al. v. M.N.R.¹⁶⁷² previously mentioned, the holder of an exclusively self-targeted power of appointment was considered not to be beneficially entitled in the capital (and thus not have a Sec. 108(1)(e) "capital interest" in the personal trust), until the power was exercised, he could easily be seen to be "beneficially **interested**" in the estate in that he had received capital distributions pursuant to its exercise and such, in the words of Laskin C.J., in McCreath, "would suggest such an interest, in the sense of pecuniary stake in the fund." In the author's opinion if the obviously specialized purpose exclusively self-targeted power of appointment in Wanklyn was the issue of litigation concerning "connectedness" or "association" under the Act by virtue of the phrase "beneficially interested in a trust" the holder would have little defence, ... however how can the Department "chase" after general powers of appointment that are not limited to being exercised in respect of a particularly limited class of appointees, while the appointer is not excluded from the group?¹⁶⁷³

In the absence of technical statutory targeting, the definition of "beneficially interested" can be found to have a far reaching effect and the phrase has been the controversy of a few tax cases, mostly in respect of succession duties. In Montreal Trust Company (Torrance Estate) v. M.N.R.¹⁶⁷⁴ a taxpayer bequeathed three separate amounts to his wife, his offspring, and two charitable organizations while that of the charitable organizations was conditional on their payment of the succession duties on it, as well as the other two, regardless of whether or not the spouse and offspring accepted their bequests. Some question arose as to whether the payments on account of duty made by the charitable organizations was itself a succession of property and while the legatees did not have a direct right to enforce the duty payment the trustees did. When the duty payment failed to be made in respect of the spouse and offspring the charitable organization would not receive the fund but instead the trustees would pay out of that fund the duty applicable to both and apply the balance to other annuities specified. The charitable organization paid the duties. The Minister's submissions concerning the dutiable nature of the payments, as subject to a beneficial entitlement of the legatees were entertained by Locke J. while the taxpayers relied upon the rule in Re Miller's agreement; Uniacke v. A.G.¹⁶⁷⁵ that in order to be "beneficially entitled" a person must be the **immediate** possessor of a right to sue for the recovery of trust property. As per Judge Locke:

"As matters stand, the covenants of the charities to pay the duties are enforceable against them by the trustee. It is true that the legatees have no remedy **directly** against the charities, but they may each require the trustees under the will to enforce compliance with these covenants and failing

¹⁶⁷² 53 D.T.C. 1167,

¹⁶⁷³ In the case of special powers of appointment the objects of the power may have a "beneficial interest" as per the reasoning in Lutheran Church of Australia v. Farmer's Co-Op, 1970 121 C.L.R. 628, at 635.

¹⁶⁷⁴ 58 D.T.C. 1051, (SCC)

¹⁶⁷⁵ [1947] 2 All. E.R. 78,

such compliance, to pay the succession and other duties out of the corpus of the Charities Fund, as directed by the will."

This was one of the first cases in the Canadian context where indirect rights were found to cause the holder to be considered at common law, beneficially entitled to property held in a trust. In *J.C. Mackeen Estate v. Minister of Finance*¹⁶⁷⁶ a part of an arrangement to avoid Succession Duty was of question where the testator had previously transferred property to Albertan resident R. Ltd. for shares and debt as consideration. Upon his death the shares and debt were to be held in trust the income therefrom, during the lifetime of his wife, to be paid to Alberta resident P. Ltd., the common shares of which were held by his wife. Upon the spouse's death the instruments were to be divided and transferred to a non-resident and three Albertan resident corporations, which were owned by another three Albertan resident holding companies the shares of which were held by his daughters. While the lengthy arrangement was initiated so that no testamentary recipient Albertan corporation had Nova Scotian resident shareholders thus exempting the bequests from succession duties, the Minister contended that the offspring and spouse were successors to the estate property; (while being particular the Nova Scotian Succession Duty Act S.N.S. 1972 provided that if the shareholders of a non-resident corporation which became "beneficially entitled" to estate property they would be **deemed** successors, and subject to the duty on the increase in value of their shares). At issue was whether the holding corporations, which were non-resident, the shareholders of which were the widow-offspring, became "beneficially entitled" to the trust property the trust interests of which were given to the operating corporations. Counsel for the Minister of Finance argued that since the parent corporation could wind-up the operating corporation which received the bequest and which was wholly owned, the parent corporation would be "beneficially entitled" to the property thus the widow/offspring would be subject to succession duty on the shares, while the executors argued that the phrase "beneficially entitled" had a "well defined legal meaning" and indicated the ability to sue for the recovery of the property (through execution of the will/trust agreement). Judge Hart provided, in conclusion:

"The person beneficially entitled to property may be further removed from the exercise of ultimate ownership of the property than the "beneficial owner", but as long as that person has the right to legally establish the exercise of the rights of ownership over the property then it may be said that he is beneficially entitled thereto;

...In my opinion the Legislature of Nova Scotia in using the expression "where a corporation...becomes beneficially entitled to a property of the deceased" it is using it in the broad sense to cover the situation where the corporation is put in a position to **ultimately** exercise the rights of ownership over property of the deceased. It would be unnecessary to use additional words such as "directly or indirectly" or "is controlled by" to effect its purpose. **"Becomes beneficially entitled to" is broad enough to cover situations in which the property is registered in another name or held in trust or placed in any form in which the corporation can legally recover the property for its own benefit.**¹⁶⁷⁷"

An almost identical arrangement was of issue in *R.A. Jodrey Estate v. Minister of Finance (N.S.)*¹⁶⁷⁸ concerning the same succession duty Act however this time the issue was presented to the Supreme Court of Canada. Essentially, the testator had bequeathed property to an Albertan resident company the shares of which were held by an Albertan resident holding company while the shares of the latter were owned by his Nova Scotian resident grandchildren. The Minister contended that the holding company could be recognized as successor and thus the increase in the value of the children's shares was subject to duty, and again subject to verification was whether or not a holding corporation could be recognized as "beneficially entitled" under an estate when it wholly owned the subsidiary direct testamentary legatee. Martland J. provided on the issue:

"...In my view, the corporation is no less "beneficially entitled" when the property is held by its wholly-owned subsidiary as when it is held in trust for it. **Its legal entitlement is even more immediate as it does not have to call upon a third party to perform its obligation as trustee.** It only has

1676 [1977] C.T.C. 230, (N.S.S.C.)

1677 This opinion was maintained by the Appeal Division in [1978] C.T.C. 557.

1678 [1980] C.T.C. 437

to exercise its rights as sole shareholder of its subsidiary. Nothing in the context of the subsection 2(5) justifies giving a restricted meaning to the expression "beneficially entitled" which ought to be read according to the meaning of the words in ordinary language. I cannot find that it has acquired a technical meaning to which it must be restricted in this statute"

"...The fact that it was not made a beneficiary under the will does not preclude this finding in view of the fact that it had complete and absolute control of the named beneficiary, the subsidiary company, and had the legal capacity to compel that company to turn over to it the share of the estate bequeathed to it."

"...to use the words of Rand, J. in the Montreal Trust Company (supra) case, the parent company though having no right as a beneficiary of the will to sue the executors directly had "an ultimate and alternative resort as the effective cause of payment."1679

With Torrance Estate, Mackeen Estate, and Jodrey Estate representing consistently authoritative opinion that a taxpayer is "beneficially entitled" or "interested" under a trust when he can ultimately and alternatively resort to an effective cause of payment other than that supported by a right, held as a beneficiary, under the trust/estate directly one should be quick to realize the restrictive effect they have on the Sec. 74.5(10) and 94(7) definitions of "beneficially interested", (for purposes of income attribution and application of foreign resident trust provisions), and their scope when such special statutory definitions do not apply in respect of the phrase. The two statutory definitions apply to taxpayers who hold the rights to **directly** receive property from the trust or indirectly receive property from the trust through one or more trusts, **but not** corporations or partnerships. These features are considerable given the topics discussed under Mackeen Estate and Jodrey Estate. Very much unlike the definitions of "capital" and "income interest" defined in Sec. 108(1)(c) and (e) the "beneficially interested" status may arise only when the right exists to receive the property in either of the specified manners (as opposed to have it indirectly applied for ones benefit), but perhaps the most important distinction is that it would appear that the holder of such a right need not be a beneficiary under the trust, as compared to the Sec. 108(1)(c) and (e) definitions where the right holder acts in a capacity expressly as a beneficiary under the trust.¹⁶⁸⁰

Whether or not a taxpayer is beneficially interested in a trust if he takes back a reversionary interest is a topic that was one of the issues in *The National Trust Company Ltd. v. M.N.R.*¹⁶⁸¹ while in that case the Exchequer Court held that the taxpayer is not assessable in respect of a possible reversion under the Dominion Succession Duty Act due to the fact that both legal and equitable interests had been disposed of by the taxpayer. This was confirmed at the Supreme Court of Canada level¹⁶⁸² if the beneficiary to which the equitable title had been transferred died before he did, the property would revert to him directly, however, in the author's opinion the term "interest" in this case was given too mechanical a definition, restricting it to essentially a property interest, while if the rationale in *McCreath* supra. applied the reverter would most likely have been subject to succession duty. The case however does comment on a few cases where it was held that a provision for reversion of legal title on the failing of the completion of the gift did not render the gift one in which the donor was not excluded from possession or enjoyment or benefit, such as *C. of S.T. New South Wales v. Perpetual Trustee Co. Ltd.*¹⁶⁸³, *Cochrane*¹⁶⁸⁴. On the other hand in a judgment in *Helvering v.*

1679 Dickson, J. representing the dissenting minority provided to no avail that "...The fact that there would be no legal impediment to one acquiring the property is not sufficient. Beneficial entitlement arises only in those situations where equity recognizes the interest". He also made note to *People v. McCormick*, (1904), 208 Ill.R 437, and, *Montana Catholic Missions v. Missoula Country*, (1905), 200 U.S. 118, as two cases where equity recognized beneficial rights were restricted.

1680 Can this extremely obvious deficiency be interpreted to mean that option holders, creditors, etc. will be considered "beneficially interested" for purposes of the income attribution and foreign resident, even though the charging provisions of the Act to which these parties are recognized expressly denote them as "beneficiaries"? In the author's opinion the answer to this question provided by R.C. should be documented in a form not weaker than a ruling.

1681 [1946] Ex. C.R. 650,

1682 54 D.T.C. 1164

1683 (1943) A.C. 425

1684 (1905) I.R. 626-(1906) I.R. 200

Hallock¹⁶⁸⁵ the Supreme Court of the United States held that provision for a reversion effectively created an interest in the gift held by the giftor that terminated only upon his death.

In the author's opinion, the reasoning in *Helvering v. Hallock* could easily prevail in ascertaining whether a taxpayer is "beneficially interested" in a trust or whether he has an "interest" in a trust for purposes of the Act. Clearly under a reversion the contributor has in a very broad terms reserved himself a contingent right to receive trust property although he may not hold that right as a beneficiary thus in the author's opinion he could easily satisfy the Sec. 74.5(10) and 94(7) definitions of a "beneficially interested" while he may not be recognized as having a "capital" or "income interest".

1685 309 U.S. 106,

Costs of Income and Capital Interests.

The cost of income or capital rights (interests) under trusts or estates, whether personal or otherwise, has become a more important aspect of tax planning with trusts as the Department of Finance, in the 1988 reform, has made alterations to the ITA that cause tax consequences to be recognized more frequently in respect of the cost of certain interests, while as a means of integration of the taxation of benefits flowing out from the trust the cost of the "interest" has always been important. In *The Queen v. Stirling*¹⁶⁸⁶ it was held with respect to the term cost in Sec. 40(1)(c)(i) and 54(a)(i):

"As we understand it the word "cost" in those sections means the price that the taxpayer gave up in order to get the asset; it does not include any expense that he may have incurred in order to put himself in position to pay that price or to keep the property afterwards."¹⁶⁸⁷

The "cost" described is important for both income and capital interest cost purposes.

Income Interests.

Under subsection 106(1.1) the cost of an "income interest" is restricted but only for the purposes of the Sec. 106(1) cost deduction provision¹⁶⁸⁸. Where the income right is under a non-personal trust then Sec. 106(1.1) will not apply and instead, since the right will be considered a "capital interest", the Sec. 107(1.1) cost definition acting in concert with the other general provisions of the Act, (such as Sec. 52(1)-(6)), will determine its cost however in respect of "capital interests" and Sec. 107(1.1) it is important to recognize that that provision determines only the **initial** cost for "capital interest" but through events that transpire as the interest is held, due to (mainly) Sec. 53(1) and (2) there will be on-going cost adjustments to the "ACB". It is this latter adjustment process that will often hinder advantageous estate/trust transactions and cause tax consequences indirectly.

Subsection 106(1.1) provides that for purposes of the cost deduction provision in Sec. 106(1), and notwithstanding Sec. 69(1)(c), the cost of an "income interest," unless acquired only from a **former beneficiary**, shall be nil hence obviously, since a beneficiary is required to recognize full proceeds of a disposition of an income interest in income under Sec. 106(2)¹⁶⁸⁹, it will only be where a previous beneficiary has had to recognize tax consequences that the subsequent beneficiary will be able to recognize a deductible cost. If the income right was acquired directly from the trust itself for consideration payable, as per the new "personal trust" rules such a right could never gain the status at an "income interest" and it would be treated under the capital interest rules and at the same time as an **acquisition for consideration payable**, would taint the trust and cause all at the other rights thereunder to be considered "capital interests."

"Cost of income interest in a trust – Sec. 106(1.1)"

(1.1) The cost to a taxpayer of an income interest of the taxpayer in a trust is deemed to be nil unless
(a) any part of the interest was acquired by the taxpayer from a person who was the beneficiary in respect of the interest immediately before that acquisition; or
(b) the cost of any part of the interest would otherwise be determined not to be nil under paragraph 128.1(1)(c) or (4)(c).¹⁶⁹⁰

¹⁶⁸⁶ 85 D.T.C. 5199

¹⁶⁸⁷ See also *Bodrug Estate v. The Queen*, 90 D.T.C. 6521 FCTD.

¹⁶⁸⁸ that allows the certain recognized cost to be deducted from proceeds recognized from both its extinguishment and disposition

¹⁶⁸⁹ in the case of residents

¹⁶⁹⁰ March 2001 FINANCE TECHNICAL NOTES: Subsection 106(1.1) Provides that, for the Purposes of determining the deduction available under subsection 106(1) in respect of a beneficiary's income interest in a trust, the cost to the beneficiary of the interest is nil except where the interest was acquired from a beneficiary under the trust.

Subsection 106(1.1) is amended so that the deemed nil cost also does not apply to a beneficiary's income interest in a trust where

- any part of the interest was acquired from a person who was the beneficiary in respect of the interest immediately before that acquisition, or
- the cost of any part of the interest was ever, determined not to be nil under the taxpayer migration rules in section 128.1.

Subsection 106(1.1) is also amended to ensure that it applies for the purposes of the Act, and not simply subsection 106(1).

The Sec. 106(1.1) provision does not state that the amount of consideration paid for the right will equal its cost although it is this amount of proceeds that the interest disposer will be required to recognize in income under Sec. 106(2). Subsection 106(2)(c) requires that the fair market value of the property at the time of the interest's disposition received as consideration for a disposition at the interest be included in the disposer's income however it does not have, on its own or in concert with Sec. 106(1.1), any effect on the cost of the interest the acquiror is to recognize upon the purchase.

Testamentary Transfers of Existing Interests.

Subsection 69(1)(c) does not apply where Sec. 106(1.1) applies to determine a resulting cost to a recipient of property received via a gift, bequest or inheritance. Under Sec. 69(1)(b) where a taxpayer has disposed of a property via a gift *inter vivos* he will recognize proceeds equal to its fair market value however if the property was an income interest, (or a capital interest for that matter), the recipient of the gift will not recognize a cost in that Sec. 69(1)(c) would apply, which is expressly provided in Sec. 106(1.1).¹⁶⁹¹ It's also important to recognize that the cost to the recipient will be nil where he receives the interest as a testamentary gift, a bequest, or an inheritance, regardless of the fact that the disposer may have had to recognize it's fair market value in his terminal income under Sec. 70(2). Subsection 70(2) requires that the **value** of rights or things, (which clearly includes an income right), that are not capital property, be included in the deceased's terminal income except where Sec. 70(3) applies. If it doesn't apply the deceased will recognize the value of the property and if it is bequeathed to the taxpayer, Sec. 69(1)(c) will apply and again the taxpayer will not be able to recognize a cost as per Sec. 106(1.1). If Sec. 70(3) applies when the right or thing has been transferred or distributed to beneficiaries or other persons beneficially interested in the estate or trust then Sec. 70(2) requiring recognition of the interest's **value** will not apply and the amount received by the recipient upon the ultimate realization or disposition of the right by the recipient will be included in his income. Is it possible for the income interest to cause a substantial Sec. 70(2) inclusion with respect to the deceased, be bequeathed to a beneficiary and then be recognized in the beneficiary's hands as a capital property so that when it is subsequently satisfied through an income distribution the income isn't taxable? Income rights in trusts are fully subject to Sec. 70(2) and when a testator recognizes a Sec. 70(2) inclusion the substance of that right, when realized by the beneficiary, is on account of capital however would CRA tax the excess, or attempt to tax the excess of the income ultimately realized by the beneficiary in respect of the right over the value of the right recognized by the testator in the Sec. 70(2) inclusion? The value of the right may legitimately change after the death and the right may become enlarged or more income may simply be realized by the trust however one must recognize that Sec. 69(1)(c) does not apply to the bequest of a right following the Sec. 70(2) inclusion since subsection 106(1.1) provides otherwise.¹⁶⁹² If the testator recognizes a net Sec. 70(2) inclusion, (net of his deductible cost), in respect of the right, in the author's opinion the excess amount of income realized subsequently by the beneficiary will lead to an income inclusion. The Sec. 70(2) roll through does not change the character of the income interest nor does it allow the alteration in the character of the

1982 FINANCE TECHNICAL NOTES: Subsection 106(1) of the existing Act permits an income beneficiary of a trust to deduct the cost of his interest in the trust in computing his income from the trust. Subsection 106(1.1) is added to the Act to deem the cost to a taxpayer of an income interest in a trust to be nil except where it is acquired from a previous beneficiary.

1981 FINANCE NOTICE OF WAYS AND MEANS MOTION: That the Act be amended to clarify that the cost to a person or partnership of a capital or income interest in a trust is nil unless the interest was acquired from a person or partnership that was the beneficiary in respect of the interest immediately before its acquisition.

1977 FINANCE NOTICE OF WAYS AND MEANS MOTION: That a provision be added for greater certainty to ensure that where an income interest in a trust arises after March 31, 1977 on the death of an individual and is acquired as a result thereof its cost is nil.

1691 An income interest should rarely be the subject of an *inter vivos* gift unless the parties are non-resident so as to prevent inequitable tax consequences under Sec. 69(1)(b).

1692 It could be argued to apply regardless since the income right will become trust law capital and when the specific devise of it to the beneficiary is assented to Sec. 107(2) operates to effect the flow through of the trust's cost thereof.

source of the payment made subsequently hence the income accrued up to the date of death will be taxed under Sec. 70(2), **and** when subsequently realized, under Sec. 104(13). Income interests in trusts should always gain Sec. 70(3) treatment if possible.

Under Sec. 69(1.1) where the interest has been acquired under the Sec. 70(3) roll through Sec. 69(1)(c) isn't applicable and the taxpayer will be deemed to have acquired the interest at a cost equal to that recognized previously by the deceased plus any costs incurred to acquire it. Under Sec. 70(3) it should be recognized that there is a distinction made between beneficiaries and **other** persons beneficially interested in the estate or trust although no one seems to be able to describe, in the context of the Act, how the two may differ. It should also be noted that the provision may not provide relief where the income interest was transferred to the resulting testamentary trust or remained property of the estate in that the only eligible recipients are those that are beneficiaries or beneficially interested in the estate or trust.¹⁶⁹³

Subparagraph 70(3)(b) requires the beneficiary to include the amount realized on the disposition or satisfaction of the right in computing his income however under Sec. 106(2)(a), where the interest is renounced/disclaimed or terminated through a property distribution by the trust, the proceeds will not be includable in computing the income of the beneficiary. Subsection 70(2) and (3) offer rules specifically targeted at applying to a general class of property held by testator while section 106 provides rules specifically targeted at a certain form of property and how it is involved in a few general transactions and thus it could be quite successfully argued that Sec. 106(2)(a) and 106(3) supersede Sec. 70(3)(b) when an income beneficiary receives trust property in satisfaction of his income interest. This is unfortunate since the Sec. 70(3)(b) inclusion basis is those amounts **received** and although Sec. 106(2) may not cause tax consequences on a commutation of the interest Sec. 70(3)(b) will.

Where the beneficiary pays consideration, or incurs costs, to acquire the right those expenditures will be added to the cost of the property via Sec. 69(1.1)(b)(ii). Where they are paid to legal counsel to protect her testamentary right to the interest then they will be added to the cost only when the interest is successfully acquired. Where it isn't, the expenditures will be an expense incurred to produce income and will be deductible immediately. Where the right is transferred or distributed to a beneficiary with an equitable charge stating that he pay a certain amount back to the estate/trust or other beneficiary he will be able to add on that expenditure made to his cost, however one has to look at the nature of that expenditure made in the hands of the recipient to appreciate the deficiency in the Sec. 70(2), (3), 69(1.1) system. If the interest would have passed to another party, other than the recipient of the cash payment, then the expenditure to the third party was a valid expenditure to acquire the interest however since the recipient of the cash would not have received the income interest ultimately one has difficulty in attempting to classify the nature of that cash received. In all but the rarest of cases it will be a capital receipt in that the recipient did not dispose of an income property, nor could it be said to have been acquired in lieu of an income property. The tax neutral result of this is that the acquiror of the interest will be able to add the expenditure on to his cost which can negate any income subsequently realized in respect of the income interest while the recipient of the cash payment extinguishing the equitable charge will be included in income under Sec. 105(1) as a benefit from or under a trust. This will thus allow the deceased to provide "extra" benefits to beneficiaries that were not otherwise possible and at the same time provide for a bump-up in the cost of the interest. Subsection 105(1) does not apply in respect of non-resident taxpayers as per Sec. 212(1)(c). It also can't apply where the recipient must extinguish some testamentary debt so as to receive the rights which creates a tax advantage when the creditor is "a friend of the family". It should definitely be recognized that Sec. 70(2) causes the **value**, (being accepted as present net fair market value rather than net "tax" value), to be included in income and does not cause a deemed disposition to which Sec. 106(2) could apply. **If** a disposition could be recognized with the accompanying

¹⁶⁹³ Is it possible for a testamentary trust to be created whereby an interest is held as received from the estate from which it arose? or vice versa? One particularly important aspect about the Sec. 70(3) provision is that it recognizes the difference, for purposes of the application of the provision, between an estate and a trust by the fact that it refers to **both** and does not just identify both with the term "testamentary trust". This phenomenon is important in that in other provisions of the Act such a proper "targeting" is not effected and it reveals distinctive legislative intention. Such is especially the case with the Sec. 70(7)-(8) tainted spousal trust rules where the general estate and any trust arising out of it are recognized distinct.

deemed or actual proceeds of disposition, the deceased could be able to take the Sec. 106(1) deduction to negate any tax effect, **but this is not possible**.

It cannot be overlooked that the previous discussion applies only to income interests that were held by the taxpayer and transferred upon his death, not to income interests that arose under trust or estate that were created due to his death since these latter interests were not in existence, as a separate species of property recognized under the Act, prior to his death.

Interests Created on a Death or Inter Vivos.

Where the income interest is created through the will or other resulting testamentary document upon the death of the taxpayer then under Sec. 106(1.1) and due to the inapplicability of the Sec. 70(3)-69(1.1) system it will have a cost to its holder equal to nil. Since a testamentary trust can never be a non-personal trust an income interest can be purchased from the trust directly without fear of tainting the trust, although the interest's cost will be nil as per Sec. 106(1.1). The taxpayer is thus free to layer testamentary conditions precedent upon interests as a condition of their acceptance although they will not increase the cost to be recognized by the beneficiary, for purposes of Sec. 106(1)¹⁶⁹⁴.

If the trust is *inter vivos* then an income interest can be acquired without tainting the trust's "personal" character only when the consideration is not payable directly or indirectly to the trust or to any person who has made a contribution to the trust by way of transfer, assignment, or other disposition of property. Where the creator of the *inter vivos* trust takes back an income interest **at the time of the creation** and then subsequently disposes of it to a third party, the trust will lose its personal status and the creator will have to recognize the proceeds of the disposition of the interest under Sec. 106(2). In both cases the acquiror of the interest will not be able to recognize a cost under Sec. 106(1.1) however under the former there will be no immediate income tax effects upon the acquisition, while under the latter they will be severe.¹⁶⁹⁵ It should be recognized that under the former case, where the interest was acquired from the trust for consideration payable to a non-related person, (who hasn't made a contribution to the trust), then that particular disponent person will not be able to make contribution to the trust subsequently either in that in doing so would taint the trust.

Upon the creation of a testamentary trust a trust discretionary power allowing the trustee to determine to whom a right to, or to receive income will vest may prove a valuable method of planning a tax effective bump up in the cost of such an interest. If a particular potential beneficiary, (who must be of a class specified under the trust deed), has a non-capital loss which is staledating and about to be lost the discretionary power may be exercised to grant him an "income interest" as per the definition of the term in Sec. 108(1)(e). A trust "interest" for purposes of the Act is defined as a right held by the taxpayer **as a beneficiary** hence the granting of a right through the exercise of a discretionary power can never be captured and included in income under Sec. 106(2). If the beneficial right to property in the trust is considered itself as a property of the trust, (which is a ludicrous thought), Sec. 54(c)(iii) **may** apply however there is not a single instance in Canadian, Australian, New Zealand or United Kingdom tax cases that the author knows of where the exercise of a discretionary power causing a right to be vested in a beneficiary has been looked upon as a disposition by the trust of a right to the property. By granting the interest to the taxpayer with the non-capital loss that is about to "fall off the table," the ultimate beneficiary may purchase it from him for proceeds equal to its fair market value whereby the disponent would recognize income which would be negated by the non-capital loss and the acquiror would recognize a cost equal to the amount paid for it. The funds could be gifted back in a subsequent period or the interest could be acquired by the initial beneficiary on condition that he set up a trust for the ultimate purchaser. Given that this can be done with particular small income interests through the

¹⁶⁹⁴ however in doing so he'll expose the condition recipient to a Sec. 105(1) inclusion though possibly with a deduction to the intermediary

¹⁶⁹⁵ Where the income right ceases to be an income interest but a capital interest due to the loss of the trust's personal status the consideration paid by the initial acquiror may not become the interest's cost since under Sec. 107(1.1) the consideration was not paid to a former beneficiary **in respect of a capital interest. The right was not a capital interest at that time.** The trust will be non-personal only after the completion of the transfer, and thus one should never sell a **substantial** income interest if it is going to be the transaction that taints the trust.

exercise of several trust discretionary powers one can see how the discretionary power can be useful. Where the discretionary power has the ability to terminate the right to the income, one can see that the beneficiary can be forced to dispose of the right to the ultimate beneficiary accordingly.

Costs Incurred verses the Cost of An Interest.

The cost of an "income interest" as a species of property is to be differentiated from expenses incurred to acquire income from the trust.

In *Gladys Evans v. M.N.R.*¹⁶⁹⁶ the taxpayer incurred legal expenses in obtaining a finding in court that she had an income life interest in a trust and the Minister denied the deduction thereof by her from her Division B income.¹⁶⁹⁷ The Supreme Court of Canada found that the expenses were incurred to produce taxable income and were thus deductible. If this case were to occur today the same would result since Sec. 106(1.1) defining the cost of income interests, refers only to costs **paid to the former beneficiaries**, not expenses incurred to acquire it.¹⁶⁹⁸

In *Drilol v. M.N.R.*¹⁶⁹⁹ a taxpayer and the executors of an estate settled a dispute over the right to a pension amount whereby the taxpayer paid \$26,000 in cash to the executors so that they would drop their claim. The Minister did not allow her to deduct the amount in computing her income on account that it was expended not to produce income however the Tax Court Judge, making incidental reference to *Evans*, found that the payment was made to produce income.¹⁷⁰⁰

There must be a direct link between the payment/expenditure and its purpose of producing income and this was to issue in *Gelinas v. M.N.R.*¹⁷⁰¹ where the taxpayer paid a considerable sum for legal fees related to the establishing of the validity of a will which effectively operated to bequeath to her capital shares of a firm in which she was employed. The Tax Court found that the action, and thus its expense, was to establish ownership of capital property and thus could not be said to be brought about to produce income while in respect of the contention of the taxpayer that one of the reasons she pursued such an action was to obtain the shares of the corporation, thus its control, so as to retain her employment and produce employment income the Judge found legal fees could only be deductible in respect to back pay, etc., not in respect of the acquisition of capital property.

Cost Inflations.

There are a couple of ways taxpayers can inflate the deductible cost of an income interest in a trust without causing tax consequences to the former beneficiary they purchase the interest from, thus neutrality can be avoided. If a trust is created having as trustees non-residents it will itself be considered non-resident and if that trust agreement grants income interests to non-residents then some interesting transactions can occur. Firstly, since the trust isn't resident the non-resident income beneficiary can dispose of his income interest to a Canadian resident without fear of marginal taxation following subpara. 115(1)(a)(iv). Fair market value proceeds should form the basis of the acquisition so as to avoid the application of Sec. 69(1). Following the acquisition the trustee(s) may become resident in Canada, if need be, however, even if they don't, the Canadian resident income beneficiary will be able to fully deduct the tax cost of the income interest against the income subsequently realized while the former beneficiary would not have been taxed on that deductible cost.¹⁷⁰²

¹⁶⁹⁶ 60 D.T.C. 1047

¹⁶⁹⁷ This case occurred prior to the implementation of Sec. 106(1.1) in 1981.

¹⁶⁹⁸ The latter doesn't prevent the treatment of the former.

¹⁶⁹⁹ 89 D.T.C. 122,

¹⁷⁰⁰ In essence he found that the purpose of the expenditure wasn't to acquire any right that wasn't previously held by her but was made so that the counter claim by the estate would be dropped. In this respect one should examine whether this case provides a basis upon which an argument can be based for the Sec. 69(1.1)(b) cost bump up of a "right or thing" acquired by a taxpayer under the Sec. 70(3) flow through when he has had to make such an expenditure. Technically, it would seem that the bump up should follow but the question remains how the receipt of the payment in the hands of the estate or other beneficiary should be treated: as capital or income.

¹⁷⁰¹ 89 D.T.C. 117

¹⁷⁰² Section 94-94.1 will apply to the non-resident trusts but can be managed

The second way involves the use of Sec. 75(2) whereby loss producing property is held in a trust but beneficially owned by its contributor, thus allowing the loss to be recognizable by both the trust and the contributor. If a taxpayer, which need not be "the contributor" in Sec. 75(2), creates a trust where the income interests are transferred to the holding trust then any Sec. 106(2) income recognition on the disposition of those interests by the trust will be absorbed by the losses being recognized, which are also deductible by the contributor.

Several marginal income interests can be granted to minor income beneficiaries in a testamentary situation who are not fully utilizing their personal tax credits. The trustees can, pursuant to their powers, accumulate income if the interests are not disposed of to a single consolidator and upon such a disposition the tax credits will be utilized however understandably there has to be a transfer of funds. After their transfer to the ultimate beneficiary the trustee can abstain from exercising his powers of accumulation, or have them canceled as a consequence of the transfer so as not to cause preferred beneficiary election problems etc..

Capital Interests.

Subsection 107(1.1) applies to provide that the **initial** tax cost of a "capital interest" acquired by the taxpayer will equal nil if certain conditions exist however once so determined the adjusted cost base of that interest **may** be subject to continual adjustments, corresponding to certain trust/beneficiary transactions, under Sec. 53(1)-(2). These latter adjustments may or may not apply to the capital interest, depending on the residency of the trust and its tax recognized character, however where they do, potentially substantial and quite possibly immediate recognition of tax consequences may occur when distributions are made but there is no commutation of the interest for instance. It is these adjustments that cause the holders of capital interests on-going concerns as trust/beneficiary transactions occur.

Quite similar to Sec. 106(1.1), subsection 107(1.1) provides that for purposes of Sec. 107(1), and notwithstanding the effect of Sec. 69(1)(c), the cost of the capital interest will be nil unless it was acquired from a previous beneficiary **or** was issued to the taxpayer by the trust for consideration **paid** by him to the trust or apparently any other party, whereby its cost in the latter case would be nil unless its cost is equal to the fair market value of the property paid as consideration **at the time the interest was issued**.¹⁷⁰³ Where the interest in another trust is held by the subject trust and the taxpayer pays consideration to acquire that interest in the second trust it cannot be said that it was **"issued"** to him and instead it is an out right sale however where the trust grants him a beneficial interest in the legal title of that beneficial interest in the second trust held by it, the interest has been "issued" in that it previously did not exist.

Subsection 107(1.1) applies for purposes of Sec. 107(1) only and not for purposes of subdivision c, (and it expressly overrides Sec. 69(1)(c)). Subsection 107(1) computes for purposes of subdivision c the ACB of the capital interest and it refers to the ACB of the interest and its cost amount the latter not affected by Sec. 107(1.1) but affected by Sec. 108(1). Subsection 107(1.1) prevents the interest from having an initial cost if it isn't acquired from a former beneficiary or the trust for consideration payable. Subparagraph 107(1)(b) prevents the recognition of a capital loss on the interest's disposition unless it has a legitimate ACB which will be affected by Sec. 107(1.1) in this case: ACB defined in Sec. 54(a) has as a major component the cost of the interest which Sec. 107(1.1) serves to limit. Even if the effect of Sec. 107(1.1) serves to reduce the cost of the interest to nil subsequent ACB adjustments under sec. 53(1)-(2) will serve to integrate income/tax consequences recognized with subsequent dispositions to give them consideration; a Sec. 53(1)(d.1) bump for example will increase the ACB of the interest for purposes of subdivision c **after** the effect of Sec; 107(1.1) and prevent a capital gain from being incurred in respect of it when the interest is disposed of. In the author's opinion, confirmed with the Department's private opinion, upon a taxpayer becoming resident in Canada section 128.1 will apply to bump the ACB of the capital interest to its FMV, for purposes of Sec. 107(1) notwithstanding that prior to the application of section 128.1 the criteria in Sec. 107(1.1) may not have been satisfied. Apparently the beneficiary acquires the interest from himself upon becoming resident.¹⁷⁰⁴

¹⁷⁰³ If the cost of the capital interest exceeds or is lesser than the consideration's fair market value it would appear that as per Sec. 107(1.1), for purposes of Sec. 107(1), its cost will equal nil.

¹⁷⁰⁴ It's thus possible to bump the a.c.b. of any particular capital interest in a resident trust using a two trust chain, altering residencies in a certain sequence, and executing a Sec. 107(2) roll out, without suffering a Sec. 128.1(1) disposition.

Subsection 69(1)(c), like Sec. 128.1(1), arbitrarily creates an initial ACB of the property acquired regardless from whom and if the draftsman of Sec. 107(1.1) wasn't of the opinion that it should apply the Sec. 107(1.1) provision should have referred to it. Subsections 53(1)-(2) continue to apply to capital interest having various characters in certain situations while they are held however some adjustments occur only at the year end of the taxpayer.

“Cost of capital interest in a trust – Sec. 107(1.1)”

(1.1) The cost to a taxpayer of a capital interest of the taxpayer in a personal trust or a prescribed trust is deemed to be,

(a) where the taxpayer elected under subsection 110.6(19) in respect of the interest and the trust does not elect under that subsection in respect of any property of the trust, the taxpayer's cost of the interest determined under paragraph 110.6(19)(a); and

(b) in any other case, nil, unless

(i) any part of the interest was acquired by the taxpayer from a person who was the beneficiary in respect of the interest immediately before that acquisition, or

(ii) the cost of any part of the interest would otherwise be determined not to be nil under section 48 as it read in its application before 1993 or under paragraph 111(4)(e) or 128.1(1)(c) or (4)(c).

Interests Acquired as Gifts.

Where the capital interest is acquired via a gift, either testamentary or *inter vivos*, bequest, or inheritance subsection 69(1)(c) will not apply although the disponent will be required to recognize the full tax consequences of such a disposition under Sec. 69(1) or 70(5). Under Sec. 70(6) a favorable roll over provision is available which allows the testator to avoid the recognition of capital gains, etc., due to the fact that he will be deemed to have disposed of the property for proceeds equal to its adjusted cost base. Under Sec. 70(5)(c)-107(2) the recipient of a property, deemed to have been disposed of by the testator for its fair market value immediately before his death, will recognize a cost of that property equal to its fair market value recognized by the testator. Due to the fact that Sec. 69(1) opens with "Except as expressly otherwise provided in this Act..." both the effects of Sec. 70(5) and 70(6) over-ride the effect of Sec. 69(1)(c), it does not preclude Sec. 70(5) or (6) from taking effect. Thus through the application of Sec. 70(5) or (6) the cost to a recipient of a capital interest that passes through those provisions will be recognized as either the fair market value of that interest, or its adjusted cost base, recognized just prior to the death.¹⁷⁰⁵ Understandably, this concerns only interests which existed prior to the death of the taxpayer since interests in estates and testamentary trusts created by the death did not exist immediately before his death. With this in mind, a gift of the interest *inter vivos* only, except where it comes under the effect of Sec. 73(1), will cause the disponent to recognize full fair market value proceeds and will disallow the recipient from recognizing anything but an initial nil ACB.¹⁷⁰⁶ Understandably where such a transaction is being contemplated one has to look at the opposite alternative wherein the recipient actually pays consideration equal to the interest's fair market value so as to at least provide for an effective cost integration however unless the interest is segregated from the contributor/settlor

¹⁷⁰⁵ In the case of Sec., 70(5) it is actually section 107 that will ultimately determine the interest's cost.

¹⁷⁰⁶ This is particularly important when the interest has caused the gift or f.m.v. disposition tax consequences and the trust property is expected to decline in value: a double capital loss could be created in such an instance when both are subsequently disposed of.

with a spousal trust consideration paid to him will taint the trust's personal status. Cash may not even be transferred as consideration but instead a promissory note can be given.¹⁷⁰⁷

To Whom is Consideration Paid?

Subsection 107(1.1) provides that the initial ACB of a capital interest will not be nil when the interest was acquired from a person who was the beneficiary in respect to that interest immediately before its acquisition. However, it does not provide that the amount paid for the interest will be its initial cost. Nor does it state that the consideration must be paid to that pre-existing beneficiary cited, only that the interest must come from the beneficiary.

A testamentary wind-up can be structured to provide the estate with more funds to be distributed via the payment of funds thereto as an equitable charge to be performed before the interest in a severed trust is acquired such a payment may constitute a valid cost for the purpose of Sec. 107(1.1). The Sec. 107(1.1) provision does not require that the actual beneficiary of the interest receive the consideration paid for it when two testamentary trusts are created, one with interests in the other, and consideration is paid to the beneficiary trust that capital interest received will have a Sec. 107(1.1) cost.

This is in contrast to the specification expressed by the provision in respect of previously existing interest vis-a-vis they must be acquired only from the person who held them as a beneficiary. It would seem reasonable in light of the meticulousness already existing in the provision that due to the lack of specification the draftsman acknowledged the possibility of indirect issuances as well as instances wherein the consideration is paid to the trust from which the interest is issued, and in this regard it would thus appear that where the testamentary or *inter vivos* trust deed is drafted so that the interest can only be issued when consideration is paid to a non trust party (and obviously the trust itself), the recipient of such an interest will be able to recognize a cost "equal to the amount paid for it."¹⁷⁰⁸

Given that the main anti-avoidance thrust of the past reform has been the implementation at the "personal trust" rules, wherein a trust will lose the eligibility to be treated under all of the favorable provisions if it is "tainted," the definition of "personal trust," in Sec. 248(1), must be reviewed to recognize the importance of the weakness in the Sec. 107(1.1) provision. A "personal trust" is tainted when it isn't a testamentary trust that is an *inter vivos* trust under which one or more beneficial interests have been acquired for **consideration payable directly or indirectly to the trust itself or any person who has made a contribution to that trust** by way of transfer, assignment or other disposition of property and in this respect it can be easily seen how instrumental the weakness in Sec. 107(1.1) can be in maintaining a personal trust's status while at the same time allowing for interests acquired therein to have a cost. Consideration paid to a sister trust, that was not connected in any manner to the issuing trust, as a condition of having the interest issued would not be caught by the personal trust definition so as to disqualify the issuing trust from being "personal". Since the recipient trust, (of the consideration), is not issuing an interest it too would otherwise retain its personal status and if it's non-resident Sec. 105(1) won't apply to it.

There's a difference between paying consideration to satisfy a condition restricting vesting of an existing contingent interest and paying consideration to acquire the interest. The former does not increase the cost of the interest. In *Allison v. Murray*¹⁷⁰⁹ a life tenant under a U.K. settlement wished to avoid death duties upon her death and wished to vary the settlement so as to become absolutely entitled to trust property while offspring's' rights were to be varied out via court order. As a condition she was to take out life insurance with the deleted beneficiaries as annuitants so as to compensate their loss on the variation while the Chancery court held she had paid for the contingent interest deleted from them, which enlarged her entitlement, with

¹⁷⁰⁷ Given that the disposition of a capital interest in a personal trust **might** not cause tax consequences, which will be seen as per Sec. 107(1), the tax consequences above, as well as any that may arise upon the acquisition of the interest, must be evaluated in light of what the ultimate use of the interest will be, eg. disposition to third party or extinguishment through distribution.

¹⁷⁰⁸ Subsection 105(1) will **usually** apply to the payment to cause full inclusion thus such an arrangement may not be tax neutral.

¹⁷⁰⁹ 1975 3 All E.R. 561

the insurance policy. The court did not state that such was paid "to" the deleted beneficiaries and the case illustrates an instance where Sec. 107(1.1) would operate to allow a cost of a capital interest.

Adjusted Cost Base Adjustments.

Subsection 107(1.1) does not determine the initial acquisition ACB that a capital interest might have per se but only determines that it will be nil if certain conditions are not met on its acquisition however subsections 53(1) & (2) will apply anytime thereafter to cause potential ongoing adjusted cost base adjustments to the interest as a result of trust/beneficiary transactions. Since an income right in a non-personal trust is a capital interest as per Sec. 108(1)(c) all of the following adjustments may apply to it as well. Subsection 40(3) provides that whenever due to the adjustments in Sec. 53(1) & (2) the ACB of a capital property (capital interest) falls below zero a capital gain will be recognized equal to the negative portion as if the property had been disposed of and immediately reacquired. Although the resulting capital gain will qualify for the capital gains deduction in section 110.6, it will still have to be included in the taxpayer's income and it is thus the accumulation of the Sec. 53(1) & (2) adjustments (or possibly one singular one), that may cause tax consequences to be recognized when the interest is simply held, rather than disposed of to a third party.¹⁷¹⁰ It is in conjunction with Sec. 40(3) that the Sec. 53(1) & (2) ACB adjustments become critical, not just in their amount, but in their timing as well. The reductions in the ACB of a capital interest in a personal trust will occur only if the interest was acquired for consideration payable to any party¹⁷¹¹ and **only** if the transaction is between the trust and the beneficiary. If the interest was not acquired for consideration payable then the main ACB adjustment provision, Sec. 53(2)(h), will not apply to it.

Subsection 53(1) requires certain amounts to be added to the adjusted cost base of a capital interest in a trust provided that the interest or the trust is of a certain character.¹⁷¹²

Section 94 Non-Resident Trusts.

Paragraph (d.1) provides that where the capital interest is in a trust to which Sec. 94(1)(d) applies its ACB will be increased by the "amount required by paragraph 94(5)(a) to be added in computing the adjusted cost base to him of the interest." Section 94 applies to trusts which are not resident in Canada and was thoroughly discussed in the relevant chapter on non-resident trusts while Sec. 94(5) provides that the adjusted cost base to a taxpayer resident in Canada of a capital interest which caused foreign accrual property income to be recognized by the taxpayer, (the purpose of section 94), will be increased by a certain amount. Subsection 53(1)(d.1) concerns only the Sec. 94(5)(a) provision which provides that there shall be added to the ACB any amount that was required to be included in that taxpayer's income for the year or any preceding year but **only in respect to that interest**. The latter part of that provision is critical for section 94 may apply when the taxpayer is "beneficially interested," defined in Sec. 94(2), which includes holders of both "income" and "capital interests" with respect to their definitions, (however it **doesn't include rights "to income" or "capital," just rights to receive them**).

The amount that may be included in the income of the taxpayer who is "beneficially interested" in the trust, that can be added to the capital interest due to the fact that it is recognized in respect of that capital interest is equal to that amount recognized under Sec. 91(1) & (3) equal to the "interest's" participating percentage of the F.A.P.I. of the trust, and the F.A.P.I. reserve¹⁷¹³. Once again it is only the amount in respect of the capital interest that is held that is to be added, even though the taxpayer may be substantially more "beneficially interested" than just through the "capital interest".

Subsection 94(1) applies to taxpayers "beneficially interested" in a foreign trust while Sec. 94(7) defines "beneficially interested" as the owning of a right to receive any income or capital of the trust directly or indirectly through one or more trusts, while the right itself may be either immediate or future, etc., etc., or

¹⁷¹⁰ Subsection 40(3) applies at any particular time **in the tax year** thus a gain may be recognized and subsequently the a.c.b. can be increased within the same period. If the increase in the a.c.b. was orchestrated first, then reduced, the negative recognition, and thus the gain, would not have been recognized.

¹⁷¹¹ and if they are non-resident Part XIII can't capture the payments for withholding tax on a Sec. 105(1) basis

¹⁷¹² First of all, under Sec. 53(1)(a) any amount deemed by Sec. 40(3) to be a gain from a disposition of property before that time will be added to the a.c.b. to "bring it back to zero" from which subsequent deemed gains may be realized.

¹⁷¹³ which is computed with respect to Sec. 94(1)(d) and all of the other appropriate supporting provisions

whether conditional on or subject to the exercise of a discretionary power. Given that a "capital interest" as defined for purposes of the Act through Sec. 248(1), in Sec. 108(1)(c), includes only rights both "to" the capital or right "to receive" it, (under a personal trust), the obvious inconsistency arises whereby income will not be "attributed" where the taxpayer has only a right "to" the capital, not "to receive it," since as per the definition in Sec. 94(7), he will not be "beneficially interested" in the trust.

Subsection 94(5)(a), in accompany with Sec. 53(1)(d.1), recognizes that the ACB of the capital interest will be increased, **"at any time in a taxation year"**, by any amount that is required to be included in computing the taxpayer's income for that year or any preceding tax year in respect to that interest, or that **would have been included** but for the application of the attribution rules in Sec. 56(4.1) and sections 74 to 75. Thus, it is only at the year end of the Canadian resident taxpayer that the appropriate F.A.P.I. is recognized under Sec. 91(1) or (3) while **during** the year the ACB is being increased by that amount. If an amount is attributed to another taxpayer under any of the noted sections the ACB of the interest will still be increased even though its holder is not recognizing income under Sec. 91(1) or (3).

Under subsection 53(2)(b.1) the exact opposite adjustments must be made to a capital interest in a trust to which Sec. 94(1) applies as were applicable under Sec. 53(1)(d.1). Under that paragraph the ACB of the interest must be reduced by the amount described in Sec. 94(5)(b) which is the amount deducted by the taxpayer in respect to the F.A.P.I. that he was required to recognize under Sec. 94(1) and 91(1) & (3), being the amounts described in Sec. 91(2) & (4). Subsections 91(2) & (4) allow the taxpayer to take a reserve on the income to be recognized, subject to the discretion of the Minister, as due to foreign exchange restrictions imposed by the other country or to deduct an amount in respect to the "foreign accrual tax applicable" to the income to be recognized. The former is included in the income to be recognized in the following year under Sec. 91(3) while the latter is not but is restricted by the mechanics in Sec. 91(4) and the definition of "foreign accrual tax applicable" in Sec. 95(1)(c).

Once again such deductions, and ACB reductions, must be directly related to the capital interest which caused them to arise the capital interest that was the substance of the "beneficial interest" that caused the application of Sec. 94(1). Where the taxpayer holds both an income and a capital interest in the trust, which causes him to be "beneficially interested," it will only be those amounts included and deductible under section 91 that relate directly to the capital interest that will cause an ACB adjustment. Where the taxpayer has rights to income that is accruing to the trust he'll recognize a section 91 inclusion and if the income isn't distributed/distributable he'll acquire a capital interest in respect of it¹⁷¹⁴ thus allowing the Sec. 94(5) adjustments to occur. When a pure income beneficiary has immediately enforceable rights to the income and it isn't distributed to him whereby he acquires a capital interest in respect of it can it be said that the cost to him of that capital interest, the amount he paid for it, is equivalent to the value of the income immediately distributable in that he has given up that right to enforce a distribution for a right to enforce one subsequently? Would the trust lose its personal status if the event was recognized as a disposition and acquisition? Subsection 94(1)(d) may apply to his income interest so as to also cause him to recognize a F.A.P.I. inclusion equal to a certain amount which need not be equivalent to the income inclusion.

One particularly dangerous aspect about the Sec. 94(5)(b) ACB adjustment is that it provides that the ACB will be reduced by the amount that would be **deductible** by the interest holder had it not been for the application of the attribution provisions in Sec. 56(4.1) or sections 74 to 75. Understandably, in order to maintain any "equity" in an attribution situation, the attributee **must take** the Sec. 91(2) & (4) deductions if they exist in that the ACB of the capital interest to its holder will be reduced arbitrarily.

Identical to the application of Sec. 94(5)(a), para. (b) will apply at any time in the tax year, regardless of when the recognition of a deduction is effected, i.e. at year's end. Given that both the Sec. 91(2) & (4) deductions are discretionary and will be determined by the taxpayer at his year end it would be clearly understandable that the year end ACB of the interest depends upon, and cannot be ascertained, until the taxpayer takes the deductions. Where the interest is to be disposed of, the deductions may not be taken whereby the F.A.P.I. may be negated by any non-capital losses and thus the ACB will be higher thus reducing

1714 as per Sec. 52(1)

a capital gain or increasing a capital loss. Non-capital losses that were about to terminate could thus be beneficially absorbed.

Section 94.1 Offshore Investment Funds.

Subparagraph 53(1)(m) provides an ACB adjustment in respect of interests in non-resident entities which are "offshore investment fund property" as described under section 94.1. Section 94.1 applies, by virtue of Sec. 94.1(2)(b), to those trusts described under Sec. 94(1)(c) or (d) hence not only will section 94 apply to a certain character of non-resident trust/beneficiary relationship, but so too will section 94.1 which causes a recognition of very arbitrarily determined income from the "non-resident entity", the trust. Subparagraph 53(1)(m) provides that there shall be added to the cost of the offshore investment fund property any amount that is required to be included in the taxpayer's income for a tax year previously while Sec. 94.1(1)(a) clearly implies that an interest in a non-resident entity¹⁷¹⁵ is an offshore investment fund property thus clearly an interest, be it income or capital in the tax law sense of the word, in a non-resident trust falls under the effect of Sec. 53(1)(m). Since only capital property have ACBs, as per Sec. 54(a), the Sec. 53(1)(m) adjustment is not applicable in determining the "ACB" of an income interest. Since an "offshore investment fund property" is an "interest in" a non-resident entity there appears to be the possibility that the "interest in" the non-resident entity (trust) need not be an "income" or "capital" interest in the strict definition of the word under Sec. 108(1)(c) or (e) but instead may be "an interest" determined by the principles of common law, thus casting a far wider net and allowing the ACB of the chose in action to be increased when it doesn't technically constitute an income or capital interest.

Subsection 94.1(1)(f) provides, once all of the conditions in Sec. 94.1(1) exist, that there will be included in income of the taxpayer the aggregate of all amounts, each of which is the "designated cost" to the taxpayer of the offshore investment fund property at the end of each month in the year multiplied by the applicable monthly prescribed tax rate that exceeds the amount of income the taxpayer otherwise recognized, (other than capital gains), from the O.S.I.F. property during the year.

Subsection 94.1(2)(a) defines "designated cost" to be the aggregate of certain amounts being amongst others the cost amount to the taxpayer of the property, (determined without reference to Sec. 53(1)(m)), and the aggregate of amounts previously included in income by virtue of section 94.1 thus it can be easily seen that the more often the taxpayer either doesn't recognize income, or isn't capable of doing so the more the designated cost will grow and the more income will have to realize in the future to avoid the application of Sec. 94.1(1). If the non-resident entity realizes only losses, which then form the substance of the taxpayer's return, then the taxpayer will be in a double loss situation since he will have to still recognize income as per section 94.1. Since the Sec. 53(1)(m)(i) provision causes the ACB of the interest to be increased by the amount that is caused to be included in computing income **only** by virtue of Sec. 94.1(1) one would want to insure that the subsection applied as little as possible in order to suffer the minimum bump up in the ACB of the interest. Income being distributed or becoming payable by the non-resident trust to the resident beneficiary would be included in his income under Sec. 104(13)(c) and would not be the subject of an application of Sec. 94.1(1) while the ACB of a capital interest in the trust would not be increased. If instead the Sec. 94.1(1) mechanics apply income would be recognized while the ACB of the capital interest would be increased. The substantial difference in the two methods of recognizing income is the effect they have on subsequent distributions. If the income of the trust was distributed, (and section 94.1 did not further apply), then there wouldn't be a creation of a capital interest since the taxpayer would not obtain a right to what would be in substance income that had been capitalized. If income isn't being paid to the taxpayer who will be its ultimate direct or indirect recipient one would want to ensure that his capital interest, the right he has to, or to receive capital at some later date, has an adequate ACB that would allow for the avoidance of potential tax consequences when the amount is distributed or the interest is disposed of to a third party. The larger the legitimate ACB or cost of the interest, as per Sec. 94.1(2)(a)(i), the larger the Sec. 94.1(1) inclusion resulting.

¹⁷¹⁵ non-resident trust described in respect to Sec. 94(1)(c) or (d)

The section 107 capital interest disposition/distribution rules do not apply uniformly favorably to capital interests, personal trusts or otherwise, in non-resident trusts that have been "purchased."¹⁷¹⁶

Through Sec. 94(5)(a) and Sec. 53(1)(d.1) the ACB of a capital interest, **at any time** in the tax year, may be increased by the amount of F.A.P.I., etc., that is to be included in computing its holder's income for the year and as time goes on within the tax year such increases will increase the ACB **during the year**. Given that the designated cost of the capital interest is dependent upon the cost amount to the taxpayer at the relevant time,¹⁷¹⁷ the designated cost of the interest will increase as a result of the application of Sec. 94(5)(a) and such will lead to an increased designated cost upon which a Sec. 94.1(1) arbitrary inclusion will be calculated. Subsection 94.1(1)(f)-94.1(2)(a)(iii) will not apply within the tax year to increase the designated cost of the interest monthly. This immediate income integration could lead to very harsh tax results if the Department vicariously applies both Sec. 94(1) and 94.1(1) to the same trust and nothing but practice prevents them from doing so. Whether the Department enforces this aspect is a question that could be posed at the next Roundtable Discussions.¹⁷¹⁸

Valuation Costs

Subparagraph 53(1)(n) provides that reasonable costs incurred by the taxpayer, for surveying or **valuing** the property **for the purpose** of its acquisition or disposition¹⁷¹⁹ may be added to the ACB of the property and one has to consider whether a disposition of the property, after it has been appraised, must occur in order for the adjustment to be available.¹⁷²⁰ Obvious this provision applies to both income and capital interest as well as discretionary interests¹⁷²¹. The provision expressly provides that those expenses incurred **"for the purpose"** of its acquisition or disposition and should not be confused with the substance of the phrase "those expenses incurred **in the** acquisition or disposition etc." in that the former captures those expenses that were sustained in order to prepare for an acquisition or disposition, (that may have never occurred), while the latter encompasses only those expenses that were incurred to prepare for an acquisition or disposition which did in fact occur. Understandably, the attempt at an acquisition or disposition must have been "legitimate". Given that the value of an interest in a trust is derived from the value of the underlying property that may exist in trust which gives substance to the interest one could conclude that expenses such as legal fees incurred to have the trust document examined, property appraisal fees to value the underlying property and accountants' fees to have the expected cash flow etc., valued would constitute expenses that can be tacked onto the ACB of the interest, if they are **reasonable**. The expenses must be reasonable in light of a single occurrence however they need not be incurred reasonably being that they may be incurred every three to five years etc., in attempts to dispose of the interest.

Subsection 53(2) provides a series of provisions that apply to reduce the ACB of a property, as the preamble expresses, **at any time** and they are the more important provisions in that it is through their application, at any time, that the taxpayer may recognize a deemed disposition and capital gain. Once again, it must be noted that the timing of the Sec. 53(1) and (2) adjustments is almost as important as their amount.

¹⁷¹⁶ A legitimate a.c.b. is needed to avoid certain tax consequences that can be otherwise avoidable. If a purchased capital interest in a non-resident trust is disposed of, either through a distribution in satisfaction thereof or a disposition to a third party then either the a.c.b. of the interest will carry over directly to the property so acquired or the real a.c.b. will form the basis for capital gains computation under Sec. 107(2)(b) or 107(1)(a) respectively. The latter, may produce more tax consequences than the former pursuant to the closing paragraph of Sec. 107(1).

¹⁷¹⁷ as per Sec. 94.1(a)(a)(i), and given that "cost amount," defined in Sec. 248(1), means the adjusted cost base of the property

¹⁷¹⁸ If the interest is disposed of within the year the taxpayer will not have to recognize the stub period income and at the time of the disposition the a.c.b. of the interest would have been fully integrated with the income that he is to recognize.

¹⁷¹⁹ to the extent that they have not been deducted by the taxpayer in computing his income or that are attributable to any other property

¹⁷²⁰ See *I.R.C. v. Richard's Exors.*, 46 T.C. 626 (HL).

¹⁷²¹ Fees paid to appraise the value of estate property for the purpose of making distributions to the beneficiaries are added to the cost of the property.

Purchase of Interests in Non-resident Trusts: Taxable Canadian Property Cost Bump Restrictions.

Subsection 53(2)(i) applies to "a capital interest in a trust not resident in Canada that was purchased after 1971 by the taxpayer from a non-resident person..." and in taking a leap of faith, the provision would apparently be considered to be targeted at instances when the trust was not resident at the time of the interest purchase and the disponent was a non-resident at the time of the purchase.¹⁷²² The provision does not apply to unit trusts while the interest could have been purchased from the trust itself.¹⁷²³ When the interest was **issued** to a recipient upon the exercise of a power of appointment held by a person after that person received property from the recipient of the interest then the interest has not technically been purchased in that the person who received the consideration did not own the interest and in fact the interest did not exist prior to the exercise of the power. Obviously, since a discretionary interest isn't a "capital interest", as per the definition thereof in Sec. 108(1)(c), the provision does not apply to discretionary interests that **later** became enforceable against capital, thus capital interests. At the time of the purchase, they were not capital interests. The same logic can be extended to instances where the taxpayer has an income right in a **non-personal** trust that isn't resident and that only **became** a capital interest after it was purchased through the operation of the personal trust rules.

Subsection 53(2)(i) applies if the previous conditions mentioned existed and the major proportion of value of all of the trust's property was derived from certain property. Where the fair market value, (at the time the interest was purchased), of Canadian resource property, income interests in Canadian resident trusts, taxable Canadian property and timber resource properties held by the trust exceeds 50% of the fair market value of all of the trust property including money on hand, at the time of the purchase, the ACB of the capital interest will be adjusted. The applicability of the provision rests partially on the relative values of certain "trust property" but must the property held in trust be **owned** by the trustees and subject to the trust terms or simply held in trust as a **borrowing** of the property. If the "trust property" includes only that property the legal title of which is held by the trustees as per the trust deed then property loaned to the trust will not be considerable and given that trusts may be created purely with loaned property the provision obviously may not apply in certain instances. If the "trust property" to which the provision refers includes loaned property then a substantial tax benefit may be obtained in the way of negation of a possible ACB adjustment by having the trust lease or borrow etc. property just prior to the interest acquisition so that the "trust property" composition may be significantly altered. Given that the time at which the fair market value of the property must be measured is the time at which the interest is purchased a significant advantage in extending the period over which the purchase is completed in that it would allow for material alteration of the composition of the trust property, (possibly allowing it time to accumulate "money" that was normally to be distributed).

The provision is targeted at reducing those instances where a Canadian or non-resident taxpayer acquires an interest in a non-resident trust which is supported principally by taxable Canadian property whereby the disposition will not produce a Part I tax liability for any party but subsequent to which the trust can distribute using Sec. 107(2) the taxable Canadian property and the beneficiary could bump its cost up to the amount paid for the interest thus reducing the tax exposure in the cost bump.¹⁷²⁴

The amount of the ACB adjustment is determined quite arbitrarily and is dangerously unrelated to the amount of consideration paid for it. Where the fair market value of the four types of property¹⁷²⁵ exceed their cost amount, (at the time in the case of both), then that amount will create the net amount upon which the adjustment is calculated.¹⁷²⁶ If no excess results from this arithmetic computation, then no ACB adjustment can result. Where a positive excess exists then that proportion of the excess that the fair market value, (at

¹⁷²² The provision applies to resident as well as non-resident acquirors.

¹⁷²³ Where an interest is **issued** to a taxpayer who later incidentally contributes to the trust from which the interest was acquired and the contribution is not in response to the issuance then the interest has not been "purchased."

¹⁷²⁴ In accompany to the closing paragraph of Sec. 107(1) this provision limits considerably the ability to deal in such interests or achieve tax free cost bumps of the taxable Canadian property but the Sec. 53(1) provision can definitely be abused, for example by simply cleansing the trust's property of its taxable Canadian nature by incorporation or contribution to a sub-trust, though such could produce tax consequences for the trust seeing how its taxable Canadian property. Of course in would be beneficial to have the taxable Canadian property initially acquired by that third party the shares or interests in which are held by the trust in which the interest is purchased.

¹⁷²⁵ Canadian resource, timber resource, taxable Canadian property and income interest in Canadian resident trusts

¹⁷²⁶ "Cost amount" is defined in Sec. 248(1) while trust debt isn't taken into consideration.

that time), of the interest purchased, is of the fair market value of all the capital interests in the trust will be deducted from the ACB of the interest. Given this framework it should be obvious there may be a possibility that the ACB adjustment may result in the immediate recognition of a negative ACB which will translate into a deemed capital gain. What is particularly dangerous about the arbitrary nature of the application of the provision is that it does not operate solely in respect to capital interests that are enforceable against the subject property or benefits realized through the holding or disposition of the subject property, but instead it applies to **all** capital interests where the conditions exist.

The purchase price of the interest is not a factor in causing the adjustment although its fair market value is hence before purchasing the interest it would be prudent to evaluate just what its ultimate tax cost (ACB) will be after the adjustment for it won't be prudent to pay "top dollar" for an interest wherein its ACB will be excessively cut back. "Fair market value" would normally not exclude the consideration of taxation hence by actually bargaining a purchase price less than the international "fair market value", the Canadian authorities would most likely recognize the lower price as "fair market value" for the adjustment process. Obviously the entire adjustment process is open to considerable subjective factors and since it can easily be avoided through some fairly simple methods previously described it should be. Where the interest is enlarged through a variation or where the underlying property in respect of it, (and thus its resulting fair market value), is increased, after the initial adjustment, as long as there weren't additional "purchases" a corresponding adjustment would not take place. The adjustment occurs only once, at the time of the initial purchase.

Sec. 53(2)(i)

(i) where the property is a capital interest in a trust (other than a unit trust) not resident in Canada that was purchased after 1971 and before that time by the taxpayer from a non-resident person at a time (in this paragraph referred to as the "purchase time") when the property was not taxable Canadian property and the fair market value of such of the trust property as was

- (i) a Canadian resource property,**
- (iii) an income interest in a trust resident in Canada,**
- (iv) taxable Canadian property, or**
- (v) a timber resource property**

was not less than 50% of the fair market value of all the trust property, that proportion of the amount, if any, by which

- (vi) the fair market value at the purchase time of such of the trust properties as were properties described in any of subparagraphs (i) to (v)**

exceeds

- (vii) the total of the cost amounts to the trust at the purchase time of such of the trust properties as were properties described in any of subparagraphs (i) to (v),**

that the fair market value at the purchase time of the interest is of the fair market value at the purchase time of all capital interests in the trust;

The Subparagraph 53(2)(h) Distribution Adjustments.

Perhaps the most applicable Sec. 53(2) ACB provision at any given time is that in Sec. 53(2)(h) and although the Department has amended it in the 1988 reform to encompass far more events and thus cause more tax consequences it is still none-the-less applicable in only specific instances.

Subsection 53(2)(h) applies where the interest is a capital interest in a trust however it doesn't apply where the trust is a personal trust and the interest therein was acquired for no consideration payable **apparently to anyone** or where the trust was of the commercial nature described in subparagraphs 108(1)(j)(ii) to (v). In order for the provision to apply the interest must be a "capital interest" as per the definition thereof in Sec. 108(1)(c) however if the interest **becomes** a capital interest within the operation of the personal trust rules then the provisions were amended/introduced in such a way as to allow for **retroactive** application. The provisions do not apply to capital interests in personal trusts that were acquired for no consideration payable to anyone by the recipient and thus the first part of this two part test may be avoided while the second part may not where the interest had changed hands after it was issued. It is this latter part of the test, that being

that the interest couldn't have been acquired for consideration payable, that will cause the provision to apply in most cases and it considerably restricts the taxpayers ability to trade in capital interests or routinely transfer them to any great extent. This doesn't cause ACB adjustments to occur when the interest has been deemed acquired for its FMV or cost amount as per the diction of the particular provision since consideration has still not been deemed paid for it. When a personal trust capital interest is to be acquired from a beneficiary holder one must choose between gifting it, (for no consideration payable by the recipient), or causing the disposition/acquisition to occur for proceeds/consideration that will benefit both parties the maximum amount, a quite comprehensive "balancing act" where Sec. 53(2)(h), 107(1)(a)-108(1)(d) and 69(1) are to be considered. This provision also applies only when the consideration is payable and although such would include instances where such is deemed to have occurred in the Act it will not where the taxpayer is only deemed to have acquired the interest at a cost equal to etc.. Spousal transfers and FMV cost bumps upon becoming resident amongst others will not activate the provision.

Subparagraph 53(2)(h)(i) provides that the ACB of the capital interest will be reduced by any amount actually paid by the trust after 1971 as a **distribution or payment** of capital but only to the extent that such an amount became payable by the trust before 1988. There is a particularly important exception to the form in which a distribution or payment will be considered being that those that are in the form of proceeds of disposition of the interest or part thereof will not be considered. "Proceeds of disposition" are defined in Sec. 54(h), (for limited purposes), while in order to realize proceeds of disposition there has to be an actual disposition, which is defined in Sec. 54(c). In respect of the latter, Sec. 54(c)(ii)(b) recognizes that the settlement or cancellation of a right to receive an amount held by the taxpayer is a "disposition". Where a distribution or payment of capital is made in satisfaction of any part of the capital interest, the section 107 distribution provisions will apply and the disposition of the interest will be recognized.

The provision applies to "any amount paid" while Sec. 248(1) defines an "amount" as money, right or things expressed in terms of the amount of money or the **value** in terms of money of the right or thing. Where money is distributed/paid subject to an equitable charge whereby the taxpayer must fulfill a certain obligation which may cause him to expend sums of money then as per the definition of "amount" there would appear to be room for him to recognize only the **net value** of the money distributed/paid, not its gross amount. The word "value" is used in Sec. 70(2) concerning the recognition of "right & things" in the income of a deceased and in I.T. 212R2 para. 4 the Department is of the opinion that "The value of a right or thing for purposes of subsection 70(2) depends upon the facts of each particular situation." Given that not only the value of the property distributed or paid but also of the equitable obligation imposed upon the recipient in consequence of its receipt is subject to some subjective measurement methods one can see the abuse, or "flexibility" depending upon how one looks at it, that may result.

Where an equitable change is placed upon a distribution as a condition then it is **not** only the net value of the distribution to its primary recipient that will reduce the ACB of the capital interest, (if Sec. 53(2)(h) applies), however where the primary recipient makes the secondary payments to the secondary party he will usually not be allowed any form of deduction under the Act in respect of them. The secondary recipient **might** have to recognize the payments in respect of the extinguishment of the equitable charge via Sec. 105(1) while even if he also has an interest in the trust he cannot avoid it.¹⁷²⁷ Subsection 105(1)(b) does not apply where an amount has been deducted through Sec. 53(2)(h) in computing the ACB of the interest held by the taxpayer in the trust or **would be so deducted if that paragraph applied** in respect of the taxpayer's interest in the trust. Subparagraph 53(2)(h) applies only in respect of capital paid to or distributed to the taxpayer **by the trust**. Where the primary recipient pays the consideration to the secondary recipient as an extinguishment of an equitable charge **it is not the trust which is paying the capital**. If the secondary recipient would have received the payment/distribution directly from the trust then Sec. 53(2)(h) **would have** applied to his capital interest. The secondary recipient is caught by the Sec. 105(1) provision while at the same time the primary recipient of the property will have the ACB of his interest reduced by the total value (amount); **not** net of the

¹⁷²⁷ Subsection 105(1) doesn't affect non-residents.

equitable change that he has assumed.¹⁷²⁸ This isn't the case where the secondary recipient isn't resident in Canada.

Subparagraph 53(2)(h)(i) applies only with respect to payments or distributions "before 1988", the calendar year.

"Cost Integration of Capital Interest in Trust - Sec. 53(2)(h)"

(h) where the property is a capital interest of the taxpayer in a trust (other than an interest in a personal trust that has never been acquired for consideration or an interest of a taxpayer in a trust described in any of paragraphs (a) to (e.1) of the definition "trust" in subsection 108(1)),

(i) any amount paid to the taxpayer by the trust after 1971 and before that time as a distribution or payment of capital by the trust (otherwise than as proceeds of disposition of the interest or part thereof), to the extent that the amount became payable before 1988,

(i.1) any amount that has become payable to the taxpayer by the trust after 1987 and before that time in respect of the interest (otherwise than as proceeds of disposition of the interest or part thereof), except to the extent of the portion thereof

(A) that was included in the taxpayer's income by reason of subsection 104(13) or from which an amount of tax was deducted under Part XIII by reason of paragraph 212(1)(c),

(A.1) that was deemed by subsection 104(16) to be a dividend received by the taxpayer, or

(B) where the trust was resident in Canada throughout its taxation year in which the amount became payable

(I) that is equal to the amount designated by the trust under subsection 104(21) in respect of the taxpayer,

(II) that was designated by the trust under subsection 104(20) in respect of the taxpayer, or

(III) that is an assessable distribution (as defined in subsection 218.3(1)) to the taxpayer,

(ii) an amount equal to that portion of all amounts deducted under subsection 127(5) in computing the tax otherwise payable by the taxpayer under this Part for the taxpayer's taxation years ending before that time that may reasonably be attributed to amounts added in computing the investment tax credit of the taxpayer by virtue of subsection 127(7),

(iii) any amount added pursuant to subsection 127.2(3) in computing the taxpayer's share-purchase tax credit for a taxation year ending before or after that time,

(iv) an amount equal to 50% of the amount deemed to be designated pursuant to subsection 127.3(3) before that time in respect of each share, debt obligation or right acquired by the trust and deemed to have been acquired by the taxpayer under that subsection, and

(v) an amount equal to the amount of all assistance received by the taxpayer before that time that has resulted in a reduction of the capital cost of a depreciable property to the trust by virtue of subsection 13(7.2);

Subparagraph (i.1) is a new provision implemented with the 1988 tax reform that attempts to integrate the taxation of amounts realized in a trust and flowing through to beneficiaries so that they will not be subject to excessive taxation. Similar in nature to subparagraph (i), it applies to any amount that has **become** payable by the trust to the taxpayer after 1987 **in respect of the interest** other than as proceeds of disposition of any part of the interest except where such a payment is of a certain nature described in two broad exceptions. There are a few basic differences between Sec. 53(2)(h)(i) and (i.1), one of which is that the former applies to distributions or payments of **capital only** while the latter applies to amounts that became payable in respect of the capital interest. Under the former only those amounts that were **paid** would cause an ACB adjustment while under the latter the instant at which they became **payable** an ACB adjustment will follow. The fact that

¹⁷²⁸ This will effectively reintroduce at a minimum 1/4 of the amount distributed as income. If the interest was acquired for consideration payable a net distribution will reduce the a.c.b. and will lead to a 3/4 income inclusion, all things being equal, if there is a capital gain. The equitable charge extinguished will reduce the a.c.b. and will be fully included in the income of the payee. A one and three quarter income inclusion is created with such an equitable charge.

the Sec. 53(2)(h)(i.1) does not describe the nature of the amount that became payable but instead refers to it only as an amount in respect to the capital interest is significant in that there may be instances when a "capital interest" may be a right in respect of an amount other than trust law, or for that matter, tax law, capital. This is exactly the instance where the capital interest is a right to income of a non-personal trust. By not defining the nature of the payment/distribution in respect of the trust, but instead in respect to the nature of the beneficiary's interest, the scope of the provision is far wider.

Similar in nature to Sec. 53(2)(h)(i), the provision does not apply where the amount was received as proceeds of disposition of the capital interest or any part thereof.

There are two broad exceptions that will cause a distribution or a payment of an amount to be precluded from having effect. The first is where the amount was included in the **particular taxpayer's income** by reason of **Sec. 104(13)** or from which an amount of tax has been deducted under Part XIII only by reason of Sec. 212(1)(c). The reason why the amount recognized as income previously under Sec. 104(13) should not lead to an ACB adjustment when it is distributed is obvious however this applies only in respect to Sec. 104(13) inclusions and not, in particular, the Sec. 104(14) preferred beneficiary election amount. Under Sec. 104(14) an amount of accumulating income elected upon jointly by the preferred beneficiary and the trust will be included in the beneficiary's income in the year "and shall not be included in computing the income of **any** beneficiary of the trust for a subsequent year in which it was paid". Thus, the Sec. 104(14) provision does not exclude instances where the amount paid causes an ACB adjustment, which is clearly possible as per Sec. 53(2)(h)(i.1)(A) and these adjustments will result without hindrance since that subpara. refers only to Sec. 104(13) inclusions, not Sec. 104(14). With this in mind where the taxpayer has acquired a capital interest for consideration payable based upon income to be capitalized and receives advances in respect of it Sec. 53(2)(h) will cause ACB adjustments even though those advances may be less than the aggregate Sec. 104(14) income inclusions that the beneficiary may have recognized.¹⁷²⁹ Reductions in the ACB of the interest may lead to deemed dispositions regardless of the effect a reduced ACB may have upon subsequent commutation. Such amounts that were included, under Sec. 104(13), in computing the income of the **particular** beneficiary to whom they are subsequently distributed will be the only ones which maybe received without effect being that if the amount was included in computing the income of **another** beneficiary under Sec. 104(13) then it will lead to an ACB adjustment when it is distributed to a different beneficiary.

Subparagraph 53(2)(h)(i.1)(A) also provides an exception to the ACB reduction where the amount was subject to withholding tax being from which an amount of tax was **deducted**, (and not deductible), under Part XIII by reason of Sec. 212(1)(c). Subsection 212(1)(c) makes subject to withholding tax income of or from an estate or trust that would be included in computing the income of the non-resident person by reason of Sec. 104(13) had he been resident but it does not include such amount that is deemed by Sec. 104(21) to be a taxable capital gain, (or apparently amounts included under Sec. 105(1)).¹⁷³⁰

Subparagraph 53(2)(h)(i.1)(A) exempts from ACB adjustments distributions of amounts upon which withholding tax was **deducted**, not deductible. Hence, where Sec. 212(9) & (10) negates the application of withholding tax on certain amounts those amounts, when distributed or paid may cause the adjustments.¹⁷³¹

¹⁷²⁹ In short, preferred beneficiary elections should rarely be made in respect of income accumulating to substantiate a capital interest acquired for consideration payable by the interest holder until the Department clarifies its position and the Act. A Sec. 104(13.1) cut back in income recognizable by a beneficiary under a non-personal trust will produce only a one and three quarter income inclusion in stead of a double income inclusion when it is paid to a beneficiary in which Sec. 104(7.1) would apply. If the a.c.b. of the interest is bumped tax free in some manner the effective inclusion will be reduced again.

¹⁷³⁰ Since a non-resident person is exposed to withholding tax only on amounts that would be included in computing his income under Sec. 104(13) he does not recognize income from property in the general scheme-of-things hence an amount that would have been includable under Sec. 105(1) or (2) had he been resident will not be taxed at all. Subsection 115(1) applies to tax only certain characters of income earned by a non-resident person but it doesn't apply to income from property which is a trust interest, which Sec. 104(13), (14) & 105(1) & (2), income inclusions are described as in Sec. 108(5)(a). Since Sec. 212(1)(c) applies only to Sec. 104(13) inclusions, it would appear that Sec. 105(1) & (2) inclusions are not subject to withholding and if the taxpayer owns no capital interest in the trust to which Sec. 53(2)(h) could apply, then the amounts flow tax free.

¹⁷³¹ Subsection 212(9) provides that no tax is payable under Sec. 212(1)(c) in respect of amounts paid by a trust as income of or from the trust if they are derived from dividends or interest received by the trustee from a non-resident-owned investment corporation or amounts received from any one by the trustee as a royalty, copyright charge etc., on the production or reproduction of any literary, dramatic, musical or artistic work, but only where such amounts would not have been taxable if they had been paid directly to the non-resident person instead of the trust. Subsection 212(10) negates the application of

Since these two subsections cause the application of withholding tax through Sec. 212(1)(c) to be negated the Sec. 53(2)(h)(i.1)(A) provision will cause an adjustment in the ACB of the capital interest that the beneficiary may have, **but only where the distributions are made in respect of a capital interest** and not when they are made as proceeds of disposition of the interest or part thereof.¹⁷³² An income right under a non-personal trust is a capital interest as per Sec. 108(1)(c)(ii), and thus satisfies the former basic condition. Where the ACB of a capital interest owned by a non-resident is reduced to being less than nil then the beneficiary will be deemed to have disposed of and reacquired the interest and will recognize the resulting gain under Sec. 40(3). That capital gain will be taxed at the personal rate amount as per Sec. 115(1)(b), however, only on the 3/4 inclusion basis.

Subparagraph 53(2)(h)(i.1)(B) provides the second group of exceptions to the ACB reduction mechanics whereby if the trust was resident in Canada throughout the year in which the amount became payable that amount which is equal to 1/3 of the amount designated by the trust in respect of the taxpayer under Sec. 104(21) or that whole amount which was designated by the trust in respect of the taxpayer under Sec. 104(20) shall be allowed to be distributed without causing an adjustment.

Subsection 104(21) allows a trust which is resident in Canada throughout its tax year to designate an amount of its **net taxable capital gains** as having been realized by the Canadian resident beneficiary and not by itself. The amount of gain that the taxpayer must then recognize is equal to 3/4 of the actual capital gain realized and the 1/4 amount of the actual gain that must be allowed to be distributed to the beneficiary without causing tax consequences. Subparagraph 53(2)(h)(i.1)(B)(I) expressly provides that **1/3** of the amount designated will be allowed to be distributed without effect and in this respect this "1/3" amount is the one third of the three quartered capital gain which equals the one quarter of the actual gain that must never enter income.¹⁷³³

The Sec. 104(21) designation can be made only in respect of a particular beneficiary who is resident in Canada, (where the trust isn't a mutual fund trust), and only in respect of amounts that were recognized by the beneficiary under Sec. 104(13), (14) or section 105. In this respect¹⁷³⁴ Sec. 212(1)(c) would have little effect on the Sec. 104(21) designation since the designation could not have been made in respect of a beneficiary who was non-resident throughout the tax year.

Under subparagraph 53(2)(h)(i.1)(B)(II) amounts that had been designated by the trust under Sec. 104(20) as having been realized by the taxpayer will be allowed to be distributed without incident. Subsection 104(20) **requires** a trust which was resident in Canada throughout its tax year to designate as having been received by a particular beneficiary an amount which is a dividend other than a taxable dividend received on a share of capital stock of a corporation resident in Canada. The beneficiary need not be resident in Canada at any particular time. In order to avoid a tax consequence when these amounts are distributed the specific conditions in Sec. 53(2)(h)(i.1)(B)(II) must exist.¹⁷³⁵

Prior to the 1988 reform, capital cost allowance and depletion allowances, (described under section 20 and Sec. 65(1)), could be designated out to the capital beneficiaries whereby they could deduct them at their level from the trust income so recognized. This was provided in subsection 104(16) and (17) both of which were repealed in the 1988 tax reform. Now, in order to arrive at net tax income upon which Sec. 104(13) is based,

Sec. 212(1)(c) where all of the beneficiaries of a trust are foreign residents, (of a singular country other than Canada), and the trust recognizes all of its income from persons residing in that country and then distributes it to its non-resident beneficiaries.

¹⁷³² The subsection 212(9) and (10) provision do not apply exclusively in respect of personal trusts.

¹⁷³³ The 3/4 amount of the gain would have entered income under Sec. 104(13), supposedly, but if it were designated as per Sec. 104(21) in respect to **the Sec. 104(14) P.B.E. or the Sec. 105(1) income inclusion** it would be taxed twice being that it would cause an a.c.b. adjustment.

¹⁷³⁴ in the case of "family" trusts

¹⁷³⁵ Both the non-taxable portion of capital gains and non-taxable dividends described in respect of Sec. 104(19) and (20) will never cause an a.c.b. adjustment to occur if paid in respect of a capital interest and unfortunately Sec. 105(1)(b)(ii) provides that such will not be fully included in income under that subsection **only in the case of hypothetical adjustments**, but not where the Sec. 53(2)(h) provision actually applies to the interest. Rarely would it be advisable then to purchase a capital interest in a personal trust based on the accumulation and payment of non-taxable dividend streams or taxable capital gains since once such are distributed **without a commutation of the interest** Sec. 53(2)(h) will cause their full potential reintroduction into the tax base under Sec. 105(1). Even if one argues that Sec. 53(2)(h) doesn't apply to rights to receive income which are substantiated by the exempt receipts Sec. 105(1) would still apply.

they must be deducted by the trust only and cannot be designated out. Unfortunately, these deductions represent both charges that do not reduce the amount of funds the trust may be taking in but instead, through their deduction, cause tax income to become after-tax capital which the income beneficiaries do not have to recognize under Sec. 104(13). Under the present Sec. 53(2)(h) provision, a payment of such a capital reserve to a capital beneficiary would result in the ACB of the interest being reduced since it was not included in income or taxed under Sec. 104(13) and Sec. 212(1)(c) respectively, **(however, this couldn't result where the personal trust capital interest was acquired for no consideration)**. The 1988 tax reform did implement a transitional provision in respect to this phenomenon which is contained in the amendment history of the end of subsection 53(2) which provides that the new Sec. 53(2)(h)(i.1) will not apply to amounts that become payable **in a tax year of a trust that ends before 1990** but only where the trust was created prior to Oct. 2nd, 1987. The C.C.A. distributed may also be the subject of Sec. 105(1), thereby possibly entering taxable income of the beneficiary without allowing for a deduction to the trust. In this latter case essentially a recapture of C.C.A./depletion allowance will occur whenever amounts representing C.C.A. or depletion are distributed. If the C.C.A. amount is distributed to a beneficiary who has not acquired his capital interest with respect to that amount for consideration payable the Sec. 53(2)(h) ACB adjustment will not occur nor will he be required to include it in his income under Sec. 105(1). In all other cases the distribution of C.C.A. generated capital, **unless in satisfaction of the recipient's capital interest**, will cause an ACB adjustment or income inclusion.¹⁷³⁶

The last four subcategories of ACB adjustments in Sec. 53(2)(h) could more accurately be described as incidental adjustments brought about by the actions of the trust that resulted in a tax credit becoming available to the particular beneficiary or that allowed the beneficiary to receive some form of financial assistance for purchases of depreciable property made by the trust. Subparagraph (ii) provides that the amount of investment tax credit that was deducted (and not deductible) under Sec. 127(5) from the beneficiary's Part I tax payable that can be reasonably attributed to amounts designated by the **testamentary** trust under Sec. 127(7), (or certain kinds of *inter vivos* trust described under section 149), to be part of the beneficiary's investment tax credit base will reduce the ACB of the interest.¹⁷³⁷ This designation isn't available in respect to *inter vivos* trusts and once an amount has been designated by the trustees, even though it was not utilized by the beneficiary to reduce his Part I tax, the base amount will not be available to the trust. Only the credit actually received (deducted) will reduce the ACB of the interest since the reduction in taxes payable can be described as an increase in the capital of the beneficiary. The designation can only be made in respect of taxpayers who hold capital interests however once again it causes tax consequences only where the capital interest in respect of which the designation is made has been acquired for consideration payable.

Subparagraph (iii) provides that any amount added pursuant to subsection 127.2(3) in computing the beneficiary's share purchase tax credit will be deducted from the ACB of the capital interest. Basically, the apportioning of the base amount of the credit to the beneficiaries is identical to that of the investment tax credit in that it must be reasonable in light of all of the circumstances including, but not limited to, the terms and conditions of the trust. The share purchase tax credit was available in respect to certain shares issued after June 30, 1983 and before 1987, and since it is an extremely complex subject that has little current effect, it will not go into in detail but instead refer the reader to I.C. 84-4 for a more thorough study. Unlike the I.T.C. the S.P.T.C. was available to both testamentary and *inter vivos* trusts. Subparagraph (iv) provides that 50% of the amount deemed designated by Sec. 127.3(3) in respect of a share, debt obligation, or right that qualified for Scientific Research and Experimental Development Tax Credit treatment, that was consequentially deemed to have been acquired by the beneficiary will reduce the ACB of the interest. The S.R.E.D.T.C., like the S.P.T.C. was a short lived tax incentive scheme that effectively terminated before 1988.

¹⁷³⁶ the underlying thrust of these mechanics would seem to be that C.C.A. isn't to be taken unless the trust law income receivable by the affected beneficiary is also reduced and assuming that the draftsmen possessed the professional competence consonant with their office it would seem that if a C.C.A. deduction is to, by design, lead to an a.c.b. adjustment in certain instances, it can surely lead to a Sec. 105(1) inclusion in others such as when the beneficiary doesn't have a capital interest.

¹⁷³⁷ The terms and conditions of the trust plus all other circumstances will be evaluated in determining if the designated amount is reasonable however it may be entirely possible for the trustees to designate varying amounts of distinctive base which attract varying rates of credit to different beneficiaries.

In an extremely simple description, the issuer of the financial instrument would designate how much of its net proceeds would be used to carry on research and development, and the purchaser of the share would be able to take a credit against his Part I taxes based on that amount. The major difference between the I.T.C., S.P.T.C., and the S.R. & E.D.T.C. is that the two former deductions taken as an actual credit will be deducted from the ACB of the interest while in the latter case only 50% of the amount designated, upon which the credit is calculated, will be deducted from the ACB of the capital interest.

The final ACB adjustment under Sec. 53(2)(h) consists of the reduction resulting upon the receipt of all assistance received by the particular beneficiary that has resulted in a reduction in the capital cost of a depreciable property to the trust under Sec. 13(7.2). The amount of assistance received must have resulted in the reduction of the cost of the depreciable property for the trust, (which is not apparently limited to depreciable property of a prescribed class), in that not all "assistance" will do this, as described in Sec. 13(7.1), (a), (b) & (c), (amounts described in Sec. 37(1)(d), deducted as allowance under section 65 or included in income under Sec. 12(1)(a) or 56(1)(s)). Subsection 13(7.2) provides that for purposes of Sec. 13(7.1), where the taxpayer is a beneficiary of the trust, (or partner of a partnership), and has received or is entitled to receive assistance from a government municipality, or other public authority, **(not restricted to being Canadian)**, whether as grant, subsidy, forgivable loan, **deduction from tax**, investment allowance etc., the amount of the assistance that may reasonably be considered to be in respect of, or for the acquisition of depreciable property by the trust or a partnership shall be deemed to have been received by the trust (partnership) directly from the respective source. Subsection 13(7.1) provides that where the "assistance" does not fall within the three exemption provisions in para. (a), (b), and (c), the capital cost of the property will be considered to be the capital cost otherwise observable, plus the repayment of any "assistance" received in respect of the property net of the aggregate of the investment tax credit **taken** by the taxpayer, **(trust and beneficiary)**, and the amount of "assistance" received by him, or to which he is entitled to receive. In the broad picture the assistance received by the beneficiary will most often cause capital gain taxation ultimately in at least two different aspects being the ACB of the property will be reduced, (plus the C.C.A. that could normally be taken), and the ACB of his capital interest will be reduced. Unfortunately, it would seem that where the "assistance" is to be repaid, and is repaid, the capital cost of the property will be adjusted accordingly however the ACB of the capital interest will remain the same. There isn't any provision made in respect of the ACB, for subsequent repayments, even though the repayment may come from the beneficiaries and not from the trust.

The Sec. 53(2)(h) ACB adjustments apply only to capital interests that are not personal trust capital interests which were not acquired for consideration or interests in trusts described in Sec. 108(1)(j)(ii) to (v), while the trust itself may be resident in Canada or otherwise. They are applicable and cause adjustment at any time within the tax period as provided in Sec. 54(a)(ii).¹⁷³⁸

The Sec. 53(2)(h) ACB adjustments provide an ideal incentive to inflate the ACB of a capital interest, if the opportunity arises where no tax consequences will result, in that a higher ACB of a personal trust capital interest will result in a reduced potential of being pulled into the negative with a capital distribution.¹⁷³⁹ Subsection 53(2)(h) doesn't apply to personal trust capital interests which were acquired for no consideration and while a positive ACB may result if the interest passes through a Sec. 70(5) or (6) deemed disposition provision, most often such interests will have a nil ACB, resulting from a direct granting upon the trust's creation and the resulting application of Sec. 107(1.1). If the trust interest passes through under Sec. 70(5) or (6), Sec. 69(1) does not apply since, "as expressly otherwise provided in this Act," as per that subsection, subsection 70(5) or (6) apply. If the capital interest is bequeathed on death Sec. 70(5)-107(2) or 70(6) will cause the recipient to have acquired the interest at a cost equal to an amount however the provisions do not

¹⁷³⁸ The proper law of the trust and its terms are important in ascertaining what adjustments will occur in the a.c.b. of the interest when it is disposed of mid term, since the trust deed may prevent the ascertainment of income payable until after the disposition time such as at the year end. In such a case Sec. 104(13) will not apply to cause the beneficiary to recognize an inclusion since the income isn't payable to him thus there will not be bump in the a.c.b. of the interest though a reduction is possible in certain instances. If the trust deed allows proprietary rights to the beneficiary so as to allow him to be entitled to the income at the moment it arises thus full cost integration will exist at the time of the disposition.

¹⁷³⁹ assuming the interest has in fact been acquired for consideration payable

deem the recipient to have paid consideration for it hence applicability of Sec. 53(2)(h) will not automatically follow.¹⁷⁴⁰ Once such a capital interest is disposed of for consideration payable it will immediately fall under the Sec. 53(2)(h) provision in respect to future adjustments. A greater ACB is always better than a lesser one and thus the disponent's tax position at the moment of disposition should definitely be evaluated so as to ascertain if an inflation can occur. However, one should also recognize the possible effect of Sec. 69(1), where the parties are not at arm's length.¹⁷⁴¹

Another extremely important aspect concerning the inflating of an ACB is that Sec. 53(2)(h) applies fully to non-personal trusts and under the definition of "personal trust" in Sec. 248(1) where any interest, income or capital, is issued to a party for consideration payable to the trust or a person who has made a contribution etc., to the trust, the trust will lose its personal status. The loss of the personal trust status has resounding affects however if the ACB of the interest held therein is relatively high, less latent tax consequences will result. With the amendment to the scope of the Sec. 53(2)(h) provision, (the interest to which it applies), obviously its purpose is to limit advantages/benefits taxpayers could realize in trading in capital interests and resulting benefits thereby derived. The provision applies to personal trust capital interests, but only those that have been acquired for consideration payable.

¹⁷⁴⁰ This is of assistance when the initial holder did pay consideration for it. How great is the difference between being deemed to have acquired property at a certain cost and being deemed to have paid consideration for it?

¹⁷⁴¹ Issuing capital interests to non-residents, in non-resident trusts, at the time the trust is created whereby subsequently the beneficiary followed by the trust become resident offer an interesting way of inflating the a.c.b. of the interest via Sec. 128.1(1), even if the initial beneficiary and acquiror are not at arm's length.

Dispositions of Capital Interests.

A "capital interest" in a trust, as defined for purposes of the Act through Sec. 248(1) in 108(1)(c), is any right under a non-personal trust or a right under a personal trust to or to receive capital of the trust, both of which are held by the taxpayer as a beneficiary, and as such, is **usually** a capital property of the taxpayer, (though not when it may represent inventory), that when disposed of will result in the recognition of a capital gain or loss, (since it is not a depreciable capital property). Broadly speaking, there are two ways in which a capital interest may be disposed of; the first is an outright disposition, assignment, transfer, etc., caused by the actions of the beneficiary that are totally independent of the trust agreement and are simply of the nature of the taxpayer dealing with the legal title to property owned by him, while the other consists of instances where the interest is disposed of voluntarily or involuntarily by the beneficiary through cancellation, renunciation, etc., as a result of the operation of the trust agreement/will, (possibly with respect to the actions of the beneficiary).

In the former case, as a form of property similar to an "income interest", the capital interest can be disposed of in the same multitude of ways available to income interests including; through a sale, a gift, a renunciation, consent to will/trust agreement variation, mortgage foreclosure, etc. A disclaiming of the interest upon first becoming aware of its existence before it is accepted is not a disposition since the property disclaimed was never formerly owned by the disclaimer and the action operates as an avoidance of the receiving of the legal title to the property rather than as a divesting of legal title previously owned. Where the beneficiary consents to a trust deed/will variation proposal, and as a consequence his interest is impaired, altered, or extinguished regardless of to whom the substance of his right is consequently vested in, he will through the action of the consent be considered to have disposed of his interest since it was only through his voluntary consent that the equitable right/interest was altered. However, whether or not he will recognize a disposition for taxation purposes will depend a great deal on how the interest has been altered, (i.e.; whether the ultimate value of its scope has been decreased/increased, or whether a simple extension of enforceability date has occurred), in short whether there has been a material change in the beneficiary's rights¹⁷⁴².

Through four primary types of disposition, (sale, gift, renunciation, variation of trust/will¹⁷⁴³), an interest may be transferred from one beneficiary to another taxpayer and since the interest is a property that may produce taxable income for its holder, either through the designations in respect to capital gains, or in the case of income interest, Sec. 104(13) inclusions, the usual attribution provisions may apply. Since the attribution provisions operate "where an individual has transferred or loaned property, either directly or indirectly, by means of a trust or by any other means whatever...", and as such include only those instances where the taxpayer has voluntarily initiated the transfer, all of the above voluntary dispositions of interests will not be precluded from the application of the provisions.¹⁷⁴⁴ The second type of disposition of trust interest, over which the beneficiary has no control in his capacity of mere right holder, caused by the operation of the trust agreement/will, and powers instilled in persons as per its terms, will not attract the application of the attribution provisions simply because it is not "the taxpayer" who is voluntarily transferring the interest. This latter type of disposition may arise in various circumstances.¹⁷⁴⁵

Under subparagraph 54(c)(ii)(B) where "any other right of a taxpayer to receive an amount is settled or canceled" for purposes of subdivision C¹⁷⁴⁶ a disposition will have occurred and while a capital interest is defined, (in terms of a personal trust), to be a right to or to receive trust capital, the ability to "settle" it through a trust distribution will depend a great deal on whether or not the trust deed has allowed for an early extinguishment, (which it most likely has not), or will depend upon the timing of the enforceability of the right. The

¹⁷⁴² See Sec. 54(c)(ii)(A) and I.T. 448 concerning the same aspects in respect of shares in a corporation.

¹⁷⁴³ And two secondary; the revocation of disclaimer and the direction to the trustees that they hold the property on trust for someone else

¹⁷⁴⁴ For a classic case of the application of the attribution provisions to a voluntary disposition through trust variation, see *Murphy v. The Queen*, 80 D.T.C. 6314.

¹⁷⁴⁵ As per *Re: Lind*, 1915 2 Ch. 345 (CA), a taxpayer cannot validly assign an interest under a will that hasn't been created while as per *Re: Brook's Settlement Trusts*, 1939 Ch. 993, an interest possibly arising under a special power of appointment cannot be assigned unless and until the power is exercised. See also *Re: Rule's Settlement*, 1915 V.L.R. 670. Contingent and future rights can be transferred as per *Re: Midleton's Will Trusts*, 1969 1 Ch. 600, *Re: Ralli's Will Trusts*, 1964 Ch. 288.

¹⁷⁴⁶ the computation of capital gains/losses

nature of the right may be an adequate basis upon which a cancellation thereof can be easily forced. Obviously, if a right is contingent upon the occurrence of an event, as specified, within a certain period of time, and that time period has lapsed without the occurrence of the event then after the lapse the right is canceled since it can never become enforceable by the beneficiary.¹⁷⁴⁷ A beneficiary may have a contingent right that is immediately enforceable but is subject to the exercise of a trust discretionary power instilled in some obscure player whereby upon that exercise there will be a permanent loss of the right and thus a disposition thereof. This last instance should not be confused with the status a beneficiary has if he only can gain an enforceable right, contingent or otherwise, upon the exercise of a discretionary power.¹⁷⁴⁸

A right under a trust agreement derives its very existence from the agreement and thus once the trust is wound-up the existing contingent rights will be canceled, while if the trust becomes bankrupt, and very limited assets remain, income rights or specific property referenced capital rights may become invalid by the ranking of other paramount claims. If the trust property is fraudulently distributed so that the trust fund technically comes to an end though the trust doesn't, a disposition of existing capital rights doesn't occur when the beneficiary may have recourse against the trustees/property acquirors.¹⁷⁴⁹

Powers of appointment instilled in any person, obscure or otherwise, by the agreement/will allow the holder to alter the party of eventual ownership of the specified trust property and although they do not operate, (generally), to extinguish an existing beneficiary's rights directly, they can do so indirectly by simply reducing the substance of the group of properties upon which the existing rights are based. Any group of beneficiaries may be entitled to or to receive the value of a given number of trust property or given percentage of capital while a spouse may be given a power to draw on such capital for his own purposes as he sees fit, thus the power has not caused the extinguishment of the right directly but if the spouse requires so all of the property or capital which substantiated the rights may be depleted and the rights previously held will be to or to receive precisely part of the trust capital which has turn to "none". In this case, since the substance of the rights has been depleted, the rights have been effectively canceled.

With respect to powers of appointment or trust discretionary powers that operate to divest a contingent right from a beneficiary, it should be recognized that all three types of dispositions recognized by the beneficiary in respect to his rights are those not voluntarily instigated himself but were instead uncontrolled and subject to events/persons over which "he had no control". If a beneficiary sold a capital right to his spouse and attribution rules could be applied, he would be in a much more secure position if some obscure person exercised a power of appointment that effectively depleted his rights and instilled rights to the former substance thereof in his spouse since it would not have been the former capital interest holder who "transferred directly or indirectly, etc." the property. Varying in a power of appointment when the original capital interest holder doesn't own the interest will insulate him from an accusation that he should have known that the power could possibly be exercised and that the transfer was consensual.¹⁷⁵⁰ Where a trustee can exercise a trust discretionary power so as to vest an equitable right in a beneficiary then the beneficiary can participate in the trust while if the trustees are also given the power to make the same decision with respect to the same right at a later date, then the beneficiary may have his capital interest reduced and watch it vest in his spouse, the other possible discretionary object. If a particular beneficiary has a right to trust capital that only becomes enforceable if he receives a certain degree from a certain university before a certain age then he is in a position to control whether or not enforceability occurs just through his actions while if he obtains a power of appointment over the substance upon which his right is based, at the time that the contingency period has

¹⁷⁴⁷ The Report of the Royal Commission on Taxation recognized this: Vol. 3, p. 368.

¹⁷⁴⁸ Dealing in contingent interests is hindered by their very nature: usually they are referenced to an occurrence of an event exclusively related to the initial holder and have fundamental difficulties in alienation. If the event is not related to the right holder and is beyond the control of all parties involved a taxpayer may be willing to pay consideration for it but not necessarily otherwise. If the contingent right holder becomes a Canadian resident, and the trust is non-resident, Sec. 128.1(1) will apply to bump its cost to its f.m.v. and thus when it is canceled will produce a capital loss.

¹⁷⁴⁹ The capital interest, under a personal trust, is a right of the taxpayer to or to receive capital of the trust, as a beneficiary, while if recourse above lies against the trustees can the compensatory damages awarded be considered "capital of the trust"?

¹⁷⁵⁰ See the Aust. case of *Colquhoun v Dronpane Pty Limited & Ors* [2011] NSWSC 1500 (8 December 2011) where a power was assumed to exist even though it was not specified conclusively in the trust deed.

permanently lapsed, then he can decide, after he has lost the right to the capital, who will eventually receive it. Within these circumstances he can easily effectively transfer the equitable title he has, just by waiting the passage of time, to a spousal party, to whom had he transferred the contingent right, (fulfilled), directly he would have been caught by the attribution rules.¹⁷⁵¹

It was once said in a recent distinctively intolerant political forum succumb to nationalistic racism that "rights are rights and always will be rights" and in a trust/estate setting it could be said with far less ennobling sacrifice that "rights are rights and all are different". There are a multitude of different rights under trust deeds/wills and they are altered by various events/conditions that regulate the trust disposition. Immediate rights to capital or income may be subject to conditions subsequent that divests them or powers of appointment mere or in trust that can override them. Future rights may become present rights through the passage of time while contingent/conditional rights may become enforceable only upon the passage of time/occurrence of an event etc. It is these events/occurrences that alter the very nature of the rights held by beneficiaries and although a disposition of a right previously existing and an acquisition of a new one is recognizable where, for instance, an overriding power of appointment is removed, a contingent event occurs, or an estate is administered and equitable ownership of the property established, the Department administratively does not apparently pursue such taxable events. Consequently even though in common law trust interests can be recognized to have been acquired and disposed of¹⁷⁵² when a taxpayer dies and an interest vests in another, or when a power of appointment is removed that previously jeopardized the interest the Department hasn't been in the practice of assessing such as a disposition/acquisition for purposes of the ITA even though such indicate the occurrence of material economic transactions/happenings.¹⁷⁵³ On the removal of an overriding power of appointment the FMV of an interest increases/once administration is complete the interests of a beneficiary under the will become more accurately ascertained: in neither case has the Department a history of pursuing disposition assessments though how long this will continue to be informal policy is questionable and depends on the developing use of trust in tax planning in this country.

The right to or to receive capital of the trust is inherent in the beneficial entitlement granted by the operation of the trust agreement and whether or not the right is simply to use trust property or to receive it the beneficiary will still acquire a capital interest for purposes of the Act. In granting a beneficial title to the property the settlor has effectively split his whole ownership of the property, and created two separate interests held by two separate parties; the legal title to the property held by the trustee, who is precluded from benefiting from the property in his role, and the beneficial title held by the beneficiary who is immediately or ultimately to benefit from the property, though in the interim have no right to the use of the legal title. If as a consequence of the operation of the trust agreement the legal title of property is transferred to the beneficiary who holds the beneficial title thereto the ownership of the property is again fused in one party while as a result of the legal title transfer the beneficiary's equitable right to have the trust agreement administered/executed is extinguished via valid discharge given to the trustee in receipt for the transfer. The beneficial title is the base of the right to or to receive the legal title of the property and once the legal title has been obtained, or the use of it appropriately accessed, the right is understandably settled. Under subparagraph 54(c)(iii), a disposition will be recognized when property is transferred from a trust to a beneficiary thereunder except where, as provided in para. (v), the property is transferred and there is a change in legal ownership without a change in beneficial ownership, (except where there is a transfer by a Canadian resident trust to a non-resident trust).¹⁷⁵⁴ Subparagraph 54(c)(ii)(B) recognizes a disposition when a right held by the taxpayer to receive an amount is settled however where the legal title to property is transferred to a beneficiary and there results an extinguishment of his rights the beneficiary will recognize a disposition of the legal title of his beneficial interest since para. (v) does not apply to the beneficiary's interest. In the case of testamentary gifts, (and possibly as

¹⁷⁵¹ See *ABK v. Macshamhrain*, 1958 I.R. 288.

¹⁷⁵² See *Royal Trust Co. et al. v. The Queen*, 10 E.T.R. 220, *Adamson v. A.G.*, 1933 A.C. 257 (HL), *D'Avigdor-Goldsmid v. I.R.C.*, 1953 A.C. 347, *Parker v. Lord Advocate*, 1960 A.C. 608, *Coggins v. C. of S.D.*, 1961 S.R. (N.S.W.) 639, *C. of S.D. v. Isbister*, 64 C.L.R. 375, *Thomson v. Commr. of S.D.*, 1929 A.C. 450.

¹⁷⁵³ This is surprising when implicitly there is a difference between interests in residuary trusts and unadministered estates for purposes of changes in residency: Sec. 115(1)(a).

¹⁷⁵⁴ The section 107 rules cause a disposition to be recognized in the latter instance even though as per Sec. 54(c) none has occurred.

well those *inter vivos*), a disclaimer of an interest, which resulted in rights to property being granted to another party, may be revoked if that party, (or any other), has not altered his positions on the faith of the disclaimer and when revoked that taxpayer will recognize a disposition.¹⁷⁵⁵

Rights to the use of trust property may by their very nature be unassignable (personal) and such a finding usually depends on whether the life tenant can let/loan the property on which his interest is based or be entitled to the proceeds from its letting if it isn't used.¹⁷⁵⁶

Tax Cost Attribution for Disposition Purposes

Section 107 contains the basic provisions that apply to create at least part of the taxation environment that will exist when a capital interest is disposed of either by independent voluntary action of the beneficiary or as involuntary treatment under a trust agreement execution (distribution) and although they apply to set the basic rules, subdivision C thereafter applies to determine the appropriate capital gain/loss treatment.

Subsection 107(1) provides a means by which the adjusted cost base of the capital interest is adjusted, when disposed of, in an attempt to provide equity between the disposition of the right to property and the disposition of the trust property itself, however, para. (a) applies in respect of capital interests in personal or prescribed trusts only. If a taxpayer contributes property to a trust whereby the beneficial right to receive the legal title thereof is granted to another person then as per Sec. 107(1.1) the cost of such a capital interest to the beneficiary, (without or with Sec. 53(1) or (2) adjustments), is nil since he did not pay consideration for it. If he disposes of that interest, since it would otherwise have a nil ACB, he would be exposed to a massive capital gain recognition, even though the right is to receive a trust property, the ACB of which may be equal to its present fair market value, and that caused its contributor to recognize tax consequences right up to that ACB. If the ACB for capital gains purposes of the capital interest was not adjusted, the beneficiary would be penalized in disposing of the right to receive the property rather than by realizing the trust property and then disposing of it since in the latter instance the tax cost of the property, a potentially substantial ACB, as recognized by the trust, is assumed by the beneficiary upon a distribution thereof in satisfaction of his capital interest. Paragraph 107(1)(a) provides that where the trust is, effectively, a personal or prescribed trust at the time of the interest's disposition, for purposes of computing only the **taxable capital gain** from the interest disposition, or any part thereof, the adjusted cost base of the interest, or part thereof, immediately prior to the disposition shall be equal to the greater of the ACB of the interest otherwise computed as per the Sec. 53(1) & (2) & 107(1.1) rules, and its "cost amount" at that time. If the trust was not a personal or prescribed trust **before** the disposition then Sec. 107(1)(a) will not apply and the interest will have the ACB otherwise computed immediately before the disposition. If the disponent of the interest is not doing so on account of capital but instead is essentially in the process of realizing his capital interest inventory, then Sec. 107(1)(a) will not apply since the computation of taxable capital gains will never result.¹⁷⁵⁷ Prescribed trusts are defined in Regulation 4800.1 to be certain voting trusts, creditor trusts etc. but at the time of writing the Regulation was not accurately targeted in respect of Sec. 107(1).

"Disposition by taxpayer of capital interest – Sec. 107(1)"

(1) Where a taxpayer has disposed of all or any part of the taxpayer's capital interest in a trust,

(a) where the trust is a personal trust or a prescribed trust, for the purpose of computing the

¹⁷⁵⁵ The Act does not recognize a disposition when there hasn't been a change in beneficial ownership of the property but if the taxpayer severs all powers of ownership and merely becomes beneficially interested in the property when it is held in trust for sale a disposition will be recognizable. To reiterate: if the taxpayer transfers his interest be it in the form of beneficial ownership or mere possibility in the trust to another trust by which all powers of ownership of that interest are severed the beneficiary will recognize a disposition notwithstanding that he may have acquired as a consequence of the transfer an interest in the recipient trust. That latter interest may not give him powers of ownership of the particular property and may only give him a right to trust property in whatever form it may be at the time. Subparagraph 54(c)(v) targets alterations in **beneficial ownership**, not **beneficial interest**.

¹⁷⁵⁶ See *Hurley v. Hurley*, 1947 75 C.L.R. 289, *Leese v. Davis*, 1954 71 W.N. (N.S.W.) 39.

¹⁷⁵⁷ See *M.N.R. v. Independence Founders Ltd.*, 53 D.T.C. 1177 (SCC), for dealings in trust interests as an adventure in the nature of trade.

taxpayer's capital gain, if any, from the disposition, the adjusted cost base to the taxpayer of the interest or the part of the interest, as the case may be, immediately before the disposition is, unless any part of the interest has ever been acquired for consideration and, at the time of the disposition, the trust is non-resident, deemed to be the greater of

(i) its adjusted cost base, otherwise determined, to the taxpayer immediately before the disposition, and

(ii) the amount, if any, by which

(A) its cost amount to the taxpayer immediately before the disposition exceeds

(B) the total of all amounts deducted under paragraph 53(2)(g.1) in computing its adjusted cost base to the taxpayer immediately before the disposition;¹⁷⁵⁸

1758 Sept. 10, 2010 FINANCE TECHNICAL NOTES (Part 1 - non-resident trusts): Paragraph 107(1)(a) of the Income Tax Act applies for the purpose of computing a taxpayer's taxable capital gain from the disposition of a capital interest in a personal trust (or a prescribed trust described in section 4800.1 of the Regulations), except where the interest was an interest in a non-resident inter vivos trust purchased by the taxpayer and the disposition was not by way of a distribution to which subsection 107(2) applies. For this purpose the residency of the trust is to be determined without reference to section 94 as it read before 2002.

This amendment to the Income Tax Amendments Act, 2000, ensures that, in applying subsection 107(1) in respect of transfers that occur after 1999 and before 2007, the residence of a transferee trust will be determined without reference to section 94 of the Act, as it reads in its application to taxation years that began before 2007.

This amendment is deemed to come into force on June 14, 2001.

March 2001 FINANCE TECHNICAL NOTES: Paragraph 107(1)(a) applies for the purpose of computing a taxpayer's taxable capital gain from the disposition of a capital interest in a personal trust (or a prescribed trust described in section 4800.1 of the income Tax Regulations), except 'where the interest was an interest in a non resident inter vivos trust purchased by the taxpayer and the disposition was not by way, of a distribution to which subsection 107(2), applies. For this purpose the residency of the trust is to be determined without reference to section 94 as it read before 2001.

Where paragraph 107(1)(a) applies, the adjusted cost base (ACB) to the taxpayer, of a trust capital interest for capital gains, purposes is generally equal to the greater of the ACB otherwise determined and the "cost amount" of the interest. Subsection 108(1) provides that, for this purpose, the "cost amount" of a capital interest at any time is based on the amount of the trust's money and the cost amount of the trust's other property. The "cost amount" mechanism in paragraph 107(1)(a) generally allows the flow-out from a personal or prescribed trust to a beneficiary of trust capital without adverse tax consequences. However, the concluding words in subsection 107(1) provide that paragraph 107(1)(a) generally does not apply with regard to certain purchased interests in non-resident trusts.

Paragraph 107(1)(a) is amended, in conjunction with the repeal of the concluding wording in subsection 107(1) to ensure that paragraph 16(1)(a) never applies to dispositions of any capital interests in non-resident trusts acquired for consideration. New paragraph 108(6)(c) and new subsection 108(7) are relevant in determining where an interest in a trust has been acquired for consideration. Amended paragraph 107(1)(a) also provides that, for this purpose, a non-resident trust includes a trust deemed by subparagraph 94(l)(c)(i) to be resident in Canada.

Feb. 1995 FINANCE TECHNICAL NOTES: Paragraph 107(l)(a) is relevant for the purpose of computing a beneficiary's taxable capital gain from the disposition of a capital interest in a personal trust. The effect of the provision is that a beneficiary will not realize a gain from the disposition of an interest in a personal trust (or a trust prescribed under section 4800.1 of the Regulations), except to the extent that the proceeds of disposition exceed the greater of two amounts. The first amount is the adjusted cost base to the beneficiary, of that interest. The second amount is the "cost amount" of that interest. "Cost amount" for this purpose is, under, subsection 108(1), determined with reference to the cost amount to a trust of the trust's assets.

Paragraph 107(l)(a) is amended so that, in computing the second amount, there are deducted amounts that are deducted under paragraph 53(2)(g.1) in computing the adjusted cost base to the beneficiary of the interest in the trust.

May 1991 FINANCE TECHNICAL NOTES: Paragraph 107(l)(a) ensures that a disposition of an interest in a personal trust will not give rise to a capital gain unless the proceeds of disposition exceed both the adjusted cost base and the cost amount of the interest (for this purpose, the "cost amount" of a capital interest in a trust is determined under paragraph 108(1)(d) with reference to the cost amount of trust property).

Paragraph 107(1)(a) is amended so that it also applies to prescribed trusts. The purpose of this amendment is to provide consistent treatment for prescribed trusts under paragraph 107(1)(a) and subsection 107(2).

It is intended that trusts prescribed for the purpose of paragraph 107(1)(a) will be the same as those prescribed for the purposes of subsection 107(2). As provided under section 4800.1 of the Regulations, a trust maintained principally to secure a debt owing to a beneficiary, a voting trust and a trust to hold an employer's shares for the benefits of the employer's employees are each prescribed trusts for this purpose.

(b) [Repealed, 2001, c. 17, s. 80(2)]

(c) where the taxpayer is not a mutual fund trust, the taxpayer's loss from the disposition is deemed to be the amount, if any, by which the amount of that loss otherwise determined exceeds the amount, if any, by which

(i) the total of all amounts each of which was received or would, but for subsection 104(19), have been received by the trust on a share of the capital stock of a corporation before the disposition (and, where the trust is a unit trust, after 1987) and

(A) where the taxpayer is a corporation,

(I) was a taxable dividend designated under subsection 104(19) by the trust in respect of the taxpayer, to the extent of the amount of the dividend that was deductible under section 112 or subsection 115(1) or 138(6) in computing the taxpayer's taxable income or taxable income earned in Canada for any taxation year, or

(II) was an amount designated under subsection 104(20) by the trust in respect of the taxpayer,

(B) where the taxpayer is another trust, was an amount designated under subsection 104(19) or 104(20) by the trust in respect of the taxpayer, and

(C) where the taxpayer is not a corporation, trust or partnership, was an amount designated under subsection 104(20) by the trust in respect of the taxpayer exceeds

(ii) the portion of the total determined under subparagraph 107(1)(c)(i) that can reasonably be considered to have resulted in a reduction, under this paragraph, of the taxpayer's loss otherwise determined from a previous disposition of an interest in the trust, and¹⁷⁵⁹

1988 FINANCE TECHNICAL NOTES: Subsection 107(1) contains special rules applicable on the disposition of a capital interest in a trust. Paragraph 107(1)(a) ensures that such a disposition will not give rise to a capital gain unless the proceeds of disposition exceed both the adjusted cost base and the cost amount of the interest. The amendment to subsection 107(1) restricts this special rule to personal trusts, as defined in subsection 248(1).

1759 Dec. 1997 FINANCE TECHNICAL NOTES (technical): Subsection 107(1) contains special rules that apply to the disposition of an interest in a trust. Paragraph 107(1)(c) is a "stop-loss" rule which reduces a corporate beneficiary's capital loss from the disposition of an interest in a trust. The loss otherwise realized by the beneficiary is reduced by all dividends designated under subsection 104(19) or (20) by the trust in respect of the beneficiary. In computing the amount of loss reduction, dividends that reduced a capital loss of the beneficiary from a previous disposition of an interest in the same trust are excluded. Where a trust realizes a loss on the disposition of a share, the stop-loss rules in section 112 may apply to reduce the loss otherwise determined by the amount of certain dividends received by the trust on the share. However, these stop-loss rules would not apply where a beneficiary which holds a capital interest in the trust disposes of the interest and realizes a loss that can be attributed to the reduced value of shares held by the trust. Paragraph 107(1)(c) ensures that the appropriate loss reduction is made in such circumstances.

Paragraph 107(1)(c) is amended so that it applies to reduce the loss, not merely the capital loss, from the disposition of a capital interest in a trust.

Paragraph 107(1)(c) is amended in its application to taxable dividends received by corporate beneficiaries so that only, those taxable dividends that are deductible by the beneficiary will be applied to reduce the loss from the disposition.

Paragraph 107(1)(c) is also amended so that it applies to other taxpayers (except for members of partnerships who are dealt with under new paragraph 107(1)(d)). Where the beneficiary is another trust, all, amounts designated under subsection 104(19) or, (20) in respect of the beneficiary will reduce the beneficiary's capital loss from the disposition of an interest in the trust which designated the dividends. Consistent with the exclusion for mutual fund trusts from the stop-loss

(d) where the taxpayer is a partnership, the share of a person (other than another partnership or a mutual fund trust) of any loss of the partnership from the disposition is deemed to be the amount, if any, by which that loss otherwise determined exceeds the amount, if any, by which

(i) the total of all amounts each of which is a dividend that was received or would, but for subsection 104(19), have been received by the trust on a share of the capital stock of a corporation before the disposition (and, where the trust is a unit trust, after 1987) and

(A) where the person is a corporation,

(I) was a taxable dividend that was designated under subsection 104(19) by the trust in respect of the taxpayer, to the extent of the amount of the dividend that was deductible under section 112 or subsection 115(1) or 138(6) in computing the person's taxable income or taxable income earned in Canada for any taxation year, or

(II) was a dividend designated under subsection 104(20) by the trust in respect of the taxpayer and was an amount received by the person,

(B) where the person is an individual other than a trust, was a dividend designated under subsection 104(20) by the trust in respect of the taxpayer and was an amount received by the person, and

(C) where the person is another trust, was a dividend designated under subsection 104(19) or 104(20) by the trust in respect of the taxpayer and was an amount received by the person (or that would have been received by the person if this Act were read without reference to subsection 104(19)), exceeds

(ii) the portion of the total determined under subparagraph 107(1)(d)(i) that can reasonably be considered to have resulted in a reduction, under this paragraph, of the person's loss otherwise determined from a previous disposition of an interest in the

rules in amended subsection 112(3.2), this rule does not apply to a beneficiary trust which is a mutual fund trust. Where the beneficiary is a natural person, only amounts designated under subsection 104(20) in respect of the beneficiary will reduce a capital loss from the disposition of an interest in the trust.

May 1994 FINANCE TECHNICAL NOTES: Paragraph 107(1)(d) is a "stop-loss" rule which applies where a capital loss would otherwise be realized by a corporation on the disposition of the corporation's interest in a trust. The existing rule provides that the capital loss is reduced by dividends received by the trust before the disposition and flowed-through to the corporation under subsection 104(19) or (20). The reason for this rule is that the capital loss from the disposition of an interest in a trust by a corporation is assumed to increase as a result of the payment of such dividends, without any corresponding increase in taxable income of the corporation because of the non-taxable treatment of capital dividends and the inter-corporate dividend deduction for taxable dividends.

Paragraph 107(1)(c) is amended so that, where a trust is a 'unit trust', dividends received by it before 1988 are disregarded for the purposes of this rule. This amendment is appropriate because, before 1988, losses with respect to the disposition of interests in unit trusts were not within the scope of paragraph 107(1)(c) because of the restrictive definition of "trust" in subsection 108(1).

Paragraph 107(1)(c) is also amended to ensure that a reduction in computing the 'taxpayer's capital loss from the disposition of a trust interest is not applied more than once. This amendment is relevant where a taxpayer makes partial dispositions of an interest in a trust at different times.

trust.^{1760, 1761}

"Cost amount" of Capital Interests

Subparagraph 108(1)(e)(ii) provides that notwithstanding the definition of "cost amount" in Sec. 248(1), the cost amount to a taxpayer of a capital interest, or part thereof, (other than when the trust is a foreign affiliate of the taxpayer), will equal a certain net adjusted tax cost of all of the property in the trust apportioned on the basis of the fair market value of the capital interest in relation to the total fair market value of all of the existing capital interests.¹⁷⁶²

The "cost amount" of a capital interest in a personal or prescribed trust, other than a foreign affiliate, as per Sec. 108(1)(d)(ii), is equal to the proportion of the amount by which the aggregate of all money of the trust on hand immediately before the disposition and all amounts each of which is the Sec. 248(1) cost amount to the trust, immediately before that time, of each property of the trust, exceeds the aggregate of all amounts of debt owing by the trust, or obligations to pay any amount, that were outstanding immediately before that time, that the fair market value of the part of the capital interest being disposed of at that time is of the aggregate of the fair market values of all of the existing capital interests under the trust at that time. With the 1990 amendments this provision was appropriately amended to cause the cost of the cumulative eligible capital of the trust to be grossed up to 4/3 rds of its book amount.

If there was ever a provision in the Act that can be abused and whose spirit can be offended, if its terms can be properly interpreted, this is it. The "aggregate of all money of the trust on hand immediately before..."

1760 Dec. 1997 FINANCE TECHNICAL NOTES (technical): New paragraph 107(1)(d) provides similar rules where a partnership realizes a loss from a disposition of an interest in a trust. However, since the partnership which disposes of the share is treated as a flow-through entity, the loss reduction is performed at the partner level. The new provision does not apply to reduce the loss of a partnership that is a member of another partnership and applies only where the partner is a corporation or individual (other than a mutual fund trust). Accordingly, where a partnership is a member of another partnership which realizes a loss from the disposition of a trust interest, the loss of the partners of the first partnership may be reduced under new paragraph 107(1)(d).

1761 July 2010 FINANCE TECHNICAL NOTES (Part 1 — technical): Subsection 107(1) contains special rules applicable to the disposition of an interest in a trust. A trust can distribute non-taxable amounts, such as returns of capital and the non-taxable portion of a capital gain, to the holders of interests in the trust. Currently, the Act requires a return of capital to be accounted for by reducing the recipient's adjusted cost base of the interest in the trust. While the effect of this general rule is clear where the interest is held as capital property, it is not as clear where the property is held as inventory. New paragraph 107(1)(e) applies when a taxpayer disposes of an interest in a trust that is not held as capital property. The paragraph deems the taxpayer's cost amount of that interest to be the cost amount used for inventory valuation purposes less the total of all returns of capital and non-taxable capital gains payable to the taxpayer, in respect of the interest, prior to the disposition. This is to recognize that all receipts for a property held on income account should be treated as either income or a reduction in the cost of the property to the holder.

The new paragraph applies to dispositions after 2001 if the trust interest is a qualified security, as defined in subsection 260(1), and an SLA compensation payment or a dealer compensation payment, as defined in subsection 260(1) has been paid in respect of the trust unit after 2001 and before February 27, 2004. Otherwise, the new rule applies to dispositions after February 27, 2004, except that it will not apply to a disposition that took place after February 27, 2004 and before 2005, if the taxpayer had on or before February 27, 2004 entered into an agreement in writing for the disposition of the interest.

There is a further exception to the application of the new paragraph. Distributions of the non-taxable portion of capital gains will reduce the cost amount of an interest in a trust only if those distributions took place after the new paragraph came into effect — that is, in the case of a trust interest that was the subject of a security lending arrangement (SLA) that was made between January 1, 2002 and February 27, 2004, after 2001, and, in all other cases, after February 27, 2004.

1762 Where the trust is a foreign affiliate as a consequence of section 94, the cost amount of the interest will be that described in Sec. 248(1), being its a.c.b. otherwise computed, however this only applies where the amount of income or capital to be distributed at any time to any beneficiary of the trust **cannot** be affected by a discretionary power since as per Sec. 94(1)(c), (d), and 95(1)(d) the trust cannot then be treated as a foreign affiliate. As per Sec. 94(1)(c) and 94(2) the capital beneficiary will then become liable for the trust's income tax as applied as if it were resident in Canada, however, if the capital right consists only of the right to have the trust capital applied for the holder's benefit, rather than to receive it, Sec. 94(1) may not apply, as per the definition of "beneficially interested" in Sec. 94(7), and the trust will not be considerable as a F.A. and thus the constructive receipt right will gain Sec. 108(1)(d) cost amount treatment. The Specialty Corporations Rulings Division provided in Apr. 1984 that any payment of trust corpus from a foreign affiliate trust in satisfaction of a capital interest that hasn't a legitimate a.c.b. may result in capital gains due to the inapplicability of Sec. 108(1)(d) in respect of Sec. 107(1) and (2). While this result was technically recognized by the officer this intended effect was doubted and although the matter was referred to the Current Amendments Division to attend to .. apparently "the buck stopped there".

will, all things being equal, increase the cost amount of the capital interests however the provision is silent on whether this "money" must be capital or income that has not yet become payable in the current period hence it may be possible to accumulate cash income during the period, to inflate cost amounts, so as to create favorable disposition conditions, just prior to the time of the year in which the income must be paid out to the income beneficiaries.¹⁷⁶³ "Money" need not be restricted to being solely in Canadian legal tender in order to qualify while an even more critical question is whether cash income accredited to an income beneficiary's account, continues to be the money of the trust or that of the particular beneficiary.¹⁷⁶⁴ By deferring payment of income or capital funds "money" levels may be manipulated to produce favorable disposition conditions. By deferring payment of capital and accumulating it the fair market value of particular interests may be increased disproportionately to produce the opposite of that intended however the fair market value of the income interests is not taken into consideration in the apportioning though if income is capitalized capital rights are created that are considered.

"Cost of capital interest in a trust – Sec. 107(1.1)"

(1.1) The cost to a taxpayer of a capital interest of the taxpayer in a personal trust or a prescribed trust is deemed to be,

(a) where the taxpayer elected under subsection 110.6(19) in respect of the interest and the trust does not elect under that subsection in respect of any property of the trust, the taxpayer's cost of the interest determined under paragraph 110.6(19)(a); and

(b) in any other case, nil, unless

(i) any part of the interest was acquired by the taxpayer from a person who was the beneficiary in respect of the interest immediately before that acquisition, or

(ii) the cost of any part of the interest would otherwise be determined not to be nil under section 48 as it read in its application before 1993 or under paragraph 111(4)(e) or 128.1(1)(c) or (4)(c).¹⁷⁶⁵

¹⁷⁶³ A beneficiary may become entitled to such only after the trustee has assented to his right thereto which may occur only at the year end and until the year's income has been computed, possibly after losses and loss carry-forwards have been applied, that revenue does not create liability for the trustee. Where the beneficiary has a proprietary right to the income from the property it is his at the moment it is realized subject to the withholding to cover relevant expenses.

¹⁷⁶⁴ It has been held in some Australian tax cases that such accreditation takes the funds out of the original trust and creates anew another trust in respect of them.

¹⁷⁶⁵ March 2001 FINANCE TECHNICAL NOTES: Subsection 107(1.1) provides, for the purposes of subsection 107(1), that the cost of a capital interest in a trust is nil except where the interest is acquired from a previous capital beneficiary in the trust or where the interest is issued to the beneficiary for consideration equal to the fair market value of the interest at the time of issuance.

Subsection 107(1.1) is amended so that it applies only to trusts that are personal trusts or prescribed trusts. It is intended that trusts described in section 4800.1 of the Income Tax Regulations be prescribed for this purpose.

Paragraph 107(1.1)(b) is amended to provide that the cost of the interest will not be deemed nil where:

- the cost of any part of the interest would otherwise be determined not to be nil under the taxpayer migration rules in section 128.1 or former section 48 or under paragraph 111(4)(e)(acquisition of control), or
- any part of the interest was acquired from a person who was the beneficiary in respect of the interest immediately before that acquisition.

Subsection 107(1.1) is also amended to ensure that it applies for the purposes of the Act, and not simply subsection 107(1).

Dec. 1997 FINANCE TECHNICAL NOTES (technical): Subsection 107(1.1) provides, for the purposes of subsection 107(1), that the cost of a capital interest in a trust will be nil, except where the interest is acquired from the previous capital beneficiary of the trust or where the interest is issued to taxpayer for consideration equal to the fair market value of the trust interest Subsection 107(1.1) is amended as a consequence of the elimination of the \$100,000 lifetime capital gains exemption to add a reference to an election made under new subsection 110.6(19). This amendment ensures that where a taxpayer makes an election to recognize gains in respect of the taxpayer's capital interest accrued to the end of February 22, 1994 and the trust does not elect in respect of any property of the trust, the taxpayer's cost of that interest will be the amount determined in respect thereof under paragraph 110.6(19)(a),

1982 FINANCE TECHNICAL NOTES: Subsection 107(L 1) of the existing Act provides special rules for determining the

“cost amount” – Sec. 108”

“cost amount” to a taxpayer at any time of a capital interest or part of it, as the case may be, in a trust, means (notwithstanding subsection 248(1) and except for the purposes of subsection 107(3.1) and section 107.4 and except in respect of a capital interest in a trust that is at that time a foreign affiliate of the taxpayer),

(a) where any money or other property of the trust has been distributed by the trust to the taxpayer in satisfaction of all or part of the taxpayer’s capital interest (whether on the winding-up of the trust or otherwise), the total of

(i) the money so distributed, and

(ii) all amounts each of which is the cost amount to the trust, immediately before the distribution, of each such other property,

(a.1) where that time is immediately before the time of the death of the taxpayer and subsection 104(4) or (5) deems the trust to dispose of property at the end of the day that includes that time, the amount that would be determined under paragraph (b) if the taxpayer had died on a day that ended immediately before that time, and

(b) in any other case, the amount determined by the formula

$(A - B) \times C/D$

where

A is the total of

(i) all money of the trust on hand immediately before that time, and

(ii) all amounts each of which is the cost amount to the trust, immediately before that time, of each other property of the trust,

B is the total of all amounts each of which is the amount of any debt owing by the trust, or of any other obligation of the trust to pay any amount, that was outstanding immediately before that time,

C is the fair market value at that time of the capital interest or part thereof, as the case may be, in the trust, and

..D is the fair market value at that time of all capital interests in the trust;¹⁷⁶⁶

cost of a capital interest in a testamentary trust. This subsection is amended to apply to capital interests in all trusts. It provides that the cost of a capital interest in any trust is deemed to be nil except where it is acquired from a previous beneficiary or where it is issued to the taxpayer for full consideration.

1766 Feb. 2009 FINANCE TECHNICAL NOTES (budgets/technical): The definition "cost amount" in subsection 108(1) generally applies, for the purposes of sections 104 to 108, in determining the cost amount to a taxpayer of the taxpayer's capital interest in a trust.

The definition is amended as part of a series of amendments intended to provide for the income tax effects on a reorganization into corporate form of a SIFT wind-up entity. This amendment ensures that the references in new paragraphs 107(3.1)(b) and (c) to the cost amount to a taxpayer of the taxpayer's beneficial interest in a trust is determined

To be added to the aggregate amount of money is the aggregate of all cost amounts, as defined in Sec. 248(1), of all trust property, determined immediately before that time. The cost amount of depreciable property is directly related to the amount of capital cost allowance formerly deducted, hence, where possible, it would

without reference to the special definition "cost amount" in subsection 108(1). As a result, that cost amount is to be determined under the definition of that expression in subsection 248(1).

March 2001 FINANCE TECHNICAL NOTES: The calculation of the "cost amount" of a taxpayer's capital interest in a trust is primarily relevant for the purposes of determining a taxpayer's capital gain from the disposition of the taxpayer's Capital interest in a personal trust. Under paragraph 107(1)(a), for capital gains calculation purposes, the adjusted cost base (ACB) of a taxpayer's capital interest is generally the greater of the ACB otherwise determined and the cost amount of the taxpayer's interest determined under subsection 108(1).

Under the existing definition, the cost amount of a taxpayer's capital interest in a trust satisfied by way of a distribution of money is equal to the money distributed. The cost amount of a capital interest satisfied by way of the distribution of other property is equal to the sum of the cost amounts to the trust of those properties. In cases where a capital interest is disposed of without any distribution, the cost amount of a taxpayer's capital interest is considered to be the taxpayer's proportionate share of the trust's money on hand and the total cost amount of other trust property, offset by outstanding trust liabilities. The purpose of the existing definition is essentially to give beneficiaries of personal trusts recognition for cost amounts of trust assets, given that the cost of capital and income interests in such trusts will generally be nil because of the operation of subsections 106(1.1) and 107(1.1).

The definition is amended so that it does not apply for the purpose of section 107.4. This amendment applies to the 1993 and subsequent taxation years, in order to be consistent with the coming into force for section 107.4.

New paragraph (a.1) of the definition is introduced to provide a special rule in the event that an individual is deemed to dispose of a capital interest in a trust immediately before the individual's death. If on the individual's death there is also a deemed disposition of trust assets and an immediate subsequent deemed reacquisition because of the operation of amended paragraph 104(4)(a) or (a.4), that deemed reacquisition is considered to occur immediately before the individual's death in order that the "cost amount" of the individual's capital interest reflects the deemed disposition of trust assets. This amendment is intended to prevent double taxation of the same economic gain in these circumstances.

May 1994 FINANCE TECHNICAL NOTES: Subsection 108(1) contains a definition of "cost amount" to a taxpayer of a capital interest in a trust. Where the capital interest of a taxpayer in a trust is fully or partially satisfied on the distribution of property by the trust, the cost amount of the taxpayer's satisfied interest is the total of any cash and the post amounts to the trust of other property so distributed. In any other case, the cost amount of the taxpayer's interest in a trust is determined by prorating the amount obtained by subtracting the trust's debts from the total of the trust's cash on hand and cost amounts of trust property. The proration factor for this purpose is the fair market value of the interest divided by the fair market value of all capital interests in the trust.

The definition of "cost amount" in subsection 108(1) is amended in three respects. First, paragraph (a) of the definition is amended to remove the exclusion of eligible capital property in respect of a business from the application of that paragraph. Second, subparagraph (ii) of paragraph (a) of the definition is repealed. Third, the description of "A" in paragraph (b) of the definition is amended to remove the exclusion of eligible capital property in respect of a business from the application of subparagraph (ii) of that description and to repeal subparagraph (iii). These amendments, like the amendment to paragraph 85(4)(b) described in these notes, are consequential on a previously-enacted amendment to the definition of "cost amount" in subsection 248(1), so that the 4/3 gross-up of cumulative eligible capital is now provided under subsection 248(1).

May 1991 FINANCE TECHNICAL NOTES: Paragraph 108(1)(d) [now 108(1)"cost amount" — ed.] defines the "cost amount" to a taxpayer of a capital interest in a trust. Where the capital interest of a taxpayer in a trust is fully or partially satisfied on the distribution of property, by the trust, the cost amount of the taxpayer's interest so satisfied is the sum of any cash so distributed and the cost amounts to the trust of other properties so distributed. In any other case, the cost amount of the taxpayer's interest in a trust is determined by prorating the amount obtained by subtracting the trust's debts from the sum of the trust's cash on hand and cost amounts of trust property. The proration factor for this purpose at a particular time with respect to a taxpayer's capital interest in a trust is the fair market value of the interest at the particular time divided by the fair market value of all capital interests in the trust at the particular time.

Paragraph 108(1)(d) is amended so that, for the purposes of determining the "cost amount" of a taxpayer's capital interest in a trust, the "cost amount" to a trust of its eligible capital property is grossed-up by 4/3. This amendment, like the amendment to subsection 107(2) described earlier, recognizes that only 3/4 of eligible capital expenditures is included in computing cumulative eligible capital and is thus relevant in determining the cost amount of eligible capital property pursuant to the definition of "cost amount" in subsection 248(1).

1988 FINANCE TECHNICAL NOTES: Subsections 107(1) and (2) contain special rules that apply on the disposition of a capital interest in a trust. Paragraph 107(1)(a) ensures that such a disposition by a taxpayer will not give rise to a capital gain unless the proceeds of disposition exceed both the adjusted cost base and the cost amount to him of the interest. Subsection 107(2) allows trust property to be distributed to a beneficiary in satisfaction of his capital interest for his cost amount of the interest. The cost amount of a capital interest is defined for these purposes as the proportion of the cost amounts of the net assets of the trust attributable to the particular capital interest.

The amendments to subsections 107(1) and (2) generally restrict the application of these special rules after 1987 to personal trusts, as defined, in subsection 248(1). The amendment to the definition of "cost amount" in section 108 ensures that after 1987 such definition overrides the definition of "cost amount" in subsection 248(1).

be prudent to time the disposition of a capital interest to occur just prior to the deducting of C.C.A., (or E.C.E.A.), so as to have the cost amount of the interest at the maximum, or, to deduct less C.C.A. (E.C.E.A.) in prior periods, if feasible. By reducing or avoiding capital distributions to beneficiaries (whether or not they satisfy capital interests) until after the disposition, the cost amounts of all the interests are increased however, the fair market value of the capital interests existing is also intricately derived from possible non-extinguishing and extinguishing capital distributions, hence, the effects of a possible distribution would have to be evaluated. Depending on the trust's ability to negate or reduce the effective taxation of capital gains through capital losses, etc., it may be prudent to have the trust dispose of property with substantial accrued gains so as to cause it to realize amounts of money far in excess of the cost amount of the property which would be far lower, and if a planned disposition was not possible then action on incidental dispositions could be planned. If loss accruing property is also the object of the effect of Sec. 75(2) then capital losses produced on the disposition thereof will be recognizable at least twice. Obviously, if the trust has substantial amounts of property that it rents but does not own, even though capital interests may be referenced to benefits from them, they will not have effect in the computation of the gross amount of trust property for purposes of apportioning down the cost amounts of the individual capital interests **but** such could quite materially affect the fair market value of the interests involved so as to significantly affect the final result. Lending property to the trust prior to an interest's disposition can thus disproportionally increase its FMV so as to allow it to have a larger cost amount however such will also increase its FMV for disposition purposes however not necessarily by the same amount by which its cost amount is increased.

The amount of debt owing by the trust or the amount of any obligation to pay any amount outstanding immediately before the time of the disposition will reduce the cost amount of all capital interests while it is important to note that it is only the debt/obligation in respect to the trust that is treated and not those related to the trust that have been assumed by its beneficiaries. The terms are wide enough to include obligations of the trust to distribute funds to the beneficiaries as well as to otherwise include commercial debt.¹⁷⁶⁷ Since the trust will recognize an obligation to pay an amount to a beneficiary only when that beneficiary has an immediately enforceable right to it, the effect of discretionary interests which become enforceable only upon the exercise of the discretionary power, will be to reduce the otherwise recognizable obligation. Debt assumed by the beneficiary in respect of trust property will not be given effect and thus increase the cost amounts of the interests, however, whether or not the beneficiary will be able to deduct interest paid in respect to that debt is a different and important question, which relates to whether or not there is a direct "connectedness" between the debt and the deriving of taxable income by the beneficiary.¹⁷⁶⁸

One can see the obvious advantage of having a beneficiary assume a debt of the trust prior to a distribution of property in respect of his capital interest in that it will reduce the trust debt existing while if he does so the assumption thereof may still be considered as a condition of a pending distribution which would allow him to access potentially favorable treatment under Sec. 107(2)(c) when the distribution subsequently takes place.¹⁷⁶⁹ Intentionally assumed revenue debt used to adjust income beneficiaries' annual recognizable entitlements will also cause effects on the ability of a capital beneficiary to recognize a tax free interest disposition hence such income adjusting transactions should not be instigated when capital interests are to be disposed of. If a non-resident trust beneficiary is about to become resident outside of Canada trust debt

¹⁷⁶⁷ In January 1981 the Non-Corporate Rulings Division provided: "In our opinion the words 'amount of any debt owing by the trust or of any other obligation of the trust to pay an amount' do not include a reference to the value of a life tenant's life interest in the trust except to the extent that any part of the income of the trust has become payable to a beneficiary but is unpaid." In July 1979 the same opinion was held by the same Division. Income unpaid though payable at the year end would create double taxation due to its reducing the capital interest cost amount **if under the trust terms** it was recognized to be payable to the beneficiary at moment of its receipt but was only deferred in payment.

¹⁷⁶⁸ As per *Panizza v. Commr. of S.D.*, 81 A.T.C. 4214, money owed to a beneficiary is debt nonetheless. Guarantees given by the trust in respect to the beneficiary's debt/obligation to pay in respect to the trust would, in the authors opinion, not be considerable as debt or "obligations to pay" of the trust until such time as the beneficiary is unable to fulfil his obligations. One could argue that the use of the two descriptions to target the liability, unadjusted for beneficiaries and the latter being of a particularly broad character, are designed to capture trust rights that represent liabilities with respect to the trust.

¹⁷⁶⁹ Subparagraph 107(2)(c) does not describe **when** the debt must be assumed to qualify in respect of a **distribution**, but there must be a distribution hence some property would have to be distributed for the assuming of debt to have beneficial effect upon subsequent interest dispositions.

could be favorably assumed so as to inflate the Sec. 108(1)(d) cost amount of the interest to reduce Sec. 128.1(1) tax consequences.

In the author's opinion, rental agreements that require the trust to make payments of rent, in the future, for the use of some property constitute obligations to pay a certain amount since the trustee has committed the trust to extinguish that obligation, however such is distinguishable from interest charges on debt in that only the accrued interest charges, and not those sustainable in the future, should be treated as obligations to pay.¹⁷⁷⁰ If debt is to be assumed by a trust understandably its assumption should be deferred until after the pending disposition of the capital interest has occurred since if it were assumed prior to the disposition the cost amount of the interest would be reduced.

The subparagraph 108(1)(d)(ii) provision refers to obligations to pay or debt outstanding **immediately** before the time however a trust's obligation to pay/debt owing is independent of its recognition by the trust and thus capital interest disposers should take into account the possibility of latently recognizable debt when disposing of their interests. This is especially true in the case of estates in the midst of administration. It is quite plausible that the fact that the trust/estate chose not to recognize a debt/obligation to pay will not preclude CRA from reassessing the disponent in respect of the ACB of his interest previously disposed of after it is recognized by the trust/estate. On the other hand there are certain types of obligations to pay that do not become enforceable against the trust, or do not exist as such, until the conclusion of court action etc. such as quantum meruit claims etc. and until unfavorable court judgment is delivered they do not constitute "obligations to pay". If a capital interest is disposed of prior to that time, in the author's opinion, R.C. could not recompute the ACB of the interest.

Once the positive amount described in para. 108(1)(d)(ii) is ascertained, it is apportioned as per the fair market value of the capital interests existing under the trust at that time, the result being the "cost amount" of each specific capital interest. Ascertaining the fair market value of a capital interest may be somewhat of a subjective exercise however it is only by ascertaining the fair market value of all of the existing capital interests, as well as that of the specific interest being disposed of, that the cost amount can be determined. The fair market value of the specific interest being disposed of may be readily ascertainable in light of the value of the consideration being offered for it, however, the present fair market value of a capital interest, in funds that are to be accumulated over 10 to 15 years from fluctuating income patterns, that is held by a beneficiary that is contingent upon some very future event may be particularly difficult to ascertain since there are so many factors and probabilities involved. The fair market value of capital interests would be even more subjectively arrived at if there has been a history of, fickle or otherwise, exercises of powers of appointment, advancement, encroachment, or whether there exists trust discretionary powers. It is important to note that only those rights having the character that allow them to qualify as "capital interests" will have effect here thus if a trust (or mere) discretionary power is exercisable to grant one of two or more possible beneficiaries an interest in capital that is to be accumulated over a period of time, then it will only be upon that exercise that a "capital interest" will arise, and until that time the accumulating capital will serve to inflate **exclusively** the cost amounts of existing capital interests. The existence of the unexercised power will inflate the cost amount of the interests existing but it may have the opposite effect on the fair market value of those interests however the increase in the net aggregate cost amount to be apportioned may increase the net interest cost amount more than the apportioning decreases it.

Alterations in Residency by Both Beneficiary and Trust: Effects on ACB and Other Issues.

Obviously, if trust and beneficiary are to become non-resident, the beneficiary should generally do so first since his capital interest will be precluded from being effected under the Sec. 128.1(1) deemed disposition rules by virtue of the fact that it is a taxable Canadian property. If the trust were to become non-resident first, although the cost amount of its property, (and thus the cost amount of the capital interest), will increase due to the deemed dispositions under Sec. 128.1(1), it will be rare if the fair market value of the interest after the cessation in residency will be equal to its new cost amount.¹⁷⁷¹ If the beneficiary is to become non-resident,

¹⁷⁷⁰ A great deal would depend on the rental/lending contract and whether it can be canceled.

¹⁷⁷¹ If the result of the application of Sec. 128.1(1) due to the composition of the trusts property would be a capital loss

and the trust is already non-resident and thus as a consequence the beneficiary is exposed to the recognition of a substantial capital gain under Sec. 128.1(1), it could prove beneficial to alter the residency of the trust, temporarily, so as to allow it to be resident in Canada, thus benefiting from the property cost amount bump provided in Sec. 128.1(1), and then having the trust become non-resident immediately after the beneficiary does so whereby the increased property cost will preclude the trust from recognizing substantial gains under Sec. 128.1(1), ... however the foreign jurisdiction tax laws would have to be examined. Subsection 128.1(4) does not apply to trusts.¹⁷⁷²

One can manipulate the prevailing conditions of the trust so as to inflate a particular capital interest's cost amount just prior to its disposition so that it will become its ACB for capital gains purposes when it is disposed of, especially since the cost amount is only vaguely, and in one instance, related to the character of the particular interest, however, the closing paragraph of Sec. 107(1) provides that para. 107(1)(a) does not apply in a certain instance. Where the interest was a capital interest in an *inter vivos* trust not resident in Canada that was purchased by the taxpayer para. 107(1)(a) will not apply, but only for the purposes **other than computing possible capital gains** on the satisfying distribution of a personal or prescribed trust commented on in Sec. 107(2). An *inter vivos* trust, as defined in Sec. 108(1)(f), consists of a trust or estate that does not satisfy the conditions described in Sec. 108(1)(i) that allow it to be a testamentary trust. There are the obvious two possible interpretations of the closing paragraph of Sec. 107(1); the first being that the trust cannot be non-resident at the time of the capital interest disposition although the interest could have been purchased when the *inter vivos* trust was resident in Canada while perhaps less supportable is the second being those interests in non-resident *inter vivos* trust that were purchased by the taxpayer.¹⁷⁷³ Obviously if an *inter vivos* personal trust is about to become permanently non-resident, and a permanently resident capital interest holder is contemplating disposing of the capital interest, he should do so prior to the trust's cessation in residency, (possibly through a transfer to a holding trust).

It is fairly clear how the mechanics of Sec. 107(1)(a) and 108(1)(d)(ii) attempt to eliminate the tax consequences that may result when a capital interest is disposed of and it has a nil or minimal ACB due to Sec. 107(1.1) and the Sec. 53(1) & (2) ACB adjustments. By determining the net tax value of the trust property and ascertaining what proportion of that is "attributable" to a particular interest the recognized tax cost implicit in the value of the interest is allowed to filter through to reduce the possible capital gains taxation of the interest. Unfortunately there are some very serious fundamental deficiencies in such an approach, including the fact that property to which the capital interest does not relate can affect its cost amount, as is the case with inventories¹⁷⁷⁴, as well as the fact that the apportioning process is very arbitrary and the whole mechanism can be manipulated fairly easily. It should be remembered that it is only available in respect to trusts that were personal or prescribed before the disposition and it is applicable in determining the ACB of the capital interest for taxable capital gain computation purposes only.

It is also only applicable where the interest, in the case of an *inter vivos* trust, not resident in Canada wasn't purchased by the disposing taxpayer regardless of his residence other than where the trust is making a distribution to which sec. 107(2) in respect of personal or prescribed trusts applies. If the interest in the non-resident *inter vivos* trust is disposed of a whopping capital gain will occur if the purchase price was low in comparison to its FMV at the time of the disposition since Sec. 107(1)(a) will not operate to create an assimilation of the inherent net tax cost of the trust's property. This is a major obstacle in structuring dispositions of non-resident trust capital interests and it applies regardless of where the trust or taxpayer were actually resident when the taxpayer purchased the interest. There is the obvious way of avoiding a capital gain however in the case where the Sec. 108(1)(d) cost amount of the interest is relatively excessive in relation to its ACB: bring the trust resident at the time of the disposition so that any "non" taxable Canadian

the beneficiary should cease residency first. A lot depends on the difference between the f.m.v. and cost amount of the non taxable Canadian property.

¹⁷⁷² This doesn't even take into consideration the fact that the non-resident trust may constitute a foreign affiliate of the ceasing-to-be resident beneficiary within the section 94 rules and consequently the cost apportionment and capital gain integration rules will not operate.

¹⁷⁷³ The phrase refers to an interest that "was an interest in an *inter vivos* trust..." as opposed to that which, at the time of disposition, "is an interest in an *inter vivos* trust..."

¹⁷⁷⁴ and other property which exclusively substantiate income interests

property is bumped to a cost equal to its FMV via Sec. 128.1(1). Subsequent to the disposition severely reducing the tax consequences the trust could again become non-resident with minimal tax consequences if the FMV of its "non" taxable Canadian property hasn't increased substantially. It could also prove possible to vary the personal trust to allow for a Sec. 107(2) distribution of property the Sec. 248(1) ACB of which may be quite large so that the Sec. 107(2)(b) flow through occurs whereby a subsequent sale thereof to any party would produce less tax consequences.

Bumping the ACB

If a taxpayer contributes property to a trust and maintains a power of appointment over it not only will the aggregate tax cost of the trust's property be increased but no new capital interests will be created thus such a transfer will increase the cost amount of the existing capital interests only **though not necessarily their fair market value**. In such an instance however not only will Sec. 75(2) apply to the contributor¹⁷⁷⁵ to double the recognition of any income arising from the property but the tax free Sec. 107(2) distributions from the particular trust **of any property** will be forever terminated¹⁷⁷⁶. If the power is exercised to transfer the property to the contributor's spouse Sec. 107(2) will offer a tax free distribution only while for the balance of the distributions Sec. 107(4.1) will apply. If the property's tax cost is large enough it will allow the other beneficiaries to dispose of their interests for tax free proceeds under sec. 107(1)(a) and it may be possible to increase their legitimate ACB so much as to have it exceed the **FMV** of the property to be distributed in respect of it other than property subject to the power. In such a case the trust will recognize taxable dispositions under Sec. 107(4.1) and excess ACB of the interests satisfied will not produce any tax consequences under Sec. 107(4.1)-(4)(f)-107(2)(b) unless the beneficiary assumes debt. It is for this reason that the avoidance of Sec. 75(2) is most important since if it doesn't apply the legitimate ACB will be tacked onto the cost of the property received. The "gap" between the FMV of the property and the tax cost thereof resulting to the beneficiary under Sec. 107(2) will be a tax free gain. If instead of being satisfied the interest is disposed of after the power is exercised to divert the property away a capital loss may be recognizable. The fair market value of the property subject to the power would have to be substantial understandably if the ACB of the particular property to be ultimately bumped is large as well as the aggregate tax costs of the trust's property.¹⁷⁷⁷ The trust could initially be created in such a manner so as to allow the tax free ACB bumps in the legitimate interests involved. Non-resident contributors/settlers are of major assistance in this instance obviously since Sec. 75(2) does not apply to them.

The operation of the provision in respect of the disposition of a capital interest in an ascertained trust cash amount will usually cause the interest to have an ACB **not** equivalent to that cash amount where the trust is in the least bit "complicated" by the holding of various properties with various tax values and various liabilities.¹⁷⁷⁸

Paragraph (b) of subsection 107(1) provides that in computing the allowable capital loss on the disposition of any part of a capital interest the ACB of such part shall be that immediately prior to the disposition as otherwise determined under the Act without reference to para. (a) hence a taxpayer will not be able to recognize a capital loss from a disposition of a capital interest in any trust unless the interest has a real ACB and the only way an interest can have a real ACB is through the application of Sec. 107(1.1), 48(2), 53(1), and section 70 provisions etc., which **habitually** are responsive to tax exposing events. These provisions are in substance counter balancing adjustments that allow a property to have a cost as a result of an activity/event that took place that attracted taxation itself hence they serve only to reduce or eliminate possible double taxation should the property be the subject of another event, in this case, a disposition. Artificial inflations as described are possible however.

¹⁷⁷⁵ if he is the party who retains the power of appointment

¹⁷⁷⁶ unless the contributor isn't resident and thus Sec. 75(2) cannot apply to him

¹⁷⁷⁷ One may be concerned in instances where the property is contributed subsequent to the trust's creation with the prospect that the Department will argue that the contribution is to a different trust since such would prevent this tax free cost bump from operating.

¹⁷⁷⁸ In a perfect world all of the capital interests under the trust will **not** have an aggregate fair market value equal to the net fair market value of the trust property due to the deferral of enforceability.

In the grand "scheme of things" the Sec. 107(1)(a) & (b) provisions can be used to obtain tax benefits either when the trust is being terminated or during its life, without attracting taxation to any party through the recognition of reoccurring dispositions of capital interests. A common occurrence in a family trust planning situation is the simple gifting of a capital interest in the personal trust to a taxpayer whereby since he has not paid anything for it he cannot recognize it to have an ACB greater than nil, given that the personal status is to be maintained and the trust has substantial amounts of property. Since he has not paid anything for the interest under Sec. 107(1.1) the beneficiary cannot recognize an ACB greater than nil and if Sec. 128.1(1) or the Sec. 53(1) adjustments are not applicable, the ACB will remain as such. If the trust is wound-up and the beneficiary recognizes a disposition as a consequence of the right being canceled **other** than through a property distribution, (such as also the case with permanently impaired contingent rights), the beneficiary will not be able to recognize a capital loss since the interest's ACB was nil, as per Sec. 107(1)(b). If the contingent interest is disposed of by "A", the beneficiary, then he can receive proceeds of disposition up to its cost amount without recognizing tax consequences and thus by having the co-operation of the other beneficiaries and trust so as to inflate the "cost amount" of the interest the contingent beneficiary can realize some benefit. Trust debt adjustments, money accumulations, etc., need not be permanent nor cause tax consequences to the parties involved. The interesting aspect about the disposition is that the acquiror, "Frank", will recognize the interest to have an ACB equal, (initially), to the amount paid for it, as per Sec. 107(1.1), and if the contingent right subsequently is canceled, since the ACB is real, under Sec. 107(1)(b) the taxpayer may recognize a capital loss **equal to the whole of the ACB**, not just the portion that produced a capital gain for the initial beneficiary. In such an instance where the interest isn't transferred there would be a grave underutilization of resources since the capital loss otherwise recognizable (the difference between the cost amount of the interest and 0) would not produce tax benefits. It could be said that a contingent interest should always be transferred to a holding company/trust so as to produce tax consequences for the initial beneficiary (which could be eliminated with a tax free roll-over) and set up the cost of the interest for the subsequent beneficiary. Any capital gain recognized by the initial beneficiary will eventually be tacked onto the tax cost of the property realized, if any, while if the contingent event doesn't materialize the full capital loss in substance will inure to the beneficiary if the holding corporation realizes it. If a tax free roll-over is used to bump the cost there may not be excess ACB but if the contingent event doesn't occur then any ACB that exists will create a full capital loss.¹⁷⁷⁹ If the initial beneficiary reacquires the contingent interest, after "circumstances change", for consideration that may include the proceeds formerly received by him, he will be able to recognize the interest as having a real ACB equal to that consideration paid and if the right fails to become enforceable and is canceled, he will be able to recognize a capital loss.¹⁷⁸⁰ What is even more entertaining is that the taxpayer ultimately holding the interest need not recognize a disposition thereof in the form solely of a cancellation for no proceeds but instead may have the right extinguished through a distribution to which Sec. 107(2) applies. Where Sec. 107(2) applies, (to personal trusts), there may be a bump up in the cost of the property received in satisfaction of part of the capital interest, equal, as per subpara. 107(2)(b), to the amount which the real ACB of the part of the interest being satisfied exceeds its "cost amount", which in that case as per Sec. 108(1)(d)(i), is the trust's recognized cost amount, of the property being distributed. Obviously, the higher the ACB of the interest, especially so if it did not attract tax consequences, the more the possible bump up may be or the more potential for it to occur. If the trust is not personal then a distribution in satisfaction of a capital interest will be treated under Sec. 107(2.1) whereby the beneficiary will be deemed to have disposed of the part of the interest satisfied for proceeds equal to the fair market value of the property received thus an inflated ACB achieved prior to the loss of personal trust status will be beneficial, especially given the fact that it may

¹⁷⁷⁹ This must be qualified however to not apply where the fair market value of all of the interests is of an extent that disallows the contingent interest from having a cost amount greater than the future cost amounts of the benefits expected to be realized when vesting occurs: in such an instance, via Sec. 107(2)(b), there will not be cost integration and any gain recognized by the initial beneficiary will **not** inflate the cost of the property realized. In such a case the tax free roll-over provisions should be relied on, primarily sec. 85(1).

¹⁷⁸⁰ A contingent capital interest was chosen only as an example and the same could occur with absolute interest which may be undermined by powers of appointment, or diluted by the exercise of discretionary powers granting entitlement to the limited pool of capital. See *Eilbeck v. Rawling*, 54 T.C. 136, where the House of Lords held ineffective loss producing transactions involving powers of appointment.

not have caused tax consequences to any party. If the personal status of the trust is lost when the capital interest has a nil ACB then severe tax consequences will result since any distribution or disposition in respect of or of the interest will cause it to be disposed of for proceeds equal to the fair market value of the property received without an artificial bump up in its ACB.¹⁷⁸¹

If you can inflate the ACB of any capital interest without causing negative tax consequences to be recognizable by any beneficiary or without placing any of the beneficiaries at a disadvantage, it is always advantageous to do so because an inflated ACB is always in all circumstances better than one which is nil. This is especially so if the trust is about to lose its personal status or if the capital interest is already one under a personal trust that was acquired for consideration payable by the beneficiary and thus subject to ACB reductions under Sec. 53(2)(h) which severely restrict the ability of the beneficiary to realize tax free non-satisfying capital distributions, which are otherwise available in respect of interests that were not "purchased".

Corporate Disponers and the Effect of Dividends.

Under subparagraph 107(1)(c) where the taxpayer is a corporation and the interest is not in a prescribed trust¹⁷⁸² any capital loss it recognizes on the disposition of the interest or part thereof will be reduced by the aggregate of all amounts received **by the trust** before the disposition as dividends and designated in respect of the corporation under Sec. 104(19) or (20).¹⁷⁸³ If the corporation does not recognize a **capital loss** on the disposition of the capital interest but instead recognizes an **"income" loss**, due to the fact that it carries on a business in dealing and trading in capital interests, the provision is not applicable since in fact and in substance the corporation has not realized a loss on account of capital. All amounts that were received by the trust in the form of taxable and non-taxable dividends which were designated under Sec. 104(19) or (20) in respect of the **particular** corporation will reduce the capital loss. However, the corporation need not ever have received the proceeds of the dividend or any other funds from the trust. Only those amounts that were designated in respect of the particular corporation will reduce its otherwise computed capital loss and thus when the corporation is wound-up into a parent corporation under Sec. 88(1)(a)(iii) the parent will not be exposed to the capital loss reduction.¹⁷⁸⁴ Alternatively, when one examines the definition of prescribed trusts in Regulation 4800.1 it could prove favorable to force the loss of the prescribed trust status prior to the disposition so as to preclude the cut back from occurring however the ACB of the capital interest would have to be examined to ascertain if this would be ultimately fiscally feasible. Under new Sec. 107(1) it can be possible to inflate the ACB of a capital interest in a prescribed trust in a tax free manner.

The amount of the capital loss that is to be reduced by all of the Sec. 104(19) or (20) designations is the amount of the capital loss from **any part** or all of the interest thus a capital loss recognized on the disposition of only part of the interest will be reduced by the entirety of the Sec. 104(19) & (20) designations made in respect of the **entire** interest. Unfortunately, the provision does not state that once particular amount of the Sec. 104(19) or (20) designations have been used to negate a possible capital loss, they cannot be used again hence, due to a technical deficiency, the corporation may find itself repeatedly exposed to the para. when it disposes of parts of its original right and have its capital loss otherwise recognizable reduced by the same repeated amounts.¹⁷⁸⁵

Although Sec. 107(6) prevents persons or partnerships from recognizing losses on the disposition of property that held by a trust that accrued when it did not have a capital interest in the trust the same does not apply to the actual interests in the trust itself.¹⁷⁸⁶ If the interest of the trust is transferred to another corporation

¹⁷⁸¹ Becoming resident and benefiting from Sec. 128.1(1) may alleviate the exposure.

¹⁷⁸² which are described in Regulation 4800.1 **but not** for purposes of Sec. 107(1)(c)

¹⁷⁸³ It does not capture those instances where the shares are partnership joint estate.

¹⁷⁸⁴ Under Sec. 88(1)(a)(iii) and (c) (ii) the interest will be deemed to have been disposed of for proceeds equal to its cost amount, otherwise computed, to the subsidiary and acquired for the same cost by the parent, hence, clearly not only is there no effective taxation on the wind-up but the parent is placed in the exact identical situation in respect of the a.c.b. of the interest as the sub. was.

¹⁷⁸⁵ Is the Department that vicarious?

¹⁷⁸⁶ Subsection 107(6) actually is very broad and is discussed subsequently however to be brief it also applies to property disposed of property for which it was substituted which was owned by the trust while some relief is offered when persons related to the vendor or partnerships in which the vendor was a majority interest partner can hold a capital interest and prevent the loss cut back.

or partnership or to a trust Sec. 107(6) would seem not to apply to the loss recognized since the recipient may either not be at arm's length with the original corporation (thus satisfying Sec. 107(6)(b)(ii)) or because the interest disposed of was not owned by the trust or "property for which it was substituted was owned by the trust" within the context of the provision. By having the corporate beneficiary become a majority interest partner in a partnership to which it has transferred the interest Sec. 107(6) can be avoided and while Sec. 112(3.1) may further require that the shares be held another 365 days so as to avoid the section 112 cut back in the loss.¹⁷⁸⁷

Partial Dispositions.

Subsection 107(1) applies where a taxpayer has disposed of all or any part of his capital interest and the result of the Sec. 108(1)(d)(ii) computation is a "cost amount" of the interest or part thereof disposed of. Section 43 provides that for the purpose of computing a gain or loss from a disposition of a part of a property, the adjusted cost base to the taxpayer of that part disposed of will be "such portion of the adjusted cost base to him at that time of the whole property as may reasonably be regarded as attributable to that part". A capital interest in a trust/estate is a right of the taxpayer as a beneficiary to or to receive capital of the trust (personal) and as such it represents a singular property although the taxpayer may hold many such rights, yet taken together they describe a capital interest consisting of a package of rights, even though they are enforceable and exercisable distinctively. A multitude of different capital rights under a trust are not equivalent to each other if they are differently enforceable, and exercisable, in such a way as to achieve differing results thus rarely will two capital interests be treated as "identical properties", hence, section 47, which operates to average the ACB at such properties, will not apply.¹⁷⁸⁸ With these factors taken into consideration it should seem obvious that when the provision in section 43 and Sec. 107(1) describes "a part of the interest" or "a portion of the property" the ACB of that portion of the "interest" or "property" referred to will be the ACB of that part of that particular capital right referred to determined as if the other capital rights held by the beneficiary did not exist. In this case the ACB of the particular capital right will be prorated to that part of that particular capital right being disposed of.¹⁷⁸⁹ In essence, the original consideration paid for that part of the capital right becomes its ACB and as the taxpayer acquires differing capital rights each will have a different ACB which must be recorded, while it will be this ACB upon which Sec. 53(1) & (2) will operate. Understandably, there may be interesting variations in the ACB of the capital interests held by the beneficiary, and given that some of them may have been purchased, Sec. 53(2)(h) will apply in certain instances thus making tax free distributions of non-satisfying capital, it may be possible to choose the capital interest the ACB of which can more advantageously be lowered due to that subsection. Alternately, the recognizable ACB of a particular capital interest may be substantially different from its "cost amount".

At risk of being redundant, the Sec. 107(1) provision operates only to establish the ACB of the interest to be used in computing the taxable capital gain or allowable capital loss from a disposition of an interest (or to adjust it), however, it does not apply where the disposition is on account of an income activity carried on by the taxpayer. If the former is the situation, then the subdivision C "Taxable Capital Gains and Allowable Capital Loss" provisions apply to compute the net income inclusion. If the latter is the situation, then the subdivision b "Income or Loss from a Business of Property" provisions will apply to determine the net income inclusion, however Sec. 107(1) will not apply since taxable capital gains and allowable capital losses are not being computed.¹⁷⁹⁰

Subsection 107(1) applies whenever a disposition of all or any part of a capital interest has occurred to produce capital gains or losses and a disposition may be in any of the forms mentioned at the beginning of

¹⁷⁸⁷ This further assumes that the corporation, trust, and partnership own less than 5% of the issued shares of any class of the paying corporation.

¹⁷⁸⁸ See I.T. 387R for further discussion on factors to be considered.

¹⁷⁸⁹ The a.c.b. of the trust property in respect of the subject interest being disposed of will form the numerator of the fraction that prorates the cost amount and the a.c.b. of the interest while the denominator will equal the aggregate of the a.c.bs/costs of the trust property to which the entire interest relates.

¹⁷⁹⁰ The provision has in fact been amended to compute only taxable capital gains etc. **of the taxpayer** and if the taxpayer will not recognize such from the disposition then the provision surely doesn't apply.

this chapter. It applies both to instances where the beneficiary has voluntarily dealt with his interest as a separate property and where he has transacted an arrangement involuntarily as a result of the ultimate end of the trust agreement such as where the interest was terminated through a distribution of property from the trust. It is this type of transaction/disposition to which the balance of the provisions in section 107 apply, however, it must be remembered that Sec. 107(1) continues to apply in concert with them.

A "capital interest" and an "income interest" are two distinct types of property under the Act treated very differently and separately from the property of the trust/estate which may ultimately satisfy them and thus their ability to alter the treatment of a disponent may be quite favorable in light of the treatment that would have resulted had the disponent disposed of the actual trust/estate property which is to be used to satisfy the interest. As per Sec. 106(2)(b), capital gains or losses will not be recognizable on the disposition of an income interest while in respect of Sec. 107(1) the disposition of a capital interest will result in the measurement of capital gains or losses, (unless the disponent recognized the interest as inventory). With this in mind, it may appear favorable for a taxpayer to transfer depreciable capital property with substantial accrued recapture potential or inventory to a trust under which he retains beneficial ownership thereof in the form of a capital interest being a right to or to receive the value of that property. Through abuse of the application of Sec. 107(1.1) and/or 107(1)(a)-108(1)(d) the interest holder could then dispose of the capital interest and avoid the recognition of income but possibly recognize a capital gain. Obviously where the depreciable capital property has a low U.C.C. the "cost amount" of the interest as Sec. 108(1)(d) will be reduced however, this will not preclude the excess of purchase price over it, (as it causes the artificial ACB), to be treated as anything other than a capital gain. If the property were disposed of directly, a capital gain (possibly) **and recapture** would be recognizable.¹⁷⁹¹ Where inventory is the property then the taxpayer has effectively altered a full income inclusion into a 3/4 income inclusion which may be negated, as a capital gain, through any number of methods.¹⁷⁹² Where the interest acquiror subsequently realizes the property from the then non-personal trust, (since on the acquisition of interest the trust will become tainted), another capital gain may be recognizable, due to Sec. 107(2.1), by the interest holder, while the trust will also recognize an income producing disposition of the property if it is inventory or heavily depreciated depreciable capital property, however, this will only occur if the trust loses its personal status.

Capital Cost Allowance Increases Gains without Relief.

Capital cost allowance deducted by the trust will usually be recaptured, if the fair market value of the property increases or remains constant, or will not be, appropriately if it falls. By reducing the cost amount of the capital interests with C.C.A. taken (which reduces the cost amount of the trust property to be apportioned) capital gains, potential or actual, are increased upon a disposition of the interest and the capital gain may not always find its way back into the capital cost of the trust property via Sec. 107(2)(b)-107(3) unless the ACB of the interest is substantial. A trust consisting of one depreciable capital property takes C.C.A. of 100\$ on a property the FMV **and capital cost** of which is 1000\$. On the sale of the exclusive capital interest for its fair market value the beneficiary must recognize a capital gain (1000\$ (assume unadjusted for tax consideration of the disponent) - 900\$ (Sec. 108(1)(d) cost amount)). On a distribution of the property to the second beneficiary as per Sec. 107(2)(b)-107(3) the cost of the property will be increased to 950\$ **only** (900\$ (cost to trust) + (1000-900)\$/2 (Sec. 107(3)-107(2)(b))), and the beneficiary will be exposed to one half the original amount of recapture and one half the original capital gain. Essentially then 1\$ C.C.A. deducted has produced aggregately 1.50\$ capital gain (or 1.125\$ income inclusion at 3/4 capital gain inclusion rate) plus .50\$ recapture for a total income inclusion of 1.625\$ for every 1\$ taken. Something could be said for creating taxes on the deduction of C.C.A. in a trust the interests of which are to be transferred.

¹⁷⁹¹ Subparagraph 107(2)(d) applies to attribute the trust's **capital** cost of the d.c.p. to the beneficiary if it would be **greater** than the **cost** thereof otherwise recognizable on an a.c.b. tack-on under Sec. 107(2) to the beneficiary. If due to excessive a.c.b. of a capital interest it isn't **capital** cost of the property is bumped without recapture exposure though as per Sec. 107(3) 2\$ of excess interest a.c.b. (a.c.b. less cost amount of the interest) **only** produces a **1\$** bump in the capital cost.

¹⁷⁹² This assumes that the original taxpayer has ceased to regard the property as inventory held in trust and the trust does not act in agency to tarnish its capital nature. In such a situation where inventory is transferred to the trust and there is a severance in beneficial ownership a taxable disposition will be recognized.

If the property is personal use property other than listed personal property then a contribution thereof to a trust whereby a capital interest is taken back as consideration will cause the interest not to retain the personal use characteristic depending on the circumstances as per Sec. 54(f), (generally, where the property ceases to have a personal nature to the trust or any beneficiary under the trust), hence, if the personal use property is transferred via Sec. 73(1) to a trust and the capital interest taken back by the contributor can have its ACB bumped under Sec. 107(1) through planned dispositions, a loss that was ultimately realized upon the right cancellation would be deductible, even though the right was a substitute for the personal use property. Understandably, the loss eventually generated may not at all relate to the personal use property. This will occur only if the beneficial **ownership** of the property is severed.

Spousal Cost Bumping?

Where a taxpayer transfers property to an *inter vivos* spousal trust and takes back a substantial but not sole capital interest as per Sec. 73(1), he will not recognize tax consequences by virtue of Sec. 73(1) while regardless of the application of the "personal trust" definition in Sec. 248(1), as per Sec. 107(1.1) he will recognize the interest as having a cost equal to the fair market value of the property at the time of contribution.¹⁷⁹³ If he sells such an interest outright the trust will lose its personal character due to the fact that the acquiror has paid consideration to a contributor of property to the trust, however, if he transfers that interest to the spouse who then disposes of it to a third party, not only will its cost amount, as described under Sec. 107(1.1), be retained, (due to the fact that she has "acquired it from a person who was the beneficiary in respect of the interest"), but when it's disposed, the acquisition will not taint the personal trust character as per the definition thereof in Sec. 248(1). Since the ACB of the interest to the spouse at that point is equal to the Sec. 107(1.1) initial cost of the interest which is equal to the FMV of the property under Sec. 107(1) the spouse will not recognize a capital gain on the disposition. If the spouse receives property from the trust on a distribution, since she recognizes the capital interest as having a "FMV" ACB she will be able to bump the cost of the property received, as per Sec. 107(2)(b), so that the inherent capital gain will be eliminated.

¹⁷⁹³ There may be a problem if the contributor retains beneficial ownership over the particular property in specie due to the Sec. 54(c) disposition recognition mechanics. However, Sec. 54(c) opens with "except as expressly otherwise provided" and Sec. 73(1) does just that.

Disposition of Income Interests.

Section 106 consists of four different subsections which apply to cause tax consequences to be recognizable when the income interest is disposed of to a third party, where it is extinguished through a distribution of property from the trust, and when income is realized from the trust without the interest being impaired or satisfied. They are all based upon the premise that the property being dealt with is an "income interest" in the specific definition thereof in Sec. 108(1)(e).¹⁷⁹⁴

Under Sec. 106(2) when a taxpayer disposes of an income interest in a trust, except where Sec. 106(3) is applicable, he will be required to include in computing his income for the year the proceeds of disposition, deemed or otherwise realized, upon the disposition while his taxable capital gain or allowable capital loss from the disposition shall be deemed to be nil.¹⁷⁹⁵ Under Sec. 106(1) he will be able to deduct the cost of the interest from the proceeds recognized to determine the net income inclusion while under Sec. 106(2)(c), the cost to the taxpayer of any property received as consideration for the disposition will be equal to the fair market value of the property at that time.

The word "disposes" can be taken to have a diverse number of meanings ranging anywhere from instances where the right is canceled due to the termination of the trust to where the taxpayer disposes of it for consideration receivable, however, the common characteristic is that the former holder of the legal title of the equitable right ceases to own it in his personal capacity.

As per *Timpson's Exors. v. Yerbury*¹⁷⁹⁶ there are four primary ways to dispose of a trust interest:

- assign it to a third party directly,
- direct the trustee to hold the property which substantiates the right on trust for another,
- contract for valuable consideration to assign it thus passing equitable interest, and
- declare a trust in respect of it directly.

(A release, consent to variation, retraction of disclaimer also cause dispositions to certain parties in most instances.¹⁷⁹⁷)

The disposition of the income interest is considered to be equivalent to the disposition of a property that when realized would be income hence logically, the proceeds received from the disposition should be fully included in income. In *Gladys Evans v. M.N.R.*¹⁷⁹⁸ the Supreme Court of Canada held that "the fact that a bare right (in a trust) to be paid income can be sold or valued on an actuarial basis at a lump sum does not require or permit that right, while retained by the taxpayer, to be regarded as a capital asset"¹⁷⁹⁹ and thus it is upon this basis that regardless of how the property is held or disposed of, since its ultimate basis of existence is only income, it can be treated only as an income property. When it is disposed of the proceeds will be on account of income, not of capital.

Where an income interest is settled or canceled, except where Sec. 106(3) applies, it can be considered to be disposed of in that the former holder no longer holds the legal title to it. This may occur where the holder executes a surrender of the right or a release and while he may not realize proceeds of disposition for such an action, he **may** be deemed by Sec. 69(1) to have made a gift of property to the party who subsequently realizes the substance of the former income right.¹⁸⁰⁰

An "income interest" is a right or thing to which Sec. 70(2) or (3) and 69(1.1) applies where its holder dies while Sec. 70(2) provides that the value of the right shall be included in the deceased's terminal income as if it had been realized or disposed of **at the time of his death**, and not previously. Given that an income interest (right) may terminate, as per the terms of the trust deed, upon the death of its holder the effect of Sec. 70(2)

¹⁷⁹⁴ If the property is an income right in a non-personal trust or a property that isn't a right to or to receive income from a personal trust, be it immediate or future, absolute or contingent, the provisions do not apply to it since it is not an "income interest".

¹⁷⁹⁵ The fact that the legislators felt it necessary to deem the capital gain/loss on the disposition of the interest to be nil clearly suggests that income interests are recognized as capital property.

¹⁷⁹⁶ 1936 1 All E.R. 186

¹⁷⁹⁷ See also *Comp. of Stamps v. Howard-Smith*, 54 C.L.R. 614, for three.

¹⁷⁹⁸ 60 D.T.C. 1047

¹⁷⁹⁹ This is to be compared to the jurisprudence of *Gadsden v. M.N.R.*, 1983 D.T.C. 127, that appropriately points out that the legislators must have recognized the income interest as a capital property thus requiring the special rule in Sec. 106(2)(b).

¹⁸⁰⁰ *Review Murphy v. M.N.R.*, 80 D.T.C. 6314.

can be reduced when the value of the right will be nil, at the time of the holder's death.^{1801, 1802}

The disposition of the **right to income** of the trust is completely different from the disposition of the income that arises from that right. The former is the property, as Sec. 108(5)(a), from which income is realized. Where the taxpayer assigns the income **from** the income right to another party he has not disposed of the primary right to that income that is the property upon which the income accrues. Under Sec. 56(4), where a taxpayer has assigned or transferred to a person with whom he was not dealing at arm's length **the** right to an amount that, if the right thereto had not been transferred would be included in computing his income because the amount would have been received **or receivable** by him, the amount shall be included in computing his income **unless** the income is from the property and the taxpayer has transferred or assigned the property. This applies where the taxpayer retains the legal title of the income right but assigns or transfers the right to the income that would have normally been recognizable by him under Sec. 104(13) in a particular year since he is retaining the property which gave rise to the income.¹⁸⁰³ Subsection 56(4) operates to attribute back to the holder of the income producing property the income that was the subject of the assignment/transfer of the right, however, it does not negate the possible recognition by the ultimate income recipient of that amount. Given that the initial right to an income amount, as provided in the trust agreement, is not disposed of but is instead retained by the initial holder the transferee/assignee does **not** become a beneficiary under the trust nor does he acquire an "income interest" but instead he acquires a right enforceable against the initial holder of the legal title to the income¹⁸⁰⁴. Since he does not, **for purposes of the Act**, acquire an income interest he does not recognize income inclusions under Sec. 104(13) since he is not a beneficiary, (this avoids the application of Sec. 104(24)). He does however recognize a "benefit" from the trust **as a taxpayer** and thus Sec. 105(1) operates to cause him to have to include that amount in computing his income in the year in which it was received if it can be recognized as a benefit. Thus, both the transferee and transferor of a right to an amount of income that arose due to a fundamental beneficial right will be required to recognize that in respect of the right that was assigned. Understandably income interests, being the right to, or to receive income from the trust, that are enforceable against the trustees as held by a beneficiary should be disposed in their entirety, if they are to be done so, in order to avoid attribution. There may be restrictions placed upon the divisibility of an income right that will disallow it from being disposed of, **in part**, but instead will result in it having to be disposed of in its entirety. The settlor of the trust can expressly provide for this as a condition of holding the right in the trust deed and in accepting the interest the beneficiary has recognized that characteristic of the property.

Subsection 106(2)(a) recognizes that when the interest is disposed of in a taxation year by a taxpayer, "there shall be included in computing his income for the year the proceeds of disposition" while under para. (c), "for greater certainty, the cost to the taxpayer of each property received by him as consideration for the

1801 Where the interest has a deductible cost as described under Sec. 106(1.1), that can be deducted against realizations of income either through a distribution or disposition as provided for in Sec. 106(1), the termination of an interest upon death would prove self-defeating since the interest could not be subject to the Sec. 70(3), 69(1.1) transfer rules that would allow that cost to be deducted when the income is actually realized. The deductible cost of the interest would be lost though it had caused income recognition in the hands of the previous beneficiary when it was acquired. In such an instance if practical given the characteristics of the trust deed, the trust could provide that the interest would continue to exist to the extent that it could receive income up to its cost amount, **if it was transferred** to the otherwise subsequent life tenant under sec. 70(3). This would allow the deductible cost to be absorbed. If the interest is described as such it can require the heir to satisfy an equitable charge whereby certain amounts are to be paid to some party thereby limiting the amount of benefit the recipient actually realizes though allowing for a deduction of the booked cost against the income. The Department allows excess expenses incurred in respect of the right or thing to be deducted against other sources of income by the deceased but this does not seem to apply to deductible **costs**.

1802 See the recent UK case on income interest valuation in *Watkins & Anor v Revenue & Customs* [2011] UKFTT 745 (TC) (17 November 2011) when the income right goes through a death of the holder.

1803 In *Lyons v. M.N.R.*, 83 D.T.C. 113, an income beneficiary under a trust "transferred, assigned, and set over such portion of the expectant **right**... to the receipt of the one-third income from the assets of the estate..." to a party and that party was required to recognize the subsequent distributions as income. The income arising from the right was not solely transferred/assigned but the entire right thereto was. Subsection 56(4) operates if the income would otherwise have been **received or receivable** by the initial right holder. If the income interest only allowed the holder to indirectly benefit from the application of the income, **without receiving it**, then if such a right isn't transferred, but the holder assigns the use of the income to another person, Sec 56(4) can not apply.

1804 See *Williams v. F.C.T.*, 1965 N.Z.L.R. 395 (CA), & *Blair v. C.I.R.*, 1937 300 U.S. 5, for instances concerning income interest assignment or assignment of income from that interest.

disposition is the fair market value of the property at the time of the disposition."¹⁸⁰⁵ There may be instances where the property is not receivable at the time of disposition and this may cause a break down in the cost integration and taxation in respect of it. Subsection 106(2) applies to the disposition by any taxpayer of any form of income interest in any trust or estate as described in Sec. 104(1)¹⁸⁰⁶ resident anywhere however logically it would be applied only where the disposition is executed within the jurisdiction of the ITA. A disposition of an income interest, as a disposition of an income producing property, will be captured under Sec. 115(1)(a)(iv) but only where Sec. 106(2) applies and where the trust is resident in Canada, (apparently at the time of the disposition). Income realized from the holding of an interest in a trust or estate is subject to withholding tax when it is paid to a person who was a non-resident throughout his tax year as per Sec. 212(1)(c), (with some exceptions). Where the interest is disposed of, either to a third party or as an extinguishment in certain instances Sec. 115(1)(a)(iv) applies to provide that those proceeds of disposition that are required to be included in income as per Sec. 106(2) that are net of the amount that would be deductible by the taxpayer under Sec. 106(1), had he been resident in Canada throughout the year, will be considered as taxable income earned in Canada.

"Disposition by taxpayer of income interest – Sec. 106(2)"

(2) Where in a taxation year a taxpayer disposes of an income interest in a trust,

(a) except where subsection (3) applies to the disposition, there shall be included in computing the taxpayer's income for the year the amount, if any, by which

(i) the proceeds of disposition exceed

(ii) where that interest includes a right to enforce payment of an amount by the trust, the amount in respect of that right that has been included in computing the taxpayer's income for a taxation year because of subsection 104(13);

(b) any taxable capital gain or allowable capital loss of the taxpayer from the disposition shall be deemed to be nil; and

(c) for greater certainty, the cost to the taxpayer of each property received by the taxpayer as consideration for the disposition is the fair market value of the property at the time of the disposition.¹⁸⁰⁷

¹⁸⁰⁵ and in fact doesn't lose its personal nature. Consideration was not paid to the settlor to acquire the interest therein. That was given with condition precedent on the payment.

¹⁸⁰⁶ "...or estate (in this subdivision referred to as a "trust")"

¹⁸⁰⁷ March 2001 FINANCE TECHNICAL NOTES: Subsection 106(2) applies where a taxpayer disposes of an income interest (as defined in subsection 108(1)) in a trust. paragraph 106(2)(a) provides that unless the disposition results from a distribution of property by the trust, the taxpayer's proceeds of disposition are included in computing the taxpayer's income for the year that includes the disposition.

Paragraph 106(2)(a) is amended to ensure that where a taxpayer disposes of an income interest in a trust that includes a right to enforce payment by the trust, the proceeds of disposition of the income interest are offset by the amount that has been included in the taxpayer's income under subsection 104(13) because of that right. This measure is meant to ensure that there is no double taxation where such rights are disposed of

June 1996 FINANCE TECHNICAL NOTES: Subsection 106(2) applies where a taxpayer disposes of an income interest in a trust. Unless the disposition was as a result of a distribution by the trust, the taxpayer's proceeds of disposition are included in computing the taxpayer's income for the year that includes the disposition. In addition, the taxpayer is treated as not having realized any taxable capital gain or allowable capital loss on the disposition, and the cost to the taxpayer, of any property the taxpayer receives as consideration for the income interest is the property's fair market value.

Subsection 106(3) applies where trust-property has been distributed to a beneficiary in satisfaction of all or part of the beneficiary's income interest in the trust. The provision establishes, for greater certainty, that in such a case the trust-is treated as having disposed of the property for its fair market value.

"Proceeds of disposition of income interest – Sec. 106(3)"

(3) For greater certainty, where at any time any property of a trust has been distributed by the trust to a taxpayer who was a beneficiary under the trust in satisfaction of all or any part of the taxpayer's income interest in the trust, the trust shall be deemed to have disposed of the property for proceeds of disposition equal to the fair market value of the property at that time.

Under Sec. 2(3)(c), a non-resident person is taxable under Division D of Part I, section 115, when he disposes of a taxable Canadian property and although the operational definition of "taxable Canadian property" in Sec. 115(1)(b) does not include income interests in trusts the definition of taxable Canadian property in Sec. 248(1) provides that for purposes of **section 2 only** the definition includes, (c), an income interest in a trust resident in Canada. It is only through the definition of "taxable Canadian property" in Sec. 248(1) that the non-resident person will recognize a tax liability when he disposes of an income interest in a trust resident in Canada. If the trust wasn't resident in Canada at the time of the disposition then the definition would not apply and obviously no tax liability would result, regardless of to whom the interest was transferred.¹⁸⁰⁸

There would appear to be a technical deficiency in the scope of the definition of taxable Canadian property in that it refers only to "an income interest **in a trust**." An "income interest" as defined in Sec. 108(1)(c) subdivision K, is a right in a "trust" while in Sec. 104(1) a trust and estate are considered **for purposes of subdivision K** to be "a trust".¹⁸⁰⁹ Under subsection 248(1) "an estate" and "a trust" are referred to **separately** and are operationally defined through those paragraphs to have the definitions provided for in Sec. 104(1) which identifies the trustee or the executor as being the trust or the estate for purposes of imposing a tax liability. Subsection 104(1) **differentiates** between an estate and a trust by the way it is phrased and structured. Given these facts **outside** of subdivision K, an estate is not equal to a trust when there is no statutory provision made for such a merging. In the author's opinion "an income interest in a trust resident in Canada" **cannot** be equated with "an income right in an estate resident in Canada" since it is **only in subdivision K** that the terms "estate" and "trust" are synonymous. Since neither the Sec. 248(1) or the Sec. 115(1)(b) definitions of "taxable Canadian property" capture income interests **in estates** they are not, taxable Canadian property. This is critical in that Sec. 115(1)(a)(iv) refers only to income interests "in a **trust** resident in Canada" hence, the provision will not apply to income interests in estates.¹⁸¹⁰

Section 116 provides the rules that apply where the non-resident taxpayer disposes of **taxable Canadian property** and these rules apply where the property is disposed of to anyone, regardless of their residence. CRA will usually realize the appropriate payment of the applicable taxes on the disposition from the disponent either through Sec. 116(1) or (3). Upon such a collection of tax or security the Minister will issue a disposition certificate attesting to the fact that security has been posted or tax has been paid. The acquirer of the property, regardless of his residency may become liable for the tax that would have been otherwise payable by the

Subsections 106(2) and (3) are amended to clarify that they do not apply to a disposition that forms part of a qualifying exchange under section 132.2. A qualifying exchange is a tax-deferred transfer, of property from one mutual fund to another, and includes the disposition by investors in the transferor fund of their shares or units of that fund in exchange for units of the transferee fund.

To coincide with the introduction of section 132.2, these amendments apply after June 1994.

¹⁸⁰⁸ If it's economical it could prove valuable to have the Canadian resident trust become non-resident temporarily when a non-resident income beneficiary is about to sell his income interest to **any** party regardless of their residence. The nature of the trust's property would have to be taxable Canadian property or have losses accrued in it so as to avoid tax consequences under Sec. 128.1(1) while the foreign jurisdiction's tax law would have to be reviewed to ensure that subsequent reentry into Canada does not produce tax consequences. Powers to appoint the office of trusteeship to non-residents are particularly handy in this respect.

¹⁸⁰⁹ Sec. 104(1): (in this subdivision referred to as a "trust").

¹⁸¹⁰ The fact that at common law the residuary beneficiary of an estate does not receive payment of the estate's accumulated income **as income** prevents his interest from being an income interest, since it is not a right to receive trust/estate income only capital. In the case of specific bequests this isn't the case since equitable title to the income producing property relates back to the time of death.

disponer if he had adhered to the proper procedures, (obtaining of a disposition certificate), as per Sec. 116(5).

Under subparagraph 115(1)(a)(iv) only the amount of proceeds of disposition on the disposition of an income interest required to be included in income as per Sec. 106(2) that are net of "the amount in respect to that income interest that would, if he had been resident in Canada throughout the year, be deductible under Sec. 106(1) in computing his income for the year" will be included in taxable income earned in Canada. Subsection 106(1) allows for a deduction of the cost of the interest, not only against income inclusions recognized under Sec. 106(2) **but also** regular income inclusions brought about through the application of Sec. 104(13). Where the non-resident person recognizes income under both Sec. 106(2) **and** 104(13) in the year, **had he been resident** he would have been able to deduct the cost of his interest against **both** inclusions, thus when he disposes of the interest he will be able to deduct in respect of both inclusions. Income payable to a non-resident person as income from a property which is an interest in a trust will be subject to withholding tax under Sec. 212(1)(c), however, it will not be "included in computing his income for a taxation year" since the non-resident person will not include it in computing taxable income for a year under section 115. He will recognize it only as a payment as per the rules and concept of the withholding tax under Part XIII; which does not operate to compute "income" but instead operates only to impose a tax on certain payments that would have been income if the recipient had been resident in Canada. The non-resident can thus **not** write off the cost of his interest under Sec. 106(1). If a non-resident beneficiary is entitled to receive an amount of income from the trust, rather than receive it directly he could sell the interest to a Canadian resident whereby the consideration could include amounts for income currently coming payable. As per Sec. 115(1)(a)(iv) the entire amount of the income interest's recognized cost would reduce the non-beneficiary's section 115 taxable income earned in Canada amount, while most importantly withholding tax would not be applied to the consideration under Sec. 212(1)(c). If the trust had first paid out the income or the trustees acknowledged it as payable Sec. 212(1)(c) would apply to it fully and possibly excess income interest cost would be wasted failing the ability to produce losses when deducted against lesser consideration recognized under Sec. 106(2). A discretionary power instilled in the trustee allowing him to accumulate a particular income beneficiary's share of income until the next period providing the beneficiary is non-resident can be of assistance in ensuring that the beneficiary doesn't have to recognize the amount as payable under the Sec. 104(13)-(24) mechanism and thus ruin the arrangement. The end result of all this is of course the reduction of Sec. 212(1)(c) withholding tax on the value of income entitlements that when accounted for in the proceeds of disposition of the interest will be absorbed by excess Sec. 106(1.1) cost through the Sec. 106(1) deduction.

*Shirley Patricia McKenzie v. Her Majesty The Queen*¹⁸¹¹ provides an excellent illustration of where a trust can transfer property in commutation of a trust income interest. In this case the trust made a note-distribution in payment of the income interest while the CRA assessed that since the cash that the note was satisfied with was never held in the trust, the s. 106 mechanics did not apply. The Tax Court held:

III. Positions of the Parties

[18] It is the taxpayer's position that the exception to the application of paragraph 106(2)(a), where subsection 106(3) applies to the disposition of the income interest by the taxpayer, applies in this case. Subsection 106(3) applies when property of the trust has been distributed by the trust in satisfaction of all or any part of the taxpayer's income interest in the trust. It is the taxpayer's position that each of these three requirements is met: (i) that the 1.7 million dollars received by the taxpayer from the trust was property of the trust when paid; (ii) that the payment constituted a distribution by the trust of that property; and (iii) that this was in satisfaction of all of her income interest in the trust.

[19] It is the respondent's position that (i) the 1.7 million dollars received by the taxpayer was property of the BC numbered company when the appellant received it, as the cash had never been held by the trust but directions were used instead; and (ii) the 1.7 million dollars was not distributed to the taxpayer, rather the trust's property, being the Swiss Herbal shares, was distributed *in favour of* Barbara McKerrell. In support of the latter position, the respondent maintains that the property was not distributed in accordance with the terms of the trust, therefore could not have been distributed in

satisfaction of the taxpayer's income interest in the trust, and the rule in *Saunders v. Vautier* does not permit the amendment of the trust to provide for such a distribution right or obligation. Further, the rule in *Saunders v. Vautier* could not apply to the transactions implemented in accordance with the Termination Agreement and the Settlement Agreement, and the trustee of the trust thereby was not acting in accordance with her fiduciary obligations, when the trust paid the amount to the taxpayer prior to the trust being wound up.

[20] The Crown relies very heavily upon the Federal Court of Appeal's decision in *Chan v. The Queen*, 2001 FCA 302, 2001 DTC 5570, which upheld the Tax Court's decision, 99 DTC 1215.

IV. Analysis

[21] I am entirely satisfied on the evidence that the 1.7 million dollars received by the taxpayer from the trust was property of the trust. There is no evidence to the contrary. There is no reason to think that cash need to have been moved between the parties. This was not an ineffective or unimplemented transaction. Clearly the BC numbered company had the cash, the trust's law firm was put in funds, and the law firm's certified trust cheque was credited for cash when presented. It is difficult to see how the respondent could think there would have been a need to actually deliver cash from the trust, or think that the delivery of the trust's promissory note to the taxpayer was in these circumstances any different than the delivery by the trust of a certified cheque or money order from the trust's bank. Neither would actually be cash. Surely the respondent would not seriously have contested a bill of exchange involving a bank and I have been provided with no persuasive argument that enforceable promissory notes from solvent entities should be treated any differently. The respondent cannot succeed on its first argument.

[22] As to whether the trust distributed the 1.7 million dollars to the taxpayer, I am unable to see how it could be considered to have done otherwise. There is no apparent reason put forward to suggest that the term "distributed" should not be given its ordinary meaning. Indeed, the pending amendments to the French version of the subsection, which will change "allocated to" to "distributed to", supported by the government's explanation that "distributed" was the intended concept, is consistent with giving the word "distributed" its ordinary meaning. Black's Law Dictionary defines "distribute" as including "to deliver" and "trust distribution" as cash or other property paid or credited to a trust beneficiary.

[23] The Crown is relying almost entirely upon the decision of the Federal Court of Appeal in *Chan* which it maintains is virtually on all fours with, and indistinguishable from, the taxpayer's situation. With respect, it is clear from a reading of both the Tax Court judge's decision in *Chan* and the Federal Court of Appeal's decision that the *Chan* case involved fundamentally different facts.

[24] The respondent relies upon the trial judge's reasons in *Chan* that "[t]he word 'distribute' in the context of subsection 107(2) refers to an allotment of trust property to a beneficiary in accordance with his proportionate share. Such a distribution, being an action taken by the trustee in response to fiduciary duty, is one for which consideration cannot be exacted except in accordance with a provision in the trust deed."

[25] While this language appears to support the respondent, the Tax Court judge in *Chan* carried on that, rather than being a trust distribution in satisfaction of Mr. Chan's income interest, Mr. Chan had instead sold his income interest to his parents and received consideration from his father for that sale. That is, the trust was not a party that either paid the amount or terminated the beneficiary's interest. The comments of the Tax Court judge as to what constitutes a distribution from the trust must be considered in light of those significantly different facts and findings to those to which the taxpayer, Ms. McKenzie, was a party. That this formed the basis of the Tax Court's decision in *Chan* is abundantly clear from the Federal Court of Appeal's decision wherein they wrote:

15 In order for Section 107(2) to apply, it is our view that it is necessary for the taxpayer to demonstrate that the property which was transferred to him was indeed property distributed out of the trust assets. While this could include cash, that cash must have been in the trust.

16 There is no evidence that the cash came out of the trust nor is there evidence that

indeed the trust had sufficient cash to pay that mount [sic] at the time it was paid. The onus is on the taxpayer to demonstrate that the cash which the Appellant received came from the trust itself, and this he has failed to do. Thus, there is no evidence that trust property was distributed to the Appellant so as to allow him to invoke the provisions of Section 107(2).

As the Federal Court of Appeal wrote earlier in *The Queen v. Friedberg*, 92 DTC 6031: "In tax law, form matters."

[26] It is the respondent's further submission that, whatever the reason was for the payment by the trust to the taxpayer of 1.7 million dollars, it was not distributed in satisfaction of all or any part of her income interest in the trust. Its reasoning in support of this is that the rule in *Saunders v. Vautier* does not permit the amendment of the trust, the parties did not purport to amend the trust in any event, and, since the rule in *Saunders v. Vautier* only permits the winding up of the trust, the payment to the taxpayer immediately before the winding up of the trust was not in accordance with the terms of the trust and constituted a breach of the fiduciary obligation of the trustee.

[27] It is clear from the authorities and doctrine put forward by the respondent, and the cases referred to therein, that the rule in *Saunders v. Vautier* does not appear to permit the amendment of the terms of a trust by the beneficiaries but only permits the winding up of the trust at the direction of all of the beneficiaries. However, no authority has been put forward by the respondent for its further proposition that the rule in *Saunders v. Vautier* does not permit the termination of the trust in this case in accordance with the Termination Agreement agreed to by the beneficiaries and the trust. In accordance with that Termination Agreement, the 1.7 million dollars was distributed by the trust to the income beneficiary and immediately thereafter the capital beneficiary received the remaining property of the trust. Indeed, the Termination Agreement is clear that Barbara McKerrell irrevocably directed the trustee to terminate the trust immediately after the payment to the life tenant.

[28] In the circumstances of this case, I am not prepared to either contort the plain meanings of the terms used in section 106, nor to add any glosses to the rule in *Saunders v. Vautier* for which I have been given no authorities, in order for the Tax Court to deal with what appears to have simply been a historic possible employment benefit valuation and timing issue for which there are clear charging provisions in the *Act*. The respondent cannot succeed on its second argument either.

[29] Leaving aside the issue of a possible employment benefit which cannot be dealt with or decided in this appeal, the appropriateness of allowing this appeal is confirmed by its consistency with the scheme of the *Act* and the Canadian tax policy it reflects. Canada taxes capital gains on property and income from property; Canada does not tax gifts. It is clear that all of the capital gains on the Swiss Herbal shares in question have been taxed in accordance with the *Act*. It is also clear that all of the dividend income received on those shares has been taxed in accordance with the *Act*. The respondent does not, and could not, suggest otherwise. A plain reading of subsections 106(2) and (3) of the *Act* makes it clear that the *Act* generally does not seek to tax an income beneficiary whose rights are disposed of to the trust itself, but will tax any economic gain the income beneficiary may be able to realize on a disposition to a third party. It can be noted that, in the case of a disposition of a life interest to the trust, the distribution from the trust is akin to the receipt by the income beneficiary of the after-tax, capital portion of the amount settled on the trust which could have been gifted by a settlor to a beneficiary without tax consequences under the *Act*.

[30] The appeal is allowed with costs.

Income Tax Interpretation Bulletin

Disposition of an Income Interest in a Trust

IT-385R2

DATE: May 17, 1991

SUBJECT: INCOME TAX ACT

Disposition of an Income Interest in a Trust

REFERENCE: Subsection 106(2) (also subsections 56(2), 69(1), 74.1(1) and (2), 104(13), 106(1), (1.1) and (3), 108(3), 110.1(1), 112(1) and 138(6), paragraphs 108(1)(e) and 248(8)(c) and the definition of "personal trust" in subsection 248(1))

Application

This bulletin cancels and replaces Interpretation Bulletin IT-385R dated August 6, 1979. Current revisions are designated by vertical lines.

Summary

This bulletin discusses the disposition of an income interest in a trust and the circumstances under which the proceeds are required to be included in the transferor's income pursuant to subsection 106(2). The bulletin also considers the amount to be attributed to proceeds of disposition and the costs of the income interest that may be deducted.

Discussion and Interpretation

1. Paragraph 108(1)(e) defines an income interest of a taxpayer in a trust. Where such an interest in a trust was created or materially altered after January 31, 1987 and acquired after 10:00 p.m. Eastern Standard Time on February 6, 1987, it is an income interest in a trust only if it is the right of a person as beneficiary to receive all or part of the income of a personal trust. Income of a personal trust (or the trust's income referred to in 2 below) means income computed for trust accounting purposes and not for income tax purposes, and as further modified by subsection 108(3). A personal trust, as defined in subsection 248(1), is either a testamentary trust, or an *inter vivos* trust in which no beneficial interest was acquired for consideration payable to the trust or to a person who has made a contribution to the trust. For the purposes of the definition of a personal trust, love and affection will not be regarded as consideration. Further, the mere retention of an interest in the trust at the time the trust was created, by the individual or related individuals who settled the trust will not result in the disqualification of the trust as a personal trust.

2. Prior to the amendment of the definition as outlined in 1 above, an income interest in a trust was the right (whether immediate or future and whether absolute or contingent) of a person as a beneficiary under the trust to receive all or any part of the trust's income. This definition continues to apply to such interests that were created before February 1, 1987, have not been materially changed after January 31, 1987 and were acquired not later than 10:00 p.m. Eastern Standard Time on February 6, 1987.

3. As a result of the amendment to the definition of an income interest, any interest in a trust defined in paragraph 108(1)(j) (other than an income interest acquired in the circumstances outlined in 1 and 2 above) is treated as a capital interest, whether or not that interest is a right to receive all or any part of the income or capital of the trust.

Assignments and Other Dispositions

4. A taxpayer who assigns or disposes of an income interest in a trust in favour of another person will be subject to the provisions of subsection 106(2) and must include in income the proceeds of disposition. If the transaction is not at arm's length and the proceeds are less than fair market value, the taxpayer will be deemed by virtue of subparagraph 69(1)(b)(i) to have received proceeds of disposition equal to the fair market value of the interest disposed of. Where the taxpayer disposes of an income interest by gift *inter vivos*, subparagraph 69(1)(b)(ii) applies with the result that the proceeds of disposition are deemed to be the fair market value of the income interest.

5. Where the assignment in favour of another person is a payment in respect of proceeds of disposition of an income interest in a trust when it is due and the assignee has a legal right to receive it, subsection 106(2) does not apply to the assignee, but the transaction may be governed by the provisions of subsection 56(2).

6. A payment, as described in subsection 106(3), to a taxpayer from a trust in satisfaction of all or part of the taxpayer's income interest in the trust is not a disposition producing income under paragraph 106(2)(a) and no amount is included in the income of the taxpayer by reason of the payment.

Disclaimer

7. A taxpayer who executes a disclaimer (not in favour of any person) of an income interest in a trust at the time the taxpayer becomes aware of it (or within a reasonable time thereafter) will be considered not to have acquired that income interest in the trust. Subsection 106(2) will, therefore, have no application in such a situation. For the purposes of this paragraph "disclaimer" includes a renunciation of a succession

made under the laws of the Province of Quebec that is not made in favour of any person. A person who has accepted any funds from the trust in respect of an income interest in the trust or executes a "disclaimer" in respect of an income interest in the trust in favour of another person would be considered to have acquired the income interest and therefore would be unable to execute a valid disclaimer.

Release or Surrender

8. Where a taxpayer formally releases or surrenders all or any part of an income interest in a particular trust in respect of future payments (amounts not due and payable at the time of the release or surrender) in favour of one or more other persons, the taxpayer will be deemed, by virtue of paragraph 69(1)(b), to have received proceeds of disposition equal to the fair market value at the time of the release or surrender of the income interest released or surrendered and must include that amount in income pursuant to subsection 106(2). It should be noted that paragraph 248(8)(c) does not apply to an income interest that arises upon the death of the deceased since such an interest could not have been property of the deceased immediately before death.

9. A taxpayer who for no consideration validly releases or surrenders an income interest in a trust in respect of future payments (not due and payable at the time the release or surrender is executed) and does not direct in any manner who is entitled to receive the benefits, will not be considered to have received any proceeds of disposition for the purposes of subsection 106(2). The result will be the same if the taxpayer designates or otherwise agrees which person or persons will benefit by reason of the release or surrender, if the same person or persons would be entitled to benefit in the same way under the trust without the taxpayer's designation or agreement. However, the attribution rules of subsections 74.1(1) and (2) are considered to apply if the person or persons who benefit under the terms of the trust as a consequence of the release or surrender are persons described in those subsections.

Cost of an Income Interest in a Trust

10. Subsection 106(1) permits a taxpayer to deduct an amount in respect of the cost of an income interest in a trust where amounts have been included in income either on the disposition of such interest pursuant to subsection 106(2), as described in 4 and 8 above, or where the taxpayer has income from the interest under subsection 104(13), or both. The amount that can be deducted in any year, however, cannot exceed the lesser of

(a) that portion of the cost that was not deductible for previous years, and

(b) the amount included in income for the year pursuant to subsections 104(13) and 106(2) minus, for interests acquired after 5:00 p.m. E.S.T. on November 26, 1985, the deductions allowed in respect of those amounts for the 1986 and subsequent taxation years under subsections 112(1) or 138(6) and, for the 1986 and 1987 taxation years under subsection 110.1(1).

For the purposes of subsection 106(1), the cost to the taxpayer of an income interest in a trust acquired directly from the person who was a beneficiary in respect of the income interest will generally be the amount paid for it. However, if the interest was acquired from the beneficiary in a non-arm's length transaction and the amount paid for it exceeded its fair market value, its cost will be deemed to be its fair market value by virtue of paragraph 69(1)(a) and, if the income interest was acquired from the beneficiary by way of gift, its cost will be deemed to be its fair market value by virtue of paragraph 69(1)(c). If the income interest was not acquired from a person who was a beneficiary in respect of the interest, its cost is deemed to be nil by virtue of subsection 106(1.1).

Satisfying Property Distributions.

Subsection 106(3) provides that where at any time **any** property of a trust has been distributed by the trust to a taxpayer who **was** a beneficiary under the trust in satisfaction of any part of an income interest that the taxpayer holds in **that** trust the trust will be deemed to have disposed of that consideration for proceeds equal to its fair market value at the time while the recipient beneficiary will not be required to recognize the disposition of his income interest, or part thereof, under Sec. 106(2) as per para. (a) therein. He will realize the property effectively tax free.¹⁸¹² The provision doesn't designate or attempt to describe the type of property

¹⁸¹² This provision also applies to estates.

which may be distributed while it also doesn't provide that a minimal amount of any outstanding income interest must be extinguished. In respect of the latter topic, the income right may only be contingent yet it still carries the status of being an "income interest" hence a taxpayer-settlor could obtain a considerable degree of flexibility by instilling income rights, contingent upon occurrences of what some would consider as utterly improbable events, in as many beneficiaries as possible so that the trust could make distributions in satisfaction of these interests to as many people as possible, effectively tax free.¹⁸¹³

Subparagraph 106(2)(a) provides that property distributed in satisfaction of the income interest will not be included in computing the recipient's income, however, where illegitimate avoidance/offensive distributions do occur, such as where principal assets are distributed to satisfy incidental contingent rights subsection 105(1) may be fully applicable to the recipient so as to totally destroy any tax advantage but again not where the income beneficiary is non-resident. Where a property valued at \$100,000 is distributed to an income beneficiary in satisfaction of a contingent income interest that could never generate more than \$10,000 in income, obviously a benefit has been conferred on the income beneficiary and the \$90 000 difference could be subject to the full inclusion while at the same time causing the trust to recognize tax consequences as per Sec. 106(3). Even if the trust deed is varied or the composition of the trust assets changed to income producing the present value of the income right must be compared to the value of the assets to be distributed in respect to them. The Sec. 106(2)(a) - (3) mechanism cannot be used as offensively as to drain a trust or produce capital losses in respect of capital interests therein as has been thought.

"Proceeds of disposition of income interest – Sec. 106(3)"

(3) For greater certainty, where at any time any property of a trust has been distributed by the trust to a taxpayer who was a beneficiary under the trust in satisfaction of all or any part of the taxpayer's income interest in the trust, the trust shall be deemed to have disposed of the property for proceeds of disposition equal to the fair market value of the property at that time.

The provision does not provide that a minimum qualitative or quantitative feature of an interest must be satisfied, (extinguished), with such a distribution, but instead only provides that the distribution must be in satisfaction of all or any part of the taxpayer's interest in the trust, and in this regard one must look at how income interests, (rights), are structured so as to appreciate how dangerously close the provision comes to destroying the Sec. 104(6)-(13) mechanics. Rights to or to receive income, of any nature, under a trust may be broadly referenced whereby they will exist for considerable lengths of time in respect of the income of a certain group of properties or they may be narrowly subdivided and enforceable on an annual basis. If a particularly limited income right is such that it is enforceable only against a particular amount of income in a particular year that is realized from a particular group of properties held in trust is it not extinguished or satisfied when the income realized, that is the property of the trust, is distributed to the rightful beneficiary? In this sense, has the beneficiary not received the property (income) of the trust in satisfaction of his interest? The phrase "in satisfaction of" appears in the Sec. 107(2), (2.1), (4.1), and (5), which apply when property is distributed and the capital interest is extinguished with the only implied meaning that the interest continues to exist until the receipt of the property as consideration. A limited income interest being a right to enforce the distribution of income in a trust, exists until that income is distributed, since until that time the right has not been extinguished.¹⁸¹⁴ If just before the end of the period, in respect to which the income right is enforceable, the subject income is distributed in satisfaction of the right, has "property" not been distributed in satisfaction to an income right?

Perhaps the weakest aspect of the provision is that there need not to be a significant portion of the income interest extinguished or disposed of in order for the provision to apply though the application of Sec. 105(1)

¹⁸¹³ It should be recognized that only the distribution of cash will result in the avoidance of the recognition of any tax consequences, good or bad.

¹⁸¹⁴ If the income is not distributed then the holder's right becomes a capital right in the following period with respect to that income capitalized only.

forms the restraint where materially obvious and abusive distributions occur.¹⁸¹⁵ There is a difference between satisfying one of a bundle of severable rights and paying consideration to an interest holder to release his singular right and receive a much more narrowly defined one though it appears that both instances will qualify for Sec. 106(3) treatment.

The subsection 106(3) provision does not contemplate what property of the trust may be distributed while in trust law, the capital assets may be distributable only to the capital beneficiaries, hence in order to make a distribution to an income beneficiary, the consent of the respective capital beneficiary may need to be obtained. The consent should not be recognized as a disposition of the capital right held by the beneficiary since he is only allowing certain property to be distributed, not to have his right to a certain value canceled. If a power of appointment exists whereby capital property can be distributed regardless of the respective beneficiary's right, such a distribution is even easier to execute. Essentially what could occur in one offensive arrangement is that the capital interests in the personal trust under which a general power of appointment exists could be purchased for proceeds, which, depending on the debt of the trust, could cause nominal taxable gains to be incurred while after the capital interests have a recognized ACB the power could be exercised to distribute substantial amounts of capital property in satisfaction of income interests, some of which may be held by the capital beneficiaries themselves. On a Sec. 106(3) distribution, the trust would recognize either good or bad tax consequences due to the deemed disposition, but the capital interest of the beneficiary could be effectively canceled due to excessive appointments in respect to the income interests. The cancellation could result in the recognition of a capital loss fully recognizable depending on the parties involved.¹⁸¹⁶ If property remains that can be distributed to the capital beneficiaries Sec. 107(2) may apply to allow a cost bump thus reducing subsequent capital gains, or Sec. 107(2.1) could be forced to apply to it, if the conditions are imposed, thereby possibly causing immediate capital loss to the beneficiary.

The property must actually be distributed to the beneficiary being that it cannot simply be credited to his capital account but he must take legal title to it. Where the trustees exercise a power of appointment and grant the beneficiary a capital interest in the trust that he formerly did not have then, understandably, the interest will serve as such a property. However, the trust will also be deemed to have disposed of that property for its fair market value, however, it is questionable whether "the property" received by the beneficiary will be the same as "the property" held by the trust that was distributed. Can a trust have a right to receive capital from itself? If not the property distributed by the trust is not a capital interest and the section 107 rules do not apply, however, the right is "a right of any kind whatever...or a choice in action" which falls squarely under the definition of "property" in Sec. 248(1). Given these facts, could it easily be derived that a trust will recognize a disposition of the chose in action when the trustees exercise the power of appointment and grant the beneficiary a capital interest if, for instance, the power is determined by the exercise? If they were instead to distribute the legal title rather than beneficial title to the property, then the tax consequences of such a distribution would occur only once; when the legal title was distributed.¹⁸¹⁷ By distributing beneficial ownership the same should occur.

Subsection 106(3) calls for the recognition by the trust of a disposition of the property distributed in satisfaction of an income interest and the resulting realization of proceeds equal to the property's fair market value at the time of the disposition, and while this may cause the trust to recognize capital gains and income, it will also allow it to recognize capital losses or losses when the property has the respective attributes, (tax cost, ACB). Such losses recognized will result in a reduced income which may be payable to beneficiaries under Sec. 104(13), hence where the Sec. 53(2)(h) and the Sec. 105(1) provisions do not apply such losses

¹⁸¹⁵ See *I.R.C. v. Castlemaine*, 25 T.C. 408.

¹⁸¹⁶ See *Eilbeck v. Rawling*, 54 T.C. 136, for limitations in this arrangement.

¹⁸¹⁷ A broad interpretation of the Sec. 248(1) definition of "personal trust" may result in a particularly dangerous situation where the income beneficiary acquires a capital interest in an *inter vivos* trust as property in satisfaction of his income right in that, in accepting such consideration he has consented to the transfer by him to the trust of the right to income which becomes vested in another beneficiary as per the operation of the trust deed, (and not a power of appointment), then the trust has never received the consideration. However, when the right to that certain share of income ceases to exist and the trust operates to thus accumulate it, then it has undoubtedly received the right as consideration. Since the former income beneficiary has acquired the capital interest in the trust from the trust for consideration "paid" to the trust, the personal trust may lose its status.

will translate into the potential to distribute real income tax-free. Where capital losses or income losses are recognized due to these distributions, the trust may then be in a better position to **sell** property to its beneficiaries, that have substantial capital gains whereby the tax cost of the property will be bumped tax free whereafter the proceeds could be distributed as capital.¹⁸¹⁸ Subsection 106(3) applies regardless of who initiated the arrangement of terminating the interest and in arranging to absorb losses as mentioned above proprietary rights may be severed thus causing dispositions of relevant capital interests in the trust. This apparently hasn't been at issue ever in Canada though it is one avenue the Department could use to attack the tax benefits.

When Sec. 106(3) is applicable there is no relief afforded to the taxpayer in respect of the ability to write off the cost of his interest as per Sec. 106(1), since he is not required to recognize proceeds under Sec. 106(2)(a). With this in mind¹⁸¹⁹, it should be obvious that a distribution in satisfaction of an income interest should not be executed until its cost has been completely written off under Sec. 106(1), since until that time the income distributed would not be exposed to tax. This is one aspect that should be the subject of a Departmental review. It is extremely inequitable to cause a Sec. 106(1.1) deductible cost to be wasted when in fact its creation caused an income inclusion under Sec. 106(2) for the former beneficiary. Effectively the value of the interest in trust property as opposed to income terms may be taxed more than once: when the interest is acquired, causing a full income inclusion, and when the trust sustains a disposition of its property in satisfying the interest. A more equitable commutation would be to allow the deductible cost to be applied against the trust's capital gain on the property's disposition or perhaps there should be a similar tax free distribution as described in Sec. 107(2) with adjustments to the cost of the different inclusion rates. Virtually anything could prove better than an instance where a large deductible cost allowed by a consequentially large previous taxation can't be used to offset a capital gain incidental to it but instead is simply lost.

Since Sec. 106(3) is applicable only in respect of "income interests" and not income rights under trusts that do not meet the definition of "personal trust", it provides yet another incentive for ensuring that a trust retains its "personal status". Subsection 106(3) applies only where a distribution is made in satisfaction of any part of an income interest, however, it does not require that the respective beneficiary be permanently thereafter unable to own an income interest. Hence, where a power of appointment is properly structured, an income interest could be vested in the same beneficiary in respect of whom an interest had former been extinguished. At his point one has to wonder about the instrumental application of section 245, as a last resort of the Department.

Subject: Winding-up of an Estate.

ATR-3 Date: November 29, 1985

Facts

1. Mr. X who operated several businesses, passed away in January 1968. His will, which was made in 1967, stated that in the event of his death his business was to be carried on. Apart from other clauses, the will named his wife income beneficiary for the rest of her life, and his two sons as capital beneficiaries. Mr. X also appointed his wife, his brother Mr. Y, and his lawyer Mr. Z as executors of the estate.
2. Since 1968 the estate has been carried on in accordance with the terms of the will.
3. In 1980, Mr. Z moved to another area for personal reasons. Since that time, he has assumed sole responsibility for the administration of the estate. One executor, Mr. Y died in 1970. The other, Mrs. X, does not want to be responsible for the estate's administration. Mr. Z, who is now in ill health, is concerned that if anything should happen to him the estate would be left unmanaged.

Proposed Transaction

4. Mr. Z feels that it would be best to apply to the court to wind up the estate. This proposal has been unanimously approved by Mrs. X and her two sons.

¹⁸¹⁸ It's to be noted that the beneficiary will not be able to obtain equitable treatment if he has to assume a debt on the property however such would reduce the potential for the application of Sec. 105(1) to excessive distributions.

¹⁸¹⁹ and other factors not taken into consideration such as accrued losses/gains inherent in the property etc.

5. In winding up the estate, Mrs. X would have to be paid a yearly sum of money in lieu of the income she had previously received from the estate. This amounts to approximately \$21,000 a year. The remainder of the estate would be transferred to her two sons. It was thought that the best way to accomplish this would be to buy Mrs. X a life annuity, but this proved too costly. It was then agreed that all the assets of the estate would be transferred to the two sons who would give her mother \$21,000 a year for life. To ensure that the agreement would be carried out, the sons would deposit sufficient funds in an interest-bearing deposit account in a bank or trust company to provide for the annual payment. This arrangement was approved for the annual payment. This arrangement was approved by all the beneficiaries and an agreement was signed in anticipation that the matter could be concluded.

Rulings

6. In connection with the proposed arrangement, you have requested the following rulings:

- (a) the income beneficiary, Mrs. X, will not be considered to have disposed of an income interest in a trust to which subsection 106(2) applies; or
- (b) if subsection 106(2) does apply, then her proceeds of disposition will be considered to be nil;
- (c) Mrs. X will not be considered to have conferred a benefit on the capital beneficiaries within the meaning of subsections 56(2) or 245(2).

7. Provided that our understanding of the facts as outlined above is correct and the proposed transaction is completed as described in 4 and 5 above, we rule that:

- (a) Since Mrs. X is to receive consideration (i.e. an undertaking by her sons to provide her with \$21,000 a year for life) for relinquishing her income interest in the trust, the provisions of subsection 106(2) would apply if the arrangements for winding-up the estate were completed as described in 5 above.**
- (b) The proceeds taxable under subsection 106(2) would be the capitalized value of the payments expected to be made to Mrs. X.**
- (c) The provisions of subsection 56(2) or 245(2) would not apply.**
- (d) We further advise that the sons would be taxable on all income arising from the capital of the trust from the date of distribution, including the funds set aside to provide for the payment of \$21,000 a year to their mother.**

This is an updated version of an advance ruling published on July 31, 1978 as TR-78.

Income Tax Rulings are published for the general information of taxpayers but are considered to be binding on the Department only in respect of the taxpayer to whom the ruling was given.

Distribution of Income.

An "income interest" is a right **to, or to receive** income of the trust, (and not "from" the trust), while it may have any combination of the characters described in the Sec. 108(1)(c) definition. As per Sec. 108(5)(a), an amount included in computing the income of a beneficiary under Sec. 104(13), (14), or section 105 will be deemed to be income from a property which is an interest in a trust and not from any other source from which the trust derives it. Where an income right is to have the income applied in a certain manner such as to cover certain expenses other than to allow the direct receipt of it the right is considered an "income interest" while the beneficiary will recognize its benefit under Sec. 105(1) (or possibly 105(2)), and not under Sec. 104(13), and the trust will not obtain a Sec. 104(6) deduction thus double taxation of the income will result.

When income is realized by the trust it may be payable as such to a particular beneficiary as an operation of the trust deed which serves as an expression of an intention of the settlor to grant a gift of property to the beneficiary. The beneficiary's right to the income may be enforceable only in respect of income realized in a particular period or in respect of income realized by the trust over the length of time of its existence while it may be enforceable against a certain percentage of the income realized or against a certain maximum absolute amount of income realized. If the right is enforceable against an absolute amount of income realized in a particular period then when that amount is distributed the right is effectively satisfied in that it is no longer enforceable against any amount while if the right is enforceable against a certain unlimited percentage of income of the trust, as it is realized annually over the entire life of the trust, then when a current year's income is distributed it does not extinguish or settle any part of the right although it may reduce the total absolute amount of proceeds that the right may be enforceable against. If it is not distributed then the income beneficiary acquires a right to receive it in the form of capital in a later period and thus by the simple passage of time acquires a "capital interest."¹⁸²⁰

Through the operation of subsection 106(1.1) and (2) the initial tax cost of an income interest will generally be equal to the amount of income that its former holder was required to recognize in income when he disposed of it and thus since this amount of economic benefit was previously taxed it should avoid tax when it is realized and in order to do this the tax cost recognized must be deductible from the proceeds realized, be they as a distribution or as a disposition. It is only when consideration is paid to the former income beneficiary in respect of the acquisition of the income interest will the consideration form a cost of the interest as opposed to an expense incurred to acquire it. Subsection 106(1.1) does not apply in respect to discretionary interests which are not rights.

The Subsection 106(1) Deduction

Subsection 106(1) allows a taxpayer to write off the cost of his income interest against the income he realized, either from a disposition of the interest or part thereof or as a distribution from the trust and except for a few minor adjustments and a limitation in scope with respect of non-residents it fulfills the policy of tax integration.¹⁸²¹ Subsection 106(1) provides that where an amount has been included in a taxpayer's income in respect of his income interest in a trust by reason of Sec. 106(2) or 104(13), except to the extent where an amount has been deducted under Sec. 112(1), (inter corporate taxable dividends), or 138(6), (subsection 112(1)'s equivalent with respect to insurance corporations), a certain amount may be deducted by the taxpayer. The amount is the lesser of the amount included in his income for the year, from those **two** subsections and the amount by which the cost of the income interest to the taxpayer exceeds the aggregate of all amounts that were **deductible** by virtue of Sec. 106(1) in previous years. Subsection 106(1) is operative only in respect of Sec. 104(13) and 106(2) income inclusions and it does not apply to income inclusions brought about by the effect of subsections 104(14), 105(1) or (2). Where a P.B.E. is elected under Sec. 104(14) the cost of any income interest the preferred beneficiary has will not be applicable in negating an income inclusion and will thus not be reduced hence by making alternate P.B.E.s every second year the

¹⁸²⁰ The income then becomes tax capital and when distributed will not usually be taxed as income.

¹⁸²¹ By settling the trust in a tax haven and having an income beneficiary resident therein sell his interest to a Canadian resident the deductible cost can be inflated and subsequently the trust may become resident possibly benefitting from Sec.48(3) to avoid section 94-94.1 whereby income integration will be broken.

deductible cost of the income interest can be regulated¹⁸²². The same results where the income interest is a right to have the income applied for the maintenance of a property as described under Sec. 105(2): however the trust deed would have to state that income is to be applied directly to maintain the property or paid to the beneficiary to maintain the property.

Subsection 106(1) is operative only in respect of inclusions under Sec. 104(13), and 106(2) that resulted in amounts being included in computing the beneficiary's income, however, where the beneficiary does not recognize income under those two subsections, he will not be able to deduct the cost of the interest. Subsection 212(1)(c) recognizes that withholding tax will be applied on **payments** made that would be income of or from an estate or trust to the extent that it would be included in computing the income of the person **had he been resident**, however, in this instance the provision does not operate to require that the distribution/able amount be included in computing the taxpayer's income. Under Sec. 115(1)(a)(iv), **income** will be recognized by a taxpayer who was not resident at any time in his tax year when he **disposes** of an income interest in a **trust only** and it is only in this instance that the non-resident taxpayer will recognize "income" in respect of an "income interest" in a **trust**, (which does not include an estate). A taxpayer who is non-resident throughout the tax year will only be able to deduct the cost of the income interest only when it is disposed. For this reason, the non-resident income recipient may find it advantageous to dispose of the right to receive current income, annually, so that under the Sec. 115(1)(a)(iv) mechanism he can write off the cost of the interest he may recognize and receive the consideration tax free rather than incur withholding tax as per Sec. 212(1)(c) however this assumes that his interest is severable.

“Income interest in trust – Sec. 106(1)”

(1) Where an amount in respect of a taxpayer's income interest in a trust has been included in computing the taxpayer's income for a taxation year by reason of subsection 106(2) or 104(13), except to the extent that an amount in respect of that income interest has been deducted in computing the taxpayer's taxable income pursuant to subsection 112(1) or 138(6), there may be deducted in computing the taxpayer's income for the year the lesser of

(a) the amount so included in computing the taxpayer's income for the year, and

(b) the amount, if any, by which the cost to the taxpayer of the income interest exceeds the total of all amounts in respect of the interest that were deductible under this subsection in computing the taxpayer's income for previous taxation years.¹⁸²³

The deduction in Sec. 106(1) is not available where an amount has been deducted under Sec. 112(1) or 138(6) in respect of the income inclusion and it is obvious that this is only possible where the income is recognized under Sec. 104(13) and the trust has designated the income as being from taxable dividends as allowed under Sec. 104(19). Except for the other designation provisions in all other cases as per Sec. 108(5)(a) the income realized under Sec. 104(13) will be considered income from a property which is a trust interest. Only the Sec. 112(1) and 138(6) deductions are referred to while there isn't mentioned instances

¹⁸²² the trust's terms would have to allow for such by allowing a discretionary power to interfere with the enforceable right in the year

¹⁸²³ 1988 FINANCE TECHNICAL NOTES: Subsection 106(1) provides for a deduction in computing the income of a beneficiary from a trust in respect of his cost of acquiring an income interest in the trust. This amendment to subsection 106(1) removes a reference to subsection 110.1(1) as a consequence of the repeal of the \$1,000 investment income deduction.

1986 FINANCE TECHNICAL NOTES: Subsection 106(1) provides that an income beneficiary of a trust may claim a deduction against any income received from the trust or any income gain realized on a disposition of his income interest in respect of the cost of that interest where such interest was purchased from any other beneficiary of the trust. Thus a beneficiary may recover the cost of his interest in a trust before being subject to tax on income derived therefrom. The amendment to subsection 106(1) denies a deduction under this provision to the extent that the beneficiary is entitled to a deduction in calculating taxable income under subsection 112(1)(inter-corporation dividends), 110.1(1)(\$1,000 interest and dividend deduction) or 138(6)(dividends received by a life insurer) in respect of the income distributions of the trust.

where an amount has been deducted by the taxpayer under section 110.6 in respect of taxable capital gain designations made by the trust under Sec. 104(21). In that case, a deduction would be available under Sec. 106(1) as well as section 110.6 where a capital gain has been designated as part of the Sec. 104(13) inclusion thus a net loss could be created.¹⁸²⁴ Where the income beneficiary is not a corporation then he may avail himself of the section 121 dividend tax credit after the Sec. 104(19) designation has been made by the trust. Since he would have taken the Sec. 106(1) deduction thus causing a nil income inclusion with respect to the Sec. 104(13) provision, the tax credit would operate to reduce the effective taxation on other streams of income realized.¹⁸²⁵

The amount that **may** be deducted under Sec. 106(1) is the lesser of two amounts: the amount included in computing his income and the amount by which the cost of the income interest to the taxpayer exceeds the aggregate of amounts that were, in respect of that interest, **deductible under Sec. 106(1)** in computing his income in previous tax years. Obviously the Department is not going to allow a deduction that exceeds the amount of income that the taxpayer has to recognize while under Sec. 248(1), "amount" means money, **or the value** in terms of money of the "right" or "thing," hence, where income is distributed subject to an equitable charge such as the payment of university fees, maintenance of family etc., it can be argued that it is only the net value of the money indefeasibly vested in the recipient that is to be included in his income, not the gross amount. The limiting amount of the deduction will usually be the cost thereof at the time to the taxpayer that was not previously **deductible**, and great importance must be placed upon the recognition of the fact that the cost is reduced by the amount that was formerly **deductible** and not **deducted**. If the Sec. 106(1) deduction is not taken, when it could have been, the cost that may be subsequently deductible will none-the-less be reduced. It is a factor that must be recognized by trustees when they are in the position to withhold the exercise of a discretionary power and thus cause income not be payable to an otherwise beneficiary under Sec. 104(13). If the preferred beneficiary is in a current loss position then a payment under Sec. 104(13) will not cause any tax consequences and will prematurely reduce the deductible cost of the income interest. If instead they file a P.B.E. and the beneficiary recognizes income under Sec. 104(14) then the deductible cost of the interest will remain unchanged. If the beneficiary has non-capital losses that will be "falling off the table" shortly, the latter is more beneficial since it will allow utilization of losses that would have normally been lost and it will maintain the deductible cost of the interest at a higher amount.¹⁸²⁶

Deductible Cost vs. Deductible Expenses

It is important to recognize that the deductible **cost** of the interest will be affected only by those amounts which were deductible under **Sec. 106(1)** and not any other subsection. In *Gladys Evans v. M.N.R.*¹⁸²⁷ the taxpayer sustained \$12 000 worth of legal costs to establish an income right in an estate while the Department disallowed the expenses deduction on the fact that they were paid on account of capital. The Supreme Court of Canada provided in March 1960 that the expenses incurred were incurred to produce income and thus were deductible under then Sec. 12(1)(b). If the circumstances were to happen today, the expenses would be deductible under Sec. 18(1)(a), however, they would not preclude the Sec. 106(1) provision from having effect when Sec. 104(13) or 106(2) income is recognized. Since the expenses incurred were not paid to a former beneficiary they would not constitute a cost under Sec. 106(1.1), however, they would be immediately deductible against the income from property and thus they could produce a non-capital loss, regardless of whether income is even recognized from the trust.

¹⁸²⁴ The same results when designations are made under Sec. 104(27) in respect of superannuation and pension benefits or Sec. 104(29) in respect of certain "phantom" resource income.

¹⁸²⁵ Inflating the deductible cost of an income interest via a tax free arrangement does have several advantages.

¹⁸²⁶ This assumes that the trustees have the power to withhold payment in respect of a beneficiary who is in "a class by himself" as per the P.B.E. rules in Sec. 104(15)(b)(ii). Note that the Sec. 104(15)(b) accumulating income apportionment rules are segregated on a basis of discretionary powers over **accumulating income**, **not current income**, thus a deferral of payment until the following period, of a unalterable income amount, as per the exercise of discretionary power as spelled out in the trust agreement, will not cause harsh tax consequences.

¹⁸²⁷ 60 D.T.C. 1047,

In Bernice Mackinnon and Her Majesty the Queen¹⁸²⁸ the Tax Court had to consider the instance where a taxpayer incurred legal fees to realize from an estate RRSP proceeds that had been erroneously paid to it instead of her. It held:

[21] The second issue concerns the deductibility of the legal expenses incurred by the appellant to recover what was rightfully hers. In fact, the Agreed Statement of Facts states that the legal expenses were incurred in order to recover the sum of \$162,554.94 together with interest fixed at \$67,171.70.

[22] Counsel for the respondent agrees that the legal expenses are deductible insofar as they pertain to the recovery of the pre-judgment interest but are not deductible with respect to the principal amount of the RRSP, as this should be considered as being of a capital nature (paragraph 18(1)(b) of the Act), and therefore the legal expenses relating thereto were not incurred for the purpose of gaining or producing income from property under paragraph 18(1)(a) of the Act. Counsel for the respondent therefore suggests that the legal expenses be prorated accordingly. Counsel for the appellant maintains that the legal expenses relating to the principal amount were incurred for the purpose of gaining or producing income from property and that there is no capital aspect to the payment of that amount.

[23] *In Evans v. MNR, 60 DTC 1047, the Supreme Court of Canada addressed the issue of the deductibility of legal fees. The appellant in that case was seeking to recover legal fees paid in the pursuit of her testamentary right, as a beneficiary, to the income flowing from her share of the residue of the estate. The court determined that a distinction must be made between establishing a right to, or receiving, a capital asset and collecting income to which one is entitled but which one cannot obtain without incurring legal fees. The Supreme Court further said that the nature of the property cannot be altered by the circumstance that it was mistakenly claimed by another. Justice Cartwright also pointed out that the grounds on which the payment or the right was withheld from the appellant were in no way relevant and that the sole factor to be considered is the nature of the right. He further stated that a right flowing from a will does not depend on a court judgment for its existence. The judgment permits the release of a sum of money owing to the legal owner and does not create the right to that sum.*

[24] The definition of property found at subsection 248(1) of the Act, and more particularly the phrase “a right of any kind whatever”, has been the subject of many court decisions. In *Manrell v. The Queen*, 2003 DTC 5225, Madam Justice Sharlow had this to say on the meaning of property:

[48] I turn now to the jurisprudence that has considered the statutory definition of “property” and the meaning of the phrase “a right of any kind whatever”. There is ample authority for the proposition that the word “property” is capable of many meanings, and that in the fiscal context its meaning must be understood to be broad and inclusive. For example Justice Linden, writing for this Court in *Kieboom v. Minister of National Revenue*, [1992] 3 F.C. 488, [1992] 2 C.T.C. 59, 92 DTC 6382 (F.C.A.), said this:

As for the word property, it too has been widely interpreted. The *Income Tax Act*, subsection 248(1) defines property as “property of any kind whatever whether real or personal or corporeal or incorporeal [page 500] and, without restricting the generality of the foregoing includes (a) a right of any kind whatever, a share or a chose in action,”. Lord Langdale once stated that the word property is the ‘most comprehensive of all the terms which can be used, inasmuch as it is indicative and descriptive of every possible interest which the party can have.’ (See *Jones v. Skinner* (1836), 5 L.J. (N.S.) Ch. 87 (Rolls Ct.), at page 90; see also *Re Lunness* (1919), 46 O.L.R. 320 (App. Div.), at page 322; *Fasken, supra* [*Fasken, David v. Minister of National Revenue*, [1948] Ex.C.R. 580], at page 591; and *Vaillancourt v. Deputy M.N.R.*, [1991] 3 F.C. 663 (C.A.).)

[49] Based in part on this understanding of the word “property”, Justice Linden concluded that a person who owns common shares of a corporation is considered to have transferred property to his wife when he enters into an arrangement whereby she subscribes for newly

issued common shares of the corporation at a nominal price, reducing his interest from 90% to 20%, while increasing her interest correspondingly. This case is authority for the proposition that a share interest in a corporation is property, and the transaction in issue was a transfer of property because it resulted in a movement of part or all of that bundle of rights from one shareholder to another. While this case recognizes and restates the proposition that in the income tax context the word "property" has a very broad meaning, it does not say that everything of value is "property".

[50] The phrase upon which the Crown relies in this case, "a right of any kind whatever", like the word "property", has a very broad meaning. But it is not a word of infinite meaning. It cannot include every conceivable right. It cannot be given a meaning that would extend the reach of the *Income Tax Act* beyond what Parliament has conceived. Even counsel for the Crown conceded that it does not include a human right, or a constitutional right.

[51] It is not difficult to imagine examples in which the meaning of "a right of any kind whatever" would be taken too far. Consider the case of a person who is injured in a car accident caused by the negligence of another person. The injured person has the right, possibly a valuable right, to claim damages against the negligent person. Suppose that claim is released in consideration of the payment of a sum of money. One could say that the right to claim damages was disposed of. But no one would accept the argument that the payment is the proceeds of disposition of capital property. Why? Because fundamentally the payment is compensation for a personal injury, something that is well understood to be beyond the reach of the *Income Tax Act*. Although a legal claim for damages for personal injury is a "right", the settlement transaction is not within the scope of the capital gains provisions in the *Income Tax Act*.

[52] Counsel for Mr. Manrell has provided what appears to be an exhaustive list of all the cases in which something has [sic] found to be "a right of any kind whatever". I will not reproduce the whole list. But I will cite a few illustrative examples. The right represented by a term life insurance policy that has no cash surrender value but is convertible without evidence of insurability is a "right" for purposes of the definition of "property" in the *Estate Tax Act*, S.C. 1958, c. 29 (a definition very similar to the definition in the *Income Tax Act*): *Estate of Harry A. Miller v. Minister of National Revenue*, [1973] C.T.C. 793, 73 DTC 5583 (F.C.T.D.). An entitlement to receive payments from the pension plan of a deceased spouse is a "right" for purposes of the definition: *Driol v. Canada*, [1989] 1 C.T.C. 2175, 89 DTC 122 (T.C.C.). An irrevocable promise in a marriage contract to pay a sum of money to the spouse during the marriage gives rise to a right in the hands of the recipient spouse as of the date of the promise, and that right is at that time a "right" for purposes of the definition: *Furfaro-Siconolfi v. Canada*, [1990] 2 F.C. 3, [1990] 1 C.T.C. 188, 90 DTC 6237 (F.C.T.D.). An entitlement to maintenance or alimony is a "right" for purpose of the definition [sic]: *Canada v. Burgess*, [1982] 1 F.C. 849, [1981] C.T.C. 258, 81 DTC 5192 (F.C.T.D.), see also *Nissim v. Canada*, [1999] 1 C.T.C. 2119, *Donald v. Canada*, [1999] 1 C.T.C. 2025 (T.C.C.).

[53] The fact is that in the history of tax jurisprudence in Canada, involving dozens of cases that consider the statutory definition of "property", there is not a single case in which the word "property" has been held to include a right that is not or does not entail an exclusive and legally enforceable claim. This does not prove that the Crown's argument is wrong, but in my view it casts serious doubt on it.

[25] A distinction is to be made between fees incurred to affirm a right and those incurred to acquire a right. This distinction was made in *Kellogg Co. of Canada v. M.N.R.*, 2 DTC 548 (Exchequer Court of Canada) at page 553 (a decision affirmed by the Supreme Court of Canada):

No "material" or "positive" advantage or benefit resulted to the trade of Kellogg from the litigation except perhaps a judicial affirmation of an advantage already in existence and enjoyed by Kellogg. I do not think that the Crown can be heard to say that because the

litigation affirmed a right which Kellogg, in common with others, was already entitled to and enjoyed that therefore it acquired something which should be treated as an asset or an enduring advantage to its trade. . . . It was to maintain this trading and profit-making position that Kellogg was obliged to make the expenditure in question.
[Emphasis added.]

[26] The application before the Ontario Superior Court was necessary to obtain approval of the out-of-court settlement because it involved a minor. It was also necessary in order to dispose of the objection by the litigation guardian with regard to pre-judgment interest. **The legal fees incurred were necessary in order for the appellant to have returned to her that which was rightfully hers after the passing of her son, and they were not incurred for the purpose of acquiring a right. In my opinion, the legal fees were incurred by the appellant in order to materialize that right and they thus fall under the exception contained in paragraph 18(1)(a) of the Act and are therefore deductible.**

[27] The appeal is allowed in part and the assessment is referred back to the Minister of National Revenue for reconsideration and reassessment. Both parties shall bear their own costs.

When a taxpayer acquires an income interest as such from another taxpayer the proceeds are fully includable in the recipient's income by virtue of Sec. 106(2). If the interest is rolled through via Sec. 70(3) on a death of the beneficiary there is a possibility that its deductible cost can be bumped. If it isn't technically a defined income interest can it be a capital property for purposes of Sec. 73(1)?

Distributions to Non-Residents.

Subsection 212(1)(c)(i) requires that withholding tax be applied on income of or from an **estate or trust** to the extent that such amount would, if the non-resident person were resident in Canada and to who Part I applied, be included in computing the income of the person by reason of Sec. 104(13), except to the extent that such amount is deemed by Sec. 104(21) to be a taxable capital gain of the non-resident person.¹⁸²⁹ If the payment was derived from a non-taxable dividend it will also be subject to the tax as per the 1990 amendments. Amounts payable to non-resident persons that have been the subject of a Sec. 104(21) designation will have no withholding applied, however, it must be recognized that this a valued concern only where the trust is a mutual fund trust in that under Sec. 104(21) the designation can be made only in respect of beneficiaries who are resident in Canada if the trust is not a mutual fund trust.

Under Sec. 212(11) where an amount has been paid or credited by a trust or estate to a beneficiary or other person beneficially interested therein, regardless of its source to the trust or estate, it will be deemed for purposes of Sec. 212(1)(c) to have been paid or credited as income from the estate or trust. For purposes of the imposition of Part I tax through the Sec. 104(13) mechanism in Division B income serves as an equitable tax base. Subsection 212(1)(c) was amended in the 1988 reform to make reference to, **exclusively**, amounts that would be includable in the recipient's income, (other than consisting of Sec. 104(21) designations), under Sec. 104(13) only, had he been Canadian resident, however, those amounts must satisfy the opening phrase of Sec. 212(1)(c), "income of or from an estate or trust". It is at this point that the substance of Sec. 212(11) becomes interesting. As per subsection 212(11), **regardless of the source from which the trust or estate derived it**, any payment will be **deemed** to income for purposes of Sec. 212(1)(c). Unless the payment, however, is Division B income of the trust or amounts distributed as or derived from non-taxable dividends paid by a Canadian resident corporation it will not be captured under Sec. 212(1)(c) for withholding tax. If the amount can be tax capitalized to an extent whereby it loses its Division B income characteristic, so that it couldn't be includable in the beneficiary's income under Sec. 104(13) if it had been paid to the beneficiary when he was resident the subsection will not apply to it.¹⁸³⁰

A distribution of capital to a non-resident beneficiary would normally attract the application of section 107, in particular Sec. 107(5), but only where it satisfies a capital interest. If they are payments or distributions of

¹⁸²⁹ It is important to note that both "estate" and "trust" are expressly recognized in that outside of subdivision k a trust does not include an estate.

¹⁸³⁰ See *Ida E. Brown v. M.N.R.*, 50 D.T.C. 218, for an illustration of bookkeeping character alterations.

capital which do not satisfy interests then they **may** cause the ACB of capital interests to be adjusted as per Sec. 53(2)(h) or they may ultimately, where the former does not apply, be recognized in income under Sec. 105(1). If they are the latter they will not be subject to withholding tax since under Sec. 212(1)(c) only Sec. 104(13) inclusions will be affected. If they are distributions in respect of capital interests in personal trusts that were not acquired for consideration payable, and they do not operate to satisfy an interest Sec. 53(2)(h), 105(1), 104(13), and 212(1)(c) do not apply to them. Section 115 is entirely silent on distributions of capital, hence, taking the above statutory effects into consideration it would appear that a distribution or payment of capital by a trust to a non-resident beneficiary other than in instances where a portion of a capital interest is satisfied will not attract taxation under Part I or Part XIII¹⁸³¹. Altering income that would normally cause a Sec. 104(13) to that which normally wouldn't without causing the trust to recognize it is a primary concern.

Royalties and N.R.O.I.C.s.

Under Sec. 212(9) no tax is payable under Sec. 212(1)(c) on an amount paid as income of or from a trust if it may **reasonably** be regarded as having been derived from dividends or interest received by the trustee from a non-resident-owned investment corporation or on account of or in lieu of or in satisfaction of a royalty on or in respect of **a copyright** in respect of the production or reproduction of any literary, dramatic, musical or artistic work. This applies only where no tax would have been payable under Part XIII if the N.R.O.I.C. or person paying the amounts in respect of the copyright would have paid them to the non-resident person directly rather than the trustee. Under Sec. 212(2) withholding tax will be applied on dividends paid or credited by corporations resident in Canada, that are capital dividends or taxable dividends other than a "capital gains dividend" described under, amongst others, Sec. 133(7.1) as a dividend paid out of the balance of the N.R.O.I.C.'s capital gains dividend account, after the N.R.O.I.C. has elected under the proper Regulations. Where the dividend is not in respect of such an election then automatically it will be the subject of withholding tax under Sec. 212(2) even when it was a capital dividend. If it is flowed through a trust Sec. 212(1)(c) will capture it and expose it possibly to a lower treaty rate. Under Sec. 104(10) where all of the property of a trust is owned by the trustee for the benefit of non-resident persons or their unborn issue in addition to amounts deducted under Sec. 104(6) there may be deducted in computing the income of the trust for purposes of Part I the amount of dividends and interest received from a N.R.O.I.C. in the year that were not deductible under Sec. 104(6). Where the trust's income consists only of dividends and interest received from N.R.O.I.C. then obviously it need not recognize taxable income under Part I. Under Sec. 104(11) where any part of the dividends received from a N.R.O.I.C. are **deductible** under Sec. 104(10) in computing the income of a trust for a year **for purposes of Part XIII** the trust shall be deemed to have paid to "**a non-resident person**" on the last day of the year an amount equal to that part as income of the non-resident person from the trust. The provision does not specify to whom this payment was deemed to be made, however, it really does not matter since under Sec. 215(1) & (6) the trust will have to deduct the applicable withholding tax if any and remit it to the Receiver General. The withholding tax will not result where the dividend was a capital gains dividend as described under Sec. 133(7.1) that is exempt from withholding by virtue of Sec. 212(2)(a).

Under Sec. 212(1)(b)(i) interest payable by a N.R.O.I.C. will not be subject to withholding while under Sec. 104(10) it will be deductible in computing the trust's Part I income and since Sec. 212(9)(a) makes such amounts exempt from withholding when they pass through a trust there will be no income or withholding tax applied on such payments. Under Sec. 133(1)(a) the N.R.O.I.C. will not be allowed a deduction for such interest paid by it on account of bonds, debentures, securities or other indebtedness, thus such amounts will be exposed to the Sec. 133(3) special tax rate of 25% applicable to the corporation.

Pre-1949 Non-resident Trusts

Under subsection 212(10) where all of the beneficiaries of a trust established before 1949 reside during the tax year, in one country other than Canada and all amounts included in computing the trust's income for the tax year were received from persons resident in that country, no tax will be payable under Sec. 212(1)(c)

¹⁸³¹ unless it was derived from non-taxable dividends...

in respect of amounts paid or credited to a beneficiary as income of or from the trust. The term "beneficiary" is defined only in respect of subdivision K under Sec. 108(1)(b) to be a person beneficially interested in a trust (or estate) hence, the term extends to include persons other than those who hold "income" or "capital interests" being that it may also include discretionary beneficiaries. It would seem reasonable to accept that that definition could apply by virtue of common law principles, to Sec. 212(10). Subsection 212(10) applies where all of the beneficiaries of the trust reside during a tax year in one country other than Canada, however, it does not preclude the beneficiary from also residing in Canada. Subsection 250(1) applies to cause a person to "be deemed to have been resident in Canada" though it doesn't prevent them from residing in any other country, when certain conditions exist. It cannot be used to determine whether or not a person was also resident in another country, hence, in that instance for Canadian tax law purposes the usual common law principles concerning the determination of residence must be applied.

The provision applies to trusts that were "established before 1949" and one has to wonder whether a trust constituted prior to 1949 but varied, possibly many times thereafter, will qualify. Depending on how materially the trust is varied it may not be able to retain its original settlement date as the time at which it was established.

One aspect of the diction that stands out, that due to the time at which the provision was enacted can be interpreted in only one way, is the fact that it refers to the **receipt** of amounts included in income not just the fact that the amount was **receivable**. Since the provision reads "...all amounts included in computing the income of the trust for the taxation year were **received** from persons resident in that country..." one cannot overlook the fact that the person must be resident in that country not only when the amount was required to be included in the trust's income but also when it was actually paid to the trust. The payers of the amount must reside in the same country as all of the beneficiaries of the trust. If the trust terms provide for the accumulation of income received then equitable treatment is not provided in respect of instances where a non-resident capital beneficiary disposes of his capital interest and is required to recognize capital gains under Sec. 115(1)(b). The income will be recognized by the trust and the beneficiaries may recognize capital gains on the dispositions of their interests. Since capital dividends, (non-taxable dividends), from Canadian resident corporations would not be includable in computing the trust's income if the trust was created prior to 1949 and the beneficiaries were exclusively resident in another single country it would be possible to get the capital dividends out of the country if the trust held the capital dividend producing shares and thus avoid the effect of Sec. 212(1)(c)(ii)-(11). What the Department has precluded you from doing directly it has left open your ability to do indirectly, though this can only occur in the case where the Sec. 212(10) conditions are met.

Under subsection 214(1), tax is payable on the amounts described in section 212 without a deduction allowed to those amounts whatever, hence, this further reinforces the effect of Sec. 106(1) and disallows the write off/deduction of the cost of an income interest against the income realized.

Under Sec. 214(3)(f) where Sec. 104(13) would have required that an amount payable by a trust to a beneficiary be included in computing the income of the non-resident person, had Part I been applicable, that part shall be deemed to be an amount paid or credited to that person as income of or from the trust or the earlier of the day on which the amount was paid or credited or the day that is 90 days after the end of the trust's taxation year. It will not be affected at a subsequent time when it is actually paid or credited. Since the provision refers exclusively to "**trusts**" and not to "**trusts or estates**" one has to wonder when a payment or crediting by **an estate** will be recognized for purposes of Part XIII. Subsection 212(1)(c) and (11) target income from and **of** a trust or estate hence the fact that an estate in the midst of administration can pay, in trust law, only capital on account of the beneficiaries rights does not allow such payment to be excluded from withholding tax. In the case of specific devises the beneficiaries proprietary rights relate back to the time of death allowing payments to retain their income character on their current distribution to the beneficiary.

Under subsection 215(1) when a person pays or credits or is deemed to have paid or credited an amount upon which withholding tax is applicable he shall deduct or withhold the amount, therefore, that is equal to the tax there upon and remit it to the Receiver General. Where the estate or trust fails to do this it then becomes liable itself for the payment, as per Sec. 215(6).

Income or Capital Distributions.

The manner in which a right to a particular economic receipt from the trust held by a beneficiary is described in the trust document has resounding effects on how the resulting economic receipt realized will be taxed either through the realization of the trust property or upon the disposition of the interest. The ITA recognizes two distinct and mutually exclusive forms of rights to property of the personal trust, however, the trust documents themselves may by no means describe in meticulous detail the nature of the interests for tax purposes. As a result of this, there may arise particularly "unfair" tax consequences where capital in the trust law sense is distributed and received only as **"income"** to the beneficiary in that the trust documents have not allowed for the particular beneficiary to have a "right to the capital", as may occur under Sec. 53(2)(h)-105(1).¹⁸³² It cannot be over-stressed how important it is for a trust deed to meticulously define the manner in which the right to the property is referenced in the deed vis-a-vis the nature of the property to the beneficiary, for if it is not, costly tax results may result. The author says this with regard to the Sec. 104(13)(c) inclusion of only non-capital payments from non-resident trusts and the Sec. 53(2)(h)-105(1) mechanism.

The tax character of the right the beneficiary **under a personal trust** has depends directly on the nature of the property of the trust **in its hands** in respect of which it is enforceable. This can be derived from the fact that the definitions of the income and capital interests refer to the income or capital **of the trust** regardless of its character in the beneficiary's hands. At this point the state of mind of the settlor of the trust and what he chose to recognize as corpus or income is important as interpreted from the settlement deed.

The subparagraph 108(1)(e) definition of income interest is based on the right of a taxpayer to or to receive trust law income, as per Sec. 108(3), from the personal trust, thus by implication the capital interest under a **personal trust**, as described in Sec. 108(1)(c), must be a right to receive trust law capital and thus a personal trust capital interest may benefit from substantially different treatment under Sec. 53(2)(h) than that afforded non-personal trust capital interests which are rights to **tax** law capital.

The classic case, upon which a substantial amount of case law has been based concerning the character of the receipt from a trust, is the instance in *Brodie v. C.I.R.*¹⁸³³ when all of the **"income"** from certain shares held in trust was to be paid to the surviving spouse for her life while it was also provided in the trust deed that if a certain amount, £4000, was not available as income from the shares then the trustees could draw on **capital** to fulfill the minimal distribution requirements. The spouse did not have a direct right to the capital but instead all of the capital remaining upon her death was to be held for or distributed to the remaindermen. Even upon the most superficial review of the trust deed it could be ascertained that the intention expressed by the testator was that "income" payable to the spouse in any year would not be less than £4000. In 1923-24, 29-30, the income of the trust proved insufficient and the trustees drew on capital to satisfy the spouse's right. The Commissioner of Inland Revenue assessed the additional amounts drawn from capital in the trust as "income" in the hands of the spouse, thus causing her to be taxed upon them while the trustees contended that such amounts were capital, which would thus cause them to be excluded from taxation.¹⁸³⁴

Finlay, S. based part of his conclusion on the fact that:

"The intention which was expressed in the will was that the **income** payable to his widow during her life should not be less than £4000 a year. That raises the point, and the main point which arises in the case, and the question is this; it is whether that £4000 was in truth the **income of the widow**...of course if certain sums of capital were simply handed over by the trustees to the lady and **received** by the lady **as capital**, it is quite clear that Income Tax would not attach, but it is, to my mind, not less clear that, **if the sums paid were paid to the lady and received by the lady as income then it is immaterial what they may have been in the hands of the trustees who paid them.**"

As the most conclusive of statement he provided:

"But I think, the governing consideration is this; the question being, was the sum **received as income one has to consider what was the source from which it was received and what were the circumstances in which it was received. If the capital belonged to the person receiving the**

¹⁸³² At the same time there appears to be no instance that the author knows of in which the distribution of trust law income has been treated as a distribution of capital, which would cause a substantial reduction in its taxability.

¹⁸³³ 17 T.C. 432,

¹⁸³⁴ See also *Ewing v. F.C.T.*, 1928 2 A.L.J. 246.

sums - if he or she was beneficially entitled not only to the income but to the capital - then I should think that, when the payments were made, they ought to be regarded, and would be regarded as payments out of capital, but where there is a right to the income, but the capital belongs (beneficially) to someone else, then, if the payments out of capital are made and made in such a form that they come into the hands of the beneficiaries as income, it seems to me that they are income and not the less income, because the source from which they came was, in the hands, not of the person receiving them, but in the hands of somebody else, - capital."

The reasoning in Brodie is fairly simple when one examines the legal realities of the trust and all its corresponding rights and properties, however, it is flawed, if applied to the taxation of trusts in Canada, in that it would appear to cause income payments made to "capital" beneficiaries, (who have no right to income per se), to be treated in the hands of the beneficiaries as capital in that they could not be treated as anything else but capital. The mechanics of the Sec. 104(13) income inclusion, the Sec. 104(6) deduction and the basis upon which both function, being the "amounts payable" definition in Sec. 104(24), makes this result **only close** to impossible under the ITA where a pure "capital" beneficiary is to receive a portion of a capital gain, to which he is legally entitled, in the year in that a distribution of that gain will be considered a capital distribution, which may serve to satisfy and extinguish the capital right in the trust. However, seen as distribution of capital, (in the trust law sense), the trust will not obtain a deduction for it. It is only when the gain is recognized as tax **income** (Division B), and is considered to have been passed on to the beneficiary **as tax income**, (Division B), that the trust may avail itself of a deduction, and thus the beneficiary will recognize "income". It is apparent as per the reasoning in Brodie that in common law it is not so much the character of the property in the hands of the trust that determines the nature of the receipt by the beneficiary but the nature of the right of the beneficiary that is of importance. **Under the ITA however the tax nature of the substance of the payment as received in the trust's hands will determine its taxability**¹⁸³⁵. Also, the Sec. 108(1) definitions of capital and income interests in respect of personal and prescribed trusts have as their basis rights to income or capital of the trust, **regardless of the nature of its receipt in the beneficiary's hands**.¹⁸³⁶ The nature of the trust's property to which the right relates determines the interest's tax character however it need not have an influence on the taxability of the distributions made in respect of it. In the case of capital distributions in respect of inventorial capital interests it doesn't while in the case of income flowing through Sec. 104(13)-(6) it does.

Subsection 108(1)(c), amended with the 1988 reform in accompany with Sec. 108(1), provides that **any** right a taxpayer has as a beneficiary in a **non-personal** and **non-prescribed** trust will be considered as a "capital" interest, even though the right may have the legal characteristics of being entitled to enforce a distribution of trust law or tax law "income" only. In this case then entire framework upon which the taxation of benefits occurs will be considerably altered even though Sec. 104(13) will cause the beneficiary to recognize benefits distributed as "income" and be taxed accordingly. The characterization of benefits distributed from the trust being either tax income or tax capital **does not follow** the deemed character of the tax "interest" in the trust but in fact the two concepts are completely independent of each other in the case of non-personal and non-prescribed trusts.¹⁸³⁷

In Brodie, the right to income of the trust was the only right the spouse had under the trust as expressly provided in the will while the rights to capital were held by someone else. The trustees were obliged within

¹⁸³⁵ See *Trustees of The Mrs P L Travers Will Trust v Revenue & Customs* [2013] UKFTT 436 (TC) for an instance where trustees made decisions to treat as capital, revenue realized on intangible copyright that had a limited life. The ct. accepted the decision could be made based on some classic jurisprudence which has some implication here since a foreign trustee can make equal decisions under that foreign law before the economic receipt hits here.

¹⁸³⁶ If the taxpayer holds the right to trust capital as an inventory it will produce income for him when it is disposed of however it doesn't prevent the right from being a capital interest.

¹⁸³⁷ Since the right to, or to receive income, from a non-personal and non-prescribed trust is a capital interest which is afforded capital property treatment when disposed of, only partial recognition of proceeds of disposition will result when it is disposed of, however, upon the continual realization of income distribution from the trust, its cost will not be allowed to be "written-off" which is treatment available to "income interests".

their fiduciary duty to bring up to a certain amount the **income** the spouse was to realize while in Lindus and Hortin v C.I.R.¹⁸³⁸ a very similar situation arose wherein the trustees were allowed, through the exercise of a discretionary power instilled in them to "make payments out of the capital of the trust funds by way of **supplement** to the income" of the beneficiary however, once again the particular beneficiary had only a right to "**income**". Finlay, J., having a particularly busy day on January 18th, 1933, provided in reaching his conclusion:

"The substantial argument - apart from the general broad argument upon which I need not go back - was that in this case, it was income because there was a discretion on the part of the trustees; there was no right in the beneficiary and, therefore, it was really in the nature of a voluntary gift, and what was suggested in substance was that it came within the principle of the decision in the case of Stedeford v. Beloe, 16 T.C. 505. On the part of the Crown, what was said was, that that is not so; that, no doubt, there is a discretion, but, none the less the discretion is one to be exercised by the trustees towards their cestui que trust, and that when once this income is paid to the lady, it is her income and not the less her income because the trustees, having a discretion, might have said that, having regard to the circumstances of the lady or the depletion of the trust funds or so on, they felt unable to pay it."

He then effectively concluded that regardless of whether the payments were made with respect to the trust deed or as an exercise of discretion, as long as the beneficiary was entitled to only "income" then the amount paid to her, regardless of how it became payable, would be treated as "income" in her hands.¹⁸³⁹

The key to all of this is that the beneficiary did not have a discretionary capital right, which would spring into existence upon an exercise of the power, but as per the trust terms had only an "income" right, and the discretionary right that did exist was limited to being that in respect of income for her maintenance. If the trust deed expressly provided for her to have a potential right to be entitled to the trust corpus that was dependent upon a favorable exercise of the discretionary power, it's doubted if the result would be the same.

The same circumstances, except with one slight inconsequential deviation, arose in Williamson v. Ough (Inspector of Taxes)¹⁸⁴⁰. In that case, the trustees could make discretionary payments of capital to supplement a pure income beneficiary's distribution, however, they were to attempt to recoup the capital in subsequent periods by reducing the income payments made to the beneficiary. The latter aspect was held not to have reduced the fact that the payments were income in the hands of the beneficiary for once again the beneficiary had only a right to participate in income, not in capital.¹⁸⁴¹ This obviously causes considerable difficulty in structuring a power of encroachment under the Canadian Income Tax Act. If the power to encroach on capital for the benefit of the pure income beneficiary is not structured so as to give the beneficiary a capital right upon its exercise, (and thus essentially become a power of appointment), then when it is exercised the beneficiary will receive trust law capital in respect of the income interest held and since it could not cause an ACB adjustment to the interest, and wasn't previously included in computing the income of the recipient, it will lead to a full Sec. 105(1) income inclusion.¹⁸⁴²

In Stevenson (Inspector of Taxes) v. Wishart¹⁸⁴³ the spouse of the settlor, Mrs. H., was an income beneficiary under a trust wherein the trustees had been instilled not just with a discretionary power to choose the source of funds which could be made payable to her **but also with a power of appointment** whereby through an appointment, she could retroactively actually obtain a right to trust capital. Mrs. H. entered a nursing home after two heart attacks and the trustees, in an exercise of their powers of appointment, appointed £109,000 out of capital, on her behalf, to defray her medical and residence expenses. All of the

1838 17 T.C. 442

1839 See also Tillard v. C.I.R., 1938 N.Z.L.R. 795.

1840 20 T.C. 194

1841 See also Milne's Executors v. C.I.R., 37 T.C. 10.

1842 Could it not be argued that the income beneficiary could have a capital interest contingent upon the reduction in the realized income so as to allow her to receive such as a capital beneficiary? This may be the very case in which case Sec. 105(1) could not capture a supplementing distribution since it would be hypothetically or actually subject to a Sec. 53(2)(h) reduction in the a.c.b. of the interest. The distribution in this case **would not extinguish the on-going interest** hence section 107 could not apply and the Department would not be able to charge that Sec. 53(2)(h) doesn't apply to such an advance/distribution.

1843 1986 1 All E.R. 404,

appointments made in the relevant years were spent in the year to extinguish her personal expenses via disbursements through a float account that the trustees opened for her in a local bank. The C.I.R. assessed the amounts as having been received by her as "income" for her maintenance while the trustees contended that the exercise of the power of appointment did not have the effect of conferring an "income" right upon her but rather a capital right. Knox, J. of the Chancery Division provided that the nature of the benefits received by Mrs. H. did not themselves influence her entitlement to them, and that to label them as income payments made in satisfaction of the reoccurring liabilities incurred in the process of maintaining her **was to confuse the functional purposes of the payments with the right in respect of the payments were made.** (The power of appointment had been exercised annually for a number of years.) Effectively, unless on analysis the power of appointment and the manner in which it was exercised produced an **income** entitlement, the sums appointed **could only be capital.** The appointments were made in respect of the capital of the trust only, not in respect of its current or future income thus an income entitlement could not have been produced. A reoccurring interest in trust income had not been created and the capital of the trust was held to merely be undergoing distribution.

One can see a remarkably useful purpose for including a power of appointment, exercisable by the trustees, in the trust agreement for tax purposes for if properly constructed it can allow for virtually tax free distribution of capital to alternate potential beneficiaries as well as redirection of income payments to various beneficiaries thus allowing them to utilize more productively their respective individual tax positions, (vis-a-vis loss carry overs, basic deductions, etc.). By the moderate use of powers of appointment a beneficiary may be able to recognize an "income" distribution in one year and then go back to recognizing only "capital" distributions in that the **very right** of the beneficiary to receive from differing sources amounts is being replaced and altered. Greater flexibility can be obtained where the right created by the appointment is limited, as per the trust agreement, to a certain period of time in that the power can be exercised more frequently in respect of the same property.¹⁸⁴⁴

If the trust is resident throughout its tax year in Canada, then only the amount of its **Division B income** that becomes payable to a beneficiary will be included in his taxable income under **subsection 104(13) only.** If the trust distributes a portion of its tax capital to a beneficiary, unless the trust is a personal trust, it may lead to a Sec. 105(1) income inclusion as a benefit realized by the beneficiary, but not where it has led to an adjustment in the ACB of the capital interest in the trust held by the beneficiary or capital interest in the personal trust that was acquired by the beneficiary, under Sec. 53(2)(h), or where it could lead to a hypothetical ACB adjustment if those provisions would have applied and for this to occur the interest cannot be extinguished on the distribution. If Sec. 105(1) does apply, as is the case where a capital distribution is made to a pure income beneficiary, (that holds no capital interest), (but not generally where the distribution was in respect of a disposition of the income interest as per Sec. 106(3)), then the capital will be introduced back into taxable income with no resulting deduction to the trust under Sec. 104(6).¹⁸⁴⁵

In the case of spousal trusts, as provided by Sec. 108(3), income entitlement for the underlying spouse is based on trust law income, not tax law income hence there is considerable disparity here since while a non-spousal beneficiary incurs the tax burden of the stream coming to them through the trust (give or take some adjustments as detailed in previous chapters), the spouse in a spousal trust can be completely alleviated of dealing with tax consequences. His "income" is dependant on non-tax calculation principles, only trust law income, and it can be substantively eliminated through various provisions/methods of calculation as the testator's/settlor's motive is expressed in the settlement documentation.

If the beneficiary formerly owned *inventorial* property and transferred legal ownership to a bare trust and retained full beneficial ownership, and the property represented capital for the trust's purposes and upon its disposition the proceeds would be distributable to the beneficial owner it would be questionable whether they represent a distribution capital in respect of a capital interest or a distribution of income in respect of an income interest. The manner in which the trust interest arose, is held, and disposed of by the beneficiary and

1844 See Esdaile v. I.R.C., 20 T.C. 700.

1845 This isn't the case with non-residents since Sec. 214(3)(a) doesn't capture Sec. 105(1) benefits.

the property to which it relates as well as how the trust holds the property are all factors that must be examined in ascertaining not just the nature of the interest in the beneficiary's hands but the manner in which it should be taxed.

A very fundamental aspect of the flow through of income to a beneficiary under a trust as per the ITA must be addressed here in that it's a salient concern and that is whether the income that a beneficiary is to recognize under Sec. 104(13), (the trust's Division B income), can be reduced through accounting deductions so as to alter the character of the receipt. A beneficiary may have sole income and capital rights under a trust and if the trust deducts accounting depreciation from its trust law income without deducting C.C.A. will that accounting depreciation be recognized as Division B income by the beneficiary when distributed in the current year as trust law capital? Essentially the beneficiary is realizing the same economic receipt but how is he realizing it? Does the reduction in the **trust law** income payable due to the deduction cause a reduction in the shadow Division B income recognized as payable under Sec. 104(24) **or** by the mere fact that the trust law capital, (in the form of the depreciation), is in substance still Division B income of the trust cause it to be includable in the beneficiary's income under Sec. 104(13) even though he receives it as trust law capital? The Exchequer Court in *Cooper v. M.N.R.* cited found that a **pure income** beneficiary was to include depreciation funds received from the trust but only on the reasoning in *Brodie v. C.I.R.* while *Ida Brown v. M.N.R.* is too weak a Canadian case to place reliance on. The moment the trustees take a depreciation charge, or deduct any trust law deductible though tax undeductible expenses from the trust's trust law income will result in the change of the character of the funds from that of trust law income to trust law capital however Sec. 104(24)-(13) is targeted at distributions of Division B income **regardless** of the form in which it is paid to the beneficiary.¹⁸⁴⁶ In the author's opinion, it **may be** that unless **tax** deductions are taken to reduce the trust's Division B income, it will be includable in the recipient beneficiary's income under Sec. 104(13), regardless of the nature of his interest in it, **if it is paid in the current year in which it is recognized by the trust**. If it is "tax capitalized" through mere retention, (in the absence of a beneficiary's right to enforce its current distribution), it can be distributed as capital subsequently, and will thus be taxed in the trust's hands. It should be understood that this result occurs **only due to the wording of Sec. 104(13)-(24) and not any other provision in the Act**. The fact that the beneficiary is recognizing a receipt as trust law capital and not income may be irrelevant in light of the wording of Sec. 104(13)(a). Of course whether the trust pays the amount as income may be of concern however even if the trust distributes the shadow Division B income **as trust law capital** it may still **in substance** be distributing tax law income unless it takes a tax deduction to alter it to tax law capital, thus avoiding the Sec. 104(13)(a) targeting. Of course, if the accounting depreciation is capitalized so as to reduce the amount of trust law and tax law income payable the income beneficiary can recognize less of a Sec. 104(13) inclusion and when the Division B income is taxed in the trust's hands it can be distributed in the following period as trust and tax law capital.¹⁸⁴⁷

The critical question is whether the accounting depreciation alters the tax character of the receipt flowing through to the beneficiary. *Postlethwaite v. C.I.R.*¹⁸⁴⁸ concerned an issue underlying this phenomenon when at issue was the source of payments made in respect of an annuity to be paid from capital of the trust. In the particular period the accumulating income (cash) of the trust was approximately equal to the amount of the annuity payments and the annuity payments were not made until the cash had actually been received so as to inflate the trust's liquid float. All of its capital was tied up in investments during the year thus it had to draw on the cash income to make the payment. The source of the payments of "capital" constituted current tax income and **notwithstanding** that the trust paid tax upon it it also was assessable in the beneficiary's hands as taxable income when received.¹⁸⁴⁹ It is doubted that the Minister of National Revenue will pursue double taxation of income in an instance similar to the case though Sec. 104(13) operates to perhaps allow her to.

¹⁸⁴⁶ This isn't the case with trusts that were not resident in Canada throughout their tax year.

¹⁸⁴⁷ All one is doing in this case is altering who recognizes the Division B income.

¹⁸⁴⁸ 1963 41 T.C. 224

¹⁸⁴⁹ The case also provides jurisprudence to the effect that the taxing authorities have no authority over which accounts the trustees may draw use to satisfy an annuity and that if the power is wide enough the trustees can draw on any account be it capital or income to satisfy the most tax effectively.

Foreign Trust Distributions.

There may be substantial economic or legal (not to mention tax), reasons for setting up a trust in another country and while sections 94 and 94.1 concerning trusts not resident in Canada and "offshore investment funds" may preclude a creation or existence of a trust in the foreign country from being tax "efficient" due to the arbitrary tax liabilities imposed upon the resident beneficiary this isn't always the case. A question that is most relevant in respect of this chapter and that situation concerns whether one jurisdiction's legal concepts of trust "income" and "capital" as well as "rights to" or "interests therein" held by the beneficiaries carry through and are applied by and accepted as valid principles upon which the domestic legal and tax structure can stand. One country's approach to the nature of the beneficiary's "interest" in the trust, both in the trust law and tax law sense, need not be identical to another's.¹⁸⁵⁰

Such a question of a conflict in laws arose in *Lord Inchyra v. Jennings*¹⁸⁵¹ wherein a trust was created and settled in the District of Columbia (U.S.A.) whereunder a British resident was to receive one quarter of the "income" of the trust; the prevailing trust law in D.C. recognized, for tax purposes, that such an entitlement was to "capital" and thus would not be subject to domestic tax, when its substance was paid to her when she was resident, thus, under the jurisdiction of that law. The Commissioners of Inland Revenue assessed the British resident beneficiary for "income" received via a distribution under the trust agreement and she appealed.

Pennycuik, J. speaking for the Chancery Division provided that:

"It is established beyond doubt that the nature of the taxpayer's right to a foreign possession, or income from a foreign possession, **must be determined in accordance with the law of the foreign country concerned**; see *Garland v. Archer - Shee*, 15 T.C. 693, and *Rae v. Lazard Investment Co. Ltd.*, 41 T.C. 1. So here there is no dispute that the nature of Lady Inchyra's interest under the will of Mrs. Van Swinderen (settlor) must be determined in accordance with the law of the District of Columbia."

Upon examination of the will and codicil it was evident that the beneficiary had an income interest under U.K. law and:

"It is at the next sage that Counsel part company with Mr. Miller, for Lord Inchyra, contends that one must ascertain in accordance with the law of the District of Columbia, not only the nature of Lady Inchyra's interest but also the quality of the receipts in her hands as capital or income... The supplemental case makes it clear that for these purposes the annual payments under the codicil are treated as capital under the law of the District of Columbia. **So, upon this argument, the character of the annual payments in the hands of Lady Inchyra as capital or income for the purpose of United Kingdom tax is conclusively determined by the law of the District of Columbia, in effect its fiscal law and law relating to the trust accounts and trustees' commissions.**

Mr. Beattie, for the Crown, contends that, having ascertained the nature of Lady Inchyra's interest under the law of the District of Columbia, one **must determine the character of her receipts as capital or income in accordance with the law in England.** In support of that contention he cited *Associated Insulation Products Ltd. v. Golder*, 26 T.C. 231, and, in particular, express statements by Macnaghten, J., at page 237 and Uthwatt, J., sitting in the Court of Appeal, at page 240. I will read the latter:

"The question whether the asset received is income within the meaning of a particular Federal Taxing Act (U.S.) is irrelevant for the purposes of any point before the Court, **and the opinion of the Federal (U.S.) fiscal authorities upon the transaction is, in an English Court, of no value in law.**"

Quite apart from the authority, I should have thought it clearly right in principle to say that **an English Court**, having ascertained the nature of the taxpayer's interest under the foreign transaction or disposition, must determine its character as capital or income in accordance with the law of

¹⁸⁵⁰ The *Baker v. Archer-Shee* - *Archer-Shee v. Garland* cases illustrate this.
¹⁸⁵¹ 42 T.C. 388,

England. The question of capital or income for the purposes of United Kingdom tax is eminently one to be determined in this country in accordance with the law in this country."

As part of the concluding comment, Judge Pennycuick provided:

"I can find nothing in the speeches to suggest that wherever a payment is made under a foreign transaction of disposition, the English Court, having ascertained the nature of the disposition under the local (foreign), law, must go on to look to the local (same) law to determine whether the payment is capital or income in the hands of the recipient for the purpose of English tax. On the contrary, there is more than one passage in the judgments and speeches which explicitly recognizes the contrary; see, in particular, per Lord Pearce at page 31:

"The question whether a receipt is "income arising from possessions out of the United Kingdom" is a question to be decided according to the "law of England," (see *Cammie & Henry Dreyfus Foundation Inc. v. I.R.C.*, 1956 A.C. 39 at page 44). But it cannot be decided in vacuo. The **factual situation** (which includes the foreign law) has to be examined in order to apply the English law."

Pennycuick, J. went on to find that, since the law allowed for, as expressly provided in *Brodie*, the distribution of capital to be treated as income in the hands of the recipient, deemed "capital" distributions **for the purposes of D.C. law** were considerable as income distributions for the purpose of applying the English taxing statute, in that the recipient's right to trust property was a right to, what was in substance, trust income.

This precedent found considerable acceptance in *Lawson v. I.T.*¹⁸⁵² where a Californian resident trust received capitalized stock dividends. The U.K. resident life tenant was entitled to all of the benefits from the shares under **Californian** law. The Crown assessed the life tenant as being entitled to the sum as income, as per the reasoning in *Brodie*, but the U.K. court found otherwise and held that the amount was received **as capital** since the shares had been substantiated with the capitalized earnings. Californian trust law granted the life tenant a right to the shares and these shares **for U.K. trust law purposes** were capital and thus the right the life tenant had for U.K. tax purposes included a right to trust capital and thus the receipt wasn't income in her hands.¹⁸⁵³

Where the trust was not resident in Canada throughout its taxation year "all amounts that become payable in the year" by the trust to the beneficiary will be included in the beneficiary's income as Division B income under Sec. 104(13)(c), however, not where they are "as proceeds of disposition of the beneficiary's interest as part thereof, or (ii) an amount paid as a distribution of capital by a personal trust." The amendment made to the provision in the 1988 reform was clearly targeted at instances that have the character as that described in *Lady Inchyra*¹⁸⁵⁴ however, this by no means is to insinuate that the provision is "all-encompassing" for it does suffer from at least two weaknesses caused by the listed exceptions. Proceeds of disposition received from the trust in respect of the disposition of any part of the beneficiary's interest will not be included and thus distribution proceeds from the extinguishment of the right may gain or suffer non-taxable or taxable consequences depending on the nature of the trust and the manner section 106 **and/or** 107 apply. Subsection 104(13)(c) does not specify the nature of the interest that might cause the proceeds or receipt to be realized, hence, both "capital" and "income interests" as defined in Sec. 108(1)(c) and (e) may be captured and treated. Only amounts paid as "capital" from a personal trust will be exempted and realizing that a "personal trust" by no means must be resident one can conclude that the nature of the receipt is critical and thus the *Lady Inchyra* principles may be called upon if the conditions warrant it.¹⁸⁵⁵

¹⁸⁵² 1970 1 All E.R. 761 (ChD)

¹⁸⁵³ See also *Archer-Shee v. Garland*, 1931 A.C. 212, for relevance of law of trust determining domestic treatment of interest. See also *In re: Latham*, 1961 Ch. 616.

¹⁸⁵⁴ what are in substance "income" distributions from foreign jurisdictions that are treated in **that** jurisdiction as capital

¹⁸⁵⁵ The reader should recognize, with its proper importance, that the provision reads "an amount **paid** as a distribution of capital **by** a personal trust" and not "an amount **received** as a distribution of capital **from** a personal trust," the consequences being that only those amounts paid that were in substance the **capital of the trust**, (being mutually exclusive from its current income), will be exempted. Is the capital referred to that of a trust nature or tax capital? It would seem that since a personal trust is referred to it would satisfy the conditions if it was merely trust law capital, though, as per *Lady Inchyra*, measured in the Canadian context. Depreciation reserves can be systematically collected and distributed as a means of going around the rules.

The timing of the recognition of the economic receipt from the trust and the current status of an existing right under the trust are of paramount value in coordinating tax efficient strategies. In *No. 109 v. M.N.R.*¹⁸⁵⁶ the beneficiary was entitled to revenue of the estate for life and obtain a right to capital only when she became a widow. The beneficiary was to receive as income, as spelt out in the will, certain interest earned on certain mortgages which had fallen very badly in arrears and upon the sale of different estate property a surrogate Court Judge ordered that a portion of the proceeds were to be apportioned as revenue to her as income from the estate. The Minister assessed her as having received income from the estate and she objected on the grounds that the payment was received as capital, however, she received it while still being a married woman thus owning only a contingent right to the capital. At the Income Tax Appeal Board hearing, *W.S. Fisher Q.C.* concluded upon the substance reasoned in *Brodie and Lindus & Hortin* which resulted in the closing comment:

"...where it was held that beneficiaries who are entitled to income from an estate or trust are taxable on the full amounts received by them, even although the trustees may be forced or called upon the resort to taking amounts out of the capital of the trust in order to make up the income payments I think the legal principle established by those cases are applicable in the present instance. While there are provisions in our Income Tax Act for relief from income tax in respect of annuitants, who are entitled to claim that part of their annuity as a return of capital, I have been referred to no such provision in the Canadian income tax legislation which covers the position of a **purely income beneficiary** of an estate."

If the beneficiary above had been a widow at the time the court order, (possibly regardless of the time of sale), was obtained there would not have been any question as to the nature of the rights she would have had and she would have been able to receive the distribution as capital.¹⁸⁵⁷ Care should be taken to recognize that this does not apply where the distribution was made "in satisfaction" of any contingent right, (which she effectively had), in that in the above case her contingent capital right was not being extinguished or impaired in the least. One wonders whether her counsel could have been successful if he would have argued that the disposition of the property and the distribution of the proceeds had in effect, reduced the scope of her **contingent** right under the trust, thus, in effect being a distribution in satisfaction of her capital right which had, in effect, been "disposed of." A contingent right to a **stated absolute** amount could be argued to have been partially "disposed of," as per the Sec. 54(c)(ii)(B), where the underlying amount is reduced since in effect a portion of the right is being canceled, being that the holder cannot enforce it against an equally large amount.¹⁸⁵⁸

The entire case brings into question the timing of the enforceability of the rights to be held by the beneficiary which has been a topic largely excluded from public discussion in Canada. If the trust deed is drawn up so that a particular taxpayer is granted a right to receive income in one year and then gains another right to capital every second year then the timing of the nature of the distributions of either income or capital may be coordinated so as to cause the minimal of tax consequences to both parties. Given that a capital gain realized by the trust can be designated as having been recognized by only a beneficiary who, as per the conditions and the trust deed, could reasonably be considered to qualify as a capital beneficiary, a substantial amount of flexibility can be obtained by ensuring that on a regular basis otherwise purely income beneficiaries are also capital beneficiaries. An equally powerful trust characteristic is the discretionary power instilled in a

¹⁸⁵⁶ 53 D.T.C. 249

¹⁸⁵⁷ A distinction must be pointed out between distributions in respect of contingent rights to capital and advances in respect of such rights, and drawings on capital to make up income. Distributions in respect of contingent interests gain Sec. 107(2) treatment, advances are treated by Sec. 53(2)(h)-105(1), and application in respect of pure income rights without the income beneficiary obtaining any right to capital under Sec. 105(1). It is questionable whether an income beneficiary doesn't obtain a capital interest immediately extinguishable upon the exercise of a discretionary power exercised to supplement deficient income while if the trust doesn't create a discretionary power but instead provides that capital will be distributed a contingent right exists. In the present context under the ITA, unlike the former Acts, only taxable income recognized by a trust can generally flow through to a beneficiary: there are peripheral instances where this norm is not followed and the above case focuses on the character of rights held since such concludes the result under the present Act.

¹⁸⁵⁸ This **could** apply even if the court order expressed that the payment was to be made in respect of the impairment of her income right.

trustee, etc., which allows him, through its exercise, to alternate the beneficiaries who are to recognize taxable income in any given year by alternating the ownership of the beneficial title to the income.

In *Morant Settlement v. C.I.R.*¹⁸⁵⁹ the settlor created a trust with £100,000 for the benefit of himself and his dependents whereby the £100,000 was to be invested and he was to receive a minimal net income of £6,500 annually while if in any particular year investment income was insufficient, the trustees had the power to draw on capital to fulfill the minimal amount. The settlor did not retain an absolute right to the capital and the trustees could not invest it without his consent, (hence, he could clearly have fallen under the Sec. 75(2) provision). However, the Commissioner assessed the settlor for the deficiencies paid out of capital as income and he contended that since the capital "belonged" to him, any distribution of capital was just that, and not a distribution of "income" in his hands. He relied heavily upon the reasoning in *Brodie*, being that he had both a right to income and what was **to the trust, capital**, and thus he contended that he had the flexibility to label the receipt as having one or the other character, the key obviously being his ill-perceived right to capital. Unfortunately, he qualified his income right as having a minimum annual distribution amount. Cohen, J. provided in respect of the nature of the trust interests:

"The question is one of considerable difficulty but, we have to come to the conclusion that the argument presented by Mr. Stamp and Mr. Hillis must prevail. In the cases on which Mr. Donovan relied, (for the settlor), the quality of the interest retained by the settlor was not in issue. We think that it is always open to the settlor to determine the nature of the interest he retains, **but that in order to see what that nature is the Court must look at the settlement.** We do not doubt that the document could have been framed so as to reserve to the settlor an interest in the capital. Equally, the settlor could have directed the application of part of the capital in the purchase from a third party of an annuity for the settlor. Had he done so the annuity would have been taxable as income in his hands. It seems to us that in the case before us he has directed the trustees to pay him an annuity primarily out of income, but, if and so far as the income is insufficient for the purpose, out of capital unless he directs otherwise. We are unable, therefore, to avoid the conclusion that the settlor has chosen to attach an income quality to the payments under consideration and must abide by the consequences."

Thus, once again, where a right to a specific amount was described as being received as income by the recipient under the trust deed, regardless of the source from which the amount comes, it was held that it can only be recognized as "income" to that party. One wonders if rather than using the phrase to describe the benefit "shall receive as income an annuity payable out of trust income with special drawing privileges on capital" one instead used "shall receive annual payments equal to £6,500 out of the capital and the income of the trust" whether the case would have been decided in the same fashion. Obviously, since the settlor referred to his benefits, under the trust deed, as income, he could only receive it as such.¹⁸⁶⁰

¹⁸⁵⁹ 30 T.C. 147

¹⁸⁶⁰ The description of the right may mean nothing to avoid the taxation of a distribution if that distribution is Division B income of the trust but in avoiding income inclusions on distributions of trust capital either by a resident or non-resident trust the source of the payment in trust law will have to be recognized.

Capital Distributions by Personal Trusts.

The trust agreement or will establishing the residuary estate has as one of its purposes the conveyance of the legal title to property¹⁸⁶¹, existing or to be realized, to the beneficiaries thereunder and as such the distribution of the legal title to the trust property to the beneficiaries in satisfaction of the rights granted to them under the trust agreement is an ultimate end of the agreement.

This is a surprisingly complicated and technical area of the ITA's treatment of trusts and should be studied in-depth before anything is transferred into and out of a trust.

The capital interest as defined in Sec. 108(1) in respect of personal trusts is a right of the taxpayer as a beneficiary under the trust to or to receive the capital of the trust and the right described arises out of the beneficial title which was acquired by the beneficiary as a gift from the settlor of the trust when it was constituted. The right referred to is obviously the right the beneficiary has to enforce the execution of the trust agreement whereby the legal title of the property held by the trustee will be transferred to him or for his benefit as per the trust agreement. Once the legal title of the property has been transferred to or for the beneficiary then the right is canceled since the trust agreement in respect of that right has been completely fulfilled.

Subparagraph 54(c)(iii) provides that except where described in paragraph (v) therein, a transfer of property of a trust to any beneficiary under the trust will be considered a disposition, however, under para. (v) any transfer of the property by virtue of which there is change in the **legal** ownership thereof without a change in **beneficial** ownership, other than a transfer by a trust resident in Canada to a trust not resident in Canada, will not be recognized as a disposition. The subparagraph opens with "except as expressly otherwise provided," hence, in order for a disposition to be recognized when property is transferred to a beneficiary by a trust without a change in beneficial ownership it must be expressly provided for in some other provision in the Act.

Under section 107 where property of a trust is distributed by the trust to a beneficiary under the trust in satisfaction of all or any part of his capital interest in the trust, the trust will be deemed to have recognized a disposition of that property for certain proceeds while the beneficiary will be deemed to have disposed of the interest satisfied for a certain amount. Upon a preliminary review of these distribution provisions it should be recognized that they apply only where all or part of the capital interest **is satisfied** and thus they do not apply simply because the trust has distributed legal title of the property to the beneficiary via an advance.

A "capital interest" is a right to or to receive a certain amount from the trust and it represents a legally enforceable claim that could be upheld by the courts, however, the right arises from the holding of a beneficial interest in the property, the legal title of which is held in trust. A beneficial title may encompass any number of rights to or to receive various properties, however, when the legal title to any one of those properties is distributed to the beneficiary some part of his beneficial right will be extinguished (his right will be satisfied) and consequently some part of his capital interest may be satisfied. As the property of the trust grows; appreciates in value or increases in quantity, so too does the scope of the capital interest granted to the beneficiary in the form of the beneficial title to the property and to economic returns.¹⁸⁶²

Subsection 107(2) provides that where property of a personal or prescribed trust has been distributed by the trust **to** a taxpayer who was a beneficiary under the trust in satisfaction of all or any part of his capital interest in the trust certain dispositions will be recognized with various tax consequences.

The provision does not apply to instances where the property was transferred to another person directly from the trust in satisfaction of the trust beneficiary's obligation to pay an amount to the person, even when the beneficiary's interest is satisfied. In order for the section 107 provision to apply, the beneficiary must directly realize the legal title of the property from the trust.¹⁸⁶³ In some cases it's beneficial to do so, in some cases it's not.

¹⁸⁶¹ or providing benefits therefrom

¹⁸⁶² In *Lord Chichester v. Coventry*, 1867 L.R. 2 H.L. 71, Lord Romilly defined satisfaction as "the donation of a thing with the intention that it is to be taken either wholly or in part in extinguishment of some prior claim of the donee."

¹⁸⁶³ This significantly limits the type of tax free distribution a trust can make. See also Australian tax Case #116, (1941), 10 C.T.B.R. 342.

"Distribution by personal trust – Sec. 107(2)"

(2) Subject to subsections (2.001), (2.002) and (4) to (5), if at any time a property of a personal trust or a prescribed trust is distributed (otherwise than as a SIFT trust wind-up event) by the trust to a taxpayer who was a beneficiary under the trust and there is a resulting disposition of all or any part of the taxpayer's capital interest in the trust,^{1864 1865}

1864 July 2010 FINANCE TECHNICAL NOTES (Part 1 - technical): Subsection 107(2) applies where a personal trust or a prescribed trust described in section 4800.1 of the Regulations distributes property to a beneficiary and there is a resulting disposition of part or all of the beneficiary's capital interest in the trust. Under paragraph 107(2)(a), the trust is deemed to have disposed of the property for proceeds of disposition equal to the property's cost amount. Under paragraph 107(2)(b), the property is deemed to have been acquired by the beneficiary for an amount equal to the total of the amount described in paragraph 107(2)(a) and a "bump" equal to the specified percentage of any excess of the adjusted cost base to the beneficiary of the capital interest over its cost amount (as defined by subsection 108(1)) to the beneficiary of the interest. Under subparagraph 107(2)(b.1)(iii), the specified percentage for property (other than non-depreciable capital property and eligible capital property) is 75%. Where subsection 107(2) applies, paragraph 107(2)(c) provides that the beneficiary is deemed to have disposed of all or part, as the case may be, of the capital interest for proceeds equal to the amount determined under that paragraph.

Feb. 2009 FINANCE TECHNICAL NOTES (budgets/technical): Subsection 107(2) applies where a personal trust or a prescribed trust described in section 4800.1 of the Regulations distributes property to a beneficiary and there is a resulting disposition of part or all of the beneficiary's capital interest in the trust.

Subsection 107(2) is amended in conjunction with a series of other amendments intended to provide for the income tax effects on a reorganization into corporate form of a SIFT wind-up entity. The subsection is amended so that it does not apply to a distribution that is a SIFT trust wind-up event.

March 2001 FINANCE TECHNICAL NOTES: Subsection 107(2) applies where a personal trust or a trust described in section 4800.1 of the Income Tax Regulations distributes property to a beneficiary in satisfaction of all or part of the beneficiary's capital interest in the trust. Under paragraphs 107(2)(a) and (b), the trust is deemed to have disposed of the property for proceeds of disposition equal to the property's cost amount and the property is deemed to have been acquired by the beneficiary for the same amount plus a "bump" equal to the specified percentage of any excess of the adjusted cost base to the beneficiary of the capital interest over its "cost amount" (as defined by subsection 108(1)) to the beneficiary of the interest. Under paragraph 107(2)(c), the beneficiary is deemed to have disposed of the capital interest for proceeds equal to the deemed acquisition cost (determined as if the specified percentage referred to above were 100%) less a reduction equal to the amount of debt assumed by the beneficiary that is conditional upon the distribution of the property. Under subsection 107(), the specified percentage is 100% in the case of non-depreciable capital property (e.g., land and shares) and 50% in any other case.

May 1991 FINANCE TECHNICAL NOTES: Subsection 107(2) provides a rollover on the distribution of property from a personal or prescribed trust to a beneficiary in satisfaction of all or part of the beneficiary's capital interest in such a trust. Thus; where trust property is distributed to a beneficiary in these circumstances, the trust is generally not taxable on the distribution. In addition, the beneficiary is generally deemed to have acquired the property at its cost amount (as defined in subsection 248(1)). The cost at which the beneficiary acquires the property is generally increased to the extent of any excess of the adjusted cost base of the beneficiary's former capital interest in the trust over the cost amount (as defined in paragraph 108(1)(d)) to the beneficiary of such interest. The beneficiary is deemed to have received proceeds of disposition for the trust interest equal to that cost.

Aug. 19, 1988 FINANCE TECHNICAL NOTES (Commons Finance Committee): The Minister of Finance released draft legislation on trusts and their beneficiaries on October 1, 1987. One of the measures in the draft legislation, which is contained in Clause 75, will discontinue after 1987 the tax-free rollover of property from a commercial trust to its capital beneficiaries.

In consultations after, the October, 1 1987 release, it was brought to the attention of the Department of Finance that the proposed new rules would have a serious negative impact on the value of certain publicly traded units in a trust. The particular trust arrangement will terminate shortly before the end of 1990. It was agreed that the proposed measure not apply until the end of 1990 for a trust in such circumstances. The above amendments extend the grandfathering for the proposed measure until the end of 1990 so that the measure will not apply for a trust in those circumstances.

1988 FINANCE TECHNICAL NOTES: Subsection 107(2) is amended to limit its application to personal trusts (as defined in subsection 248(1), and prescribed trusts. The corresponding rules for distributions by other, trusts are set out in new subsection 107(2.1). It is contemplated that a trust maintained principally to secure a debt owing by a beneficiary, to consolidate voting rights for shares of which the trust is the registered owner or to provide an intermediary, through which to hold shares in the capital stock of an employer for the benefit of employees will be a prescribed trust for the purposes of subsection 107(2).

See also under 108(1)"cost amount".

1865 March 2001 FINANCE TECHNICAL NOTES: Subsection 107(2) is amended to clarify that it applies in connection with distributions in respect of a capital interest in a personal or prescribed trust only if the distribution results in disposition of all or part of the capital interest. Where the distribution does not constitute a disposition of a capital interest in a trust

(a) the trust shall be deemed to have disposed of the property for proceeds of disposition equal to its cost amount to the trust immediately before that time;

(b) subject to subsection (2.2), the taxpayer is deemed to have acquired the property at a cost equal to the total of its cost amount to the trust immediately before that time and the specified percentage of the amount, if any, by which

(i) the adjusted cost base to the taxpayer of the capital interest or part of it, as the case may be, immediately before that time (determined without reference to paragraph (1)(a)) exceeds

(ii) the cost amount to the taxpayer of the capital interest or part of it, as the case may be, immediately before that time;¹⁸⁶⁶

(b.1) for the purpose of paragraph (b), the specified percentage is,

(i) where the property is capital property (other than depreciable property), 100%,

(ii) where the property is eligible capital property in respect of a business of the trust, 100%, and

(iii) in any other case, 75%;

(c) the taxpayer is deemed to have disposed of all or part, as the case may be, of the capital interest for proceeds equal to the amount, if any, by which

(i) the cost at which the taxpayer would be deemed by paragraph (b) to have acquired the property if the specified percentage referred to in that paragraph were 100% exceeds

(ii) the total of all amounts each of which is an eligible offset at that time of the taxpayer

because of new paragraph (i) of the definition "disposition" in subsection 248(1), the rules in amended subsection 107(2.1) apply.

Subsection 107(2) is amended so that it is expressly subject to amended subsections 107(4) to (5). This amendment is made for technical

clarity and does not represent any change in policy. Amended subsections 107(4) to (5) describe trust distributions to which subsection 107(2.1) is to apply.

Subsection 107(2) is also amended so that it is subject to new subsections 107(2.001) and (2.002).

1866 Dec. 1997 FINANCE TECHNICAL NOTES (technical): Paragraph 107(2)(b) is amended to permit an additional amount determined under new subsection 107(2.2) to be included in the cost of property distributed to a beneficiary of a trust described in paragraph (h), (i) or (j) of the definition "flow-through entity" in subsection 39.1(1) in satisfaction of all or a portion of the beneficiary's interest in the trust. A trust described in paragraph (h), (i) or (j) of the definition "flow-through entity" in subsection 39.1(1) is also a prescribed trust under section 4800.1 of the Income Tax Regulations for the purpose of subsection 107(2).

in respect of the capital interest or the part of it; ¹⁸⁶⁷ ¹⁸⁶⁸

(d) where the property so distributed was depreciable property of a prescribed class of the trust and the amount that was the capital cost to the trust of that property exceeds the cost at which the taxpayer is deemed by this section to have acquired the property, for the purposes of sections 13 and 20 and any regulations made under paragraph 20(1)(a)

(i) the capital cost to the taxpayer of the property shall be deemed to be the amount that was the capital cost of the property to the trust, and

(ii) the excess shall be deemed to have been allowed to the taxpayer in respect of the property under regulations made under paragraph 20(1)(a) in computing income for taxation years before the acquisition by the taxpayer of the property;

(d.1) [Repealed, 2010, c. 12, s. 10]¹⁸⁶⁹

¹⁸⁶⁷ July 2010 FINANCE TECHNICAL NOTES (Part 1 — technical): Paragraph 107(2)(c) is amended to clarify that it applies to determine a taxpayer's proceeds of disposition of the capital interest in a trust (or of the part of it) disposed of by the taxpayer on a distribution, to which subsection 107(2) applies, of property by the trust. This amendment applies to distributions, from a trust, made after 1999.

March 2001 FINANCE TECHNICAL NOTES: Paragraph 107(2)(c) is amended so that the reduction, because of debt assumed by the beneficiary, to a beneficiary's proceeds of disposition of the beneficiary's capital interest is now provided under the new definition "eligible offset" in subsection 108(1).

¹⁸⁶⁸ July 2010 FINANCE TECHNICAL NOTES (Part 1 -- technical): Subparagraph 107(2)(b.1)(iii) is amended to replace the reference to 75% with a reference to 50%, consistent with the current capital gains inclusion rate. This amendment applies to distributions, from a trust, made after December 20, 2002.

March 2001 FINANCE TECHNICAL NOTES: Paragraph 107(2)(13.1) is introduced (in conjunction with consequential amendments to paragraphs 107(2)(b) and (c) and the repeal of subsection 107(3)) so that the specified percentages referred to above are explicitly provided under subsection 107(2). This amendment is intended to clarify the operation of subsection 107(2). In addition, the specified percentage for property (other than non- depreciable capital property and eligible capital property) is being increased from 50% to 75%. The specified percentage for eligible capital property is increased from 50% to 100% in recognition that only a maximum of 75% of the cost of eligible capital property can ultimately be deducted for income tax purposes. This amendment is intended to reduce the differential in the tax treatment of depreciable and non- depreciable property in this context, so that this differential corresponds more closely to that which prevailed before the increase in the capital gains inclusion rate from 50% to 75%.

¹⁸⁶⁹ April 2010 FINANCE TECHNICAL NOTES (budget): Subsection 107(2) applies where a personal trust or a prescribed trust described in section 4800.1 of the Income Tax Regulations distributes property to a beneficiary and there is a resulting disposition of all or part of the beneficiary's capital interest in the trust.

Paragraph 107(2)(d.1) determines the tax consequences of the disposition of taxable Canadian property ("TCP") by a trust to a non resident beneficiary before October 2, 1996. In the event that the property was deemed to have been TCP under a number of specified provisions of the Act, paragraph 107(2)(d.1) ensures that it continues to be TCP for the beneficiary. First amendment

Subparagraph 107(2)(d.1)(iii) is amended by adding to the list of specified provisions, that deem property to be TCP, a reference to subsection 85.1(5).

This amendment applies in determining after October 1, 1996 whether a property is TCP of a taxpayer. Second amendment Consistent with the addition of 60 month sunset clauses to the other provisions of the Act that deem various exchanged properties to be TCP of a taxpayer, and given that paragraph 107(2)(d.1) applies only to distributions before October 2, 1996, that paragraph is being repealed.

The repeal of paragraph 107(2)(d.1) applies in determining after March 4, 2010 whether a property is TCP of a taxpayer.

2010 FINANCE NOTICE OF WAYS AND MEANS MOTION: See under 85(1)(i)

March 2001 FINANCE TECHNICAL NOTES: Paragraph 107(2)(d.1) is amended to clarify the tax consequences of the disposition of taxable Canadian property by a trust to non-resident beneficiaries before October 2, 1996. In the event that the property was explicitly deemed to have been taxable Canadian property under a number of specified provisions of the Act, paragraph 107(2)(d.1) ensures that it continues to be taxable Canadian Property of the beneficiary. This amendment applies in determining after October 1, 1996 whether property is taxable Canadian property.

(e) [Repealed, 1994, c. 7, Sch. VIII, s. 43(1)]¹⁸⁷⁰

(f) where the property so distributed was eligible capital property of the trust in respect of a business of the trust,

(i) where the eligible capital expenditure of the trust in respect of the property exceeds the cost at which the taxpayer is deemed by this subsection to have acquired the property, for the purposes of sections 14, 20 and 24,

(A) the eligible capital expenditure of the taxpayer in respect of the property shall be deemed to be the amount that was the eligible capital expenditure of the trust in respect of the property, and

(B) 3/4 of the excess shall be deemed to have been allowed under paragraph 20(1)(b) to the taxpayer in respect of the property in computing income for taxation years ending

(I) before the acquisition by the taxpayer of the property, and

(II) after the adjustment time of the taxpayer in respect of the business, and

(ii) for the purpose of determining after that time the amount required by paragraph 14(1)(b) to be included in computing the taxpayer's income in respect of any subsequent disposition of property of the business, there shall be added to the value otherwise determined for Q in the definition "cumulative eligible capital" in subsection 14(5) the amount determined by the formula

A × B/C where

1870 June 1992 FINANCE TECHNICAL NOTES. Subsection 107(2) provides a tax-deferred transfer or rollover on the distribution of property from a personal or prescribed trust to a beneficiary in satisfaction of all or part of the beneficiary's capital interest in the trust. Paragraph 107(2)(e) permits eligible capital property of such a trust to be transferred from the trust to a beneficiary for proceeds of disposition equal to 4/3 of its cost amount. The repeal of paragraph 107(2)(e), and its replacement by new paragraph 107(2)(f), is intended to take into account, where the transfer occurs after 1987, the change in inclusion rates for eligible capital property from one half to three quarters in respect of fiscal periods commencing after that time. The repeal of paragraph 107(2)(e) is also consequential on the amendment to the definition "cost amount" in respect of eligible capital property in subsection 248(1).

May 1991 FINANCE TECHNICAL NOTES: Paragraph 107(2)(e) is introduced to permit eligible capital property of a personal or prescribed trust to be transferred from the trust to a beneficiary under subsection 107(2) for proceeds of disposition equal to 4/3 of its cost amount. Paragraph 107(2)(e) also provides, in conjunction with subsection 107(3), that the same grossed-up amount, plus one-half of any increase, referred to in the previous paragraph, would be considered the cost of the property to the beneficiary. In addition, the beneficiary's interest in the trust would be considered to have been disposed of for, that grossed-up amount plus the entire amount of any such increase.

This amendment is appropriate because only 3/4 of the proceeds with respect to the distribution of an eligible capital property by a trust [is] deducted in computing the cumulative eligible capital of the trust under paragraph 14(5)(a). Similarly, only 3/4 of the beneficiary's cost of the eligible capital property is included in computing the beneficiary's cumulative eligible capital. In order not to allow a trust to claim an inappropriate deduction under paragraph 20(1)(b) or section 24 after the transfer of eligible capital property to a beneficiary, the proceeds from the disposition of such property for a trust are grossed-up by 1/3, so that the trust would have a nil balance of cumulative eligible capital in the event that it transfers all of its eligible capital property to beneficiaries.

Paragraph 107(2)(e) also provides that an eligible capital property transferred under the provision maintains its Lax characteristics after its transfer to a beneficiary. Thus, where the eligible capital expenditure of the trust in respect of such property exceeds the cost at which the trust's beneficiary is deemed to acquire the property, 3/4 of such excess is deemed to have been allowed as a deduction to such beneficiary under paragraph 20(1)(b). The purpose of this measure is to ensure that a beneficiary will not be entitled to claim a deduction under section 110.6 on a subsequent disposition of such property in respect of amounts, that would have been recaptured and included in the income of a trust under section 14 had the trust continued to hold the property until its disposition to a third party.

A is the amount, if any, determined for Q in that definition in respect of the business of the trust immediately before the distribution,

B is the fair market value of the property so distributed immediately before the distribution, and

C is the fair market value immediately before the distribution of all eligible capital property of the trust in respect of the business.¹⁸⁷¹

““eligible offset” – Sec. 108(1)”

“eligible offset” at any time of a taxpayer in respect of all or part of the taxpayer’s capital interest in a trust is the portion of any debt or obligation that is assumed by the taxpayer and that can reasonably be considered to be applicable to property distributed at that time in satisfaction of the interest or part of the interest, as the case may be, if the distribution is conditional upon the assumption by the taxpayer of the portion of the debt or obligation;¹⁸⁷²

“Fractional interests – Sec. 107.4(2.1)”

(2.1) For the purpose of applying paragraph (2)(a) in respect of a transfer by a transferor trust of property that includes a share and money, the other trust or trusts referred to in that paragraph may receive, in lieu of a transfer of a fractional interest in a share that would otherwise be required, a disproportionate amount of money or interest in the share (the value of which does not exceed the lesser of \$200 and the fair market value of the fractional interest).

“Cost of capital interest in a trust – Sec. 107(1.1)”

(1.1) The cost to a taxpayer of a capital interest of the taxpayer in a personal trust or a prescribed trust is deemed to be,

(a) where the taxpayer elected under subsection 110.6(19) in respect of the interest and the

1871 March 2001 FINANCE TECHNICAL NOTES: Paragraph 107(2)(f) is intended to prevent, where the property distributed by a trust is eligible capital property, an overstatement of the income inclusions under subparagraph 14(l)(a)(v) or paragraph 14(1)(b) on the subsequent disposition of eligible capital property by the beneficiary. Paragraph 107(2)(f) is amended consequential to the re-numbering of subsection 14(1), which is described in further detail in the commentary to that subsection.

Nov. 1994 FINANCE TECHNICAL NOTES Subsection 107(2) provides a tax deferral on certain capital distributions by a personal trust or a prescribed trust. Clause 107(2)(f)(ii)(B) is amended, consequential on the amendment to subparagraph 14(l)(a)(v), to ensure that there will not be an over-inclusion under that subparagraph (as a result of amounts having been deducted under paragraph 20(1)(b) in computing the trust's income from a business for fiscal periods that ended before the trust's adjustment time (within the meaning assigned by subsection 14(5)) in respect of the business.

June 1992 FINANCE TECHNICAL NOTES: New paragraph 107(2)(f) is also intended to prevent an overstatement of the deemed taxable capital gain under subparagraph 14(l)(a)(v), or of the amount to be included in computing income under paragraph 14(1)(b), on the subsequent disposition of eligible capital property by the beneficiary. Such an overstatement would occur because the calculation of the beneficiary's deemed taxable capital gain under subparagraph 14(1)(a)(v), or the amount to be included in income under paragraph 14(l)(b), would not include any amount relating to cumulative eligible capital amounts deducted by the trust under paragraph 20(1)(b) before the taxpayer's adjustment time (as defined in paragraph 14(5)(c)).

1872 March 2001 FINANCE TECHNICAL NOTES: Subsection 108(1) is amended to introduce the expression "eligible offset".

A taxpayer's "eligible offset" in respect of all or part of a taxpayer's capital interest in a trust reduces the taxpayer's proceeds of disposition arising from the satisfaction of all or part of that interest, in the event there is, a distribution to which amended subsection 107(2) or (2.1) applies. Where such a distribution was conditional upon the assumption by the taxpayer of a debt or obligation, the taxpayer's eligible offset at any time of in respect of that interest is the portion of the debt or obligation assumed by the taxpayer that can reasonably be considered to be applicable to the property distributed at that time in satisfaction of that interest.

For further detail of the effect of this amendment, see the notes on amendments to subsections 107(2) and (2.1).

trust does not elect under that subsection in respect of any property of the trust, the taxpayer's cost of the interest determined under paragraph 110.6(19)(a); and

(b) in any other case, nil, unless

(i) any part of the interest was acquired by the taxpayer from a person who was the beneficiary in respect of the interest immediately before that acquisition, or

(ii) the cost of any part of the interest would otherwise be determined not to be nil under section 48 as it read in its application before 1993 or under paragraph 111(4)(e) or 128.1(1)(c) or (4)(c).

Care should be exercised in ensuring that this provision is complied with exactly in order for CRA not to reassess (either as a sale of the interest or a Sec. 105(1) benefit) when funds are purportedly received from the trust: the trust must actually have the property that is being purportedly rolled out to the beneficiary. This was the issue in *Mai Tai (Matthew) Chan v. The Queen*¹⁸⁷³ where a concerned beneficiary commenced an action against his parent settlors of a trust and between the two of them arrived at a financial settlement, without actually touching the property in the trust. The taxpayer-beneficiary attempted to argue that he had received a roll-out of trust property in satisfaction of his capital interest though the Fed Appeal Court held:

"[1] This appeal concerns the issue of whether a payment in settlement of an interest in a trust is property distributed by the trust in satisfaction of the taxpayer's capital interest in the trust or a simple disposition of his capital interest in the trust. If it is the former it is subject to a rollover and is not taxable at the time of the distribution; if it is the latter, it is not subject to a rollover and is taxable at the time of the disposition.

...

[7] When the matter became before the Tax Court the key question had become whether the money paid to the Appellant was property of the trust which was "distributed" by the trust in satisfaction of the Appellant's interest.

[8] The Tax Court held that the payment to the Appellant was not a distribution of trust property to the Appellant because it was not an action taken by the trustee in response to his obligations under the trust. The Court held that the Deed of Release and Disclaimer was quite inconsistent with any sort of distribution of property of the trust. The Appellant's father had demanded and received consideration as provided in the form of the Deed of Release and Disclaimer. The deed eliminated any fiduciary duty owing by the father and the mother to the Appellant with respect to the ownership in the 3,500 shares which they had previously held in the trust. Thus the Tax Court Judge held that the transaction was a sale and therefore the payment was not subject to a rollover.

...

[14] We are of the view that after the execution of the Consent Order and the Release the Appellant was disentitled to the shares because he had disclaimed "all his beneficial rights, interest and entitlements" to them. The legal effect of this is that the father and the mother became the legal and beneficial owners of the 3,500 shares. Thus, the effect of the Consent Order and Release is the same as a sale.

[15] In order for Section 107(2) to apply, it is our view that it is necessary for the taxpayer to demonstrate that the property which was transferred to him was indeed property distributed out of the trust assets. While this could include cash, that cash must have been in the trust.

[16] There is no evidence that the cash came out of the trust nor is there evidence that indeed the trust had sufficient cash to pay that amount at the time it was paid. The onus is on the taxpayer to demonstrate that the cash which the Appellant received came from the trust itself, and this he has failed to do. Thus, there is no evidence that trust property was distributed to the Appellant so as to

allow him to invoke the provisions of Section 107 (2)".

Tax Free Dispositions by the Trust.

Under paragraph (a) when property is distributed the trust will be deemed to have disposed of it for proceeds equal to its cost amount to the trust immediately before the time. "Cost amount", defined in Sec. 248(1) for these purposes, when deemed realized by the trust, will result in the avoidance by the trust of any and all tax consequences relating to dispositions as capital gains and losses, recapture and terminal loss or income. This may prove particularly advantageous for the trust when the property has substantial accrued gains, however, where the property has accrued losses, obviously this will defer their recognition and thus in the latter case a **sale** may prove more beneficial. The proceeds, which would be paid by the otherwise entitled beneficiary will then become similarly subject to his beneficial title and would thus be distributable back out to him. He would hence receive the funds back but the loss would have been forced to be recognized by the trust.¹⁸⁷⁴

It would seem very possible to deduct against a Sec. 107(2) disposition by the estate/trust those expenses incurred to make the conveyance and these can be in both the direct form, those costs incurred by the estate to have the title registered in the beneficiary's name etc., as well as indirect form, such as those costs incurred generally to administer the estate to the point of allowing for distributions such as inventory establishment, valuation of interests and property, probate fees, etc.. Since these costs are incurred to make a distribution they would be deductible against the proceeds of disposition and given the tax free roll out mechanics they would produce capital losses for the estate/trust. If Finance doesn't wish to have this result they should correct their product: see the subchapter below.

Cost Integration.

Paragraph (b) of Sec. 107(2) provides the main thrust of the attempt to integrate the cost structures previously mentioned. The provision states that the taxpayer shall be deemed to have acquired the property distributed at a cost amount equal to the property's cost amount to the trust immediately before that time and the amount by which the ACB of the capital interest or part thereof extinguished exceeds the "cost amount" of that part of the capital interest to him. The trust's cost amount of the property will always become part of his cost.

The ACB of the interest, or part thereof, extinguished should be determined with respect to two principles one of which was previously mentioned being the ACB of a part of the interest may be directly dependent upon the consideration paid to acquire that particular part. Recalling from a previous chapter, a capital interest is a descriptive name given to any **number of an aggregation** of different rights arising out of the trust agreement. Since they may not be of similar nature they cannot be defined as identical property, (described under section 43), hence, any right may carry its own ACB if it was acquired separately. The ACB of the entire "capital interest" is equal to the sum of the adjusted cost bases of its individual rights while the ACB of any particular part is **not** determined as an average of the aggregate ACB. A distribution by a trust may serve to extinguish one of the unique clearly defined rights that a beneficiary holds and thus the ACB which will be utilized in the para. (b) provision will be the separately recorded ACB of that right. However, where only a part of the right is extinguished even under section 43, some sort of method must be used to determine the portion of the ACB to use. Section 43 recognizes that when part of a property is disposed of by a taxpayer, "the adjusted cost base to him, immediately before the disposition, of that part is such portion of the adjusted cost base to him at that time of the whole property as may reasonably be regarded as attributable to that part", however, in this case there is no explicitly described basis on which to base such attribution. Subsection 107(2) is the only provision which primarily operates to allow for an effective tax free distribution at the same time that it provides an integration of the tax cost structure of the interest and the property received. In fact,

¹⁸⁷⁴ This could prove slightly difficult to do when the beneficiary is the purchaser given that through Sec. 54(c)(iii) and (v) a transfer of property of a trust to a beneficiary where there has been a change in legal ownership without a change in beneficial **ownership** will not be recognized as a disposition, however, the critical aspect is that the provision refers to beneficial **ownership** as compared to beneficially interested.

there is not one instance where **the fair market value** of the property received or the interest extinguished is even brought into consideration under the provision, hence, the prorating of the ACB of the portion of the interest should be on a tax cost basis. Given that the beneficial title will be based upon property of the trust that should have a known tax cost it would seem fairly clear that the prorating factor should be obtained by dividing the tax cost of the property received (to the trust) by the tax cost of all of the trust property (to the trust) to which the right is enforceable in respect of, and thus the applicable ACB of the interest may be determined.¹⁸⁷⁵

The Cost Bump and Beneficiary's Proceeds of Disposition

It is only the excess of the adjusted cost base of the interest over its cost amount otherwise computed that will be added on to the tax cost¹⁸⁷⁶ of the property which will form, aggregated, the tax cost of the property to the taxpayer. The cost amount of a capital interest, where money or property of a trust has been distributed in satisfaction of the whole or part of the interest, will be the aggregate of money distributed and the tax costs of the property¹⁸⁷⁷ so distributed, hence, when the taxpayer has paid more for the capital interest extinguished in respect of the property than the tax cost of the property held in trust that will be subsequently distributed to him, he will be able to bump up the cost of the property received by the excess to preserve tax free integration.

Under paragraph (c), the beneficiary shall be deemed to have disposed of that part of the interest satisfied for proceeds equal to the cost at which he is deemed to have acquired the property, bumped up, less any eligible off-set. The larger the ACB of the interest in relation to the tax cost of the property the larger the bump up in the cost of the property received and resulting in the larger the deemed proceeds. However, it will not result in a larger possible capital gain once the Sec. 107(1) provision has been applied to the disposition of the interest. Since the interest is deemed disposed of, Sec. 107(1) will apply and under para. (a) therein the ACB of the capital interest, for capital gains computation purposes, will be equal to the greater of the ACB otherwise computed or the "cost amount".¹⁸⁷⁸

The "cost amount" of an interest when it is deemed disposed of through a distribution from the trust is the tax value of all of the trust's property net of any debt or obligation to pay that the trust need not be liable for, immediately before the distribution. The cost amount of the interest is thus reduced by the amount of debt the trust is liable for, although the beneficiary may never himself become liable for that debt.¹⁸⁷⁹

The Effect of Debt or Other Obligations Assumed.

Under Sec. 107(2)(c) the taxpayer is deemed to have disposed of his interest for proceeds that equal the tax cost of the property received to him, as determined under para. (b) therein, net of **any** eligible off-set debt assumed by him, (or **any** other obligation to pay). **The provision does not state that the debt assumed, or obligation to pay, must be that which the trust was immediately previously liable** for hence it will be possible to charge the distribution with an equitable charge/condition precedent requiring the recipient of the property to provide a benefit to another party. The recipient need not assume debt **of the trust** in order for it to reduce his deemed proceeds, however, if he does he will be **increasing** the cost amount of the remaining capital interests in that he will be reducing the trust debt which, as per the mechanics of Sec. 108(1)(d)(ii) translates directly. **Interestingly if debt isn't actually assumed but instead satisfied through payment while the trust remains liable for it there will not be any equitable treatment offered.**

The beneficiary's deemed proceeds will be reduced by the debt he assumes, that was formerly charged on the trust or otherwise created, however, if the deemed proceeds fall between the ACB of the interest computed as per the principles previously identified and its "cost amount", (which is computed as per Sec.

¹⁸⁷⁵ In the author's opinion, the fair market value of the underlying trust property should not be used as an apportioning basis since what is being attempted by Sec. 107(2) is cost to cost integration, not capital gains integration for purposes of capital gains/C.C.A., nor fair market value integration.

¹⁸⁷⁶ to the trust

¹⁸⁷⁷ to the trust

¹⁸⁷⁸ The closing paragraph of Sec. 107(1) provides certain disposition rules other than when Sec. 107(2) applies thus it cannot be argued that a Sec. 107(1) disposition isn't to be recognized on a commutation.

¹⁸⁷⁹ The provision is definitely quite arbitrary and can be subject to abuse.

108(1)(d)(ii)), he will not recognize any tax consequences. Effectively, he has been able, (upon the assumption of the debt formerly charged on the trust), to increase the other capital beneficiaries' potential to avoid the recognition of capital gains on the disposition (to third parties) of their interests since he has effectively increased their interests' cost amounts.

Perhaps even more valuable is the instance where the recipient of the distribution assumes so much debt or obligations to pay as to reduce the deemed proceeds of disposition of his interest to below its ACB otherwise computed which as per Sec. 107(1)(b) will translate, through the operation of subdivision C, into a capital loss immediately recognized by the distributee. Given that there appears to be no qualification placed on the type of debt assumed the above could be a particularly rewarding attainable transaction, especially when one realizes that by assuming so much debt of the trust, the cost amount of the remaining capital interests, (for purposes of dispositions to third parties), will be increased as well as (perhaps) their fair market value. One could thus realize capital losses upon a distribution and increase the potential to realize tax free capital gains for the remaining beneficiaries.¹⁸⁸⁰ It would appear that the debt or obligation to pay assumed need not exclusively be that chargeable against the estate/trust **previously**, while it could also be argued that obligations to pay amounts to beneficiaries are afforded treatment. Perhaps most importantly, the obligation to pay assumed for the purpose of acquiring the particular property may be deductible in computing income independently, should it be an income/inventorial property. If inventory/income property is distributed and such a distribution doesn't offend any income beneficiaries' entitlements the bump up in the cost due to excessive ACB will prove beneficial while a capital loss may still be recognized on a debt assumption.¹⁸⁸¹

In order to be eligible for Sec. 107(2) treatment the debt or obligation to pay assumed by the taxpayer must be as a condition upon the receipt of the distribution and thus the trust deed/will may expressly recognize this arrangement or the instrument may grant the power to force the assumption of debts in such a manner by the beneficiaries. The scheme of distribution as agreed upon by the beneficiaries regardless of that determinable from the trust deed is also a valid basis for this condition.

Where an equitable charge is placed upon the distribution whereby a third party will simply receive benefits such as cash, property, etc., without doing anything then that person **may** be required to recognize that payment in income under Sec. 105(1)¹⁸⁸² unless he isn't resident.¹⁸⁸³

Consequently it would not appear possible to cause a cascading of benefits between the immediate distributee and the third parties, when the former realizes the trust property but agrees to the imposition of a life interest of other equitable charge, without realizing **negative** tax consequences even though one has realized the positive one of recognizing the obligation to pay an amount and consequently the reduction in proceeds.¹⁸⁸⁴

The debt or obligation to pay must be assumed by the beneficiary **personally** and it must have that characteristic in his respect. Debt assumed by his personal holding corporation does not qualify and debt that he was previously **owed** will not remain "debt assumed by him" when it is canceled as a consequence of the

1880 The success of this would depend on the beneficiaries' abilities to inflate the a.c.b. of their interests without tax cost to any party, such as upon becoming resident or sale-reacquisition after increasing the trust's property content subject to a power of appointment.

1881 There isn't any requirement that the debt be assumed at any particular time: it could be before and after the distribution and if it is assumed well before the cost amounts of all of the capital interests are inflated via Sec. 108(1)(d); facilitating a tax reduced/eliminated disposition of any particular one of them until the property is rolled out.

1882 even when he has a "capital interest" in the trust since such a payment will not have been made by the trust; the Sec. 53(2)(h) requirement

1883 In a Technical Interpretation provided in Jan. 1981 by the Non-Corporate Rulings Division it was provided that a life interest does not constitute a debt or other obligation to pay an amount as described under Sec. 108(1)(d)(ii) and one would expect CRA to have the same opinion in respect of the Sec. 107(2)(c) description of the obligation to pay however in the author's opinion a life interest or equitable charge fully qualifies for such treatment.

1884 If the payment is to be made to a non-resident then the capital loss could be obtained tax free since Sec. 214(3) and 212(1)(c) does not apply to Sec. 105(1) benefits, while if it is not the capital loss could cause a full inclusion in income under Sec. 105(1) regardless of the amount of the mere capital loss if in fact any was created. Obviously where commercial debt is assumed Sec. 105(1) will not apply to its extinguishment while if the capital beneficiary assumes the obligation to pay an amount to a non-resident, on trust that the beneficiary's spouse has the power to appoint capital beneficiaries then an interesting arrangement could be created. Upon an exercise of the power granting an exhaustive capital interest to a Canadian resident, in the author's opinion, that beneficiary would not be captured by Sec. 105(1) but instead section 107 when the capital is distributed out to him.

distribution and will not cause tax consequences under Sec. 80(1) or 107(2)(c), although it will increase the cost amounts of other capital interests.

Perhaps the most surprising aspect about this debt/obligation is that it need not be satisfied within any particular period of time hence it may be possible to impose an equitable charge on the property distributed which will have to be extinguished 10-20 years **after** the date of the distribution, and thus until that time the taxpayer need not disburse benefits.¹⁸⁸⁵ The assumption of the debt and its subsequent extinguishment will require an expenditure of funds by the distributee, however, if the expenditure is to be made 10 years later its value at the time of the distribution will be significantly less. If at the time the debt becomes due, it is forgiven, then section 80 will operate on the 10 year previous dollar value. If the debt/obligation to pay is forgiven or settled for lesser amounts than its face value, Sec. 80(1) will operate to reduce first the taxpayer's non-capital and farm losses before it reduces his net capital losses that are being carried forward, unless the debt carried an interest charge and the interest paid was not deductible under Part I, (which it could be), or if the debt/obligation was settled/extinguished via a bequest or inheritance.¹⁸⁸⁶

The use of debt in testamentary trust/estate situations is of particular importance in two instances; planning for possibly tax free capital bequests in the case where a spousal trust is constituted as per the rules in Sec. 70(7) & (8), and where property is rolled out of the trust, spousal or otherwise. A capital loss can only be recognized by the beneficiary if his proceeds of disposition¹⁸⁸⁷ are less than the capital interest's legitimate ACB. If two beneficiaries buy capital interests in the trust, the interests will have legitimate ACB's, however, the disponent of those interests will quite likely realize capital gains of some amount based on the fair market value of the trust property. If the trust deed provides a power to the trustees that allow them to raise capital through mortgaging the trust property and appoint it to a third party then some devious transactions can occur. The funds raised through the mortgage will, in the author's opinion, be distributable to the third taxpayer under the effect of Sec. 107(2) since the exercise of the power has given him a capital interest. On the trust wind-up the mortgage will be assumed, the tax cost of the property to the beneficiary will be bumped with the excessive ACB of his interest while the mortgage assumed will reduce the proceeds of the disposition of his interest to below its legitimate ACB thus precipitating a capital loss. The parties do not have to be at arm's length but instead could be ... "Larry and his brothers, Daryl and Daryl". Obviously, the use of debt and its interaction with the relevant tax provisions should not be overlooked in a trust setting.

The recognition of the existence of debt obviously has substantial consequences and it is not known whether the Department will reassess the disponent of interests in respect of debt that was latently discovered owing by a trust/estate after the interest has been disposed of. If such latently recognized debt is given appropriate retroactive standing then the cost amount of the capital interest disposed of may be reduced thus causing the disponent to recognize more capital gains. It is to be noted that the Sec. 107(2)(c) provision refers to debt or obligations to pay but it does not further describe the nature of the obligation to pay. In the author's opinion, such obligations could include equitable charges, however, if a latently arising debt is discovered and charged against a beneficiary in respect of the property that he has already realized from the estate, in the author's opinion, that beneficiary will not obtain beneficial treatment under Sec. 107(2)(c) in respect of the debt since its charge was not as a condition of the delivery of the legal title of the property.¹⁸⁸⁸ This proves to be very inequitable treatment¹⁸⁸⁹ and it thus causes a taxpayer to take the steps to ensure that no unaccounted for debt exists when he purchases the interest in the estate or gives binding receipt in respect of estate property delivered in satisfaction of it.¹⁸⁹⁰

¹⁸⁸⁵ Even if the recipient of the benefits has a capital interest in the same trust then the benefits **will** be taxable once received.

¹⁸⁸⁶ The Sec. 107(2)(c) debt need not charge interest.

¹⁸⁸⁷ bumped tax cost of property net of debt/obligations assumed

¹⁸⁸⁸ It was not assumed as a condition of the delivery; it was imposed as a consequence of estate administration law as an equitable debt, and its imposition isn't as a condition of the delivery.

¹⁸⁸⁹ when the particular beneficiary has purchased his capital interest allowing it to have a legitimate a.c.b. or become resident while holding it

¹⁸⁹⁰ The subparagraph 107(2)(c) provision doesn't state that the debt must be assumed at the time of the distribution. In effect its assumption could occur substantially before or after the distribution but, in the author's opinion, the amount of debt must be ascertainable at that time. A taxpayer has not assumed a debt or obligation to pay when he has merely become

Quantum meruit claims are those established by parties in respect of services provided *inter vivos* that were not intended by the grantor to be gratuitous but instead were to be based on a contractual relationship whereby the provider was to be paid by the taxpayer, deceased or otherwise, in some form or another. A famous case consists of *Deglman v. Guaranty Trust Co. of Canada* and *Constantineau*¹⁸⁹¹ however, the result of a quantum meruit claim, in the form of a court order, is the establishment of a debt owed by the estate and not of a beneficiary status hence a quantum meruit claim may have effect under Sec. 107(2)(c) and 108(1)(d) but it is important to note that the debt arises only after the favorable court order. Until that time, like pending lawsuits or contingent liabilities, the claim does not, in the author's opinion, gain treatment under Sec. 107(2) or 108(1)(d) and thus doesn't affect the cost amount of the capital interest.

The Sec. 107(2)(b) cost bump cannot be deferred and applied at the taxpayer's discretion when a terminal distribution of various properties is received. This makes it very much unlike Sec. 98(3) concerning a wind-up of a partnership, and restrictive like Sec. 88(1)(d), however the beneficiary doesn't elect to allocate cost excess to any particular property; the provision does that arbitrarily. The resulting cost of the property to the beneficiary can be in excess of its FMV due to excessive Sec. 108(1)(d) cost amounts while cost to cost apportioning should occur when numerous properties are received in satisfaction of the interest. The fact that the fair market value of the trust property is not a limitation on the cost bump allows for some very adventuresome loss creations as described throughout this book.

More analysis of debt and distributions.

Upon a distribution under para. 107(2)(c) a beneficiary is deemed to have disposed of his capital interest (or part) satisfied for proceeds of disposition equal to the trust's tax cost of the property received, bumped by the excess of the satisfied interest's ACB (previously) that is greater than its "cost amount" as defined in Sec. 108(1)(d)(i) to be the trust's tax cost of the property distributed, however, the proceeds deemed recognizable are that net of any debt or obligation to pay assumed by the beneficiary as a condition of the distribution.

If the trust consists of aggregate property having a cost and FMV equal to \$1,000, and has sustained a mortgage¹⁸⁹² then some interesting side effects can be generated if it has two capital beneficiaries, each of which has a 50% entitlement, and a trustee who can assign the debt to any particular distribution as a condition and that power isn't fiduciary and can be exercised, expressly, without respect to the even hand rule. First of all, after the proceeds of the mortgage, \$600, have been distributed out to them tax free the capital beneficiaries can dispose of their interests for tax free proceeds equivalent to \$200¹⁸⁹³. The acquirors could be each other or family members etc.. On a distribution the trustee decides that one of them, Ben. A, will receive his 50% satisfying share, but through the trustee's power, he will assume \$400 of the \$600 debt, thus as per the mechanics of Sec. 107(1)(b) & 107(2), the beneficiary will realize the property at a cost of \$500¹⁸⁹⁴ and assume the debt of \$400. His proceeds of disposition will equal, 107(1)(c), $\$500 - \$400 = \$100$, while his real ACB will be \$200. He will thus recognize a capital loss equal to \$100, as per 107(1)(b), and actually realize **net** economic benefits of \$100. The trust will dispose of the balance of the property, realizing \$500, and extinguish the balance of the debt, \$200, and distribute the rest out to Ben. B, who will realize \$300, and **not** recognize any tax consequences under Sec. 107(1)(a) since his interest's cost amount equals \$300. The beneficiaries have thus realized the \$400 which was the maximum benefit to be realized, **but**, Ben. A has realized a capital loss of \$100, the value of which is $\$100 \times 27\% \text{ approx. } \times 75\% = \$20$, (taxes that it could negate with deduction). It must be noted, however, that the previous beneficiaries received \$600 tax free¹⁸⁹⁵ hence, on the whole a capital loss of \$100 was generated. If a gift is made from one of the original beneficiaries to Ben. A, of \$80, then no tax consequences will follow and Ben. A will not have "lost" anything. If the two initial capital beneficiaries loaned the funds to the trust after they had sold the interests then they

liable for latently recognizable and unascertained levels of debt.

1891 [1954] S.C.R. 725,

1892 the proceeds of which were distributed tax free to the capital beneficiaries through the Sec. 53(2)(h)-105(1) mechanism

1893 Sec. 108(1)(d)(ii), $(1000-600)/2 = \$200$, the Sec. 107(1)(a) cost amount

1894 $\$1,000/2 + (200-500)$

1895 as per the mechanics of Sec. 53(2)(h) - 105(1) and by virtue of the fact that the interests were not purchased and the trust was personal

could defer on collecting the amount for some time if they wanted to, although Sec. 56(4.1) may apply to attribute income from the debt back to them, the advantage being that as time goes by the value of the loan will decrease.

The system is more subject to warping when one considers the events that might occur as per the trust agreement, or the ability to negate tax consequences on interest dispositions. If a taxpayer acquires a capital interest in the trust whereunder a power of appointment, or discretionary power, exists whereby upon its exercise by a third party receives a capital interest then some interesting side effects may occur as a result of its exercise and the amount paid for the capital interest. First of all, regardless of debt the capital interest may be purchased for its cost amount being determined under Sec. 108(1)(d)(ii) whereby it will obtain a recognized ACB. If the power is exercised so as to distribute a significant portion of the capital to the other beneficiary then the amount of capital that is eventually distributed out to the initial capital beneficiary may be significantly reduced, especially in light of the ACB of the capital interest, which will thus allow the recognition of a capital loss to the former interest holder. What's more the power may reduce the fair market value of the interest but it won't affect its cost amount in a simple trust situation¹⁸⁹⁶ which will increase the interest's legitimate ACB and tax free proceeds potential. Where the interest was acquired from the beneficiary who subsequently becomes the subject of the exercise of the power then even more entertaining consequences result.

The debt can be owed to any party other than the eventual debtee. If a taxpayer mortgages some of his property prior to death, and with the cash makes liquid testamentary gifts to his spouse tax consequences will not result if the spousal trust he creates is charged with the extinguishment of the mortgage, as per the Sec. 70(7) and (8) untainting rules.¹⁸⁹⁷ If the capital interests under the trust are granted to the offspring, who also are the mortgagors, and the exclusive income interest given to the spouse, and the mortgage is to be met out of trust capital, and can be assigned as a condition of a distribution thereof, then an interesting arrangement exists. The spouse could use income, (capital received from the trust), to purchase the offspring's capital interests for amounts that equal their cost amount, thus not causing the offspring to recognize tax consequences. The trust could then be varied so as to give the trustees the power to pay out capital to the spouse in satisfaction of her income interest, (which would not cause her to recognize immediate tax consequences), whereby capital distributions could then be made and received to a limited extent, tax free, by the spouse under Sec. 106(3). Subsection 106(3) may cause advantageous or disadvantage tax consequences to be recognizable by the trust, depending on the property that was distributed. Subsection 105(1) will restrict abusive use of Sec. 106(3) to drain the trust. Since she has purchased the capital interests, they will have a legitimate ACB which may not have caused tax consequences to be recognized by the offspring. If the trustees drain the trust of its capital enough then the remaining property, (which may only be that with accrued gains/income), could be distributed in satisfaction of the capital interests and made conditional on the assumption of the mortgages. As per Sec. 107(2)(c), the spouse may recognize a capital loss, if the proceeds of disposition of the interest¹⁸⁹⁸ is less than the interest's ACB. The amount of the capital loss will of course depend on the amount of the debt, the tax cost of the property distributed, and the ACB of the interest which can be controlled as per the time of acquisition and the trust's property mix. The spouse can then turn around and extinguish the mortgages with the cash she received directly from the testator, whereby the offspring will receive not just the mortgage amount but also the proceeds of the interest's disposition, tax free. The spouse will receive the trust property essentially tax free, and recognize a capital loss, while depending on the amount of use of Sec. 106(3), (and the relative tax attributes of the trust property), the trust may be able to reduce its Division B income through loss recognitions.¹⁸⁹⁹

Interest deductibility is not a consideration above however if interest is paid in respect of a debt sustained to acquire income producing property, as in the situation where the assumption of a debt is conditional upon the distribution of property to a beneficiary, then the interest should be deductible. If the mortgage does not

¹⁸⁹⁶ where all capital interests are subject to being undermined by the power

¹⁸⁹⁷ Such a debt is not a non-qualifying debt.

¹⁸⁹⁸ tax cost of property plus excess of a.c.b. over cost amount of property, net of mortgages

¹⁸⁹⁹ Since offspring have an enforceable claim in the form of the mortgage, Sec. 105(1) is not applicable to the proceeds received from the spouse.

relate to an income producing property, either in respect of the testator before the property and mortgage were transferred to the trust, the trust, or the beneficiary, then the interest paid may not be deductible and instead the taxpayer will recognize its receipt as interest income causing a unilateral inclusion in the tax base. If the trust mortgages property to acquire cash to distribute tax free to the capital beneficiary, the interest on the mortgage will not be deductible following the reasoning in *Bronfman Trust v. M.N.R.* however, beneficial consequences results even if it is not, (and the loan charges no interest and was extended by a beneficiary). If the capital interest is purchased distributions will cause ACB adjustments as per Sec. 53(2)(h) that may either cause immediate negative tax consequences or increase the potential for their recognition however, if the interest is not purchased by its particular holder, then Sec. 53(2)(h) adjustments will not result from capital distributions to the holder, and with this in mind Sec. 73(1) provides an ideal way of transferring a purchased capital interest and sterilizing its "purchased" attribute while at the same time allowing its ACB to be maintained. Interesting commutation situations may be created when a capital interest with a legitimate ACB exists under a trust which has borrowed money from an income beneficiary, and then extinguished that income beneficiary's right, tax free, under Sec. 106(3) with distributions of the funds. Where a personal *inter vivos* trust is created, and the creator takes back a capital interest, for purposes of Sec. 53(2)(h) the interest will be considered acquired for no consideration hence the Sec. 53(2)(h) ACB adjustments will not apply to it. Under Sec. 107(1.1) however, that interest will have an initial ACB equal to the FMV of the property given for it hence the interest will have a legitimate ACB. In such a situation, after the trust has been loaded with debt and restrictively drained through Sec. 106(3), terminal distributions may be made to the creator, who will benefit from the application of Sec. 107(2)(c), (with respect to the debt), and recognize a capital loss.

Subsection 107(2) recognizes that a beneficiary's proceeds of disposition of his capital interest will be that net of debt or other legal obligations to pay any amount that has been assumed by the beneficiary as a condition of the distribution and while the cost amount of a capital interest may be increased by cash that is payable to the income beneficiaries, as per Sec. 108(1)(d)(ii), it may also be reduced by obligations to pay such amount of cash income to the income beneficiaries, hence in a current year, usually, the two will net each other out with no effect to the capital interest's cost amount. This is not the case where the trust agreement provides that the income beneficiary can only enforce a distribution of cash income in the current year and where his entitlement is measured on a book income basis, he may gain a right to the excess of his book income entitlement, over his cash income amount. The trust agreement may provide that the income beneficiary may be entitled to call for the trustee to dispose of income producing property within a specific period of time so as to extinguish the income liability with the proceeds, or it may allow the beneficiary to enforce a distribution of income producing property after a minimum period of time. During that interim period the income beneficiary's right is in fact an obligation of the trust to pay, thus it will qualify for treatment under Sec. 107(2)(c), and when the capital beneficiary ultimately pays to the income beneficiary the substance of his claim, Sec. 105(1) will not apply to it since it was already included in computing his income under Sec. 104(13)(a).

If a taxpayer bequeaths a property to another taxpayer then the ACB of the interest the legatee has in the estate while it is being administered is determined by Sec. 108(1)(d) and not Sec. 70(5) since the latter refers to dispositions of property owned by the deceased. The deceased did not own a right to the property held by a personal representative in an estate which was in the midst of administration but a right arising out of the legal ownership of the property and thus Sec. 70(5)(c) does not equate the cost amount of the capital interest to be the deemed proceeds realized by the testator. Upon death, the personal representative acquires the property and thus the estate recognizes a cost of the particular property equal to its fair market value at time of death. If the legatee disposes of his interest as per Sec. 108(1)(d)(ii) he will be able to receive proceeds of disposition equal to the property's fair market value at the time, (which also equals its cost amount to the estate), however, if the fair market value of the interest decreased due to administration problems/litigation concerning entitlements even though the fair market value of the property has not declined on a disposition the second holder will not be able to realize a capital loss due to the fact that the real a.c.b of the interest does is not the artificially inflated ACB.

In the author's opinion the issue of debt of a trust should be the focus of Finance study and perhaps amendment since presently there is simply too much flexibility, that can give rise to extreme tax consequences, when debt inside a trust can be "floated around" at the trustee's discretion to affect differing interests thereunder. There should be some sort of linkage between tax consequences to trust interests that debt affects as it is shifted to act in respect of them through s. 107(2) assumption, perhaps dependent on non-arm's length/arm's length status between the interest holders affected¹⁹⁰⁰.

The Applicability of Sec. 69(1)(c).

Subsection 69(1)(c) is **not** in direct conflict with Sec. 107(2) but the legislators have seemed to have forgotten how the former will apply. Subsection 69(1) opens with "Except as expressly otherwise provide in this Act" and the provision was introduced well before the section 107 distribution mechanics having as its source the pre-capital gains taxation days in the pre 1971 Act. Subsection 107(2) is situated in subdivision k and thus the "trust" referred to in the subsection includes estates as well. Where the beneficiary has what would be a capital interest in the estate, and property of the trust, regardless of its character to the estate, is distributed in satisfaction of the interest Sec. 107(2) and not 69(1) will apply to the disposition to cause the recipient to pick up the trust's/estate's cost rather than the FMV of the property at that time. Question 23 of the 1990 Roundtable Discussions provided exactly this appropriately. Since subsection 69(1) is expressly overridden by any subsection of the Act that provides otherwise one has to wonder just how applicable the subparagraph (c) therein is in the face of the seemingly universally applicable Sec. 107(2). Property acquired by way of inheritance or bequest will pass through an estate or trust and consequentially the Sec. 107(2) provision will **always** prevent the recipient from acquiring it at a cost equal to its FMV. This is expanded even more when one recognizes that the capital interest of the beneficiary that is being satisfied is that of a right to receive **trust law** capital since the income and capital interest definitions must be mutually exclusive and the income interest is based on the right to receive **trust law** income. Upon the death of the testator a great many forms of property that would otherwise be income when realized by the testator will be held as capital by the estate in its hands since the income that substantiates them has accrued during the life of the testator and although subsection 70(3) will provide for their inclusion in income when realized by a beneficiary on a roll through if they are not rolled through they become tax capital. Regardless of how section 70 attends to them in common law such *inter vivos* income receipts will be trust law capital and when distributed by the trust to a beneficiary should be captured under Sec. 107(2) which explicitly overrides the Sec. 69(1)(c) acquisition for FMV. Where a Sec. 70(3) roll through is allowed the trust will still acquire the right or thing as, in trust law, a capital property and consequently when it is distributed Sec. 107(2) overrides Sec. 69(1). Technically subparagraph 69(1.1)(a), which disallows Sec. 69(1)(c) from applying, is in fact not needed since the property (*inter vivos* income: right or thing) acquired and held as **capital** by the estate will be distributed to the beneficiary under Sec. 107(2) and it is this provision, and not Sec. 69(1)(c), that Sec. 69(1.1)(a) should prevent from applying. One argument that could be advanced in contradiction to this underlying feature is that not all property realized by the estate upon the death that was income when realized by the testator will be capital though The Department seems to be of the opinion that this isn't so as per I.T. 212R3, para. 25(a). In the author's opinion the Department's opinion of the applicability of Sec. 69(1)(c) to a situation involving the *inter vivos* recognition of rights or things upon death under Sec. 70(2) does not take into account the reason for Sec. 107(2) which appears to substantially reduce the scope of Sec. 69(1) target. In fact, in the author's opinion, the applicability of Sec. 69(1)(c) to testamentary transfers has been all but totally eliminated by Sec. 107(2) and the provision may only apply to *inter vivos* gifts as well as those types of property that cannot be distributed in satisfaction of a capital interest within the context of section 107 such as powers of appointment and testamentary options to compel entry into sale contracts etc..

1900 While the same sort of transactions can happen with regards to corporations and partnerships - though much more restricted, that shouldn't be the excuse to allow same in the case of trusts/estates.

Deductibility of Distribution Costs.

Pursuant to *C.I.R. v. Chubb's Trustee*¹⁹⁰¹ costs incurred to gain a legal opinion on the soundness of a distribution will be deductible against a deemed disposition caused by the distribution such as that in Sec. 107(2). This will operate to create a capital loss for the trust or estate or the beneficiary given that presently there is a tax free roll out. Such costs incurred by the beneficiary may not be added to the cost of the property realized but instead deducted against the tax free deemed disposition of the interest satisfied. The costs of preparing inventory to make available probate assessments which solidify the executors' title will be deductible against a Sec. 107(2) deemed disposition pursuant to *C.I.R. v. Richard's Exors.*¹⁹⁰²

Capture of Accrued Tax Consequences by Cdn. Resident Trusts or Non-Resident Trust Beneficiaries

Subsections 107(2.001) and (2.002) allow, formerly, Canadian resident trusts to elect to recognize FMV dispositions in their hands on transfers to any beneficiary of any taxable Cdn. property. Latterly, a non-resident trust can have its property cost bumped up when the beneficiary receiving the property chooses to have the roll-out to her proceed with tax effect in which case the property is deemed acquired at its FMV effectively. There are loss restrictions on the recognition of losses referenced to these subsections in Sec. 107(6) so it is possible to produce such in the hands of the trust to a limited extent.

Subparagraph (2.002)(b) however allows for some cost integration with the actual cost of the capital interest being satisfied where the property is not taxable Cdn. property or property attached to a permanent establishment in Canada effectively.

Subsection 107(2.11) allows the trust to trap the gains in the trust, via election, and consider them non-payable for purposes of the Sec. 104(6)-(13) mechanics which they would otherwise be.

“No rollover on election by a trust – Sec. 107(2.001)”

(2.001) Where a trust makes a distribution of a property to a beneficiary of the trust in full or partial satisfaction of the beneficiary's capital interest in the trust and so elects in prescribed form filed with the Minister with the trust's return of income for its taxation year in which the distribution occurred, subsection (2) does not apply to the distribution if

(a) the trust is resident in Canada at the time of the distribution;

(b) the property is taxable Canadian property; or

(c) the property is capital property used in, eligible capital property in respect of, or property described in the inventory of, a business carried on by the trust through a permanent establishment (as defined by regulation) in Canada immediately before the time of the distribution.¹⁹⁰³

“No rollover on election by a beneficiary – Sec. 107(2.002)”

(2.002) Where a non-resident trust makes a distribution of a property (other than a property

¹⁹⁰¹ 47 T.C. 353

¹⁹⁰² 46 T.C. 626 HL

¹⁹⁰³ March 2001 FINANCE TECHNICAL NOTES: New subsection 107(2.001) allows a trust to elect out of the rules in subsection 107(2) in respect of a distribution of property to a beneficiary in satisfaction of the beneficiary's capital interest in the trust where

- the trust is resident in Canada at the time of the distribution, • the property is taxable Canadian property, or
- the property is capital property used in, eligible capital property in respect of, or property described in the inventory of, a business carried on by the trust through a permanent establishment (as defined by regulation) in Canada immediately before the time of the distribution.

If this election is made, the distribution is subject to the rules in amended subsection 107(2.1). An electing trust is generally required to file a prescribed form, with the Minister with its tax return for the taxation year that includes the time of the distribution. This amendment applies to distributions made after October 1, 1996. For distributions made before the date of Royal Assent, the election is considered to have been made on a timely basis if it is filed by the filing-due date for the trust's taxation year that includes the date of Royal Assent.

described in paragraph (2.001)(b) or (c)) to a beneficiary of the trust in full or partial satisfaction of the beneficiary's capital interest in the trust and the beneficiary makes an election under this subsection in prescribed form filed with the Minister with the beneficiary's return of income for the beneficiary's taxation year in which the distribution occurred,

(a) subsection (2) does not apply to the distribution; and

(b) for the purpose of subparagraph (1)(a)(ii), the cost amount of the interest to the beneficiary is deemed to be nil.¹⁹⁰⁴

"Other distributions – Sec. 107(2.1)"

(2.1) Where at any time a property of a trust is distributed by the trust to a beneficiary under the trust, there would, if this Act were read without reference to paragraphs (h) and (i) of the definition "disposition" in subsection 248(1), be a resulting disposition of all or any part of the beneficiary's capital interest in the trust (which interest or part, as the case may be, is in this subsection referred to as the "former interest") and the rules in subsections (2) and (3.1) and sections 88.1 and 132.2 do not apply in respect of the distribution,

(a) the trust is deemed to have disposed of the property for proceeds equal to its fair market value at that time;

(b) the beneficiary is deemed to have acquired the property at a cost equal to the proceeds determined under paragraph (a);

(c) subject to paragraph (e), the beneficiary's proceeds of disposition of the portion of the former interest disposed of by the beneficiary on the distribution are deemed to be equal to the amount, if any, by which

(i) the proceeds determined under paragraph (a) (other than the portion, if any, of the proceeds that is a payment to which paragraph (h) or (i) of the definition "disposition" in subsection 248(1) applies) exceed the total of

(ii) where the property is not a Canadian resource property or foreign resource property, the amount, if any, by which

(A) the fair market value of the property at that time exceeds the total of

(B) the cost amount to the trust of the property immediately before that time, and

(C) the portion, if any, of the excess that would be determined under this subparagraph if this subparagraph were read without reference to this clause that represents a payment to which paragraph (h) or (i) of the definition

1904 March 2001 FINANCE TECHNICAL NOTES: New subsection 107(2002) applies where a non-resident trust makes a distribution, after 109. of a property (other than taxable Canadian property or business property connected with a Canadian permanent establishment) to a beneficiary of the trust in satisfaction of the beneficiary's capital interest in the trust. The beneficiary in these circumstances may elect out of the rules in subsection 107(2) in respect of the distribution, with the result that subsection 107(2.1) applies in respect of the distribution. The election is made by filing a prescribed form with the beneficiary's income tax return. Where the election is made, the cost amount of the beneficiary's interest also is deemed to be nil for the purposes of subparagraph 107(1.)(a)(ii). This amendment applies to distributions made after 1999. For distributions made before the date of Royal Assent, the election is considered to have been made on a timely basis if it is filed by the filing- due date for the beneficiary's taxation year that includes the date of Royal Assent.

“disposition” in subsection 248(1) applies, and

(iii) all amounts each of which is an eligible offset at that time of the taxpayer in respect of the former interest;

(d) notwithstanding paragraphs (a) to (c), where the trust is non-resident at that time, the property is not described in paragraph (2.001)(b) or (c) and, if this Act were read without reference to this paragraph, there would be no income, loss, taxable capital gain or allowable capital loss of a taxpayer in respect of the property because of the application of subsection 75(2) to the disposition at that time of the property,

(i) the trust is deemed to have disposed of the property for proceeds equal to the cost amount of the property,

(ii) the beneficiary is deemed to have acquired the property at a cost equal to the fair market value of the property, and

(iii) the beneficiary’s proceeds of disposition of the portion of the former interest disposed of by the beneficiary on the distribution are deemed to be equal to the amount, if any, by which

(A) the fair market value of the property exceeds the total of

(B) the portion, if any, of the amount of the distribution that is a payment to which paragraph (h) or (i) of the definition “disposition” in subsection 248(1) applies, and

(C) all amounts each of which is an eligible offset at that time of the taxpayer in respect of the former interest; and

(e) where the trust is a mutual fund trust, the distribution occurs in a taxation year of the trust before its 2003 taxation year, the trust has elected under subsection (2.11) in respect of the year and the trust so elects in respect of the distribution in prescribed form filed with the trust’s return of income for the year,

(i) this subsection shall be read without reference to paragraph (c), and

(ii) the beneficiary’s proceeds of disposition of the portion of the former interest disposed of by the beneficiary on the distribution are deemed to be equal to the amount

determined under paragraph (a).^{1905 1906}

1905 March 2001 FINANCE TECHNICAL NOTES: Subsection 107(2.01) allows a personal trust to elect to be treated as if it had disposed of, and reacquired, a principal residence at its fair market value immediately before distributing the property to one of its beneficiaries under subsection 107(2). The rule does not apply to distributions of property by a post-1971 spousal or common-law partner trust in, circumstances to which subsection 107(4) applies. (Subsection 107(4) generally applies to distributions made by such a trust to a beneficiary, other than the beneficiary spouse or common-law partner, before the death of the beneficiary spouse or common-law partner.) Subsection 107(2.01) is designed to allow a personal trust to take advantage of the principal residence exemption. In this regard, reference can be made to the definition of "principal residence" in section 54.

Subsection 107(2.01) is amended to eliminate the reference to subsection 107(4), given that subsection 107(2.1) now applies to distributions to which amended subsection 107(4) applies.

June 1992 FINANCE TECHNICAL NOTES: Subsection 107(2.01) allows a spousal trust to elect to be treated as if it had disposed of, and reacquired, a principal residence at its fair market value immediately before distributing that property to one of its beneficiaries under subsection 107(2). This effectively allows a spousal trust to take advantage of the principal residence exemption. The election is made in the trust's tax return for the year of distribution.

Strictly as a consequence of the new rules in paragraph 54(g) that would allow a wider range of personal trusts to take advantage of the principal residence exemption, subsection 107(2.01) is amended to allow trustees of all personal trusts to take advantage of the election under that subsection. A transitional rule allows trusts (other than spousal trusts) to make the election by notifying the Minister of National Revenue up to 6 months after Royal Assent to this amendment, where the distribution took place after 1990 and on or before the day of Royal Assent.

May 1991 FINANCE TECHNICAL NOTES: Spousal trusts are permitted to take advantage of the principal residence exemption by virtue of subsection 40(5). New subsection 107(2.01) is introduced to allow a spousal trust to take advantage of the capital gains exemption for principal residences on the rollover of such property to a beneficiary of the trust.

The new rule is intended to correct an anomaly arising from the application of subsection 40(7) to beneficiaries of pre-1972 spousal trusts after the death of the spouse who has a life interest under the trust. Under subsection 40(7), property distributed to a trust beneficiary is considered to have been acquired by the trust beneficiary at the time it was last acquired by the trust. As a consequence, the trust beneficiary's principal residence exemption will generally be reduced under paragraph 40(2)(b) unless the trust beneficiary (or the spouse or minor child of the trust beneficiary) ordinarily inhabited the property (or the housing unit to which the property relates) during the period after the trust last acquired the property. This result is anomalous because the principal residence exemption could have been claimed by the pre-1972 spousal trust if it had actually been sold by the trust rather than distributed to a trust beneficiary on a rollover basis.

New subsection 107(2.01) will apply on a distribution to a beneficiary under subsection 107(2) of property by a spousal trust which so elects in its tax return for the year of the distribution, except where the distribution is made by a post-1971 spousal trust under subsection 107(4). Where the property would, if it had been designated by the trust under paragraph 54(g), be a principal residence, paragraph 107(2.01)(a) provides that the trust shall be treated as having disposed of the property at its fair market value immediately before the particular time that is immediately before the time of the distribution. Paragraph 107(2.01)(b) provides that the trust shall be treated as having reacquired the property at such particular time at that fair market value and, as a consequence, the cost amount to the trust of the property for the purposes of the distribution of the property to the beneficiary under subsection 107(2) will be equal to the same amount. Accordingly, pursuant to subsection 40(7), the principal residence exemption in paragraph 40(2)(b) will apply to the trust beneficiary, on a subsequent disposition of the principal residence, without regard to the period during which the property was held by the trust.

1906 Feb. 2009 FINANCE TECHNICAL NOTES (budgets/technical): Where trust property is distributed by a trust to a beneficiary in satisfaction of the beneficiary's capital interest, the rules in subsection 107(2.1) apply if certain other sections do not apply. Subsection 107(2.1) is amended in conjunction with a series of other amendments intended to provide for the income tax effects on a reorganization into corporate form of a SIFT wind-up entity. The amendment ensures that subsection 107(2.1) does not apply to a distribution to which new section 88.1 or new subsection 107(3.1) applies.

May 2001 FINANCE TECHNICAL NOTES (Commons Finance Committee): Clause 80 of Bill C-22 would amend section 107 of the Act. This section provides rules governing the tax treatment of distributions from trusts to their beneficiaries.

Under a proposed transitional rule to be effective in years before 2003, a mutual fund trust that distributes property to a beneficiary in satisfaction of the beneficiary's interest in the trust may, under proposed new paragraph 107(2.1)(e), elect to have any capital gains realized on the distribution included in the income of the beneficiary. To make this election, the trust must have previously made an irrevocable election under subsection 107(2.11) to have capital gains payable to a beneficiary taxed at the trust level.

Paragraph (a) of this motion would ensure that an election filed by a mutual fund trust under subsection 107(2.11), to obtain the transitional relief described in paragraph 107(2.1)(e), is deemed not to have been made for the purposes of the trust's taxation years that end after 2002.

March 2001 FINANCE TECHNICAL NOTES: Where trust property is distributed by a trust to a beneficiary in satisfaction of the beneficiary's capital interest in the trust and subsection 107(2) of Act does not apply, the rules in subsection 107(2.1) apply. Subsection 107(2.1) also applies to a distribution by a trust in satisfaction of a right described in subsection 52(6). Under paragraphs 107(2.1)(a) to (c), the trust is deemed to have disposed of the distributed property for the property's fair market value and the beneficiary is deemed to have acquired the property, and disposed of the capital interest or right described in subsection 52(6), for the same amount. Notwithstanding the reference to subsection 52(6) (under which a cost

is ascribed to the right to enforce payment out of a trust's capital gains and income), it is unclear that there is relief from double taxation on gains associated with the dispositions of the distributed property and the relinquished capital interest. Subsection 107(2.1) is amended so that it no longer overrides every other provision of the Act. For example, subsection 107(2.1) no longer deems there to be a disposition of property where the existing law provides that there was no disposition because of paragraph (e) of the definition "disposition" in section 54. This amendment is consequential to the replacement of the existing definition "disposition" in section 54 with the new definition of the same expression in subsection 248(1) and new rules in section 107.4 to deal with acquisitions by trusts that do not involve any change in beneficial ownership.

Subsection 107(2.1) is amended so that it applies in connection with all distributions in respect of a capital interest in a trust regardless of whether the distribution results in a disposition of all or part of the capital interest. This includes rights to which subsection 52(6) formerly applied, but which are now included as part of a capital interest in a trust under the amended definition of "capital interest" in subsection 108(1). Distributions in respect of amounts described in paragraph (h) and (i) of the definition "disposition" in subsection 248(1) need to be referred to in order to take into account the possibility that a distribution from a trust may consist only partly in respect of such amounts. In addition, even if a cash distribution is solely in respect of such an amount, it may, not necessarily be denominated in Canadian dollars, in which case the trust may recognize a foreign currency gain or loss on the distribution. However, under amended paragraph 107(2.1)(c), proceeds of disposition are only determined with regard to the portion of a capital interest in a trust that is disposed of because of a distribution from the trust. No proceeds of disposition are determined in respect of rights to amounts to which paragraph (h) and (i) of that definition apply.

The proceeds of disposition for the portion of a capital interest in a trust that is disposed of because of a distribution (other than a distribution to which paragraph 107(2.1)(d) applies) are determined under paragraph 107(2.1)(c) as follows:

- ADD the proceeds of disposition determined in respect of the distribution (other than any portion of those proceeds that is a payment to which paragraph (h) or (i) of the definition "disposition" in subsection 248(1) applies). Note: paragraph (h) or (i) of that definition apply to a payment that represents a distribution of income or capital gains Or to a payment from a unit trust that does not cause a reduction of the number of issued units of the trust;
- where the property distributed is not Canadian resource property or foreign resource property, SUBTRACT the amount (if any) by which the fair market value of the property exceeds the cost amount of the property (however, disregard this excess to the extent it represents a payment to which paragraph (h) or (i) of that definition applies); and
- SUBTRACT the "eligible offset" in respect of the distribution, as defined in subsection 108(1). (This is essentially debt assumed by the beneficiary on the distribution.)

Where there is no disposition of a capital interest because of paragraph (h) or (i) of the definition "disposition" in subsection 248(1), an amount distributed from the trust to a beneficiary generally results in a reduction of the beneficiary's adjusted cost base of the capital interest pursuant to paragraph 53(2)(h).

Paragraph 107(2.1)(d) applies to distributions of property (other than taxable Canadian property or business property connected to a Canadian permanent establishment) from a non-resident trust unless subsection 75(2) would, if the Act were read without reference to that paragraph, result in the attribution to a taxpayer of an income, loss, taxable capital gain or allowable capital loss in respect of the distribution. In these circumstances, new paragraph 107(2.1)(d) deems the beneficiary to acquire the property at its fair market value and to dispose of the corresponding portion of the capital interest in the trust for proceeds equal to the fair market value of the property less the total of two amounts. The first amount represents the portion of the distribution that is a payment to which paragraph (h) or (i) of the definition "disposition" in subsection 248(1) applies (i.e., a payment that represents a distribution of income or capital gains, or a payment from a unit trust that does not cause a reduction of the number of issued units of the trust). The second amount is the "eligible offset" (as defined in subsection 108(1)) in respect of the distribution (i.e., essentially debt assumed by the beneficiary on the distribution). Paragraph 107(2.1)(d) also ensures that there are no tax consequences to the trust in respect of the distribution of the property.

Under new subsection 107(2.1), a distribution of property may give rise to a capital gain at the trust level; It is arguable that upon a distribution to a beneficiary from a trust of a property with an accrued capital gain, the capital gain realized by the trust is paid out to the beneficiary. In these circumstances, the taxable portion of the capital gain generally would be included in the income of the beneficiary because of subsection 104(13) and the trust would receive a corresponding deduction from its income under subsection 104(6).

This result is predicated, in part, on the assumption that a trust can make a designation under subsection 104(2.1) in respect of a beneficiary that is not a beneficiary of the trust at the end of the trust's taxation year (i.e. because the distribution of property was in satisfaction of the beneficiary's entire capital interest in the trust). However, the trust indentures of some mutual fund trusts do not accommodate the possibility of making a designation under subsection 104(2.1) in respect of such beneficiaries. As a transitional measure, therefore, where a mutual fund trust has elected under subsection 107(2.11), new paragraph 107(2.1)(e) allows the mutual fund trust to elect for the capital gain to be recognized at the beneficiary level (i.e. as proceeds of disposition of the beneficiary's capital interest).

The result under paragraph 107(2.1)(e) would appear, in combination with the results under paragraph 107(2.1)(a), to give rise to double taxation, because of the trust's election under subsection 107(2.11). However, under section 132, a capital gains refund generally would be available to the trust to offset the gain at the trust level.

These amendments apply to distributions made after 1999 (other than distributions before March 2000 in connection with rights described in subsection 52(6) that were acquired before 2000).

The examples below illustrate the operation of amended subsection 107(2.1). Except as indicated otherwise, it is assumed that the trusts referred to below are all resident in Canada.

Example 1

In 2001, a commercial trust distributes non-depreciable capital property (shares) to its beneficiary resident in Canada in satisfaction of the beneficiary's capital interest in the trust. The adjusted cost base of the shares is \$40. The adjusted cost base of the beneficiary's capital interest is \$20. The fair market value of the property is \$100.

“Gains not distributed to beneficiaries – Sec. 107(2.11)”

(2.11) Where a trust makes one or more distributions of property in a taxation year in circumstances in which subsection (2.1) applies (or, in the case of property distributed after October 1, 1996 and before 2000, in circumstances in which subsection (5) applied)

Results:

1. Subsection 107(2.1) applies to the distribution.
2. The trust is deemed by paragraph 107(2.1)(a) to have disposed of the property for \$100 proceeds so there is a capital gain of \$60 on the resulting disposition and a taxable capital gain of \$30.
3. The beneficiary is deemed by paragraph 107(2.1)(b) to have acquired the property, at a \$100 cost.
4. Because the distribution gives rise to a capital gain at the trust level, the amount of the capital gain (\$60) reduces the proceeds of disposition of the beneficiary's capital interest under subparagraph 107(2.1)(c)(ii). The beneficiary is deemed to have disposed of the capital interest for \$40 proceeds (\$100 - \$60). Alternatively, in the event that the payment of the gain, were considered to be payment of the capital gains of the trust to which paragraph (i) of the definition "disposition" in subsection 248(1) applied, \$40 would be determined under subparagraph 107(2.1)(c)(i) and no amount would be determined under subparagraph 107(2.1)(c)(ii). Consequently, under both of the alternative analyses, the beneficiary's proceeds of disposition of the beneficiary's capital interest in the trust are \$40.
5. Consequently, the capital gain from the disposition of the capital interest is \$20 (\$40 - \$20).
6. If the trust is a mutual fund trust, the distribution occurs in a taxation year of the trust before its 2003 taxation year, the trust has elected under subsection 107(2.11) in respect of the year and the trust so elects under paragraph 107(2.1)(e), the beneficiary's proceeds of disposition of its capital interest are deemed to be equal to the fair market value of the property distributed (i.e., the amount determined under paragraph 107(2.1)(a)). Consequently, the capital gain from the disposition of the capital interest is \$80 (\$100 - \$20). In these circumstances, the capital gains refund mechanism in section 132 would apply to offset the capital gains realized on the distribution at the trust level.

Example 2

In 2001, a personal trust distributes non-depreciable capital property (shares that are not taxable Canadian property) to its non-resident beneficiary in satisfaction of the beneficiary's capital interest in the trust. The adjusted cost base of the shares is \$40. The

- adjusted cost base of the beneficiary's capital interest, determined before the application of paragraph 107(1)(a), is \$0.
- The fair market value of the property is \$100.

Results:

1. Subsection 107(2.1) applies to the distribution because of the application of amended subsection 107(5).
2. The trust is deemed by paragraph 107(2.1)(a) to have disposed of the property for \$100 proceeds, so there is a capital gain of \$60 from the resulting disposition and a taxable capital gain of \$30.
3. The beneficiary is deemed by paragraph 107(2.1)(b) to have acquired the property at a \$100 cost.
4. Because the distribution gives rise to a capital gain, the amount of the capital gain (\$60) reduces the proceeds of the beneficiary's capital interest under subparagraph 107(2.1)(c)(ii). The beneficiary is deemed to have disposed of the capital interest for \$40 proceeds (\$100 - \$60). The alternative analysis in paragraph 4 of Example 1 would likewise result in deemed proceeds of
5. The capital interest in the trust constitutes taxable Canadian property for the non-resident beneficiary. For the purposes of computing capital gains, the adjusted cost base of the capital interest under subsection 107(1) is \$40, being the greater of its adjusted cost base (nil) determined before the application of that subsection and the cost amount (\$40) to the trust of the distributed property. Consequently, the taxable capital gain from the disposition of the capital interest is nil.
6. The allowable capital loss from the disposition of the capital interest is also nil.

Dec. 1997 FINANCE TECHNICAL NOTES (technical): Subsection 107(2.1) sets out rules that apply on a distribution of property, by a trust other than a personal or a prescribed trust, in satisfaction of all or part of a beneficiary's capital interest. The subsection is amended to clarify that it does not apply to a disposition that forms part of a qualifying exchange under section 132.2. A qualifying exchange is a tax-deferred transfer of property from one mutual fund to another, and includes the disposition by investors in the transferor fund of their shares or units of that fund in exchange for units of the transferee fund.

1988 FINANCE TECHNICAL NOTES: As a consequence of the change to subsection 107(2) described above, the special rollover provided in that subsection will only apply to distributions of trust property in satisfaction of a beneficiary's capital interest in a personal trust or in a prescribed trust. New subsection 107(2.1) provides rules where property is so distributed by any other type of trust. In addition, subsection 107(2.1) applies where property is distributed by a trust in satisfaction of a right described in subsection 52(6).

Where property is distributed by a trust to a beneficiary at any time in the circumstances described in subsection 107(2.1), the trust is deemed to have disposed of the property for proceeds equal to the fair market value of the property at that time and the beneficiary is deemed to have acquired the property at a cost equal to that fair market value. The beneficiary is also deemed to have disposed of his interest in the trust, or the right described in subsection 52(6), for proceeds equal to that fair market value. The reference to subsection 52(6) is intended to ensure that the rules in subsection 107(2.1) will not result in double taxation where a right described in subsection 52(6) is satisfied by a distribution to which subsection 107(2.1) applies. By its express terms, subsection 107(2.1) overrides any other provision (such as paragraph 54(c)(v)) which might otherwise apply in circumstances described in subsection 107(2.1).

(b) where the trust is resident in Canada at the time of each of those distributions and has so elected in prescribed form filed with the trust's return for the year or a preceding taxation year, the income of the trust for the year (determined without reference to subsection 104(6)) shall, for the purposes of subsections 104(6) and (13), be computed without regard to all of those distributions.¹⁹⁰⁷

Mrs. X -380

#1 Son 428

#2 Son 428

Total issued share capital

2,300

7. Both children of the deceased are over twenty-one years of age.

8. The Will provides that the net income of the Trust be paid to the spouse during her lifetime and that the residue be distributed to the children on her death. However, the Will contains the following provision giving discretion to the Trust as to encroachment on capital:

"Notwithstanding anything in this my Will contained, I expressly authorize my Trustee at any time and from time to time during the lifetime of my wife to pay to or for my said wife or to or for any child of mine such amount or amounts out of the capital of the residue of my Estate as my said Trustee in her uncontrolled discretion considers advisable; and I further authorize my Trustee at any time and from time to time after the death of my wife to pay to or for any child of mine each part of parts of the capital of the share held in trust for such child as my said Trustee in her uncontrolled discretion considers advisable."

Proposed Transaction

9. The Trustee of the Estate proposes to distribute all estate capital to the children of the deceased pro rata. The Estate will therefore be wound-up.

Reason for the Transaction

10. The children of the deceased are actively engaged in the operation of Familyco I and Familyco II and are of the age of majority. Consequently, the Trustee feels that the children should own all of the shares in these corporations directly except for shares personally held by Mrs. X. In effect, the Trust no longer serves a useful purpose.

11. The beneficiaries wish to prevent the deemed disposition of trust property pursuant to subsection 104(4) of the Income Tax Act (the Act). A disposition on January 1, 1993 would create a tax liability of such a magnitude that both corporations would most probably be forced to liquidate to satisfy their tax debts.

Rulings Given

12. Provided that the above descriptions of the facts and proposed transactions are accurate and constitute complete disclosure of all the relevant facts and proposed transactions, and that the proposed transactions are carried out as set forth herein, the following rulings are given:

- A. That on a distribution of estate capital to the children of the deceased, (on an equal and pro-rata basis), subsection 107(2) of the Act will apply.
- B. That subsection 107(2) of the Act will apply in respect of the distribution by the Estate to each particular beneficiary of property so that the application of the subsection in conjunction with subsection 107(1) and subparagraph 108(1)(d)(i) of the Act will give rise to the following tax consequences:
 - (i) The Trust shall be deemed to have disposed of the property for proceeds of disposition equal to its cost amount to the Trust;
 - (ii) Each particular beneficiary shall be deemed to have acquired the property so distributed at a cost equal to its cost amount to the Trust;
 - (iii) Each particular beneficiary shall be deemed to have disposed of his relevant capital interest for proceeds equal to the cost of the property received; and
 - (iv) Pursuant to paragraph 107(1)(a) and subparagraph 108(1)(d)(i) of the Act, the adjusted cost base of such relevant capital interest to each particular beneficiary immediately before disposition shall be deemed to be the cost amount thereof, namely, the cost amount to the Trust of each property received.

You have asked us to confirm that no section within subdivision k of the Act or any of the Income Tax Application Rules will be applied by the Minister to tax this transaction. We define to rule as your request is worded too generally.

This ruling was given in September 1987.

Income Tax Rulings are issued for the general information of taxpayers, but are considered to be binding on the Department only in respect of the taxpayer to whom the ruling was given.

Distributions from Spousal Trusts.

Subsections 70(5.2), (6) and 73(1) allow a taxpayer to contribute property to a trust without recognized tax consequences only when the trust was created by the particular taxpayer and the spouse of the taxpayer is entitled to all of the trust's income that arises before her death and where no one other than the spouse can obtain the use of the trust's income or capital before her death. Obviously the Sec. 70(6) and 73(1) roll over provisions are extremely favorable in that the recognition of accrued capital gains inherent in the property would be deferred however this deferral is not only temporary but also the provisions themselves cause inflexibility in that upon the death of the spouse there will be a deemed disposition of the property while in order for the trust to qualify when the property is contributed to it a non-spousal party can't have the remotest of capabilities of obtaining the use of the trust's property prior to the spouse's death.¹⁹⁰⁸ In order to have a non-spousal beneficiary participate subsequently there would have to be a variation in the trust's terms that may cause the disposition of a beneficiary's particular rights and this is even if an entitlement of a beneficiary remains the same but is being accelerated; since the right the beneficiary acquires isn't the same as that owned previously there will be a taxable disposition of the original deferred right with the appropriate tax exposure while the trust will still suffer from a taxable disposition under Sec. 104(4).¹⁹⁰⁹ Under Sec. 104(4) a trust which was at **any time** a spousal trust described in Sec. 73(1) or a trust that was created as a spousal trust under Sec. 70(6) be it testamentary or not, will be deemed to dispose of its property on the day that the spouse dies or the day that is 21 years after the latest of January 1st, 1971, and the day that the trust was created, thus there is a time limit imposed which restricts the accrual of gains in the trust without recognition with the new deemed disposition rules there is some deferral possibilities. If the trust distributes the property out to the spouse before any of the disposition dates Sec. 107(2) will apply to allow the avoidance of any inherent tax consequences and the deemed fair market value dispositions will be avoided. If the property is distributed out to a non-spousal beneficiary before the spouse's death Sec. 104(4) dispositions will have been avoided but Sec. 107(4) will prevent the use of Sec. 73(1)-70(6) from allowing such a tax free transfer.

Subsection 107(4) applies only to trusts which are described under Sec. 107(2) hence it does not apply where the trust has lost its personal nature and it is further refined in targeting to apply to a trust that **was** a trust described under Sec. 104(4)(a) hence it applies to trusts that were created by the will of the taxpayer¹⁹¹⁰ who died after Dec. 31st, 1971, and that were at the time they were created spousal trusts, or any trust that **was at any time** a spousal *inter vivos* trust. The use of the trust referencing of that subsection is important in that the description encompasses not only trusts that benefitted from the Sec. 70(6) & 73(1) contribution provisions¹⁹¹¹ but also trusts that have been varied from being what would otherwise be spousal trusts to trusts that allow for capital/income distributions to non-spousal beneficiaries prior to the death of the spouse. It applies to resident as well as non-resident trusts.¹⁹¹²

"Trusts in favour of spouse, common-law partner or self – Sec. 107(4)"

(4) Subsection (2.1) applies (and subsection (2) does not apply) at any time to property distributed

¹⁹⁰⁸ though he may be able to **benefit** from its use for his purposes indirectly

¹⁹⁰⁹ It's possible, of course, to incorporate the income potential out from under the trust via a Sec. 85(1) transfer with the non-spousal beneficiaries subscribing for common shares.

¹⁹¹⁰ which as per Sec. 70(6.1) includes trusts created by an order of a court with respect to an estate as per provincial dependant relief or support legislation

¹⁹¹¹ as well as those that by happenstance at one time or another satisfied the *inter vivos* spousal trust descriptions under Sec. 73(1)

¹⁹¹² It does not apply to trusts that arose out of the former spousal trust hence if the trustee is also the subject spouse and he exercises a power of appointment so as to irrevocably create a subtrust out of original trust property that subtrust **may not** be caught by the provision. Unfortunately there is a considerable problem in avoiding the application of the provision in transferring the legal title to the sub-trust since such may be regarded as a distribution in respect of a beneficiary thus suffering from Sec. 107(4) itself. It could be argued that the trust doesn't receive the property as a beneficiary since it can't enjoy the benefits of the property but must hold it on trust for the spouse but **in respect of the original trust** it may be regarded as a beneficiary. This could be countered with the Sec. 108(1) definition of a beneficiary and the fact that the context of the provisions does not seem to support the "beneficiary" argument. The fact that there isn't a change in beneficial ownership in the property disallowing Sec. 54(c) from applying with the exercise of such a power is irrelevant since the section 107 provision is the one that can cause the damage and in this case the author is of the opinion that Sec. 107(4) could apply to such an exercise of a power.

to a beneficiary by a trust described in paragraph 104(4)(a) where

(a) the beneficiary is not

(i) in the case of a post-1971 spousal or common-law partner trust, the spouse or common-law partner referred to in paragraph 104(4)(a),

(ii) in the case of an alter ego trust, the taxpayer referred to in paragraph 104(4)(a), and

(iii) in the case of a joint spousal or common-law partner trust, the taxpayer, spouse or common-law partner referred to in paragraph 104(4)(a); and

(b) a taxpayer, spouse or common-law partner referred to in subparagraph (a)(i), (ii) or (iii), as the case may be, is alive on the day of the distribution.¹⁹¹³

The subsection 107(4) provision applies only where certain types of property were distributed to beneficiaries other than the spouse prior to her death and it's obvious that the reason for this is to prevent trust draining prior to the application of Sec. 104(4) disposition provisions upon her death.¹⁹¹⁴ It applies where

1913 March 2001 FINANCE TECHNICAL NOTES: Subsection. 107(4) applies where a post-1971 spousal or common-law partner trust distributes capital property, resource property or land to a beneficiary other than the beneficiary spouse or common-law partner. When this occurs while the beneficiary spouse or common-law partner is alive, there is generally a deemed disposition of the property at its fair market value.

Subsection 107(4) is amended so that similar rules apply to alter ego trusts and joint spousal or common-law partner trusts, as. newly defined in subsection 248(1). Subsection 107(4) will apply to a distribution by these trusts where the individual (or, in the case of a joint spousal or common-law partner trust, either the individual or the spouse or common-law partner) is alive on the day of the distribution and the distribution is made to a beneficiary other than the individual (or, in the case of a joint spousal or common-law partner trust, the individual or the spouse or common-law partner). For more detail on these trusts, see the commentary on amended subsections 73(1) and 104(4).

Subsection 107(4) is amended so that the rules set out in amended subsection 107(2.1) apply to distributions covered by subsection 107(4).

These amendments also reflect changes effected by the Modernization of Benefits and Obligations Act.

June 1992 FINANCE TECHNICAL NOTES: Subsection 107(4) applies where a post-1971 spousal trust distributes capital property, resource properties or land inventory during the beneficiary spouse's lifetime to a beneficiary other than the spouse. It provides for a realization of such property by the trust at fair market value or, in the case of depreciable property, at the mid-point between undepreciated capital cost and fair market value.

Subsection 107(4) is amended to ensure that the rules therein apply where property is transferred to a non-spouse beneficiary before the end of the day on which the beneficiary spouse dies. This amendment is applicable with respect to distributions occurring after December 20, 1991.

Subsection 107(4) is also amended to eliminate the "mid-point" rule described above so that depreciable property is treated like other capital property. This is consistent with similar amendments to subsections 70(5) and 104(5).

Sept. 1985 FINANCE TECHNICAL NOTES: Subsection 107(4) provides special rules that apply where a spousal trust distributes certain types of property (capital property, resource property and land inventory) during the spouse's lifetime to a beneficiary other than the spouse. The amendment to paragraph 107(4)(a) is strictly consequential on the amendments which broaden the definitions of "Canadian resource property" and "foreign resource property" to include resource properties acquired before 1972 as well as those acquired after 1971.

1982 FINANCE TECHNICAL NOTES: Subsection 107(4) applies where a spousal trust distributes capital property during the spouse's lifetime to a beneficiary other than the spouse. It provides that non-depreciable capital property so distributed is deemed to have been disposed of at its fair market value, and that depreciable property is deemed to have been disposed of for proceeds equal to the mid-point between its undepreciated capital cost and fair market value. Paragraph 107(4)(a) is amended to include resource properties and land inventory of the trust in the categories of property that will be deemed to have been disposed of at fair market value when distributed by a spousal trust to a beneficiary other than the spouse.

1976 FINANCE NOTICE OF WAYS AND MEANS MOTION: That the provisions of subsection 107(4) of the Act relating to capital property (other than depreciable property) distributed to a beneficiary of a spouse trust, other than the spouse, during the spouse's lifetime be extended to include depreciable property, distributed to such a beneficiary. after, May 25, 1976 and revised so that after May 25, 1976 the beneficiary shall be deemed to have disposed of all or part of his interest in the trust, as the case may be, for proceeds of disposition equal to the proceeds of disposition for which he would be deemed to have disposed of the interest if subsection 107(2) of the Act applied.

1914 The distribution must however operate to satisfy a capital interest of a beneficiary otherwise Sec. 107(2), the

the property distributed was capital property, or land that was inventory of the trust, or Canadian or foreign resource property.¹⁹¹⁵ Eligible capital property is a capital property but is not a depreciable capital property of a prescribed class as provided in Regulation 1100-1106 thus para. (de) of Sec. 107(4) will not apply to it. the beneficiary will acquire the property at a cost described in Sec. 14(3) and 5(a).

The provision applies where the property is distributed to a taxpayer other than the spouse while she is alive, regardless of whether or not she is in fact any sort of beneficiary under the trust at the time, and it must be recognized that the provision applies **only where the distribution is in satisfaction of a capital interest** held by the beneficiary. If the beneficiary receives the property as a distribution in satisfaction of an income interest that he has acquired, either from the spouse directly or by variation of the trust Sec. 106(3) will apply, and Sec. 107(4) won't, to allow the beneficiary to avoid the recognition of tax consequences. The Sec. 106(3) satisfaction will however cause the trust to recognize the disposition of the particular property for proceeds equal to its FMV at the time thus to avoid any self-defeating transactions only property with accrued losses could be distributed in respect of income interests¹⁹¹⁶. Trustees discretion in this case should be understandably wide though controlled with some parameters so as to allow the required flexibility.

If the trust property is distributed to the spouse in satisfaction of any part of her capital interest there will not be any tax consequences since Sec. 107(2) will apply however when she subsequently disposes of the property the accrued gain will be recognized unless the property is disposed of using one of the tax free disposition provisions. It could be possible for her to gift it to her spouse who then, while after receiving beneficial interest therein transfers it to spousal trust for her which may have terms very similar to the original trust, when all transactions would be tax free under Sec. 73(1).¹⁹¹⁷ The provision applies to a spousal recipient if she holds the interest on trust for other beneficiaries in which case she doesn't receive the property on her personal account but qua trustee. If the spouse holds the interest on her personal account it may be possible to structure a benefit to a non-spousal beneficiary by having a condition subsequent call for the payment of cash etc. to the third person by the spouse however such a payment could be captured by Sec. 105(1) to be unilaterally included in the tax base without deduction.

Where a distribution by a trust that was at any time spousal is captured by Sec. 107(4) the trust will be deemed to have disposed of the property for proceeds equal to its FMV at the time unless the property was a depreciable capital property of a prescribed class in which case the proceeds will be deemed to be equal to the amount half way between its f.m.v and its cost amount (UCC) to the trust. In the latter case recapture

qualifying provision, wouldn't have applied to it. It would thus be possible to make **advances** to non-spousal beneficiaries in respect of their capital interests so as to allow the tax free flow mechanism in Sec. 105(1)-53(2)(h) to apply though if the property advanced doesn't change beneficial ownership can the trust suffer a disposition in respect of it so as to cause its taxation? The section 107 provisions cause the disposition of property distributed **in satisfaction of interests** but if an advance is made which doesn't operate to extinguish, not even partially, a capital interest in respect of which it is being made can the above tax free advance mechanism allow the avoidance of the Sec. 104(4) provision when beneficial ownership of the particular property already resides with the recipient? In common law an advance doesn't lead to an extinguishment of the beneficiary's right to trust property in all cases and though allowing the trustees to legitimately make the advance, through the varying of the trust deed to accelerate the interest and remove restrictions that allow the spousal characteristics to exist, will most likely lead to a capital interest disposition assessment there may be instances where the net tax consequences of such a variation/advance may be favorable. At what cost will the beneficiary receive the property advanced? Since there isn't a change in beneficial ownership perhaps its tax cost to the trust as if Sec. 107(2) proper would have applied.

¹⁹¹⁵ It would appear that buildings that were inventory of a business of the trust would not be captured however one has to recognize that the Sec. 73(1) *inter vivos* trust contribution provision does not apply to property other than capital property **with respect to the contributor**. In respect of the Sec. 70(6) roll-over again building inventory in the testator's hands would not qualify for roll-over treatment unless the Sec. 70(3) beneficiary could be argued to be the testamentary spousal trust, (though a previously constituted *inter vivos* spousal trust could satisfy such). If the contributor/testator held the buildings as capital property and the trust commenced to carry on a business in respect of them and hold them as inventory it would still be possible to distribute them **in respect of capital interests** under the Sec. 107(2) provision since that subsection doesn't provide treatment in respect of only capital property. No particular type of property is specified thus it would appear that inventory can be used to **satisfy** capital interests accelerated by a variation and access tax free roll out treatment. How excessively one could beat up on the Sheriff of Nottingham with such an arrangement in light of the fact that the Sec. 104(4) provisions target only land inventory and other capital property is questionable. A change in use in the trust's hands would have to be sustained in order to facilitate this though the tax consequences of such could be reduced if the buildings are appreciating rapidly and the trust has capital losses which can offset the tax exposure. The trust's terms would have to allow for such a change in use. If the trust is structured to carry on the business from the moment of its constitution it would realize the property as inventory and not have to suffer a change in use.

¹⁹¹⁶ or a mix of those with both capital gains and losses so as to offset each other

¹⁹¹⁷ Of course all of the parties would have to work co-operatively in order for this to occur .

and capital gain may be created or it may be possible to recognize a terminal loss. If numerous properties are distributed to one person at the same time for the same class the UCC of the class will be apportioned to the particular properties of the class, distributed or not, to ascertain which causes recapture/terminal loss.¹⁹¹⁸ When capital property, or resource property is distributed there may be recapture of resource allowances and or capital gains.

The beneficiary will be deemed to have acquired the property at a cost equal to those deemed proceeds while he will also be deemed to have disposed of his interest satisfied for proceeds of disposition equal that which he would have been deemed by Sec. 107(2)(b) to have acquired the property¹⁹¹⁹ net of any debt or obligation to pay assumed by him if its assumption was a condition of the distribution. Since the trust may be personal Sec. 107(1)(a) will apply to compute the beneficiary's taxable capital gain on the disposition of his capital interest if any. It should be noted that the Sec. 107(2)(b) caused a bump in the tax cost of the property based on the tax cost of the property to the trust not its FMV hence the beneficiary will not recognize extremely costly tax consequences, but instead only those that would have arose had Sec. 107(2) applied fully but the property's "FMV" ACB to him will not be affected.

Subsection 107(4) has the potential to impose significant tax liability on the trust with hardly any resulting to the beneficiary and though this is "in line" with the purpose of the spousal roll-over provisions it does create trust law problems if the trust deed isn't tailored to ensure that the tax liability is to the detriment of the beneficiary who caused it.

Reversionary Trust Distributions.

Subsection 107(4.1) applies to instances where reversionary trusts described in Sec. 75(2) made distributions of **any** property to certain beneficiaries. It is specifically targeted at instances where property was distributed by a personal or prescribed trust to a taxpayer in satisfaction of any part of a capital interest and where Sec. 75(2) was **at any time** applicable in respect of **any property held in the particular trust**. However it does not apply in instances where the distributee was the person from whom the particular property¹⁹²⁰ was received by the trust or was received by an individual in respect of whom the Sec. 73(1) *inter vivos* spousal transfer would apply if the property is capital property¹⁹²¹ in respect of the contributor but only while the person who contributed the property to the trust is alive at the time of the distribution.

Subsection 75(2) is the attribution provision that causes a dual recognition of income, loss, gain etc.¹⁹²² by the trust and the contributor of the property if that property is held on condition that it may revert to the person from whom it was directly or indirectly received, pass to persons determined by him at a time subsequent to the creation of the trust, or that during his lifetime the property could not have been disposed of by the trust except with his consent or pursuant to his direction. The provision applies only to trusts regardless of their residence though if the contributor of the property isn't resident the attribution will not arise and Sec. 107(4.1) will not be applicable.

Subsection 107(4.1) applies where **at any time** Sec. 75(2) applied to **any property of the particular trust** hence if the property which attracted the attribution provision was previously distributed the subsequent distribution will still be subject to Sec. 107(4.1). For this reason it would be favorable to structure a multitude of trusts each arising on a separate disposition to hold property thus sheltering other property from the provision when only one property is to be subject to the Sec. 75(2) conditions.¹⁹²³ In order for the exceptions

1918 If a substantial terminal loss would have been recognizable on the distribution had it not been for the "1/2" ratio it could prove beneficial to have the beneficiary purchase the property from the trust so as to force its entire recognition. Beneficial **ownership** would have to reside with the trust and not the beneficiary in order for this to occur. If the trust has been varied to allow the capital beneficiaries to realize the capital appreciation in trust property disposed of the trust property could be purchased (assuming beneficial ownership doesn't reside with the potential purchaser) and the gain could be distributed to him accompanying a Sec. 104(21) taxable gains designation allowing him to utilize his section 110.6 C.G.D. or net capital losses. The same could **not** be done with the P.B.E. since a spouse would have the only preferred beneficiary's share under a Sec. 104(4) trust.

1919 trust cost plus the excess of the a.c.b. of the interest satisfied over the interest's Sec. 108(1)(d) cost amount

1920 or its substitute

1921 of the trust

1922 regardless of what the Department contends its practice is

1923 Though this would disallow the advantageous use of loss property in a trust to offset income from other property that

to be available to the contributor he must receive back the particular property or its substitute that he contributed or his spouse or spousal trust etc. must receive it during his life and the recipient must be resident in Canada.¹⁹²⁴ In such cases the Sec. 107(2) tax free distribution provision will apply to the distribution. If the taxpayer in respect of whom the Sec. 75(2) provision applied isn't in existence at the time of the distribution either to any party or to a party who would otherwise be a qualified spousal recipient the Sec. 107(4.1) provision will still apply.¹⁹²⁵

“Where subsection 75(2) applicable to trust – Sec. 107(4.1)”

(4.1) Subsection (2.1) applies (and subsection (2) does not apply) in respect of a distribution of any property of a particular personal trust or prescribed trust by the particular trust to a taxpayer who was a beneficiary under the particular trust where

(a) the distribution was in satisfaction of all or any part of the taxpayer's capital interest in the particular trust;

(b) subsection 75(2) was applicable at a particular time in respect of any property of

(i) the particular trust, or

(ii) a trust the property of which included a property that, through one or more dispositions to which subsection 107.4(3) applied, became a property of the particular trust, and the property was not, at any time after the particular time and before the distribution, the subject of a disposition for proceeds of disposition equal to the fair market value of the property at the time of the disposition;

(c) the taxpayer was neither

(i) the person (other than a trust described in subparagraph (b)(ii)) from whom the particular trust directly or indirectly received the property, or property for which the property was substituted, nor

(ii) an individual in respect of whom subsection 73(1) would be applicable on the transfer of capital property from the person described in subparagraph (i) ; and

(d) the person described in subparagraph (c)(i) was in existence at the time the property was distributed.¹⁹²⁶

isn't subject to Sec. 75(2).

¹⁹²⁴ The property need not have been of the character that would have allowed Sec. 73(1) to have applied to it on the roll in to the trust: it could be inventory of the contributor that didn't gain from Sec. 73(1). The provision describes **the person** and not the nature the property must be at time of the distribution hence the property can be inventory or capital property of the trust and as long as the recipient is a qualified spousal recipient in respect of the contributor during his life the provision won't apply. The property could even be inventory to the contributor otherwise not eligible for Sec. 73(1) treatment had it been transferred directly.

¹⁹²⁵ Pursuant to a technical interpretation provided on March 22, 1991, by the Financial Industries Division, where there are several joint settlers all must have died in order for the provision not to apply: only one of them dying will not be sufficient.

¹⁹²⁶ Sept. 10, 2010 FINANCE TECHNICAL NOTES (Part 1 - non-resident trusts): Subsection 107(4.1) prevents the application of subsection 107(2) on a distribution of trust property to a beneficiary where, generally, subsection 75(2) was at any time applicable in respect of property of the trust. Subsection 107(4.1) is amended so that the determination of whether subsection 75(2) was at any time applicable in respect of property is made without regard to paragraph 75(3)(c.2). Therefore, if subsection 75(2) is otherwise applicable in respect of the property, the property remains such a property for the purposes of subsection 107(4.1) even though the property is one in respect of which an electing contributor will not be attributed income under subsection 75(2).

This amendment applies to distributions after August 27, 2010.

Oct. 19, 2007

Where the provision applies to a distribution in satisfaction of a capital interest notwithstanding Sec. 107(2)(a) to (c), subsection 107(2.1) will apply to cause the trust to recognize a disposition of the property for proceeds equal to the property's FMV.

While one would think that this provision would be the limiting factor in using a Sec. 75(2) trust to double income/loss recognition, the catch-all is very porous. It targets only trusts to which Sec. 75(2) applied or trusts that held that property but doesn't capture instances where the secondary trust was substituted, hence

Dept. of Finance letter: Ms. Kathy M. Munro, [xxx]
Dear Ms. Munro:

I am writing in connection with your letter, and subsequent discussions with officials of the Tax Policy Branch, concerning the application of subsection 107(4.1) of the Income Tax Act. In your view, subsection 107(4.1) is inappropriately broad in its effect on distributions from trusts, particularly where the trust was created before the provision's introduction.

You have provided an example of an inter vivos trust that was settled in 1986 through the gift of a gold coin with nominal value. Because the terms of the trust set out that decisions of the trust are to be determined by a majority that includes the settlor of the trust, subsection 75(2) of the Act may apply to attribute any income earned on the gold coin back to the settlor. As a result of the application of subsection 75(2) to the gold coin, subsection 107(4.1) will also apply to distributions of property from the trust. The effect of the application of subsection 107(4.1) will be to have subsection 107(2.1) of the Act apply to the distributions of property and thus prevent a rollover of the trust's properties to the beneficiaries (other than the settlor). Unlike subsection 75(2), which applies only in respect of the property contributed to the trust by the settlor, subsection 107(4.1) will apply not just to the gold coin, but to all of the properties of the trust that are distributed to beneficiaries. In your view, because the trust was established before 1989 (the year in which distributions were first subject to subsection 107(4.1)) it would be appropriate to allow some form of relief to the trust, particularly in respect of the property of the trust to which subsection 75(2) has never applied.

Having regard to your submission, we are prepared to recommend to the Minister of Finance that subparagraph 107(4.1)(b)(ii) of the Act be amended so as not to apply in determining whether subsection 107(2.1) applies in respect of a trust distribution that occurs after 2001 and before 2009 where

(a) the distribution is of property to which subsection 75(2) had not applied at any time while the property was held by any of the trusts referred to in subparagraph 107(4.1)(b)(ii),

(b) one of the trusts referred to in subparagraph 107(4.1)(b)(ii),

- was created before 1989, and

- held, at a time before 1989, particular property that was, at that time, subject to subsection 75(2), and

(c) none of the trusts referred to in subparagraph 107(4.1)(b)(ii) held any property (other than the particular property) that was subject to subsection 75(2).

While I cannot offer any assurance that Parliament will agree with our recommendation, I hope that this statement of our intentions is helpful to you.

Yours sincerely,

Brian Ernewein, General Director - Legislation, Tax Policy Branch

March 2001 FINANCE TECHNICAL NOTES: Subsection 107(4.1) applies in certain cases where a reversionary trust distributes property to a specified beneficiary under the trust. When this occurs, there is a deemed disposition of the property at its fair market value.

Subsection 107(4.1) is amended so that, in these cases, the rules set out in amended subsection 107(2.1) apply.

Subsection 107(4.1) is also amended so that the existing rule that provides for a deemed disposition of a property at its fair market value generally will apply to a distribution made after March 16, 2001 of a particular property by a particular trust that is not a reversionary trust where:

- a trust that is a reversionary trust at a particular time has transferred property to the particular trust through one or more dispositions to which subsection 107.4(3) applied, and

- the particular property was not, at any time after the particular time and before the distribution, the subject of a disposition for proceeds of disposition equal to the fair market value of the property at the time of the disposition.

1988 FINANCE TECHNICAL NOTES: A reversionary trust is a trust that has, been established under which property of the trust may revert to the settlor or pass to persons who will be determined by the settlor in the future. If the property appreciates in value, there would generally be no immediate tax consequences as the property would generally be transferred to beneficiaries on a tax-free basis under the rules provided in subsection 107(2). If the settlor had held such appreciating property directly, the transfer of the property would generally have been a taxable transaction.

The purpose of new subsection 107(4.1) is to remove the tax advantage from establishing a trust which is merely an intermediary through which the settlor holds appreciating property for a period during which the property could revert to him or he retains a right to determine who should receive the trust property. After 1988, a rollover under subsection 107(2) will not be allowed in respect of any distribution of property by a trust where subsection 75(2) has been applicable to any property of the trust. In this case, the rules in paragraphs 107(4)(d) to (f) will apply for the purpose of determining the proceeds of disposition of the trust property and the tax consequences to the beneficiary to whom the property was transferred. However, the new rule will not apply to a disposition of property after the death of the settlor or where the property was transferred to the settlor. The new rule will also not apply (and the rollover under subsection 107(2) will thus continue to be available) where the property was transferred to the spouse of the settlor or another individual entitled to receive property from the settlor on a rollover basis under subsection 73(1).

paragraph (b) can be faulted there. Paragraphs (c) and (d) target only people who did have something to do with how the property was planted in the trust. While the provision applies to indirect receipts of property by the trust one is left wondering where the line exists in the chain of ownership the property that is eventually held in the trust: if an intermediary or terminal- contributing-to-the-trust corporation is dissolved by its principal shareholder who initially owned the property will the provision apply?

Very much unlike the Sec. 107(4) provision the tax consequences of which it adapts the provision is not prevented from applying to inventory of a trust that isn't land inventory, (which Sec. 107(4) doesn't apply to due to the targeting in subpara. (a) therein). Inventory cannot be used to satisfy the interest without causing the trust to recognize a FMV disposition thereof. The beneficiary will then be deemed to have acquired the property received at a cost equal to the proceeds recognized by the trust and to have disposed of his capital interest satisfied for proceeds of disposition equal to what he would have recognized as a cost of the property determined under Sec. 107(2)(b) net of any debt or obligations to pay that were to be assumed as a condition of the distribution which will generally allow the beneficiary to avoid any tax consequences.

The application of the provision will cause the trust to recognize capital gain or losses, terminal losses or recapture, or income and losses on the commutation however if Sec. 75(2) applies to the particular property distributed so as to allow the contributor and the trust to recognize the tax consequences obviously it would be more beneficial if only loss accrued property were distributed **while the contributor was resident or alive**. If property with accrued liabilities were distributed a double income inclusion would occur unless the above were the case.¹⁹²⁷

Obviously the subsection 107(4.1) provision has the ability to both cause tax advantages and disadvantages where Sec. 75(2) can be made to apply or where its application can't be avoided. It applies to distributions made after the 1988 calendar year.

Capital Distributions to Non-Residents.

Subsection 107(5), applicable where Sec. 107(2) would have normally applied to a personal trust distribution, concerns the distribution of property by **any** trust to a non-resident beneficiary at the time of the distribution but only where the property wasn't a Canadian resource property or a property that is, or would be, if at no time in the tax year of the trust in which it was distributed, a taxable Canadian property, as defined in Sec. 115(1) and 248(1). The provision applies to any trust, regardless of its residence, if the distribution was made to any non-resident taxpayer beneficiary while the provision was amended in the last reform to also cause recipients who are partnerships other than "Canadian partnerships" to be caught.¹⁹²⁸ "Canadian partnership" defined for purposes of the Act through Sec. 248(1) to section 102 is a partnership all the members of which were, at the time when the expression was used, resident in Canada, and where one of the members of the partnership was another partnership the criteria shall apply to it as well.

The subsection 107(5) provision still does not apply to distributions to Canadian resident non-resident-owned investment corporation or family trusts resident in Canada where the beneficiaries are non-resident, which after the distribution become non-resident and is able to shelter its property from tax collections.

The Sec. 107(5) provision is designed to catch distributions of property other than Canadian resource property or taxable Canadian property to non-residents only where the trust is a personal or prescribed trust and where the distributions therefrom would have been treated under Sec. 107(2).

¹⁹²⁷ One can see the obvious danger to the tax base if the Department does not amend Sec. 75(2) in respect of the double recognition feature: a taxpayer seeing that property is dropping in value transfers it to a trust for his offspring to be delivered when they reach a certain age. The terms of the trust allow Sec. 75(2) to apply which can be very easy and the property is distributed while suffering Sec. 107(4.1) treatment: a loss is recognized by the contributor on the transfer of the property to the trust, out of the trust to the beneficiary, **and technically**, by the contributor at that time as well. The loss recognized by the trust could be used in fact to offset any capital gain recognizable on a subsequent distribution of property with accrued tax liabilities **which Sec. 75(2) doesn't apply to** so as to produce no tax consequences to the trust but produces only tax benefits for the contributor. Subsection 75(2) is, in the author's opinion, a gold mine waiting to be properly accessed.

¹⁹²⁸ Of course the Canadian tax authorities would not have access to tax distributions of property by a non-resident trust of non-resident property to a non-resident party.

Where subsection 107(5) applies the trust will be deemed to have disposed of the property distributed for proceeds equal to its fair market value at the time, while the beneficiary will be deemed to have acquired the property for a cost equal to those proceeds. It should be noted that the Sec. 107(5) provision applies notwithstanding only Sec. 107(2) para. (a) to (c) **but not (d)** hence where the deemed cost to the beneficiary of depreciable property of a prescribed class is less than the trust's historic capital cost he will not be exposed to recapture of C.C.A. previously deducted by the trust. The trust will obviously recognize all tax liabilities and benefits inherent in the property upon its distribution. Under paragraph (c) the beneficiary will be deemed to have disposed of the part of the interest satisfied with the property for proceeds equal to the adjusted cost base of the part satisfied immediately before the distribution thus he will not recognize any tax consequences. If the beneficiary had a capital interest with an expensively derived ACB, as well as an income interest, it could prove favorable to satisfy the income interest with a Sec. 106(3) distribution, which will produce the same tax consequences for the trust but if the capital interest can be disposed of a capital loss could be recognizable if less trust property is realizable by the capital interest holder. If the interest has a substantial ACB that approximately reflects the FMV of the trust property which is to be distributed in satisfaction of it, and which caused full Canadian tax consequences in the form of capital gains to its previous holder¹⁹²⁹ the interest could be transferred to a Canadian resident trust so as to disallow Sec. 107(5) but Sec. 107(2) to apply. If the interest has a substantial ACB its transfer to the resident trust may produce little if any tax consequences while subsequent to such the head trust could make a Sec. 107(2) distribution whereby there would be a Sec. 107(2)(b) cost bump in the property's ACB whereafter the trust could become non-resident when the property has a large ACB thereby reducing Sec. 128.1(1) tax consequences that would have otherwise applied to the nontaxable Canadian property. The excessive ACB of the capital interest that would otherwise have produced no relief in the face of the Sec. 107(5) disposition by the trust would then be favorably applied. Even if the non-resident recognizes **some** tax consequences¹⁹³⁰, aggregately, less tax exposure may be sustained with the above procedures.

"Distribution to non-resident – Sec. 107(5)"

(5) Subsection (2.1) applies (and subsection (2) does not apply) in respect of a distribution of a property (other than a share of the capital stock of a non-resident-owned investment corporation or property described in any of subparagraphs 128.1(4)(b)(i) to (iii)) by a trust resident in Canada to a non-resident taxpayer (including a partnership other than a Canadian partnership) in satisfaction of all or part of the taxpayer's capital interest in the trust.¹⁹³¹

¹⁹²⁹ though this need not be the case and in fact if the interest didn't produce such tax consequences the same procedures should be followed

¹⁹³⁰ which could be reduced by inflating the tax cost of the trust's property or through the use of certain powers of appointment so as to give the capital interest a substantial "cost amount"

¹⁹³¹ July 2010 FINANCE TECHNICAL NOTES (Part 1 technical): Subsection 107(5) applies to the distribution of property (other than shares in non-resident-owned investment corporations or property described in any of subparagraphs 128.1(4)(b)(i) to (iii)) by a trust resident in Canada to a non-resident beneficiary. In these circumstances, the rollover under subsection 107(2) is not available and instead subsection 107(2.1) will apply to determine the Canadian income tax consequences of the distribution to the trust and the beneficiary.

Subsection 107(5) is amended so that it applies whether the trust making the distribution is resident in Canada or not. This amendment applies to distributions made after, February 27, 2004.

March 2001 FINANCE TECHNICAL NOTES: Subsection 107(5) applies to the distribution of property (other than taxable Canadian property, Canadian resource property and shares in non-resident-owned investment corporations), where the distribution would otherwise be made to a non-resident beneficiary on a rollover basis under subsection 107(2). With regard to such distributions, subsection 107(5) provides for a deemed disposition of the distributed property at its fair market value and an acquisition by the beneficiary for the same amount. In addition, paragraph 107(5)(c) provides for proceeds of disposition of the relinquished capital interest equal to the adjusted cost base of that interest.

Subsection 107(5) is amended to replace existing exemptions with regard to taxable Canadian property and Canadian resource property with exemptions for property described in any of new subparagraphs 128.1(4)(b)(i) to (iii). For further detail on the enumerated subparagraphs, see the commentary on amended subsection 128.1(4).

Subsection 107(5) is also amended so that it only applies with regard to distributions by trusts resident in Canada. This amendment recognizes that, if a distribution of property is made from a non-resident trust to a non-resident beneficiary, Canada's authority to ultimately collect tax on a future disposition of the property has not been compromised because of the distribution. This amendment is consistent with the policy with regard to distributions before October 2, 1996, as the

The subsection does not apply to distributions of taxable Canadian property or Canadian resource property and these two categories of property represent unique advantages in the distribution of property to non-residents. Under Sec. 115(1)(b)(vi) the capital interest in a trust residing in Canada will be considered a taxable Canadian property hence if the primary trust property is transferred to an *inter vivos* trust which it creates with a power of appointment for capital interests therein those interests can be distributed using Sec. 107(2). There will not be any change in the tax positions however since the *inter vivos* trust is still resident and distributions from it will suffer Sec. 107(5) while if it leaves the country Sec. 128.1(1) will apply to its non-taxable Canadian property. What can occur however is that the *inter vivos* trust can be of a nature that has a power of appointment over excessive trust cash a non-resident co-settlor contributed so as to allow the particular interest to have a very large Sec. 108(1)(d) cost amount allowing for its virtual tax free disposition to a Canadian resident mule if need be who can ferry the trust property into the foreign jurisdiction after the *inter vivos* trust has distributed it to it allowing for a Sec. 107(2) application of that tax free ACB which will reduce the Sec. 128.1(1) consequences. The power could subsequently be exercised so as to distribute the cash to a non-resident disallowing Sec. 105(1) through 214(3)(a) from applying withholding tax on the payment of the contentious benefit. Of course the Department would try and swat this arrangement down with a section 245 application though it's not known how successful they could be if other "legitimate reasons" were forwarded by the parties for engaging in such.¹⁹³² If there isn't a change in the beneficial ownership of the property transferred to the *inter vivos* trust there will not be a Sec. 54(c) disposition that will cause tax consequences.

It's important to recognize that the subsection 107(2) to (5) distribution provisions apply only where the legal title of trust property is distributed to a beneficiary in satisfaction of any part of his capital interest though it would appear no particular part may be satisfied. They do not apply where property is distributed to a non-beneficiary person in satisfaction of the beneficiary's capital interest since the beneficiary is not in fact realizing the property and the recipient of the property **may** have to include its value in his income fully under Sec. 105(1) **if** he has not given value for it.

Loss Reductions.

Where a personal trust distributes property to a beneficiary in satisfaction of his capital interest Sec. 107(2) will usually apply to allow the trust to be deemed to have disposed of the property for proceeds equal to its

type of property deemed to be disposed of before that date under subsection 107(5) would not have resulted in a non-resident trust being subject to Canadian tax. Subsection 107(5) is amended so that, where it applies, the amended rules in subsection 107(2.1) provide for the corresponding tax consequences.

June 1992 FINANCE TECHNICAL NOTES: Subsection 107(5) provides that where trust property is distributed by a personal trust or a prescribed trust to a non-resident beneficiary in satisfaction of the beneficiary's interest in the trust, the rollover provisions of subsection 107(2) are not applicable unless the property is taxable Canadian property (as defined in subsection 115(1)) or Canadian resource property. Subsection 107(5) is amended to extend this rollover treatment to shares in the capital stock of a non-resident-owned investment corporation that is not taxable Canadian property. This amendment puts the non-resident beneficiary, in the same position as if the share were held directly by the non-resident beneficiary rather than through a trust.

1988 FINANCE TECHNICAL NOTES: Subsection 107(5) provides that where trust property is distributed by a personal trust or a prescribed trust to a non-resident beneficiary in satisfaction of his capital interest in the trust, the rollover provisions of subsection 107(2) are not applicable unless the property is taxable Canadian property (as defined in paragraph 115(1)(b)). Rollover treatment is appropriate in the case of taxable Canadian property since any gain arising on the subsequent disposition of such property by the non-resident beneficiary will be taxable at the full personal or corporate tax rate under Part I.

The amendment to subsection 107(5) extends the rollover under subsection 107(2) to distributions of Canadian resource properties to non-resident beneficiaries. Any income arising from such properties (including any income on the subsequent disposition of such properties) will ordinarily be subject to tax under Part I.

Subsection 107(5) is also amended to deny the rollover where capital property of a trust is distributed to a partnership, other than a Canadian partnership. The expression "Canadian partnership" is defined in section 102 as one in which all members are resident in Canada.

¹⁹³² The power need not be exercised by a non-resident and the non-resident co-settlor need not be related to the ultimate beneficiary.

cost amount as defined in Sec. 248(1) hence the trust will not recognize any tax consequences in respect of the property if it has accrued losses or terminal losses. The capital recipient may also be in a position to bump up the cost of the property with excessive interest ACB. In both instances the beneficiary may be placed in a position where the property received, due to one or the other factors, has a substantial accrued loss that may be deductible when the property is disposed of. If the beneficiary is able to systematically inflate the ACB of the interest via powers of appointment, changes in residency, etc., before the distribution is made or before the interest is canceled, without tax consequences to any party as per Sec. 107(1)(b) it may be possible for him to recognize capital losses when either the interest is canceled or the distributed property is subsequently disposed.

There isn't any provision in the Act which is specifically capable of hindering the occurrence of a loss through an interest cancellation just described, however Sec. 107(6) does create such a hindrance in respect of losses that have accrued while certain property was owned by the trust.

Subsection 107(6) applies to restrict the amount of "loss" that a taxpayer can recognize upon the disposition of "property or property for which it was substituted" when it was formerly "owned by a trust" and thus it stands quite capable of hindering a loss recognition where a loss loaded property was rolled out to a beneficiary under Sec. 107(2). The provision states effectively that notwithstanding any other provision of the Act, where a person or partnership has disposed of property and would otherwise have recognized a loss on the disposition the loss shall be reduced by such amount as may reasonably be considered to have accrued during the time it was held by the trust and during which period of time certain parties **did not** own a "capital interest" in the particular trust. Obviously since the character of the loss is not described it can include capital, terminal, allowable business investment, as well as losses that are recognized on account of income activities. It's equally important to recognize that it is the amount of loss that is to be reduced and not simply the amount of loss that is deductible hence superficial losses are subject to the rule.

The amount of loss which will be reduced is the amount which may reasonably be considered to have **accrued** during the period "in which the property or property for which it was substituted **was owned by a trust**" when neither the disponent, a person related to the disponent, or any partnership in which the disponent or person related to the disponent was a "majority interest partner", held a capital interest of any degree in the trust. As per the first requirement: if the property or substitute property did accrue a loss while held in the **particular** trust in which the appropriate party did not hold a capital interest the loss wouldn't be recognizable however one has to note which property must accrue the loss. The provision recognizes "the property or property for which it was substituted was owned by the trust" as being the particular property the loss on the disposition of which is to be reduced: it does not recognize property which wasn't owned by the trust or property for which it was substituted as being the property which can cause the loss hence capital interests in the trust itself will not have their losses cut back if they are disposed of at a loss since they are not owned by the trust and they are not substitute property for trust property that were owned by the trust.¹⁹³³ In a two trust level situation some serious tax consequences can occur in that the provision recognizes only property or its substitute as was owned by the trust to which the capital interest relates as being a loss base. If the top tier trust transfers a property with an accrued loss to a second tier trust whereunder a beneficiary has a capital interest¹⁹³⁴ a loss recognized by the ultimate beneficiary on an ultimate disposition of that property will be reduced by the amount accrued in the top tier trust unless it can be shown that that property was a substitute property in the hand of the second tier trust.¹⁹³⁵

¹⁹³³ Subsection 248(5) defines substitute property but Sec. 107(5) refers to property owned by the trust for which the original property was substituted: it does not recognize substitute property of the trust property which **wasn't owned by the trust** and thus capital interests in the trust, though can be argued to be trust property substitutes are exempt since they were not owned by the trust.

¹⁹³⁴ without him or any other Sec. 107(6) party having a capital interest in the top tier trust

¹⁹³⁵ If one of the appropriate parties has capital interest, of any degree based on any entitlement in the top tier trust the loss won't be cut back. The same holds true in respect of the particular top tier trust accrued loss where the appropriate party has a capital interest in the top tier trust and then acquires a capital interest in the second tier trust to which the property is distributed.

“Loss reduction – Sec. 107(6)”

(6) Notwithstanding any other provision of this Act, where a person or partnership (in this subsection referred to as the “vendor”) has disposed of property and would, but for this subsection, have had a loss from the disposition, the vendor’s loss otherwise determined in respect of the disposition shall be reduced by such portion of that loss as may reasonably be considered to have accrued during a period in which

(a) the property or property for which it was substituted was owned by a trust; and

(b) neither the vendor nor a person that would, if section 251.1 were read without reference to the definition “controlled” in subsection 251.1(3), be affiliated with the vendor had a capital interest in the trust.¹⁹³⁶

The provision recognizes three categories of parties who may hold a capital interest during a period and thus negate the cut back: the ultimate property disponer, any person related thereto at the time of the disposition, or any partnership in which the previous two parties were majority interest partners as described in Sec. 97(3.1) however the provision does not indicate that such relationships must exist while the loss is accruing or whether they can be developed subsequently. The provision does specify that they must hold a "capital interest" in the trust, not just a beneficial interest hence one would want to ensure that the right they have is of the nature described in Sec. 108(1)(c). In the case of a personal trust the capital interest could be in the form of a contingent interest such as a reversionary right but could not be a discretionary interest. the important note to make is that the interest need not be referenced to or based on the particular property and can be utterly minuscule in comparison to the others.

Subsection 107(6) was introduced in 1987 applicable to property distributed to a beneficiary from the trust in satisfaction of any part of a capital interest acquired after January 15th, 1987, except where the taxpayer was required to acquire the interest pursuant to an agreement in writing entered into on or before that date. Regardless of how the interest is acquired after Jan. 15th, 1987, if property is distributed in respect of it the disposition of the property may attract the application of the provision. If the interest remains the same, as a right, but the scope thereof is enlarged due to disclaimers renunciations of other interests an interest has not been acquired, only increased in scope. It remains the same right. Since the provision applies only in respect of the loss that accrued when a capital interest was not owned by any of the three parties there is considerable flexibility allowing for the systematic disposition and reacquisition of the right so as to inflate its legitimate

¹⁹³⁶ Dec. 1997 FINANCE TECHNICAL NOTES (technical): Subsection 107(6) is an anti -avoidance rule designed to deal with an acquisition of a capital interest in a trust that has a property with an accrued loss. Where the property is distributed to the beneficiary in satisfaction of that interest, any loss on a subsequent disposition of the property will be denied to the extent that it can be considered to have accrued while owned by the trust and at a time when neither the beneficiary, a person related to the beneficiary nor a partnership of which the beneficiary or a related person was a majority interest partner, had a capital interest in the trust.

This subsection is amended as a consequence of the introduction of the concept of "affiliated persons" in new section 251.1. As amended, subsection 107(6) will limit the recognition of a loss only to the extent that it arose when neither the beneficiary nor a person affiliated with the beneficiary had a capital interest in the trust. For this purpose, the affiliation test set out in new section 251.1 is to be read without reference to the extended definition of "controlled" in subsection 251.1(2). 1987 FINANCE TECHNICAL NOTES: New subsection 107(6) is an anti-avoidance rule designed to discourage a taxpayer from acquiring a capital interest in a trust that has a property with an accrued loss so the property can be distributed to the taxpayer in satisfaction of such interest at the cost amount of the property to the trust. Without this rule, the accrued loss could be realized by the taxpayer on a subsequent disposition of the property and used to shelter his other income from taxation. The rule reduces the taxpayer's loss on the subsequent disposition by the portion of the loss that may reasonably be considered to have accrued during a period in which the property was owned by the trust and a capital interest in the trust was not owned by the taxpayer, a person related to the taxpayer or a partnership of which the taxpayer or a person related to the taxpayer was a majority interest partner. For this purpose, "majority interest partner" has the meaning assigned by amended subsection 97(3.1). (Under that definition, a taxpayer is a majority interest partner of a partnership at any time if the taxpayer, his spouse and certain related persons either are entitled to more than 50% of the partnership income for the partnership's fiscal period that includes that time or would be entitled to more than 50% of the partnership property if the partnership were to be wound up at that time.)

ACB. If any type of capital interest was held by the vendor apparently at the time the loss accrued, or a partnership of which the vendor or the person related thereto was a majority interest partner, as described in Sec. 97(3.1), when the loss accrued, it will be recognizable. If the interest was transferred between non-arm's length parties and a power of appointment was subsequently exercised to undermine the enforceability or the substance of the right the Sec. 107(6) loss cut back would, in the author's opinion, not apply since the loss resulted from the exercise of the power during the interest's ownership.

Since the provision not withstands any other provision of the Act it would apply even when deemed dispositions have occurred, as per section 128.1, upon the taxpayer becoming non-resident.

Indirect Distributions, Benefits and Commutations.

Subsections 107(2) to (5) apply where a distribution of the legal title of trust property to a beneficiary satisfies his capital interest or part thereof and thus the three obvious requirements must be satisfied before they can apply.

If legal title is transferred out of the trust in satisfaction of a beneficiary's interest but transferred to the beneficiary's creditor in satisfaction of his claim against the beneficiary the above provisions will not apply since the distribution is not to the beneficiary and since the beneficiary's right is extinguished Sec. 54(c)(ii)(B) will allow him to recognize a disposition however Sec. 54(h) doesn't expressly describe him as having received proceeds of disposition. A debt reduction however in this instance should be considered as proceeds of a disposition since the taxpayer is having his right satisfied for the consideration of the reduction in debt. Since the creditor isn't realizing a benefit from the trust¹⁹³⁷ he will not recognize a Sec. 105(1) inclusion while the beneficiary will not as well if the Department pursues the position that the debt reduction is proceeds of disposition. The gist of the provisions operation is that the beneficiary should be taxed on the income arising from the property held in trust for him and this is facilitated by Sec. 107(2) generally applicable but understandably in response to special situations the Department has altered this treatment with the Sec. 107(2.1)-(5) distribution provisions. If the beneficiary was to have received the property from the trust he would have had to dispose of it in a FMV disposition in order to gain funds to satisfy the creditor and thus if the property is distributed directly to the creditor basically the same should occur. In fact however the trust recognizes a fair market value disposition of the property conveyed, as per Sec. 54(c) not negated by a tax free roll out provision in Sec. 107(2), and the beneficiary recognizes the debt reduction as proceeds of disposition of his interest and there isn't any tax free roll out **but** the cost amount of the capital interest satisfied obviously becomes critical in ensuring that the beneficiary doesn't sustain tax consequences. In such a case Sec. 108(1)(d)(ii) will apply to determine the interest's cost amount which as per Sec. 107(1)(a) may prevent the beneficiary from recognizing a capital gain but when the interest has a legitimate ACB and the proceeds are lower than it a capital loss will be recognizable.¹⁹³⁸ If the beneficiary has been able to increase the ACB of his capital interest in such a manner that caused no Part 1 tax consequences then the capital loss will be generated tax free, though its value of course depends on the actual way in which it was incurred: did it actually cost the taxpayer consideration.

There are three distribution provisions that cause the beneficiary to be deemed to have disposed of his capital interest for proceeds essentially equal to its ACB when the trust has recognized a fair market value of the property distributed: Sec. 107(4), (4.1) and (5). If the trust incurs a FMV disposition of the property in respect of a distribution in respect of a capital interest that the beneficiary has legitimately obtained tax-causing ACB in respect of there will be inequitable treatment if that ACB was obtained by paying tax-causing

¹⁹³⁷ he has a valid claim of value which is being extinguished

¹⁹³⁸ The difference in the cost amounts of the interest as computed under Sec. 108(1)(d) para. (i) and (ii) may be substantial when the trust has substantial amounts of property with substantial tax cost that when apportioned on the f.m.v. of capital interests basis will cause the latter to exceed the tax cost of the particular property distributed. The beneficiary recognizes proceeds of disposition equal to the f.m.v. of the debt extinguished: how much someone would want to assume the debt, not the fair market value of the property distributed to extinguish it though the two may be the same. The tax cost of the interest satisfied, which in the case where no legitimate a.c.b. has been incurred, will be only equal to the **tax cost of the property in trusts hands if the distribution is made to the beneficiary** but if not then it will equal the relative proportion of the aggregate net tax cost of the trust property before the distribution. As a result of the indirect distribution the beneficiary may recognize a capital gain if the composite of the trust property and the nature of the outstanding capital interests is not of a character that will allow the interest's cost amount to be greater than the f.m.v. of the debt extinguished.

proceeds when the underlying property had a greater fair market value: the interest will be disposed of for its ACB without creating a capital loss for the beneficiary which would be appropriate. In this respect allowing the trustee to distribute property in satisfaction of the beneficiary's debt will allow the capital loss to be recognized by him while it should be pointed out that the trust is to recognize a fair market value disposition in such cases anyhow. Where Sec. 107(2) is to apply one would want to ensure that the trustees have the ability to adjust the distribution amount in respect of the tax that will be incurred on the fair market value distribution so as to prevent a prejudice to the other beneficiaries whose entitlements will suffer to pay off the tax.

Recently the CRA has provided a private opinion that Sec. 105(1) will apply to a distribution to a third party for the benefit of the beneficiary though it has explicitly rule out the recognition of a disposition of the interest satisfied. It also provided: "Where it can be established in fact and in law that section 107 of the Act is applicable to a distribution of the property in satisfaction" of a capital interest Sec. 105(1) would not apply if the beneficiary directed or concurred with the distribution ie: having practical rights of beneficial ownership.¹⁹³⁹ Apparently this latter exception is brought on by the same reasoning as that presently underlying the section 70 roll-over provisions - the term distributed is to be equated with the creation of beneficial proprietary rights regardless of who holds legal title as agent/trustee. If this is the case how will the beneficiary recognize a disposal of the trust interest satisfied? Apparently the beneficial ownership of the property will have its cost bumped via Sec. 107(2) etc. when the property is transferred from the trust to the creditor while the beneficial ownership is severed the beneficiary will recognize a FMV disposition of this beneficial ownership.

Subsections 107(2) to (5) apply where part or all of a capital interest has been satisfied as a consequence of the distribution and in this regard one must not confuse a commutation with a mere advance that is to be taken into consideration subsequently when a commutation is in fact executed. Advances will be captured by sec. 53(2)(h) and will reduce the capital interest's ACB if they are made in respect of a capital interest in a personal trust that was acquired for consideration payable to anyone or non-personal trusts other than commercial trusts described in Sec. 108(1)(j)(ii) to (v). Where Sec. 53(2)(h) does in fact apply the ACB of the interest will be reduced to produce greater capital gains potential upon a subsequent distribution or interest disposition in the case where the trust isn't personal while if it is a personal trust the subsequent disposition of the interest or commutation via Sec. 107(2) will not produce any tax consequences due to the Sec. 108(1)(d) cost amount mechanics.

Whether or not a particular payment is an advance or a terminal extinguishment or part extinguishment is to be determined by the terms of the receipt, intention of the trustee, and the nature of the interest it is being advanced in respect of. Advances are taken into consideration when a terminal distribution is made and their value will reduce the amount the beneficiary may subsequently realize when the right is settled. The distinction between an advance and a commutation is very important when one examines the punitive distribution provisions in Sec. 107(2) and in a different way Sec. 107(4)-(4.1). In the former provision both the trust and the beneficiary will recognize a taxable disposition of the property and the interest while if an advance is merely made the trust will recognize a taxable disposition of the property and the beneficiary will recognize a reduction in the ACB of the interest¹⁹⁴⁰. In the case of the two other provisions the trust will only recognize a disposition of its depreciable capital property for proceeds half way between the property's FMV and its UCC hence if a terminal loss is to be assessed in the trust an advance will produce more of it when the trust recognizes a full FMV disposition rather than an adjusted one. It is not known whether an advance which caused a Sec. 105(1) benefit due to the fact that it couldn't have caused a Sec. 53(2)(h) adjustment in the case of personal trusts where its source was certain receipts of non-taxable income will be reassessed when the advance is taken into consideration in reducing the beneficiary's terminal realizable amount. In such a case he has not in fact realized a benefit in respect of his interest other than that caused by the technicality and had he refused the advance the proceeds would have been distributable to him tax free using Sec. 107(2) in the case of personal trusts.

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1940 which may translate into a capital gain, if at all, **only subsequently**

Where advances in respect of a personal trust capital interest that was acquired for consideration payable to any party reduce its ACB to below 0 as per Sec. 40(3) a gain will be recognizable supposedly though when one examines the Sec. 40(3)(b)(i) cost amount one can see one possible interpretation that may avoid it. The negative ACB is to be recognized as a gain if the amount of Sec. 53(2) reductions exceed the amount of Sec. 53(1) increases plus the cost to the taxpayer of that interest determined for the purpose of computing the adjusted cost base to him of the interest at that time. **A disposition of the interest is not in fact deemed to have occurred though the gain is deemed to be from the disposition of the interest and only** for purposes of the capital gains deduction rules is the interest deemed to have been disposed of. Subsection 107(1.1) provides for the notwithstanding of Sec. 69(1)(c) in computing the cost of a capital interest on its acquisition but only for purposes of Sec. 107(1) which computes the ACB of the interest when it is in fact disposed of. This is irrelevant in this case since the interest was in fact acquired other than as a gratuitous transfer to which Sec. 69(1)(c) could apply, **however**, Sec. 107(1.1) also prevents the cost to the beneficiary from being anything other than nil if its cost isn't recognized to be equal to the fair market value of the consideration paid to the trust at the time of the issuance where the interest wasn't acquired from a beneficiary but purchased by the beneficiary from the trust. If the cost isn't equal to the FMV of the proceeds at the time of issuance the interest will still have an ACB based on the amount paid for these purposes since Sec. 107(1.1) doesn't apply since a Sec. 107(1) disposition isn't being recognized. In the same way the cost amount of the interest computed via Sec. 108(1)(d) is irrelevant in this case and it will not prevent a capital gain from being recognized where selective distributions have been made so as to reduce the ACB of the interest and withhold advances from the other beneficiaries.

The fact that a capital interest isn't yet enforceable does not prevent a payment in respect of it from being recognized as in satisfaction of it so as to allow section 107 to apply. Understandably an inter-beneficiary consensual arrangement could allow the trustee to distribute excessive consideration to extinguish a distantly future contingent future right though Sec. 105(1) could apply to include in income the benefit the beneficiary realizes in the form of the excess consideration.¹⁹⁴¹ This would not be the case where the beneficiary isn't resident in Canada.¹⁹⁴² In the author's opinion the "other" beneficiaries would not be recognizing any dispositions on such an agreement since their rights would remain intact and such a practice could prove effective at creating capital losses/excessive cost bumps when trust property is subsequently distributed so as to allow Sec. 107(2) to apply to a capital beneficiary with a legitimately inflated ACB.

The section 107 distribution provisions apply only where there is in fact a legal title distribution, not when there is a right to call for the distribution but the right isn't exercised for convenience etc.. In order for them to apply the substance of the payment and its legal effect must be of a nature that disallows the beneficiary to be recognized to have the right subsequent to the payment.

Clearance Certificates.

Subsection 159(2) provides that every person, other than a bankruptcy trustee, who is an administrator, executor, or other like person including "responsible representatives" such as a trustee who is administering, winding up, controlling, or dealing with a property, business, or estate of another person who is about to distribute (legal title) to one or more persons any property over which he has control in his capacity as the responsible representative shall obtain a clearance certificate from the Minister. The clearance certificate certifies that all amounts for which **any** taxpayer is liable under the Act in respect of the particular tax year, (of either the deceased, trust/estate or the beneficiary), or any preceding tax year, and the amount for which the "responsible representative" is or can reasonably be expected to become liable for in his capacity as the responsible representative, have been paid or that security for which thereof has been accepted by the Minister. As such they are a statement by which the Department recognizes that all taxes that may arise due

¹⁹⁴¹ In the same way that it can apply under a Sec. 106(3) commutation

¹⁹⁴² Would it be possible to make advances in respect of the interest to such an extent so as to cause the same thing without Sec. 105(1) applying by virtue of the fact that there would be a hypothetical a.c.b. adjustment under Sec. 53(2)(h)? When the interest is to be subsequently satisfied and these advances are taken into consideration will the benefit then be recognizable if found to be excessive at that time?

to the distribution or that have arose and are still to be extinguished and are the liabilities of the trust, the beneficiary, **or any taxpayer** have been extinguished or for which security has been posted.¹⁹⁴³

As expressed in the preamble, it is only the responsible representative who, in his capacity as such having control over the property estate, is required to obtain the certificate which may come in three forms depending on the state of the property holdings and the responsible representative. Where the property of the trust or estate is either segregated under diverse legal ownership (trustees) or legally owned jointly by the group of trustees **each** respective one or all must apply to obtain the certificate because either one singular person or all of the persons jointly have control over the subject property and can be liable by virtue of the joint ownership.¹⁹⁴⁴

Paragraph (a) and (b) of Sec. 159(2) provides that the certificate will certify that all amounts for which **any** taxpayer is liable under the Act in respect of the distribution tax year and any preceding year **and** for the payment of which the responsible representative is or can reasonably be expected to become liable in his capacity as such, have been paid or security for which has been accepted by the Minister. The liability need not arise just in respect of the beneficiary to whom the particular property is being distributed but it may also arise in respect of payments made to other beneficiaries whereby the trustee/executor is required to withhold tax upon such as under section 153 and section 215. Obviously, the trust or estate from which the property is being distributed would be considered as a "taxpayer" for these purposes, while so too the deceased. Subsection 159(1) imposes the deceased's tax liability upon his executor. In order to obtain the certificate, the liabilities that are those of the representative in such a capacity must be paid or security for their extinguishment must be accepted, however, the provision does not provide who this security or payment may be forwarded by hence the beneficiary or another person may forward the amount. Paragraph (b) provides that the payment for which the representative is liable includes that which he may reasonably be expected to **become** liable for as the representative thus where through the distribution of the property the trust or estate is wound up, and he ceases to be the representative he will still be liable for the terminal tax liability of the distribution. Where there are four trustees, two of which are resident in Canada, and the other two are not, will a "distribution" **for purposes of Sec. 159(2)**, be recognized when the two resident trustees resign from their office and as a result of joint ownership of the trust property the legal title thereto is exclusively held by the non-residents? It would appear not since in resigning from the office they are not dealing with the property so as to cause its legal title to be distributed, but instead simply causing the trust agreement to alter the relationship and situs of the properties present legal ownership. (This is especially true if they do not have **control** over the property in their capacity as responsible representatives but instead control, jointly, resides in the foreign jurisdiction.) By virtue of the fact that Sec. 128.1(1) applies to cause deemed dispositions immediately **before** the trust becomes non-resident resigning Canadian trustees cannot avoid a tax liability in that capacity if as a consequence the trust became non-resident. Immediately before, and at the time of deemed disposition, they were trustees.

Information Circular 82-6 provides that a clearance certificate cannot be issued until all required income tax returns have been filed and assessed including those from the trust where the trust is realizing income and taxation in its hands, and it is for this reason the certificate should not be requested until after the final assessment notice has been received. When making the request for the certificate, the identity of the executor/trustee must be given (address, name, etc.) and the name of the trust/estate, as well as its address and most importantly the date that is believed to be the winding-up date of the trust/estate. Where the following documentation is not already at the district taxation office it should be sent along with the request; a copy of the will or trust document, a statement indicating the assets of the estate/trust wherever situated showing their respective ACB and fair market value, (in the case of a partial distribution the assets to be distributed should be identified), and where the distribution is part of an intestacy the administrator should be

1943 As per *Settled Estates Ltd. v. M.N.R.*, 60 D.T.C. 1128 & *Vingood Realty Co. Ltd. v. M.N.R.*, 76 D.T.C. 1173, a testator and his estate are separate taxpayers however without Sec. 159(2) it is questionable whether the Minister may stand in the position of a creditor with respect to the testator's unpaid tax liabilities and claim from the estate.

1944 The provision does not allow a trustee to acquire a certificate in such a manner as to eliminate the joint trustee's requirement to do so.

identified, as well as the details of the proposed distribution of the assets including names and addresses of the beneficiaries and their relationship to the deceased.

The request should be made in writing to the district taxation office, Estate and Trust Section (even if it exists in name only), and it should not be included in the taxpayer's (or trust's) tax return. The administrator should attach an undertaking to complete the transfer of the property involved as soon as possible once the certificate has been received.

There are three different certificates available, the appropriate one should be specified in the request. Form TX21-A covers distributions in the calendar year prior to death and subsequent period to date of death while TX21-B applies to partial distributions of property within the period that commences the day that the trust or estate is created, (immediately following the death), and ends with the effective date of the distribution. Form TX21 authorizes the final distribution of all property and is issued only once, terminally when the estate/trust is wound-up.

The certificate certifies that all taxes, Canada Pension Plan contributions, U.I. premiums, interest and/or penalties assessed and chargeable or payable out of any property of the taxpayer (trust) have been paid, or that security for payment has been accepted by the Minister. Understandably, where Sec. 106(3), 107(2.1), 107(4), (4.1), or (5) apply the tax payable may not be readily ascertainable since disposition on a fair market value basis is in order. This may also occur where the trust is to be terminally wound up. I.T. 282R provides a description of an administratively accepted procedure whereby arrangements can be made so as to obtain a certificate before the wind up and pay the taxes payable, before the wind-up.

Under Sec. 159(3) where the trustee having control, (but not necessarily ownership), over property that is to be distributed does not obtain a clearance certificate before the distribution he will become personally liable for all amounts described in Sec. 159(2), but only up to the extent of the value (tax value or FMV?) of the property distributed while the Minister may assess the "responsible representative" in the same manner and effect as that under section 152.

Unfortunately, only as per present case law, the Minister's recourse to collect tax cannot be terminated by a sloppily produced Sec. 159(2) certificate where the Department of National Revenue, subsequent to the distribution and termination of the administration of the estate, becomes aware that it has made an error and that the estate owes more taxes than first calculated. This was of issue in *Bougie et al. v. The Queen*¹⁹⁴⁵ where the District Office auditors issued the Sec. 159(2) certificate and the personal representative made terminal distributions on the faith of their accuracy. The Federal Court - Trial Division found that the Department did not jeopardize its recourse to the collection of the taxes by producing the erroneous certificate and in conclusion provided that the executrix may have rights against the beneficiaries to whom she distributed the estate for the amount of the taxes payable by her, but that such was a question of civil law, in that the debt simply consisted of a latently arising estate claim in substance. In *Bougie* the **beneficiaries** were held liable for the unremitted tax notwithstanding that Sec. 159(2) was recognized to apply only to the executors. The exposure, an "equitable debt", was a liability of the beneficiaries and Sec. 159(2) did not prevent this basis of liability but was quite independent of it. The important fact to note however is that the error had been communicated to the executor and the beneficiaries by the Department prior to the actual distribution: a *devastavit*. The court held that:

"Nothing in subsections 159(2)-(3) imposes on the heir a responsibility greater than that which he incurs under the Civil Code for the deceased's debts. Conversely, an executrix who is not an heir and who receives nothing from the estate may still become liable for the total tax debt if he distributes the money without obtaining the certificate. In short, **the clearance certificate concerns only the executor**; it does not increase the heir's liability or reduce it in any way whatsoever."

*J. Boger v. M.N.R.*¹⁹⁴⁶ was a case that involved the same situation and in that case the Tax Court judge was of the opinion, concurred with by the Court in *Bougie*, that the Minister could go after the beneficiary directly for unpaid taxes, though no statutory authority was cited. In neither of these cases was *Dep. F.C.T. v. Brown* referred to as persuasive jurisprudence.

1945 90 D.T.C. 6529, (FCTD)
1946 89 D.T.C. 15

In *Dep. F.C.T. v. Brown*¹⁹⁴⁷ an Australian estate had been completely administered and terminal distributions made before the executors resigned whereafter the tax authorities found an *inter vivos* tax liability of the deceased and reassessed the estate. The provision that allowed the taxman to impose the liability against the executor was operative only if the taxpayer was acting in that capacity, which he had ceased to do, hence the Deputy brought an action to collect the tax from the beneficiary, who had received property from the estate, by way of **equitable debt**: that arising when a creditor can go after the beneficiary for a liability that was not provided for when the estate property is not traceable and recovery from the estate/executors otherwise restricted. Dixon C.J. of the High Court of Australia commented on some very valid and salient points in delivering the opinion that the beneficiary was not liable: namely that the constitutionality of the assessment was faulty since the liability for tax could not be imposed on a party if recourse was not left open to him by which he could contest¹⁹⁴⁸ and, perhaps more importantly, the **specific** provisions upon which the assessor based the attack referred only to trustees and not beneficiaries. Of particular relevance in the latter respect was the jurisprudence of *Wolverhampton New Waterworks Co. v. Hawkesford*¹⁹⁴⁹ where it was provided: "*where a liability not existing at common law is created by a statute which at the same time gives a special and particular remedy for enforcing it...the remedy provided by the statute must be followed, and it is not competent to the party to pursue the course applicable to cases of the second class*"¹⁹⁵⁰." McTiernan J. and Williams J. concurred with Dixon to decide the slim majority but after pointing out that the relevant tax legislation must be read as an exhaustive code of rights and obligations for tax authorities and that essentially since no provision provided for it, recourse against the beneficiary could not exist.¹⁹⁵¹

In *I.R.C. v. Field and Ors.*¹⁹⁵² the tax authorities didn't grasp the tax position of an estate which was to be wound up and acknowledged that no tax liability remained unsatisfied consequentially the terminal distributions occurred. Subsequently additional tax was found to be payable and following the Commissioner's attaining favorable judgment to collect from the defunct executors a claim was made against the beneficiaries who benefitted from the estate. The Supreme Court of New Zealand concurred and created the beneficiaries' liability **without regard to the taxing statute law** though relying on exclusively equitable principles even though a *devastavit* could not be proven. The conclusion of this case wasn't overturned in *Brown* but it certainly didn't gain much support.¹⁹⁵³¹⁹⁵⁴

Subsection 159(1) causes the legal representative responsible for the filing of a Sec. 150(1)(b) return in respect of the deceased to also be liable to the tax assessed by the Minister in respect of the taxpayer for the tax year to the extent that the legal representative has or had at the end of the assessment year property belonging to the deceased or his estate over which he had control or possession. This causes the executor/legal representative to be liable in his fiduciary capacity though Sec. 159(3) causes the executor to be exposed to a personal liability if he distributes property without gaining a clearance certificate which will be granted, only if there isn't a Sec. 159(1) assessment pending. Of importance is the fact that the Sec. 159(1) provision creates liability only in respect of a tax year's income in respect of which the legal representative must file a return for under Sec. 150(1)(b): a legal representative is not obliged to file a return of a deceased unless it is expressed in a letter forwarded by the Minister under Sec. 150(2), in which case the legal representative will not have possession or control of estate property at the end of that tax year. Regulation 206(1) applies to require a deceased's legal representative to file a return, if the deceased was required to do so, for **any** calendar year prior to the date of death for which a return has not previously been filed.

¹⁹⁴⁷ 100 C.L.R. 32

¹⁹⁴⁸ something the beneficiary could not do in this instance since he hadn't the access to the taxpayer's returns etc.

¹⁹⁴⁹ 141 E.R. 486

¹⁹⁵⁰ actual debt other than those created by statute

¹⁹⁵¹ Kitto J. did open up some very relevant points in dissenting at the idea that the Act provide an exhaustive code of rights to the Minister though they were not shared by his peers.

¹⁹⁵² 1955 N.Z.L.R. 331

¹⁹⁵³ In re: Harrington, 1908 2 Ch. 687, it was held that a statutory liability that was personal ceased when the person died though presumably not if the statute creating it stated otherwise.

¹⁹⁵⁴ *Powell v. Evreniades and Ors*, 87 A.L.R. 117, FCA, illustrates instances where the national taxation authorities have statutorily allowed reductions in estate tax collection due to "serious hardship" it may pose on the beneficiaries: would there be an administrative position of such in Canada?

In the author's opinion the only provision that can allow the Minister to pursue a beneficiary in respect of a deceased's or estate's/trust's tax bill is Sec. 160(1) which provides that where property is transferred to a person with whom the transferor is not at arm's length the transferee will become liable jointly and severally with the transferor for the transferor's tax bill. The joint and several liability exists only to the extent of the lesser of the transferor's liability and the amount by which the fair market value of the property exceeds that of the consideration given for it. The transferee must have not been at arm's length with the transferor or must have been under 18 years of age or must have been his spouse or person who has since become his spouse in order for the provision to apply¹⁹⁵⁵.

Following the jurisprudence of Brown in the author's opinion, contrary to the expressions in Boger, Bougie and Field, the taxman does not have statutory authority to pursue a beneficiary in respect of an arm's length legal representative's tax liability though he does have recourse to the legal representative in respect of the deceased's or estate's tax bill: the provisions draw the line of recovery at the legal representative's office with liability of the estate and the deceased not being transposed to the beneficiary. **If the executor is liable for the deceased's/estate's debt in equity anyway why is there a perceived need for Sec. 159(1)-(2)-(3)?** Those subsections impose the **statutory** liability on the executor, something that is needed to collect *inter vivos* and testamentary tax liability. There isn't any provision made for the beneficiary. It could be possible then to have a non-resident legal representative administer the estate or any part thereof whereby Sec. 159(3) would not create a problem when he refuses to pay any estate tax liabilities. If he's at arm's length with the beneficiary Sec. 160(1) cannot apply to the beneficiary and his favorable performance can be provided for with bonus remuneration clauses etc.. In order to void Sec. 128.1(1) disposals the legal representative could administer only taxable Canadian property. Understandably Sec. 159(2)-(3) could cause a spousal trust to be exposed to section 222-223 collection procedures if the trustee thereof is responsible for the tax however this isn't necessarily the case where he is not since he may be at arm's length with the general legal representative. Common law estate debt collection principles would not be applicable with a deficiency in the complete code of tax authority being paramount. Will the Department resort to section 245 to collect the tax in light of the deficiency? Does the overall scheme of the Act as evidenced by the fact that there isn't one mention of beneficiary liability suggest that the beneficiary is to be held accountable for the debt?

As per *Marshall Estate v. M.N.R.*¹⁹⁵⁶ a trustee is still ultimately responsible for the filing of correct returns, even when such a task is delegated to an agent.

*Taylor v. Dep. F.C.T.*¹⁹⁵⁷ illustrates when a distribution occurs¹⁹⁵⁸. In that case the executor was reassessed in respect of income tax but after he and his co-executrix assented to the bequests to themselves and had attempted to have legal title of estate property transferred through the appropriate transmission applications. One of the applications had been incorrectly filed and had to be resubmitted though by that time the executrix had become aware of the reassessment. **The particular legislation extended the liability for the tax only to the extent of the value of the assets in the hands of the executors at the time of the assessment and afterwards.** The court held effectively that notwithstanding the clerical error requiring reendorsement of the transmission application the executors had done everything in their power to convey the property including obtaining valid probate, and that the particular properties did not make up the estate upon which the assessment could fall at the time it was made.¹⁹⁵⁹

¹⁹⁵⁵ while Sec. 160(4) provides a special rule in respect of spousal transfers

¹⁹⁵⁶ 68 D.T.C. 243

¹⁹⁵⁷ 123 C.L.R. 206

¹⁹⁵⁸ within the context of Sec. 159(1)

¹⁹⁵⁹ See the Aust. case of *Crnjanin v Crnjanin & Ors* [2011] QSC 295 (6 October 2011) where the court was petitioned for an order to expedite an estate administration and it was granted with the court stating:

[2] The application also seeks directions from the Court pursuant to s 96 of the Trusts Act 1973 (Qld) concerning aspects of the administration. There is no dispute between the parties concerning the directions that I am asked to make. **The need for these directions arises because the testator died with his affairs in disarray, having not lodged tax returns for many years, and some of the houses left to beneficiaries are and were in a state of disrepair. As a result, the administration of his estate has been difficult and protracted, and the directions are sought to expedite the finalisation of the estate's administration.** Because the directions are not in dispute and I am prepared to make them, I will deal with them briefly at the end of this judgment. I shall first address the

Some Points on Apportioning Tax Liabilities in Estate/Trust law

Pursuant to *Eastgate v. Equity Trustee, Exor. and Agency Co. Ltd.*¹⁹⁶⁰, In the Will of Harper¹⁹⁶¹ and *O'Donoghue v. Gilpin*¹⁹⁶² the income tax liability of an estate is to be apportioned to reduce the beneficiaries' entitlements based on the value of their interests unless a contrary intention is expressed in the will.¹⁹⁶³ This applies only in respect of the taxation caused by the death itself and not income generated after the death by the estate/trust which may be directly extinguished out of the respective benefitting beneficiaries' entitlements.¹⁹⁶⁴

In *Re: Liberal Petroleums Trust*¹⁹⁶⁵ the trust fund was to pay expenses and outgoings and distribute profits to, as part of a group of beneficiaries, non-residents and under former Sec. 104(8) such caused tax consequences to the trust when it could not and the corpus of the trust would be reduced by the tax payment which reduced the amount to which **the resident** beneficiaries would be entitled. The Court held that the *cujus est commodum* maxim could not be relied upon to cause only the non-resident's entitlements to be reduced when the provisions of the trust deed were very clearly to the contrary.

In *re: Kemp*¹⁹⁶⁶, In *re: Bowring*¹⁹⁶⁷, and *Fleetwood-Hesketh*¹⁹⁶⁸ are all precedents to support the argument

background to the contentious point of construction and set out the contents of the "self-made" will.

...

Directions for the final administration of the estate

[39] The applicant executor seeks directions for the final administration of the estate. The first relates to estate accounts and taxation liabilities.

[40] A significant accounting exercise has had to be undertaken to establish the assets and liabilities of the estate. The testator had not lodged tax returns for many years, and Mr Halloran's affidavit sets out how he, as the estate's accountant, has **had to reconstruct 17 years of the testator's affairs**, and obtain a waiver in part from the Australian Taxation Office.

[41] **The inability to ascertain with certainty that the ATO has been paid its debts gives rise to a right of the executor to apply for a direction that he can distribute "on the footing that" all the debts have been ascertained.**[15] Obviously this will not bind the ATO but it facilitates the administration of the estate. I consider that it is appropriate to make the directions sought.

...

[46] The orders of the Court will be:

1. The Court declares that, on its proper construction, clause 8 of the last will and testament of Alexander Moiseenko ("the deceased") is a specific bequest as to "all MONIES held by me in BANK or INVESTMENT ACCOUNTS" and a residuary bequest as to "ALL OTHER ASSETS both REAL, or PERSONAL held by me at the time of my death."

2. The Court makes the following directions for the administration of the estate of the late Alexander Moiseenko pursuant to s 96 of the *Trusts Act 1973*:

(a) The applicant is at liberty to distribute the estate of the deceased on the basis that there is no further liability for income tax on the part of the estate notwithstanding that the Deputy Commissioner of Taxation has refused and/or failed to provide a release of such liability and/or to otherwise certify in that regard;

¹⁹⁶⁰ 110 C.L.R. 275,

¹⁹⁶¹ 28 A.L.R. 214,

¹⁹⁶² 9 A.L.R. 27,

¹⁹⁶³ See also *Re: Croft*, 1892 1 Ch. 652, as well as Halsbury's Laws of England, 4th Ed., Vol. 19, para. 836 & 895. In *Re: Croft*, when speaking of how the estate duty was to be borne by beneficiaries under a will which did not concern itself with the issue it was held:

"I think I must presume, in the absense of words to the contrary, that a testator intends that each share of his estate shall bear its aliquot part of the duty. As I have observed, the testator here has not said so, but he has not said the contrary; and where there is nothing said one way or the other, the proper rule is to make each share bear its own burden...I therefore hold that the duty must be borne rateably by the appointees of the specific sums and of the residue respectively."

¹⁹⁶⁴ Such was the case in *Re: Bergstresser*, 1983 29 Sask. R. 129, *Re: Melnyk*, 1936 1 W.W.R. 666, but also *Re: Watkins*, 1906 12 B.C.R. 97. See also Widdifield on Executors' Accounts, 5th Ed., F.D. Baker, pg. 94-99.

¹⁹⁶⁵ 39 Atla L.R. 357

¹⁹⁶⁶ 1940 S.C.R. 353

¹⁹⁶⁷ 1918 W.N. 265

¹⁹⁶⁸ 1929 2 K.B. 55

that where a will provides that the taxes of the beneficiary in respect of income realized from the residuary trust are to be paid it is the proportion of the total taxes payable by the beneficiary in respect of the entirety of his income that the income realized from the trust is of the total income assessed in the beneficiary's hands. The effective tax brackets of the beneficiary and the fact that the trust income launched him into a higher one is of little consequence, unless, of course, the will attends to such.¹⁹⁶⁹

There are special situations however where the will is ambiguous and requires acute interpretation. Such was the case in *Lotzkar v. Southin*¹⁹⁷⁰ the head-note of which reads:

"The issue involved in the present appeal was as to whether or not the rule in *Allhusen v. Whittell* (1867), L.R. 4 Eq. 295, was applicable in respect of the estate of B L, deceased, so as to require, in respect of the obligations of the estate, including debts, income taxes owed by the deceased, succession duties, interest upon such taxes and duties, and administration expenses, an apportionment of liability as between E L, the widow of the deceased, who became entitled to the income of the estate until her death or remarriage, and those persons who would be entitled ultimately to the capital of the estate. On motion for the construction of the will of B L the trial judge held that the wording of para. (e) thereof excluded the application of the rule to the payment of succession duties. He did apply it, as from the date of death, to debts and expenses. In the case of income tax and interest thereon, he applied the rule as from April 30, 1954, this being the month in which sales of the deceased's stock-in-trade were completed. In the case of administration expenses, he applied the rule as from the date the expenses became payable. In each case the rate of interest used in the application of the rule was the rate actually earned by the estate.

On appeal, by a majority of two to one, the Court of Appeal held that the rule applied to all of the above categories of estate liabilities, including succession duties, the determination to be made as from the date of death in each case. It was also held that the amount of duties and taxes, for the purpose of applying the rule, should include the interest and penalties paid thereon. From the judgment of the Court of Appeal E L appealed to this Court.

Held: (Cartwright J. dissenting): The appeal should be allowed.

Per Martland, Judson, Ritchie and Hall: The will was construed as indicating the intention of the testator that all his debts and the succession duties should be paid by his executors, not out of the general residue of his estate, but out of the ready money of which he was possessed at the time of his death and the cash proceeds of the sale of a limited part of the residue, constituting a part of the capital of the estate. The rule in *Allhusen v. Whittell* was not applicable because, in view of the provisions contained in this will, the testator did not intend that it should apply. He designated a specified capital fund for the payment of debts and succession duties. The terms of the will displaced the application of the rule. *In re Wills, Wills v. Hamilton*, [1915] 1 Ch. 769; *Re Coulson*, [1959] O.R. 156, referred to; *Re Darby, Russell v. MacGregor*, [1939] 1 Ch. 905, statement of Sir Wilfrid Greene M.R., at p. 916, adopted.

Per Cartwright J., *dissenting*: For the reasons given in the judgment of the majority in the Court of Appeal the appeal should be dismissed. By the terms of the will it was the income from what remained after excluding the testator's "just debts, funeral and testamentary expenses and all probate and succession duties" that was given to the widow. There was no gift to her of the income derived from the moneys required to make payment of these items."

Tax Payment Arrangements and Deductions.

Subsection 159(5) allows some flexibility to the legal representatives in extinguishing the tax consequences

¹⁹⁶⁹ Pursuant to *Michelham's Trustees v. C.I.R.*, 1930 144 L.T.R. 163, such a benefit may be assessable under Sec. 105(1). The use of particular terms may serve to limit the extent of the trust's obligation to pay various duties/taxes on the income/gain generated in various jurisdictions and more nebulous directions to pay free of tax may be interpreted more generously.

¹⁹⁷⁰ [1966] S.C.R. 69

resulting from Sec. 70(2)-(5), (5.2) and (9.4). Under that provision the legal representative can elect to furnish the Minister with acceptable security and to have the tax attributable to the application of the above provisions **only** paid over a period not exceeding 10 years, in annual consecutive installments. The first instalment will be due when the taxes are ordinarily otherwise payable and the length of the instalment period must be irrevocably decided upon initially. As per Sec. 159(7) interest is charged and payable upon the gross amount from the time at which it would otherwise be payable.¹⁹⁷¹

One would not want to approach the Minister with a request for a Fairness Application when the facts of a protracted administration were clearly within the control of the executors. This was the case in *The Estate of Kenneth Christie v. Attorney General of Canada*¹⁹⁷² where because a RRIF was not collapsed by a bank since probate could not be obtained due to litigation with the widow of the deceased. The Fed. Trial Court held:

"The stated basis for the request was that "the estate, represented by [its] executors, refused to probate the will until [the widow] acknowledged the agreement. [The financial institution] refused to collapse the RRIF until the probate was complete. The matter was not resolved until more than two years later". Further, "[i]t was not clear that the RRIF should be included in [the deceased's] final return until the matter with the widow was resolved...the only way to avoid the interest was to capitulate to his widow receiving full ownership of the RRIF which was contrary to [the deceased's] wishes and was against all principals (sic) of equity and fairness".

...
[14] In addressing the various submissions of the applicant's solicitor, the recommendation document specifically refers to the applicant's position that "the estate had no legal entitlement whatsoever to the RRIF until July 31, 2003". The comments in the recommendation state that if the RRIF had become the property of the spouse, it need not have been included in the final income return for the deceased. The executors should have been aware, if successful in contesting the will, that the income would be fully taxable to the deceased, yet they made no attempt to lessen the interest burden. Further, "the RRIF income is not income of the estate, but income to the deceased...the executors were fully aware of the RRIF and its approximate value". Additionally, the officers state that the CRA must be satisfied that the estate took a reasonable amount of care to comply with the ITA. That is, the estate was expected to make efforts to avoid or minimize delays in complying, paying or remitting amounts due. A taxpayer's action or inaction must reflect what might reasonably be expected in comparable circumstances.

[15] The Director explained that because the proceeds of the RRIF did not become the property of the deceased's spouse, the full amount had to be reported as income on Mr. Christie's 2000 income tax return. The requirement arises when a RRIF is transferred to an unqualified beneficiary. **The requirement to report exists even where an information slip is not provided. Here, the executors were aware of the existence of the RRIF and its value. Therefore, the onus was on the executors to know that the income would be fully taxable to the deceased. Inability to access the funds does not operate to eliminate or postpone the tax implications. The arrears interest on this account is similar to that charged on other accounts in similar situations. The Director concluded that the circumstances did not meet the conditions beyond the taxpayer's control that would allow for the cancellation of the requested amount."**

As per *Akenhead Estate et al. v. M.N.R.*¹⁹⁷³ legal title transfer costs of an estate are not deductible by the testator against a Sec. 70(5) deemed disposition since that provision doesn't create/cause an actual conveyance.¹⁹⁷⁴ Death does and since the property is deemed disposed of **immediately before death** the

¹⁹⁷¹ See the UK case of *Thompson v Revenue & Customs* [2010] UKFTT 250 (TC) (02 June 2010) for an instance where an executor failed to make payment on account of his estate's tax liability and attempted to argue "reasonable excuse" to failing to file its returns.

¹⁹⁷² **2007 FC 1014**

¹⁹⁷³ 83 D.T.C. 105 (TRB)

¹⁹⁷⁴ In *Estate of Jean White v. The Queen*, T-875-93, the Fed. Ct.—Trial recognized, when an executor was attempting

testator can't sustain an expense making a disposition of property he doesn't own. As per the reasoning in *C.I.R. v. Richard's Exors.*¹⁹⁷⁵ such expenses would be deductible against a Sec. 107(2) deemed disposition on terminal conveyance to the beneficiary¹⁹⁷⁶ to reduce proceeds of disposition under Sec. 40(1)(a)(i) but as per *Pappas Estate v. M.N.R.*¹⁹⁷⁷ would not be deductible against income of the trust/estate.¹⁹⁷⁸ *Pappas Estate* specifically indicates this when the Judge noted that a list of expenses were incurred to "make a distribution from the estate". That "distribution" is a deemed disposition under section 107 hence they can be considered as "outlays or expenses" to make that disposition and have tax-effect there (though there is a balancing act to having them considered since any resulting nominal capital loss may be locked in the estate/trust depending on the will and the property holdings).¹⁹⁷⁹

"Election where certain provisions applicable – Sec. 159(5)"

(5) Where subsection 70(2), 70(5) or 70(5.2) of this Act or subsection 70(9.4) of the *Income Tax Act*, chapter 148 of the Revised Statutes of Canada, 1952, is applicable in respect of a taxpayer who has died, and the taxpayer's legal representative so elects and furnishes the Minister with security acceptable to the Minister for payment of any tax the payment of which is deferred by the election, notwithstanding any provision of this Part or the *Income Tax Application Rules* respecting the time within which payment shall be made of the tax payable under this Part by the taxpayer for the taxation year in which the taxpayer died, all or any portion of such part of that tax as is equal to the amount, if any, by which that tax exceeds the amount that that tax would be, if this Act were read without reference to subsections 70(2), (5) and (5.2) and the *Income Tax Act*, chapter 148 of the Revised Statutes of Canada, 1952, were read without reference to subsections 70(2), (5), (5.2) and (9.4) of that Act, may be paid in such number (not exceeding 10) of equal consecutive annual instalments as is specified by the legal representative in the election, the first instalment of which shall be paid on or before the day on or before which payment of that tax would, but for the election, have been required to be made and each subsequent instalment of which shall be paid on or before the next following anniversary of that day.

"Idem – Sec. 159(5.1)"

(5.1) Where, in the taxation year in which a taxpayer dies, an amount is included in computing the taxpayer's income by virtue of paragraph 23(3)(c) of the *Income Tax Application Rules*, the provisions of subsection 159(5) apply, with such modifications as the circumstances require, as though the amount were an amount included in computing the taxpayer's income for the year by virtue of subsection 70(2) or an amount deemed to have been received by the taxpayer by virtue of subsection 70(5).

"Idem – Sec. 159(6)"

(6) For the purposes of subsection 159(5), the "tax payable under this Part" by a taxpayer for the

to reduce proceeds of disposition on testamentary assets due to latent costs of disposition, that:

"[7] Mr. White contended that the costs regarding the sale of the lots from the time of death to the sale dates should be included. This would result in costs of \$43,152.21 thereby reducing the value of the lots from \$35,000.00 to \$29,849.56. Mr. White is concerned with the notion of double taxation. However, the *Income Tax Act* provides for a deemed disposition on death. While there is a deemed disposition on death, it must also be recognized that the estate is taxed separately, and there is no authority for the proposition that Mr. White takes."

1975 46 T.C. 626 (HL)

1976 See also *Caya Estate v. M.N.R.*, 64 D.T.C. 137 TAB.

1977 90 D.T.C. 1646

1978 Pursuant to the Sec. 107(2) tax free interest commutation mechanics such expenses would create capital losses for the estate/trust. As per the last case probate, advertising, legal title transfer and other fees and expenses may all be "a cost of distributing the worldly possessions of the deceased in accordance with his wishes" thus fully deductible in making the Sec. 107(2) (or any section 107) distribution while understandably some sort of allocation would have to occur with respect to each property conveyance.

1979 I wonder if Finance would like to sever that disposition from the property distribution by adding the 4 words "**immediately before that time**" so that the property distributed in estate/trust law isn't statutorily owned by the estate/trust for tax purposes when such occurs.

taxation year in which the taxpayer died includes any tax payable under this Part by virtue of an election in respect of the taxpayer's death made by the taxpayer's legal representative under subsection 70(2) or under the provisions of that subsection as they are required to be read by virtue of the *Income Tax Application Rules*.

"Certificate before distribution – Sec. 159(2)"

(2) Every legal representative (other than a trustee in bankruptcy) of a taxpayer shall, before distributing to one or more persons any property in the possession or control of the legal representative acting in that capacity, obtain a certificate from the Minister, by applying for one in prescribed form, certifying that all amounts

(a) for which the taxpayer is or can reasonably be expected to become liable under this Act at or before the time the distribution is made, and

(b) for the payment of which the legal representative is or can reasonably be expected to become liable in that capacity have been paid or that security for the payment thereof has been accepted by the Minister.

"Personal liability – Sec. 159(3)"

(3) Where a legal representative (other than a trustee in bankruptcy) of a taxpayer distributes to one or more persons property in the possession or control of the legal representative, acting in that capacity, without obtaining a certificate under subsection 159(2) in respect of the amounts referred to in that subsection, the legal representative is personally liable for the payment of those amounts to the extent of the value of the property distributed, and the Minister may at any time assess the legal representative in respect of any amount payable because of this subsection, and the provisions of this Division apply, with any modifications that the circumstances require, to an assessment made under this subsection as though it had been made under section 152.

"Appropriation of property – Sec. 159(3.1)"

(3.1) For the purposes of subsections 159(2) and 159(3), an appropriation by a legal representative of a taxpayer of property in the possession or control of the legal representative acting in that capacity is deemed to be a distribution of the property to a person.

Subject: Estate or Trust Distributions - Clearance Certificates.

IT-282R Date: August 3, 1976

This bulletin replaces and cancels the Interpretation Bulletin No. IT-282 dated January 19, 1976.

1. For the purpose of the Income Tax Act, the Department considers, except where a scheme of distribution is followed in accordance with paragraphs 4 to 8 below, that the property of an estate or trust is distributed on the date the administrator, executor or trustee relinquishes his control over it and transfer it to the person entitled to it, and not on the date such a person acquires the right to receive the property.

2. By virtue of subsection 159(2) every administrator, executor and trustee (except a trustee in bankruptcy) must obtain a clearance certificate before distributing any property under his control if he wishes to avoid being personally liable for the unpaid taxes, interest and penalties.

3. Depending on the circumstances, one of the following three forms of clearance certificates is issued by the Department:

(a) Form TX21-A for years prior to death and for the period ending with the date of death;

(b) Form TX21-B for partial distributions of property;

(c) Form TX21 (issued only once) for final distribution of all the property.

Form TX21-A and Form TX21-B need not be obtained prior to obtaining Form TX21.

Certificates on Distribution of Property

4. Where the provisions of subsection 106(3) or 107(5) or paragraph 107(4)(d) apply to a distribution and any tax payable by the estate or trust can be determined only after the fair market value of the property to be distributed has been ascertained on the date of distribution, a clearance certificate may be obtained from the Department by following the procedure outlined in paragraph 5 for a final distribution of all property, or in paragraph 7 for a partial distribution.
5. The estate or trust representative who intends to distribute all the assets and wind up the estate or trust should establish a scheme of distribution as of a date chosen by him, which is prior to the date of his request for a clearance certificate. Having calculated the tax payable as if the distribution had occurred on the chosen date, the representative then requests in writing a clearance certificate and files a final return for that part of the taxation year ending on the chosen date and pays any taxes, interest or penalties that are chargeable against or payable out of the estate or trust property. The estate or trust representative should fulfill these requirements as soon as possible after the chosen date. To his written request for the certificate the representative must attach its undertaking to complete the actual transfer of all the property of the estate or trust as soon as possible after the clearance is received.
6. Clearance certificate Form TX21 will be issued where this procedure is followed and the representative is not in default of filing any return or of paying any tax, penalties or interest assessed and there is no indication that the actual distribution will not take place as soon as possible after the clearance certificate is issued. Once the certificate is issued, the Department considers the chosen date to be the actual date of distribution for tax purposes and regards the estate or trust representative as holding the properties on behalf of the beneficiaries since that date.
7. Where the representative seeks clearance in respect of an intended partial distribution, a similar procedure to that outlined in paragraph 5 may be followed. To expedite the issuance of the certificate, the representative should submit a list of assets held in the estate or trust and indicate thereon the assets he intends to distribute.
8. Where this procedure is followed the comments in paragraph 6 above apply except that the clearance certificate issued is Form TX21-B which gives clearance only up to the date chosen as the effective date for the partial distribution.

82-6R6 DATE: November 21, 2007

SUBJECT: Clearance Certificate

This circular cancels and replaces Information Circular 82-6R5 dated August 2, 2006.

1. This circular explains the need for a clearance certificate issued under the *Income Tax Act*. To ask for a clearance certificate, complete Form TX19, *Asking for a Clearance Certificate*. Also, give us the documents we ask for on Form TX19. This will help us to issue the certificate without delay.

Why you need a clearance certificate

2. Under subsection 159(2) of the *Income Tax Act* (the Act), a legal representative, which we define in paragraph 3, has to get a clearance certificate before distributing property that he or she controls in their capacity as the legal representative. As a legal representative, if you distribute the property without a certificate, you are liable for any unpaid amounts (see paragraphs 4 and 5). You do not need a clearance certificate before each distribution, as long as you keep enough property to pay any liability to us.

3. A legal representative is a person who administers, winds up, controls, or otherwise deals with a property, business, or estate of another person who may be an individual, a trust, or a corporation. The legal representative for the purposes of subsection 159(2) must be an assignee, liquidator, curator, receiver of any kind, trustee, heir, administrator, executor, committee, or any other like person other than a trustee in bankruptcy. The reference to any other like person includes any person acting as a liquidator, whether or not the person was formally appointed. For instance, in a voluntary dissolution, there may be no formally appointed liquidator and the responsibility may be assumed by an auditor, director, officer, or other person. The facts of each particular case will determine whether a person is a legal representative.

4. A clearance certificate certifies that all amounts for which the taxpayer is, or can reasonably be expected to become, liable under the Act at or before the time of distribution have been paid, or that the Minister of National Revenue has accepted security for payment. The certificate applies to amounts for which you are or may become liable for payment as the legal representative. These amounts include all income taxes (including provincial and territorial taxes that we administer), along with any interest and penalties. The certificate also covers the payment of any outstanding Canada Pension Plan contributions and Employment Insurance premiums, including any associated interest and penalties.

5. If you do not get a clearance certificate before you distribute property, you are liable for unpaid amounts, whether assessed before or after the actual distribution of property. You will be personally liable for the taxpayer's debt, up to the value of the property you distributed. Under proposed legislation, for assessments completed after December 20, 2002, you will also be responsible for any and all interest that is charged as a result of these assessments.

6. When you give up control and transfer a property to the person entitled to receive it, we consider you to have distributed the property on that date. The date on which a person acquires the right to receive a property does not determine the distribution date.

How to ask for a clearance certificate

7. To ask for a clearance certificate, you have to complete Form TX19, *Asking for a Clearance Certificate*. Send it to the Assistant Director, Audit, at your tax services office. Usually, that office will process the certificate. However, under some conditions, another tax services office may process your certificate. This may happen, for example, if the deceased's properties are located in an area served by a tax services office other than yours.

8. To avoid delays, make sure Form TX19 is as complete as possible, and include the attachments. Identify the person(s) asking for the certificate by providing the name, address, telephone number, and title (for example, executor, trustee, liquidator, administrator). For a deceased person, Form TX19 has to include the full name, last address, social insurance number, and date of death. For a trust, include the name of the trust, the name and address of the trustee(s), the trust account number, and the wind-up date. In the case of a corporation, give the full corporate name, the Business Number, and the wind-up date.

9. If you have not sent us the following documents, attach them to Form TX19:

- (a) a copy of the will, including any codicils, renunciations, or disclaimers, and all probate documents;
- (b) if the individual died intestate, a copy of the document appointing an administrator (for example, the Letters of Administration or, in Quebec, Letters of Verification issued by a probate court). Also attach the details of the proposed distribution of assets, including the names, addresses, and social insurance numbers or account numbers of the beneficiaries, and their relationship to the deceased;
- (c) a copy of the trust document;
- (d) a statement showing the properties and distribution plan, including the date chosen for the distribution of properties, and a list of the recipients of each of the properties. The statement should describe each property, its adjusted cost base, and the fair market value at the date of death or at the date of distribution. If a statement of properties has been prepared for a probate court, we will usually accept a copy, and a list of any properties, such as real estate held in joint ownership, RRSPs with named beneficiaries, etc., that the deceased owned before death and that passed directly to beneficiaries;
- (e) any other documents that are necessary to prove that you are the legal representative; and
- (f) a letter of authorization that you have signed if you, as the legal representative, want us to communicate with someone else.

10. When you receive the clearance certificate, you have to complete, as soon as possible, the actual transfer or distribution of any property over which you have control.

Issuing a clearance certificate

11. All clearance certificates will be issued on Form TX21, *Clearance Certificate*. We will issue a clearance certificate only when:

- (a) you have filed and we have assessed the required tax return(s); and

(b) we have received or secured all amounts for which the taxpayer is liable. These amounts include income tax (including the provincial and territorial tax that we administer), Canada Pension Plan contributions, Employment Insurance premiums, interest, and penalties.

For an estate or trust, where the provisions of subsections 106(3), 107(4), or 107(5) apply to a distribution, and where any tax payable by the estate or trust can be determined only after the fair market value of the property to be distributed has been determined on the date of distribution, we will issue a clearance certificate as long as you do **all** of the following:

(a) you establish a scheme of distribution by a date chosen by you, which is prior to the date of your request for a clearance certificate (see paragraph 12);

(b) you calculate the tax payable as if the distribution had occurred on the chosen date;

(c) you file a final tax return for the tax year ending on the chosen date and pay any taxes, interest, and penalties that are chargeable against or payable out of the estate or trust property; and

(d) you submit your request in writing, and include a statement that you will complete the actual transfer of all the property of the estate or trust as soon as possible after you receive the clearance certificate.

We may not issue a clearance certificate if you have not filed a tax return or paid an amount for which the estate or trust is liable, or if there is an indication that the actual distribution will not take place as soon as possible after we issue the clearance certificate. Once we issue the certificate, we consider the chosen date to be the actual date of distribution for tax purposes and regard the estate or trust representative as holding the properties for the beneficiaries since that date. Do not file Form TX19, *Asking for a Clearance Certificate*, until you receive the assessment notice(s). Other than for an estate or trust, however, there may be exceptions (see paragraph 12).

12. There may be times when you cannot determine the date of distribution because it may depend on completing the final assessment and issuing the clearance certificate. Since the final assessment has to include the period up to and including the date of distribution of property, it may seem we cannot issue the final assessment or the clearance certificate. For example, this situation could arise when the properties of an operating corporation continue to generate income until they are distributed. In such circumstances, you should contact the Assistant Director, Audit, at the tax services office where you file Form TX19 to make alternative arrangements.

13. A clearance certificate covers only the properties you controlled from the date you received control to the date you asked for the clearance certificate. After you receive a clearance certificate, you may discover another property that affects the amounts of income or capital gains you reported on the taxpayer's tax return(s). If so, you will have to get another clearance certificate before you distribute the newly identified property. In this circumstance, you should contact the Assistant Director, Audit, at the tax services office where you file Form TX19. **Individuals**

14. For an individual, you should ask for a clearance certificate only for properties you will distribute in your capacity as a legal representative.

Estates or trusts

15. There may be situations when an estate or a trust will continue to exist to pay or allocate its income to the beneficiaries until a certain situation occurs (for example, a beneficiary reaches the age of majority). In such cases, we do not consider the payment or allocation of trust income to a beneficiary as a distribution of property. As a result, you do not need to ask for a clearance certificate.

Corporations

16. Under subsection 87(2) (amalgamation), you can transfer a corporation's assets and liabilities on a rollover basis to another corporation. If all conditions of the rollover are satisfied, the amalgamation should not create any additional tax liability. In this case, you do not need a clearance certificate. If you are not sure that the rollover is complete, you should apply for a clearance certificate. For any other type of corporate dissolution, you should get a clearance certificate before you distribute the corporate property.

Excise Tax Act (goods and services tax/harmonized sales tax)

17. Section 270, Part IX of the *Excise Tax Act* (goods and services tax) includes similar provisions requiring you, as a

receiver or representative, to get a clearance certificate by completing Form GST352, *Application for Clearance*

Certificate, before you distribute any property or money you control. For more information on clearance certificates related to the goods and services tax/harmonized sales tax, contact your tax services office.

“Qualifying disposition – Sec. 107.4(1)”

(1) For the purpose of this section, a “qualifying disposition” of a property means a disposition of the property by a person or partnership (in this subsection referred to as the “contributor”) as a result of a transfer of the property to a particular trust where

- (a) the disposition does not result in a change in the beneficial ownership of the property;**
- (b) the proceeds of disposition would, if this Act were read without reference to this section and sections 69 and 73, not be determined under any provision of this Act;**
- (c) if the particular trust is non-resident, the disposition is not**
 - (i) by a person resident in Canada or by a partnership (other than a partnership each member of which is non-resident), or**
 - (ii) a transfer of taxable Canadian property from a non-resident person who was resident in Canada in any of the ten calendar years preceding the transfer;**
- (d) the contributor is not a partnership, if the disposition is part of a series of transactions or events that begin after December 17, 1999 that includes the cessation of the partnership’s existence and a subsequent distribution from a personal trust to a former member of the partnership in circumstances to which subsection 107(2) applies;**
- (e) unless the contributor is a trust, there is immediately after the disposition no absolute or contingent right of a person or partnership (other than the contributor or, where the property was co-owned, each of the joint contributors) as a beneficiary (determined with reference to subsection 104(1.1)) under the particular trust;**
- (f) the contributor is not an individual (other than a trust described in any of paragraphs (a) to (e.1) of the definition “trust” in subsection 108(1)), if the particular trust is described in any of paragraphs (a) to (e.1) of the definition “trust” in subsection 108(1);**
- (g) the disposition is not part of a series of transactions or events**
 - (i) that begins after December 17, 1999 and that includes the subsequent acquisition, for consideration given to a personal trust, of a capital interest or an income interest in the trust,**
 - (ii) that begins after December 17, 1999 and that includes the disposition of all or part of a capital interest or an income interest in a personal trust, other than a disposition solely as a consequence of a distribution from a trust to a person or partnership in satisfaction of all or part of that interest, or**
 - (iii) that begins after June 5, 2000 and that includes the transfer to the particular trust of particular property as consideration for the acquisition of a capital interest in the**

particular trust, if the particular property can reasonably be considered to have been received by the particular trust in order to fund a distribution (other than a distribution that is proceeds of disposition of a capital interest in the particular trust);

(h) the disposition is not, and is not part of, a transaction

(i) that occurs after December 17, 1999, and

(ii) that includes the giving to the contributor, for the disposition, of any consideration (other than consideration that is an interest of the contributor as a beneficiary under the particular trust or that is the assumption by the particular trust of debt for which the property can, at the time of the disposition, reasonably be considered to be security);

(i) subsection 73(1) does not apply to the disposition and would not apply to the disposition if

(i) no election had been made under that subsection, and

(ii) section 73 were read without reference to subsection 73(1.02); and

(j) if the contributor is an amateur athlete trust, a cemetery care trust, an employee trust, an *inter vivos* trust deemed by subsection 143(1) to exist in respect of a congregation that is a constituent part of a religious organization, a related segregated fund trust (as defined by section 138.1), a trust described in paragraph 149(1)(o.4) or a trust governed by an eligible funeral arrangement, an employees profit sharing plan, a registered disability savings plan, a registered education savings plan, a registered supplementary unemployment benefit plan or a TFSA, the particular trust is the same type of trust.

“Application of paragraph (1)(a) – Sec. 107.4(2)”

(2) For the purpose of paragraph (1)(a),

(a) except where paragraph (b) applies, where a trust (in this paragraph and subsection (2.1) referred to as the “transferor trust”), in a period that does not exceed one day, disposes of one or more properties in the period to one or more other trusts, there is deemed to be no resulting change in the beneficial ownership of those properties if

(i) the transferor trust receives no consideration for the disposition, and

(ii) as a consequence of the disposition, the value of each beneficiary’s beneficial ownership at the beginning of the period under the transferor trust in each particular property of the transferor trust (or group of two or more properties of the transferor trust that are identical to each other) is the same as the value of the beneficiary’s beneficial ownership at the end of the period under the transferor trust and the other trust or trusts in each particular property (or in property that was immediately before the disposition included in the group of identical properties referred to above); and

(b) where a trust (in this paragraph referred to as the “transferor”) governed by a registered retirement savings plan or by a registered retirement income fund transfers a property to a trust (in this paragraph referred to as the “transferee”) governed by a registered retirement

savings plan or by a registered retirement income fund, the transfer is deemed not to result in a change in the beneficial ownership of the property if the annuitant of the plan or fund that governs the transferor is also the annuitant of the plan or fund that governs the transferee.

“Tax consequences of qualifying dispositions – Sec. 107.4(3)”

(3) Where at a particular time there is a qualifying disposition of a property by a person or partnership (in this subsection referred to as the “transferor”) to a trust (in this subsection referred to as the “transferee trust”),

(a) the transferor’s proceeds of disposition of the property are deemed to be

(i) where the transferor so elects in writing and files the election with the Minister on or before the transferor’s filing-due date for its taxation year that includes the particular time, or at any later time that is acceptable to the Minister, the amount specified in the election that is not less than the cost amount to the transferor of the property immediately before the particular time and not more than the fair market value of the property at the particular time, and

(ii) in any other case, the cost amount to the transferor of the property immediately before the particular time;

(b) the transferee trust’s cost of the property is deemed to be the amount, if any, by which

(i) the proceeds determined under paragraph (a) in respect of the qualifying disposition exceed

(ii) the amount by which the transferor’s loss otherwise determined from the qualifying disposition would be reduced because of subsection 100(4), paragraph 107(1)(c) or (d) or any of subsections 112(3) to (4.2), if the proceeds determined under paragraph (a) were equal to the fair market value of the property at the particular time;

(c) [Repealed, 2005, c. 30, s. 4]

(d) if the property was depreciable property of a prescribed class of the transferor and its capital cost to the transferor exceeds the cost at which the transferee trust is deemed by this subsection to have acquired the property, for the purposes of sections 13 and 20 and any regulations made for the purpose of paragraph 20(1)(a),

(i) the capital cost of the property to the transferee trust is deemed to be the amount that was the capital cost of the property to the transferor, and

(ii) the excess is deemed to have been allowed to the transferee trust in respect of the property under regulations made for the purpose of paragraph 20(1)(a) in computing income for taxation years that ended before the particular time;

(e) if the property was eligible capital property of the transferor in respect of a business of the transferor,

(i) where the eligible capital expenditure of the transferor in respect of the property

exceeds the cost at which the transferee trust is deemed by this subsection to have acquired the property, for the purposes of sections 14, 20 and 24,

(A) the eligible capital expenditure of the transferee trust in respect of the property is deemed to be the amount that was the eligible capital expenditure of the transferor in respect of the property, and

(B) $\frac{3}{4}$ of the excess is deemed to have been allowed under paragraph 20(1)(b) to the transferee trust in respect of the property in computing income for taxation years that ended

(i) before the particular time, and

(ii) after the adjustment time of the transferee trust in respect of the business, and

(ii) for the purpose of determining after the particular time the amount required by paragraph 14(1)(b) to be included in computing the transferee trust's income in respect of any subsequent disposition of the property of the business, there shall be added to the value otherwise determined for Q in the definition "cumulative eligible capital" in subsection 14(5) the amount determined by the formula

$$A \times (B/C)$$

where

A is the amount, if any, determined for Q in that definition in respect of the business of the transferor immediately before the particular time,

B is the fair market value of the property immediately before the particular time, and

C is the fair market value immediately before the particular time of all eligible capital property of the transferor in respect of the business;

(f) if, as a result of a transaction or event, the property was deemed to be taxable Canadian property of the transferor by this paragraph or any of paragraphs 44.1(2)(c), 51(1)(f), 85(1)(i) and 85.1(1)(a), subsection 85.1(5), paragraph 85.1(8)(b), subsections 87(4) and (5) and paragraphs 97(2)(c) and 107(3.1)(d), the property is also deemed to be, at any time that is within 60 months after the transaction or event, taxable Canadian property of the transferee trust;

(g) where the transferor is a related segregated fund trust (in this paragraph having the meaning assigned by section 138.1),

(i) paragraph 138.1(1)(i) does not apply in respect of a disposition of an interest in the transferor that occurs in connection with the qualifying disposition, and

(ii) in computing the amount determined under paragraph 138.1(1)(i) in respect of a subsequent disposition of an interest in the transferee trust where the interest is deemed to exist in connection with a particular life insurance policy, the acquisition fee (as defined by subsection 138.1(6)) in respect of the particular policy shall be determined as if each amount determined under any of paragraphs 138.1(6)(a) to (d) in

respect of the policyholder's interest in the transferor had been determined in respect of the policyholder's interest in the transferee trust;

(h) if the transferor is a trust to which property had been transferred by an individual (other than a trust),

(i) where subsection 73(1) applied in respect of the property so transferred and it is reasonable to consider that the property was so transferred in anticipation of the individual ceasing to be resident in Canada, for the purposes of paragraph 104(4)(a.3) and the application of this paragraph to a disposition by the transferee trust after the particular time, the transferee trust is deemed after the particular time to be a trust to which the individual had transferred property in anticipation of the individual ceasing to reside in Canada and in circumstances to which subsection 73(1) applied, and

(ii) for the purposes of paragraph (j) of the definition "excluded right or interest" in subsection 128.1(10) and the application of this paragraph to a disposition by the transferee trust after the particular time, where the property so transferred was transferred in circumstances to which this subsection would apply if subsection (1) were read without reference to paragraphs (1)(h) and (i) ,

the transferee trust is deemed after the particular time to be a trust an interest in which was acquired by the individual as a consequence of a qualifying disposition;

(i) if the transferor is a trust (other than a personal trust or a trust prescribed for the purposes of subsection 107(2)), the transferee trust is deemed to be neither a personal trust nor a trust prescribed for the purposes of subsection 107(2);

(j) if the transferor is a trust and a taxpayer disposes of all or part of a capital interest in the transferor because of the qualifying disposition and, as a consequence, acquires a capital interest or part of it in the transferee trust

(i) the taxpayer is deemed to dispose of the capital interest or part of it in the transferor for proceeds equal to the cost amount to the taxpayer of that interest or part of it immediately before the particular time, and

(ii) the taxpayer is deemed to acquire the capital interest or part of it in the transferee trust at a cost equal to the amount, if any, by which

(A) that cost amount exceeds

(B) the amount by which the taxpayer's loss otherwise determined from the disposition referred to in subparagraph (i) would be reduced because of paragraph 107(1)(c) or (d) if the proceeds under that subparagraph were equal to the fair market value of the capital interest or part of it in the transferor immediately before the particular time;

(k) where the transferor is a trust, a taxpayer's beneficial ownership in the property ceases to be derived from the taxpayer's capital interest in the transferor because of the qualifying disposition and no part of the taxpayer's capital interest in the transferor was disposed of because of the qualifying disposition, there shall, immediately after the particular time, be added to the cost otherwise determined of the taxpayer's capital interest in the transferee

trust, the amount determined by the formula

$$A \times [(B - C)/B] - D$$

where

A is the cost amount to the taxpayer of the taxpayer's capital interest in the transferor immediately before the particular time,

B is the fair market value immediately before the particular time of the taxpayer's capital interest in the transferor,

C is the fair market value at the particular time of the taxpayer's capital interest in the transferor (determined as if the only property disposed of at the particular time were the particular property), and

D is the lesser of

(i) the amount, if any, by which the cost amount to the taxpayer of the taxpayer's capital interest in the transferor immediately before the particular time exceeds the fair market value of the taxpayer's capital interest in the transferor immediately before the particular time, and

(ii) the maximum amount by which the taxpayer's loss from a disposition of a capital interest otherwise determined could have been reduced because of paragraph 107(1)(c) or (d) if the taxpayer's capital interest in the transferor had been disposed of immediately before the particular time;

(l) where paragraph (k) applies to the qualifying disposition in respect of a taxpayer, the amount that would be determined under that paragraph in respect of the qualifying disposition if the amount determined for D in that paragraph were nil shall, immediately after the particular time, be deducted in computing the cost otherwise determined of the taxpayer's capital interest in the transferor;

(m) where paragraphs (j) and (k) do not apply in respect of the qualifying disposition, the transferor is deemed to acquire the capital interest or part of it in the transferee trust that is acquired as a consequence of the qualifying disposition

(i) where the transferee trust is a personal trust, at a cost equal to nil, and

(ii) in any other case, at a cost equal to the excess determined under paragraph (b) in respect of the qualifying disposition; and

(n) if the transferor is a trust and a taxpayer disposes of all or part of an income interest in the transferor because of the qualifying disposition and, as a consequence, acquires an income interest or a part of an income interest in the transferee trust, for the purpose of subsection 106(2), the taxpayer is deemed not to dispose of any part of the income interest in the transferor at the particular time.

Specie Distributions and the Fair Market Value of Interests.

Subsection 17(1) of Ontario's Estate Administration Act allows an executor/administrator to sell any part of the deceased's estate not only to pay testamentary expenses but also to make distributions however it is not necessary to have the concurrence of the estate beneficiaries to do so unless it is solely to make distributions. It is only those who are beneficially entitled to the particular property that can veto the legal representative's power and they may do so obviously so as to receive the property in specie rather than cash. Section 17 of the Ontario Trustee Act provides the equivalent with respect to trusts however in respect of both provisions it must be recognized that the legal representative/trustee can sell property only when he is empowered to do so as per provisions in the two Acts or where the trust deed/will authorizes him to and if either expressly provide that particular property is to be distributed in specie and maintained until that time understandably it cannot be sold. If the trustee is given the power of sale he must convert wasting assets, or those that are dropping in value, through a sale for cash otherwise his lack of action would cause reductions in the value of the capital beneficiary's entitlement the preservation of which is to be a primary concern. If the trustee is given the power of sale and converts property his actions could be scrutinized by the affected beneficiaries to ascertain whether he acted in an even handed way and whether he obtained legitimate value for the property.

Understandably the trustee may have been taking capital cost allowance, E.C.E.A., etc., on trust property that would cause tax liabilities to be created inherent in the tax costs of the property and understandably, acting so as to not prejudice neither capital or income beneficiaries or capital beneficiaries amongst themselves these property attributes must be examined by the trustee to ascertain how the property will be distributed. this also occurs when the property loaded with the differing tax liabilities are received via testamentary disposition and are to be distributed in an even handed way amongst certain beneficiaries. If two capital beneficiaries are equally entitled to all o the trust's property consisting of two assets equal in fair market value but having different adjusted cost bases and undepreciated capital costs a distribution based exclusively on the FMV of the properties will quite likely be unequal in value and will violate the even handed principle. since the tax consequences to be recognized subsequently by the beneficiaries on the disposition of the properties will produce different results.¹⁹⁸⁰ If the trustee must evaluate the tax cost of the property when he is making distributions in satisfaction of capital or income interests then inequities may be practically insurmountable though if he has a statutory power to mortgage or the deed gives him such he could raise mortgages and compel the beneficiary to assume the mortgage on the distribution while using the proceeds to satisfy another's entitlement of equalize the entitlements of the beneficiaries having regard to the respective tax attributes and FMV of thee property distributed. When a property is distributed and it has an accrued tax benefit such as an accrued capital loss that benefit should be recognized by the trustees in determining the amount of distribution proceeds.

While subsection 104(13.2) offers a method by which net capital losses from the disposition of property can be absorbed by the trust through designating less income payable to the beneficiaries under sec. 104(13)-105(1) that were proceeds from the disposition of gain producing trust property there may still be instances where the trust has booked net capital losses or non-capital losses that cannot be absorbed before wind-up and in this case a sale of trust property with accrued gains to the beneficiaries could be used to produce gain with which to absorb the losses which would otherwise be totally lost. How successful this could be would depend a great deal on whether the beneficiaries already have beneficial ownership of the trust property which is to be "sold" to them since if they did a disposition under Sec. 54(c) would not be recognizable since there would not be any change in beneficial ownership. If the acquiror didn't already have beneficial ownership through his acquisition it will provide the trust with cash to make equalized distributions and will allow the income liabilities to be absorbed by the booked losses. the acquiror will realize the property as a purchaser **and** subsequently, the cash that he paid for it.

¹⁹⁸⁰ This is of concern , obviously, not only where the trust can distribute the property tax free under Sec. 107(2) since in any other case the trust will recognize a f.m.v. disposition and the f.m.v. of the property will form more of a predominate factor though the tax consequences of the property's distribution will have to be factored into the beneficiaries' realizable mounts so as to not prejudice the other beneficiaries entitlements.

Trust interests are an alienable property and can be disposed of in any number of ways. Although a capital or income interest may consist of a group of several distinct rights under the trust arrangement they may have been received as a singular gift from the testator and the trust deed must be examined in order to ascertain if one particular one of them can be disposed of individually or whether the entire bundle of them must be dealt with as a unit. Ascertaining the fair market value of an interest in a trust can be a very subjective exercise and its FMV is important not just when the interest is disposed of in an instance where Sec. 69(1) concerns non-arm's length parties but also where the corporate association rules in Sec. 256(1.2)(f)(i) & (iii), the Sec. 94(1)(d)(iii) equity percentage computation in respect of non-resident trusts equated with foreign affiliates, and the Sec. 108(1)(d) cost amount of capital interests, are at issue. There are numerous factors to consider in ascertaining the fair market value of the interest and the major ones must be the fair market value of trust property in respect of which the interest is enforceable and when that interest is enforceable so as to gain possession. These will be factors that a purchaser will want to examine as well as the potential for the trust to become insolvent as well expected income streams if income is to be capitalized. Of direct consequence on the FMV of the interest is the possibility that it can divest from the purchaser due to its terms so as to prevent him from ever receiving trust property because of the loss of the right and this may occur with a passage of time or with the occurrence of an event which need not be remotely related to the purchaser. Powers of appointment, advancement and encroachment will also affect the f.m.v. of the interest if they can be exercised so as to reduce its scope or undermine the interest by depleting the property. The trustee's ability to mortgage the property upon which the particular right is based may also affect its FMV.

The value of an income interest is to be derived with such factors in mind as its present value of expected pay-out over its existence and in this respect the future revenue producing abilities of the underlying property and the trustees ability to alter them must be examined, as well as the inherent characteristics of the interest itself, is it subject to powers of appointment, discretionary distributive powers, the right of the trustee to use income to satisfy debt that wasn't sustained in relation to the revenue producing process while also of concern is the trustees ability to alter the investments/business and the trusts depreciation policy and parameters. It should be noted that the FMV of an income interest to receive income from the trust may exceed that FMV of the trust's property at any particular time and thus can occur when the trust property is producing relatively large income streams in relation to the value of the property producing them. In most cases the FMV of the simplest rights to receive trust property will not equal the FMV of the trust property to be received since there may be restrictions on the interest's enforceability preventing it from being enforced until a perhaps distant following period and its value will thus be discounted by some appropriate rate of interest. In *Smith v. M.N.R.*¹⁹⁸¹ in assessing the value of an income interest the Minister's computation was found to be conceptually incorrect by the Supreme Court and it held that such things as the possibility of insolvency of the trust's rental property tenant, the uncertainty of the term of the time of enforceability of the income right, and the implicit tax consequences should all be examined in arriving at the interest's FMV. In *Christie Estate v. M.N.R.*¹⁹⁸² the question of whether a right held by the taxpayer to have an estate properly administered was a "interest in expectancy" for purposes of the Estate Tax Act regulations was answered in the affirmative and the Exchequer Court found that the value of the interest, incidental to the issue, could be found by examining the devolution right and the property involved. In *Burns Estate v. M.N.R.*¹⁹⁸³ the Exchequer Court found that the fair market value of a taxpayer's remainder interest should be computed having regard to the fact that it is enforceable only in the future and that the uncertainty involved in the change in the value of the underlying property between the time and the time of distribution is paramount.

In respect of ascertaining the fair market value of a discretionary interest one only has to review *Gartside et al. v. I.R.C.*¹⁹⁸⁴ where Lord Wilberforce provided in respect of estate tax:

"No doubt in a certain sense beneficiary, under a discretionary trust has an "interest": the nature of it may, sufficiently for the purpose, be spelt out by saying that he has a right to be considered as a potential recipient of benefit by the trustees and a right to have his interest protected by a Court of

1981 50 D.T.C. 852
1982 68 D.T.C. 5240
1983 59 D.T.C. 1083
1984 1968 A.C. 553

equity. Certainly that is so, and when it is said that he has a right to have the trustees exercise their discretion "fairly" or "reasonably" or "properly" that indicates clearly enough that some objective consideration (not stated explicitly in declaring the discretionary trust but latent in it) must be applied by the trustees and that the right is more than mere spes. **But that does not mean that he has an interest which is capable of being taxed by reference to its extent in the fund's income: it may be a right with some degree of concreteness or solidity, one which attracts the protection of the court of equity, yet it may still lack the necessary quality of definable extent which must exist before it can be taxed."**

Disclaimers, Powers, and Methods of Varying the Trust Setting.

A trust may be a particularly flexible instrument with which to arrange for an orderly transfer of legal title to property over time to another person however if not constituted with appropriate contingency provisions it can easily prove to be very restrictive in its application and execution, the result of which may cause substantial tax exposure the avoidance of which was its original purpose. The amount of tax advantages inherent in the use of a trust for the transfer of the legal title of the property are considerable however due to a variety of factors such as the length of the trust's existence, residence of the trust and the beneficiaries, and the beneficiaries' ages, the application of various provisions in the Canadian Income Tax Act may defeat at least one purpose of the trust, the escape of exposure to taxation on certain transactions with respect to the property held. A trust/estate may be subject to unfavorable provisions when it isn't a personal trust and it distributes property in satisfaction of capital interests, the beneficiaries of a non-personal trust will not benefit from the Sec. 107(1) provision in respect of the artificial ACB adjustment when and if they dispose of a capital interest, after a certain period of time the trust, regardless of whether it is personal or not, will be required to recognize deemed dispositions of its capital and other property, the income or gain or loss or capital loss may be attributed back to the contributor of the property to the trust where he retains some degree of control over it, etc.. This is only partial list of unfavorable tax consequences that can result as per the straight forward application of the Act when certain transactions in respect of the trust, its interests or the contributor or beneficiary occur. There are obviously the non-tax related unfavorable consequences that result from the operation of some of the more basic trust law principles such as the certainty of the subject matter vis-a-vis the character of a particular beneficiary's interest and the trust property to which it relates however they too have their direct relationship to tax consequences in that the beneficiary might not be in the same overall favorable tax position with which to deal with the interest in the trust or the property to which it relates as some other beneficiary.

There are three very broad ways in which the execution of a trust agreement may be varied, two of which arise from the legal position of the beneficiaries with respect to their interests, the other an exclusively trust level activity that can alter or actually create anew the trust agreement or give rise to new trusts created out of the original trust property. The beneficiaries, singularly or as group, may disclaim, renounce, or surrender their interests under the trust whereby, if the trust deed is properly drafted so as to attend to these latent events, it will automatically operate to grant rights to the subject property, in value or in specie, to some other party. In the other instance the beneficiaries may, being of unanimous consent, apply to the provincial court to have the trust varied so that its terms are changed substantially or slightly which may or may not significantly alter the characteristics of their interests. The latter is of a more permanent nature than the former in that the courts must be used to achieve the variation while in the former the parties can act in private to achieve the end result. There are presently no common law rules that will allow a trust to be varied without the use of the courts without having to terminate the trust first thus causing all sorts of tax consequences on the commutation of capital interests and the resettlement of a trust. In the former only the interests are affected as the taxable property while in the case of variations both the interests and the trust property that supports the interests may be the subject of various tax provisions.

Finally the trustees may alter the execution of the trust, permanently or temporarily, through the use of dispositive or distributive powers instilled in them by the trust agreement whereby they may, either using their absolute discretion or subject to a fiduciary duty, exercise the power of appointment, advancement or encroachment so as to create beneficial interests in specific or general trust property or take the trust property completely out from under the trust and vest legal and beneficial title in a taxpayer that was not previously interested in it under the trust deed. The power of appointment has the ability to undermine existing interests in the trust so as to completely cancel them however until such powers are exercised the potential recipient doesn't have a capital or income interest in the section 108 sense of the word since he has no **rights** to that property as a beneficiary. As previously commented a power may not necessarily be exercisable by the holder capriciously but instead its exercise may be superimposed with fiduciary obligation causing the exerciser to concern himself with the intentions of the settlor or grantor of the power when he exercises it. A **special** power of appointment is restricted to being exercisable only in respect of the limits placed upon it such s exercisable only in respect of certain parties while a **general** power can be exercised without restriction in respect of any

party.¹⁹⁸⁵

Disclaimers and Releases.

"Income" or "capital interests", as defined for purposes of the Act, are rights which as a form of property described in Sec. 248(1) will attract varying exposure to taxation when they are disposed of however the conceptual definition of a "disposition", as well as the technical definition for limited purposes in Sec. 54(c), must be examined in light of the legal realities in which a disclaimer, renunciation or release takes place in order to ascertain whether or not, and to what degree, a taxable disposition has occurred.¹⁹⁸⁶

A "disclaimer" as the name may imply, is the opposite of the act of substantiating a legal claim to the title of property and as such is a positive affirmative action whereby the title is "disclaimed" from being received or held. As such it can never conceptually be a disposition since the legal title to the property was never held to begin with; the main essence of a disposition is when the title to the property has been dealt with in such a way, **by its holder** so as to release it and cause it to vest in someone else or cause it to be canceled, while the disclaimer operates by avoidance of the receipt of title rather than transfer after it has been received.¹⁹⁸⁷

The disclaiming of a trust interest need not be made formally in writing to be valid, however it must be made within a reasonable period of time after the recipient first learns of its possible receipt and it must also be disclaimed before the recipient has actually received any benefit from it.¹⁹⁸⁸ The act must be unequivocal.¹⁹⁸⁹ If the income or capital interest in the trust is "disclaimed" by the taxpayer after he has received income or capital from the trust in respect of it, no matter what the length of time or amount of benefit, a renunciation or release will have transpired in that the taxpayer has recognized and realized to a certain extent, the interest, and has not acted so as to disclaim it before the benefits were rewarded.¹⁹⁹⁰ What he has actually accomplished is the disposition of the property that he formerly held legal title to. The essence of a pure disclaimer was the subject of *Bence v. Gilpin*¹⁹⁹¹ where Kelly C.B. described the disclaimer as:

1985 A hybrid power is that which is not exercisable in respect of certain parties but is not otherwise restricted and these are of importance with respect to the possible application of Sec. 75(2).

1986 See "Dealing with Disclaimers and Forfeitures", Barry S. Corbin, *Estates, Trusts and Pensions*, Vol. 24, Pg. 70 for additional commentary of planning for disclaimers and other "monkey-wrenches" in testamentary planning.

1987 *Bank of N.S. v. Chan et al.*, 26 E.T.R. 180

1988 See *Keinath v. Commr.*, 480 F.2d 57, for cases on reasonable time delays. *Broomhead* provides the opinion that the proper test for whether a beneficiary is entitled to disclaim is whether in the circumstances he has accepted by words or other conduct or has remained silent for so long that the proper inference is that he has determined to accept the interest. Re: *Boyd*, 1966 N.Z.L.R. 1109, citing *Halsbury* provided that the assuming of acceptance "is artificial, but is founded on human nature. A man may be fairly presumed to assent to that which he in all probability would assent if the opportunity of so doing were given to him." Proving the disclaimer is the responsibility of those alleging it. With respect to *Broomhead* it could be argued that expressions that acceptance will not occur in respect of a residuary bequest if the interest proves to be on the whole burdensome could allow the disclaimer period to be extended for a substantial period of time though given the ability it could prove better to disclaim and subsequently retract the disclaimer when accurate knowledge on the extent of the gift becomes available. Pursuant to *Lady Nass*, *Thompson v. Leach*, 86 E.R. 391, and *Doe d Smyth v. Smyth*, 1826 108 E.R. 394, in order for there to be a valid disclaimer the party disclaiming must know what it is that he is disclaiming and must have full intention of doing so.

1989 Such a notice must be given to the trustees unless the conduct of the beneficiary is such as to infer a rejection. As per *F.C.T. v. Cornell*, 73 C.L.R. 394 at 401, "the dissent need not be evidenced by disclaimer in a court of record or by deed: any evidence of actual dissent is sufficient." See *Begbie v. Crook*, 1835 2 Bing. N.C. 70. See also *Cossitt v. M.N.R.*, 49 D.T.C. 617 (SCC).

1990 See also *Dewar v. Dewar*, 1975 1 W.L.R. 1532, *F.C.T. v. Clendon Inv. Pty. Ltd.*, 1977 7 A.T.R. 493. Positive acceptance isn't necessary: it's presumed, *Townsen v. Tickell*, 106 E.R. 557, *Maunder v. Mogimie*, 1917 N.Z.L.R. 725, while tacit acceptance may amount to silence: *A.G. v. Mundy*, 1858 157 E.R. 701, *A.G. v. Brackenbury*, 1873 158 E.R. 1099. See also Re: *Clout & Frewer's Contract*, 1924 2 Ch. 230, for indicative conduct where an executor stood by for 30 years without intermeddling in the estate or applying for probate nor demanding his legacy and subsequent to which it was held that he had forfeited his right to the legacy based on prolonged inactivity on his part had lead others to assume that he had disclaimed the bequest. See also Confidential and Commissioner of Taxation [2008] AATA 927 (13 October 2008) for an instance where a taxpayer's counsel allowed the ct. to infer that the taxpayer had assented to acceptance of the interest when no concrete steps were taken to avoid it: the solicitor should have disclosed same to his client rather than acted as an agent and done nothing until subsequently past too much of a delay.

1991 1868 L.R. Ex. 76

"A disclaimer, to be worth anything, must be an act whereby one entitled to an estate immediately and before dealing with it renounces it; whereby, in effect, he says 'I will not be the owner of this property.' But for a person who has already possessed himself of an estate and acted as its owner, to come and say 'I will not be its owner.' is really a contradiction in terms..."¹⁹⁹²

Where a right under a trust/will is disclaimed the right to the substance in relation thereto is treated as if it was never acquired however it can also be said that even though the acquisition of the trust right has been avoided the former potential beneficiary did have a right that was **disposed of** through the disclaimer.¹⁹⁹³ This was the case in *Re: Stratton's Disclaimer*¹⁹⁹⁴ and that was recognized in *Keir Estate v. M.N.R.*¹⁹⁹⁵. This "right" is not itself a right to receive or obtain the use of any of the trusts property but is instead a right to receive the property right as the expressed donee in relation to the donor, the settlor, under the will. If such a "right" is canceled through the disclaiming of the rights to specific property under a will Sec. 54(c)(iii)(B) may apply, even though as per the criterion in respect of basic property law the trust right under the trust or will was never acquired.¹⁹⁹⁶

When a trust right is disclaimed and thus acceptance avoided the disclaimer is not able to determine to whom the property substantiating the right, nor the right in its particular form, will vest and thus in the absence of appropriate contingency provisions in the trust deed, the property will fall back to the trust to be subject to the remaining interests, capital or income, or if this isn't the case due to poor drafting it will fall to be held in resulting trust for the settlor since the gift was not received by the donee.¹⁹⁹⁷ It is with respect to this phenomenon that a considerable degree of flexibility can be obtained since a properly drafted trust deed will allow the beneficiaries to disclaim their interests without the recognition of a disposition thereof for tax consequences, whereby the property will be distributed to other taxpayers who are in a better position to receive it.¹⁹⁹⁸ There may be cases where a disclaiming of a life interest causes the remainder interests to accelerate so as to terminate the trust with *Re: Belleville's Settlement Trusts* forming a precedent that a merging of all interests in trust property in one person, regardless of the method, will not necessarily terminate the trust depending on the settlor's intention.¹⁹⁹⁹ The nature of the existing remainder interests and the intention of the settlor as well as obviously the existence of other life interests is critical.²⁰⁰⁰

When a taxpayer disclaims an interest a disposition will not be recognizable even if he knows to whom the trust property will subsequently vest as consequence. In *R. Herman v. M.N.R.*²⁰⁰¹ as a question of the application of the Income Tax Act, when a beneficiary disclaimed her income interest under an estate and the

1992 See also *Lady Nass v. Westminster Bank Ltd.*, 1940 A.C. 366, (disclaimer until acceptance but not after), & *Broomhead v. Broomhead*, 1985 V.R. 891, for general discussion. As per Boyd citing Davidson's Precedents in Conveyancing, 3rd Ed, Vol 5, "It must be a simple disclaimer and not a conveyance or release of the estate, which could only be made on the supposition that the donee had accepted the estate."

1993 As per *Re: Metcalfe*, 1972 3 O.R. 598, and *Re: Moss*, 1977 77 D.L.R. (3d) 314, a disclaimer operates retroactive to the time of death. As per *Mallott v. Wilson*, 1903 2 Ch. 494, *Re: Parsons*, 1943 Ch. 12, *Re: Stratton's Disclaimer*, 1957 Ch. 132, *R. v. Skinner*, 1972 1 N.S.W.L.R. 307, the law while accepting that a disclaiming beneficiary retrospectively avoids his interest and frees himself from burdens, recognises in reality that the interest exists until the disclaimer in working out the rights of the parties. This was also the case in *Hillis v. M.N.R.*, 83 D.T.C. 5365 (FCA). See also *First Nat'l Bk of Portland v. Comm.*, 39 B.T.A. 828 1939, for pre disclaimer income recognition notwithstanding retroactivity of disclaimer.

1994 1957 Ch. 132

1995 65 D.T.C. 679

1996 This should be compared to the contradictory dicta of *Brown v. Routzahn*, 63 F.2d 914 at 917.

1997 See *Re: Belleville's Settlement Trusts*, 1964 Ch. D. 163, *Re: Kebty-Fletcher's Will Trusts*, 1967 3 All E.R. 1076, *Re: Taylor*, 1957 1 W.L.R. 1043, *Re: Flower's Settlement Trusts*, 1957 1 W.L.R. 401, *Re: Hatfield*, 1958 Ch. 469, & *Re: Harker's Will Trusts*, 1969 3 All E.R. 1, *In Will of Clayton*, 1971 1 N.S.W.L.R. 76, *R. v. Skinner*, 1972 1 N.S.W.L.R. 307, *Harman v. Anderson*, 1930 N.Z.L.R. 67, *Re: Hodge*, 1940 Ch. 260, *Re: Penton's Settlement*, 1968 1 W.L.R. 248, *Doornbos Estate v. Kelly*, 31 E.T.R. 213, *Re: Bachhouse*, 1931 W.N. 168.

1998 *Platt and Ors. v. I.R.C.*, 46 T.C. 418 (CH), *Brannan v. B.C.P.T.*, 37 E.T.R. 209, *Broomhead v. Broomhead*, supra., *Re: Schar*, 1951 1 Ch. 280. See Case X30, 90 A.T.C. 287, for unfortunate diversion in income through disclaiming of interest due to the ineffectiveness of sham beneficiary entitlements whereby income was recognized by a higher tax bracket beneficiary. Property can, through a properly drafted trust deed/will, be disclaimed so that it is conveyed to the disclaimer's holding corporation/spouse/offspring instead.

1999 See also *In re: Ralli's Settlements*, 1966 A.C. 483 (PC), where due to the nature of the interest conveyed and that otherwise held a merger didn't occur while *Re: Syme*, 1980 V.R. 109, also deals with how to ascertain the testator's intention from the use of one's speech to arrive at whether or not an acceleration occurs.

2000 *Bell v. Harrison*, 52-2 U.S.T.C. 46265 DC, *Re: Jacques*, 23 E.T.R. 78.

2001 61 D.T.C. 700

Minister added the income of the estate to her income on the grounds that she had instead made an assignment of the income interest by virtue of the fact that **she knew from a review of the trust deed to whom the property would vest** after the disclaimer Fordham Q.C. disposed of the case without much consideration which was appropriate. He concisely held with respect to the taxpayer's argument:

"...by pointing out that if it could prevail no disclaimer could ever be effective where the disposition of the estate involved was governed by the provisions of a valid will. There always must be one or more beneficiaries and their identity usually is discoverable in the document itself... Where there has been an express and **unqualified** disclaimer by the beneficiary, nothing is "payable" to the latter by the executors of the will."²⁰⁰²

It should be recognized that this quote was in respect of the imposition of tax on income realized and not on the property of the estate itself which was the topic of *Keir Estate v. M.N.R.*²⁰⁰³. That case concerned, for estate tax purposes, whether a disclaimer of legacy just prior to the death of the taxpayer resulting in an extinguishment of a right operated as an immediate gift *inter vivos* and thus caused the value of "the gift" to be added to the deceased's estate for estate tax purposes. Fordham Q.C. held that the extinguishment of a right, (which was the result of the disclaimer), fell squarely in the parameters of the Sec. 3(3)(b) charging provision whereby such an event is **deemed** to be a gift thus the case was decided more on the application of specifically targeted technical **statutory** provisions rather than purely common law grounds. Since the case was based on a statutory provision in the former Estate Tax Act that has absolutely no statutory equivalent or similarity in the I.T.A. it is of little significance except that it held that the effect of a disclaimer was the extinguishment of a right; however how could "a right" be extinguished through a pure disclaimer when the right was never accepted? Obviously, if the disclaimer had not been executed the right would have been fully enforceable by the taxpayer however it did not dwell on the extinguishment of **specific property rights** the disclaimer would have otherwise acquired. It dwelt on the factors dealt with in *Re: Stratton's Deed of Disclaimer*²⁰⁰⁴ where it was held, "that being entitled to take gifts made by a testator's will was a right and that such a right could be extinguished by a disclaimer..."²⁰⁰⁵

In the recent case of *Justin Biderman et al. v. The Queen*²⁰⁰⁶ the Fed Ct. of Appeal had to address the Minister's contention that a taxpayer had transferred property within the context of section 160 – thus attraction collection efforts to the party he transferred it to in a non-arm's length environment, when the taxpayer beneficiary had disclaimed an interest in a pending estate and subsequently executed a proper disclaimer when the estate came into existence. The taxpayer seemingly never realized a benefit from the estate in respect of the property under-lying his interest though there were numerous factors that the Appeal Court held did point to the fact that what was executed was a release instead. It held:

"Did Michael B. Biderman, who is the father of the appellants, validly disclaim his inheritance to the family home given to him by his wife in her will?

...

[4] Five days prior to his wife's death, Mr. Biderman who was indebted to Revenue Canada since 1988 (the amount owed as of July 14, 1995 was \$74,723.97) signed a handwritten document dated October 1, 1991, in which he disclaimed his inheritance under the will and renounced his right to act as executor, trustee or administrator of his wife's will or estate. However, he did act as the executor of his wife's estate. In addition, he continued to live in the family home with the appellants after the death of his wife and still lives there today.

[5] On September 30, 1994, i.e., three years after his initial or informal disclaimer, Mr. Biderman

2002 The primary intention of the disclaiming party was not analyzed and it is this that is critical in establishing whether an effectively indirect conveyance or refusal to accept a bequest was contemplated. See *Keinath v. Comm.*, 480 F.2d 57, for dicta similar to *Herman* when the taxman contended that taxpayer exercised "dominion and dictation" over property's conveyance.

2003 65 D.T.C. 679

2004 1957 2 All E.R. 594 (C.A.)

2005 In *Stratton's Disclaimer* the U.K. Court of Appeal held that the disclaimer operated as a benefit to the residuary legatees and that the widow's intention of providing the benefit was immaterial in causing the conveyance provision to apply. The intention of the disclaiming party would have to be proven in order for Sec. 56(2) to apply in respect of a disclaiming of income. (In such a case the legatees are not acquiring property in specie but are merely having their interests accelerated.)

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executed what I would call a formal disclaimer of his interests as a beneficiary of his wife's estate. Then the family home, which had at the time a value of \$180,000, was transferred by Mr. Biderman, in his capacity as executor of the estate, to Earl Biderman as trustee for the appellants. This transfer made within three years from the date of the death of Mrs. Biderman avoided the vesting of the real property in favour of Mr. Biderman pursuant to subsection 9(1) of the *Estates Administration Act* of Ontario (R.S.O. 1990, c. E-22).

[6] The Minister of National Revenue (Minister) assessed each of the appellants pursuant to paragraph 160(1)(c) of the Act on the basis that Mr. Biderman had an interest in the estate assets when he signed the formal disclaimer and that he directly or indirectly transferred property to the appellants with whom he was not dealing at arm's length.

[12] In the present instance, the first and informal disclaimer made in 1991 by Mr. Biderman is, I believe, legally ineffective and of no avail to him. Not unlike the civil law in Quebec, the common law requires that a disclaimer in order to be effective be made after the death of the legator, that is to say when the legatee is entitled to inherit. While the *Civil Code of Quebec* has a specific provision expressly prohibiting a disclaimer with respect to a succession not yet opened⁵, the nature of a disclaimer at common law and its retroactive effect to the date of death of the deceased lead to the same result. In *Bence v. Gilpin*⁶, cited in *Re McFaden*⁷ and in *McLean & Kerr v. Hrab*⁸, Kelly C.B. wrote:

A disclaimer to be worth anything must be an act whereby one entitled to an estate immediately and before dealing with it renounces it whereby in effect he says: "I will not be the owner of this property".

[16] Counsel for the appellants insisted that the initial disclaimer made by Mr. Biderman prior to the death of his wife evidenced throughout an intention on his part to refuse the estate which was sealed three years later by the formal disclaimer. While the initial disclaimer could have produced this kind of result and sustained an inference to that effect, the subsequent conduct of Mr. Biderman clearly makes this submission of the appellants untenable.

[17] The second attempt by Mr. Biderman to disclaim his inheritance came on September 30, 1994¹⁴. The question to be asked with respect to such attempt is whether or not it came too late, that is to say at a time when Mr. Biderman had lost his right and the possibility to make a valid disclaimer because he had already begun to "deal" in the estate or otherwise receive the benefit of the gift. If he had done so, he had become the beneficiary under the will and, as a result, he could only surrender or release, but not disclaim, his right in the assets. In such a case, his release of the family home to the appellants would be the kind of transfer of property that falls within the ambit of section 160 of the Act.

[18] The learned Tax Court Judge reviewed the conduct of Mr. Biderman to determine whether he had acquiesced to the will and lost his right to disclaim. In so doing, he was entitled to look at the utterances made by Mr. Biderman to third parties¹⁵. He found as facts that Mr. Biderman had benefitted from the assets for almost three years before disclaiming and, as previously mentioned, that he had represented the assets to be his in his negotiation of a settlement with Revenue Canada.

[19] The appellants have attacked the validity of these findings of fact. With respect to the benefits associated with occupancy of the house, they have submitted that their father lived in the family home after their mother's death in execution of his family obligations towards them under family law. In that capacity, he continued to assume payment of the household expenses as well as payment of the mortgage¹⁶ until the mortgage, we were told, was bought in 1994 by his mother-in-law.

[20] I must say that this submission of the appellants is attractive and might have carried some weight if it had been the only gesture made by Mr. Biderman. However, his conduct entailed much more than that. He acted as sole Executor of the will in conformity with the will although he contended that, at least in relation to the probating of the will, he acted as Executor for sheer expediency¹⁷. Throughout his negotiation with Revenue Canada in 1992, while he was acting as Executor in the estate, he, in addition to representing that he had an interest, never revealed the fact that he had signed, in October 1991, an informal disclaimer and waiver of both the gift and the powers of administration.

[21] The testimony of Mr. Biderman before the Tax Court Judge was crucial. His credibility was very much in issue¹⁸:

His Honour: My concern is the credibility of Mr. Biderman is going to probably be an important part of the Reasons for Decision.

[22] First, Mr. Biderman denied negotiating with Revenue Canada on the basis that the assets willed were his personally¹⁹. Then he testified that he made a settlement offer to Revenue Canada but that the offer was refused. Mr. Carone who testified for Revenue Canada asserted that, on the contrary, the offer was accepted, that an agreement was reached, that he put together a letter to confirm the agreement and that he sent a copy to Mr. Biderman²⁰. According to the agreement, the payment was supposed to be made on April 15th, 1992, but was never made. Mr. Biderman could not recall that²¹.

[23] Mr. Biderman testified that he did not pay a rent for his living in the family home, but instead that he paid the mortgage in lieu of rent²². However, in cross-examination, he was forced to admit that in 1996 he claimed in his tax return an Ontario Property Sale Tax Credit in respect of a rent of \$10,200.00 that he asserted he had paid in that year²³.

[24] Finally, there was evidence before the Tax Court Judge that Mr. Biderman was a lawyer disbarred for his improper use of trust funds for personal advantage and that, as a lawyer, he knew that his inheritance of the family home could and would be subject to execution by Revenue Canada²⁴.

[25] Obviously, in coming to the conclusion he did with respect to the issue of acquiescence to the will, the learned Tax Court Judge gave little weight to the testimony of Mr. Biderman. In my view, there was sufficient evidence to support his findings of fact and I cannot say that they are unreasonable or that the learned judge "made some palpable and overriding error which affected his assessment of the facts"²⁵. He had the benefit of hearing the witnesses and assessing their credibility. In the absence of such error, it is not our role as a Court of Appeal nor is it in our power to substitute our opinion to that of the Tax Court Judge²⁶.

[26] Thus, what I have been calling the formal disclaimer was in actual fact a surrender or release. A disclaimer occurs *before* the beneficiary takes the gift and a release occurs only *after* he or she has accepted the gift. Because the Tax Court Judge found that Mr. Biderman, through his conduct, lost his right to disclaim when he directed the estate toward the appellants, he did so by way of release. The estate had vested in him beneficially, in other words, and the appellants received the family home directly from Mr. Biderman.

[27] The tax consequences are straightforward. This was a case of a tax debtor who transferred property to non-arm's length persons for less than fair market value. In such circumstances, the appellants are jointly and severally liable with Mr. Biderman for his income taxes owed. This suffices to dispose of this appeal."

In *Michelle Leclair v. Her Majesty the Queen*²⁰⁰⁷, a recent TCC, the Tax Court had to consider whether s. 160 applied to an unaware gift "recipient" when her father had transferred title of property to her, her remaining unaware, and whereby she transferred it back to him immediately upon becoming aware. The CRA attempted to assess her under s. 160 for her father's tax liability, allowable under s. 160 if she had received the property. The Tax Court held:

[10] The Appellant's position is that section 160 assessments are fact driven and since the transferor transferred the land to the appellant without her knowledge or consent, the assessment is invalid. The appellant further argues that liability under section 160 does not attach since the transfer could be set aside as a fraudulent conveyance.

[11] The respondent's position is that the operation of section 160 is not affected by the appellant's absence of knowledge or consent to the transfer or her transfer of the land back to her father.

[12] I will first examine the appellant's second submission that liability under section 160 does not attach since the transfer could be set aside as a fraudulent conveyance. The relevant provision is section 3 of *The Fraudulent Preferences Act of Saskatchewan* being Chapter F-21 of the R.S.S. 1978 which reads:

Transfers to defeat creditors

3 Subject to sections 8, 9, 10 and 11 every gift, conveyance, assignment or transfer, delivery over or payment of goods, chattels or effects or of bills, bonds, notes or securities or of shares, dividends, premiums or bonus in a bank, company or corporation, or of any other property real or personal, made by a person at a time when he is in insolvent circumstances or is unable to pay his debts in full or knows that he is on the eve of insolvency, with intent to defeat, hinder, delay or prejudice his creditors or any one or more of them, is void as against the creditor or creditors injured, delayed or prejudiced.

[13] It is submitted that this *Act*, which is similar to the *Statute of Elizabeth* and other acts, does not render transfers that prefer one creditor over another void, it merely makes them voidable (see *Winsor v. The Queen*, 91 DTC 1170 and *Bank of Montreal v. Bray*, (1997), 36 OR (3d) 99. In addition, it is submitted that the act only provides that the transfer is void as against creditors and not entirely void. I do not find this argument helpful in this case.

[14] **There is no doubt that the action taken by the appellant's father in transferring ownership of the property to the appellant without consideration must be considered, at first sight, as an outright gift to her, however, a closer examination of the facts raises doubts.**

[15] In order to determine whether there was an actual transfer of the property to the appellant, one must determine whether all the essential requirements of a gift are met. In the Canada Revenue Agency (CRA) Interpretation Bulletin IT-209R, a gift is generally defined as a voluntary transfer of property without consideration. The essential requisites of a gift are: intention and capacity of the donor to make the gift; completed delivery to a donee; and acceptance of the gift by the donee.

In Ruling 2000-0059963, the CRA acknowledged the effect of a valid disclaimer: the disclaiming party is considered as never having received the proceeds of a disposition.

[16] The law pertaining to gifts was reviewed by Justice C. Miller in *Benquesus v. The Queen*, 2006 TCC 193 where he quoted the following at paragraphs 7 and 8 as to the notion of acceptance:

7 The Respondent argues that the evidence that the children were "generally aware" of the terms of their father's letters to the Foundation is not sufficient to constitute acceptance. The Respondent further suggests there is no coincidental acceptance by the Foundation of the arrangements set forth in Mr. Jacques Benquesus' letters. Yet, the Foundation's behaviour in reflecting the transfer of funds as a loan on its financial statements, and also in following the Appellants' instructions to retain part of the funds as a donation and the balance to be returned to the Appellants, certainly suggests the Foundation accepted the arrangement in Mr. Jacques Benquesus' letters precisely. But it is acceptance of the gift by the Appellants that is at issue. Being "aware at the time that their father transferred the transfers to the Foundation that the transfers had been made" and "generally aware at that time of the terms", combined with providing instructions to the Foundation for charitable donations and to take back monies, clearly point to an acceptance by the Appellants of the gift. The bar is not set particularly high for finding acceptance, as indicated by Professor Ziff in his text "Principles of Property Law" at page 141:

"Acceptance of a gift involves an understanding of the transaction and a desire to assume title. This is a requirement that is treated with little rigor: in the ordinary case, acceptance is presumed to exist. The donee may rebut that presumption by rejecting or disclaiming the interest."

8 Also Professor Gillese in her text "Property Law" indicates:

"In circumstances where the gift is beneficial to the donee, the Courts will normally presume acceptance by the donee. Thus, a valid gift can be made without the donee's knowledge but is subject of the donee's right to unilaterally repudiate upon learning of the gift."

[17] In *Biderman v. The Queen*, 2000 DTC 6149, the Federal Court of Appeal reviewed the law on disclaimers as they relate to wills and section 160 of the *Act*. Mr. Justice Létourneau made detailed remarks in that respect and the relevant passages may be usefully quoted:

9 Secondly, the Tax Court judge found that Mr. Biderman had not truly disclaimed

under the will because he benefitted from the assets for almost three years by having a home for himself and his children and because he used the assets to negotiate a deal with Revenue Canada with respect to his debt.

Did Mr. Biderman validly disclaim his inheritance under the will of the family home?

10 As previously mentioned, Mr. Biderman executed two disclaimers, one prior to and the other almost three years after his wife's death.

11 In the context of wills and estates, a disclaimer is the act by which a person refuses to accept an estate which has been conveyed or an interest which has been bequeathed to him or her. Such disclaimer can be made at any time before the beneficiary has derived benefits from the assets [Footnote 3: *Re Jung* (1979), 99 D.L.R. (3d) 65, at p. 70 (B.C. S.C.). See also Mellows, *The Law of Succession*, 5th ed., Butterworths, London, 1993, at p. 420; *Williams on Wills, The Law of Wills*, vol. 1, Butterworths, London, 1995, at p. 480.]. It requires no particular form and may even be evidenced by conduct [Footnote 4: *Id.*].

12 In the present instance, the first and informal disclaimer made in 1991 by Mr. Biderman is, I believe, legally ineffective and of no avail to him. Not unlike the civil law in Quebec, the common law requires that a disclaimer in order to be effective be made after the death of the legator, that is to say when the legatee is entitled to inherit. While the *Civil Code of Quebec* has a specific provision expressly prohibiting a disclaimer with respect to a succession not yet opened [Footnote 5: See art. 631. See also Germain Brière, *Le nouveau droit des successions*, 2e ed., Wilson et Lafleur Ltée, Montréal, 1997, at p. 115.], the nature of a disclaimer at common law and its retroactive effect to the date of death of the deceased lead to the same result. In *Bence v. Gilpin* [Footnote 6: (1868) L.R. & Ex. 76.], cited in *Re McFaden* [Footnote 7: [1937] O.W.N. 404 (O.H.C.).] and in *McLean & Kerr v. Hrab* [Footnote 8: (1998), 75 O.T.C. 24 (Ont. Gen. Div.).], Kelly, C.B. wrote:

A disclaimer to be worth anything must be an act whereby one entitled to an estate immediately and before dealing with it renounces it whereby in effect he says: "I will not be the owner of this property".

13 There is no entitlement to an estate until it is opened since a testamentary gift can always be revoked until death. Once made, the disclaimer is retroactive to the date of the death of the deceased [Footnote 9: *Re Jung* (1979), 99 D.L.R. (3d) 65, at p. 70 (B.C. S.C.). See also *A.H. Oosterhoff on Wills and Succession*, 4th ed., Carswell, Toronto, 1995, at p. 492; *Williams on Wills, The Law of Wills*, vol. 1, Butterworths, London, 1995, at p. 481.].

14 Moreover, the subsequent conduct of Mr. Biderman is wholly inconsistent with his disclaimer. While he purported to renounce both the gift and the powers of administration, he began and continued to act subsequently to it as executor to his wife's estate. In such capacity, he probated the will on May 15, 1992 [Footnote 10: Appeal Book, tabs 7 and 20, at p. 134.]. Furthermore, he signed on October 6, 1994, the Transfer/Deed of Land with respect to the family home [Footnote 11 : *Id.*, tab 9.] as well as a Transfer of the shares and a Declaration of transmission of those shares on September 30, 1994 [Footnote 12: *Id.*, tabs 12 and 13.].

[18] At the end of his decision, Justice Létourneau made the following remarks about section 160 of the *Act* and disclaimers, and the relevant case law:

45 However, the situation is different in the case of a valid disclaimer of a gift. The disclaimer is retroactive to the date of death of the deceased [Footnote 34: *Re Jung, supra*, note 3, 65, at p. 70 (B.C. S.C.); *Mellows, supra*, note 3, at p. 420. See also under footnote 9.]. As stated in *Sembaliuk et al. v. Sembaliuk* [Footnote 35: (1984), 15 D.L.R. (4th) 303, at pp. 309-310 (Alta C.A.).], the nature of a valid disclaimer is such that the gift is never accepted:

There is no donee of a disclaimed gift in a real sense. The bequest lapses. It may go to the creditors or other claimants, it may go to other beneficiaries, or it may go to a residuary beneficiary.

46 Therefore, the intended beneficiary is not the owner of the gift because of the valid disclaimer and the disclaimed gift is not his to transfer or give. In other words, "a disclaimer operates by way of avoidance and not by way of disposition" [Footnote 36: *Re Paradise Motor Co. Ltd.*, [1968] 2 All. E.R. 625, at p. 632 (C.A.)]. This statement of the law by the English Court of Appeal was accepted by the Alberta Court of Appeal in the *Sembaliuk* case and leave of appeal to the Supreme Court of Canada was refused on February 18, 1985. A disclaimer does not involve a vesting and divesting of property. Consequently, where there is a valid disclaimer, there is, in my view, no transfer of property, direct or indirect, and paragraph 160(1)(c) cannot apply to the person who so disclaims.

47 If we were to accept the contention of the respondent, we would arrive at an unfair if not absurd result. A tax debtor would not be able to execute a valid disclaimer before the death of his spouse. Nor would he be able to execute one after because he could never disclaim his right to inherit the property. Such right which has the net value of the property would be transferred and such transfer would be caught by subsection 160(1). The overall effect of this contention is to radically alter the common law by deeming that a person has taken an interest in an estate against his or her will while judicial precedents clearly state that "the law is not so absurd as to force a man to take an estate against his will" [FOOTNOTE 37: *Townson v. Tickell* (1819), 3 B & Ald. 31, 106 E.R. 575, at 576-577 (K.B.); *Bence v. Gilpin* (1868), L.R. & Ex. 76, at p. 82.]. As a result, the residuary beneficiary under the will, within the limits of subsection 160(1), becomes liable to pay the taxes owed by the tax debtor who disclaimed the gift.

48 The respondent relied upon two old English cases to support her contention that the appellants had a right up to the moment of disclaimer: *Re Stratton's Deed of Disclaimer, Stratton and Others v. Inland Revenue Commissioners* [Footnote 38: [1957] 2 All. E.R. 594 (C.A.)] and *Re Parsons, Parsons v. Attorney-General* [Footnote 39: [1942] All. E.R. Annotated 496 (C.A.)]. With respect, I do not think that those cases are of much assistance to her.

49 The *Parsons* case dealt with the issue as to whether the husband was "competent to dispose" of the legacy within the meaning of paragraph 22(2)(a) of the *Finance Act, 1894*, during the period between the death of the testatrix and the date of the disclaimer by the husband. The Court of Appeal was required to interpret the words "competent to dispose" which, in the context of a deeming provision, were to be given, the Court said, their broad and popular meaning. Therefore, the husband was found competent to dispose by disclaimer. The Court expressly stated that their interpretation of these words had nothing to do with the law on disclaimer of legacies which holds that a person has no estate in a disclaimed legacy and that the gift is void *ab initio* [Footnote 40: *Id.*, at p. 497. See also the Editorial Note at p. 496.] .

50 In *Stratton's Deed of Disclaimer*, the Court of Appeal relied upon the decision in *Re Parsons*. Again, the Court had to interpret a specific provision (subsection 45(2) of the *Finance Act, 1940*) which imputed to the deceased, for estate duty purposes, a disposition in favour of the person for whose benefit the right was extinguished. In that specific context, it was found that a disposition included a disposition by waiver because it extinguished the right of the person who executed the disclaimer. The peculiarity and the specificity of the context is illustrated by this statement of Jenkins, L.J., at p. 602, where he wrote:

It might be said to be, to say the least, anomalous that a benefit conferred by transfer should be dutiable in the event of the donor's death within five

years, while a precisely similar benefit conferred by disclaimer should not attract duty on the death of the disclaiming party however soon after the date of the disclaimer that event might occur.

51 As the Tax Appeal Board rightly noted in *Plaxton v. M.N.R.* [FOOTNOTE 41: 60 DTC 38, at p. 41.], these two cases were dealing with a section of an English statute that has no counterpart in Canadian corresponding statutes. With respect to the *Stratton's Deed of Disclaimer* case, the Alberta Court of Appeal in *Sembaliuk, supra*, noted that the English Court of Appeal was careful to use the term 'extinguish' rather than a term implying any conveyance or transfer.

52 I believe it would take a much more specific and a much clearer provision than the actual subsection 160(1) in order to effect the drastic change sought by the respondent.

[19] The Federal Court of Appeal makes it clear that failed testamentary gifts are not caught by section 160 and that the section does not alter the common law. There is nothing in section 160 that indicates that different rules or potential alteration of the common law applies to different types of transfers such that its application to inter-vivos gift should be the same as to testamentary gifts. A transfer of an inter-vivos gift must be a completed transfer, not a failed or void transfer; intent and delivery by and of one party alone is insufficient. In my opinion, section 160 should not be read as to apply to a failed inter-vivos gift. If a gift lacks any of the three requirements, it is void *ab initio*. In the case at bar, what is asserted is that there was no knowledge or acceptance of the gift and once the gift was known, it was repudiated within an acceptable time by transferring back the property to her father. In my opinion, this transfer back constitutes, in these circumstances, a valid disclaimer and, as such, there was no transfer, direct or indirect of the property; hence paragraph 160(1)(c) cannot apply to the Appellant. The word "dealing" in subsection 160(c) of the *Act* connotes actual action and not a state of relationship. In my view, that provision will not apply unless there is knowledge on the part of the transferee. Therefore, the transfer in issue herein is not caught by section 160.

Income Attribution.

In order to be a pure disclaimer the acceptance of the right to receive or use the property must be avoided without qualification by the disclaimer in that in the act of disclaiming he never comes into the position or gains the capacity to determine, at his own discretion, to whom the substance of the right or the right itself will vest. Since he is not the legal owner of the right he cannot be a donor and thus the property is contingently conveyed as per the then applicable terms of the trust/will.²⁰⁰⁸ Since the beneficial title of the substance of the right is not legally held at any time by the disclaimer the subsequent vesting thereof in another beneficiary cannot be seen in any way, save for instances of meticulously expressed statute law, as a transfer and thus it seems difficult to comprehend how the income attribution rules could apply where income producing property is passed on through a disclaimer to other taxpayers. An instance where an attribution provision may be applied is definitely in the case of Sec. 56(2) where the legal or beneficial title to a property need not be owned prior to its transfer or payment to a "benefitting" taxpayer. If pursuant to the direction of a taxpayer or with his concurrence a transfer or payment of property is made to another person for the benefit of the taxpayer or as a benefit the taxpayer wished to be conferred on the recipient the payment will be includable in the taxpayer's income to the extent that it would have been if received by him. After the reading of a will, whereby a parent contingently disclaims his income interest under the trust so that the income rights of his offspring are accelerated or enlarged can Sec. 56(2) apply owing to the fact that it can be said that the benefit of the enlargement was desired to be conferred by the parent and the redirection of the bequest was made

2008 See Re: Guinness's Settlement, 1966 1 W.L.R. 1355, for the distinction between a disclaimer and a release. As per Re: Schar, 1951 Ch. 280, a deed expressing disclaimer must state nothing but its primary purpose: the nondirective disclaiming.

with his concurrence/direction in the form of the disclaiming of his income interest? In the author's opinion it could easily so apply and thus disclaimers may lead to instances of attribution even though they do not lead to the recognition of a disposition.²⁰⁰⁹

Severable Interests.

An interest arising in a trust or estate may be composed of a variety of different income and/or capital rights and although they may be disclaimed verbally or in writing, it is a question of interpretation of the intention of the settlor/testator as to whether only certain parts of the rights can be disclaimed or if they can be disclaimed for a limited period of time whereby they will become enforceable by the beneficiary after that time period has passed.²⁰¹⁰ There are minimal Canadian cases, at any level, to derive a sense of jurisprudence from while in the former case there exists a considerable body of English trust law upon which to base Canadian jurisprudence.

Where two or more properties are the subject of the same gifting provision in a trust deed or will the beneficiary may be entitled to accept one of them and disclaim the other however where the intention of the gifter is derived to be that both are to be accepted or disclaimed then the beneficiary will not be in a position to disclaim only one of them since they must be gifted as a unit and the individual properties are inseverable from each other and jointly constitute one gift.²⁰¹¹ In *Re: Pearce*²⁰¹² the general principle concerning the acceptance of or disclaiming of gifts under a will was described as:

"Where a testator makes two distinct bequests in the same sentence to the same person, one of which happens to be onerous and the other beneficial, prima facie the legatee is entitled to disclaim the onerous legacy and to take the other. But in such cases it is a question of the intention of the testator, to be gathered from the will, whether the legatee must elect to take all or none of the gifts in the will, or whether he may accept the beneficial gifts and repudiate that which is burdensome. In cases, however, where onerous and beneficial property are included in the same gift the legatee cannot disclaim the onerous and accept the beneficial, unless the will manifests a sufficient intention of the testator to the contrary. The gifts may be in substance distinct though given by one sentence in the will."²⁰¹³

It becomes redundant in stating that in planning for the use of disclaimers in a trust or a will that the gifts should not be aggregated under a single gifting provision but should be dealt with as separately as possible.

The severability of interests under a trust is a direct factor in determining whether a right to income can be disclaimed for a limited period of time whereafter it will vest in the former disclaimer. This has obvious beneficial use in tax planning. In *Re: Skinner*²⁰¹⁴ a beneficiary attempted to disclaim one year's income payable to him by a trust however Abby J. held that:

"The law is clear that, where there is a single undivided gift, the donee must take the whole: he cannot disclaim part..."

and then went on to provide:

"It seems to me that, on a fair reading of the above quoted para.(f) of the will, one could not come to any other conclusion but that the gift to the son, Dr. Skinner, is a single gift of the revenue from the testatrix's estate for life. There is nothing there or elsewhere in the will to indicate that the gift would be one of **successive and severable yearly gifts of income**, or is there anything else in the will which would indicate any right of disclaimer to part of the gift of the income for life."

The provision in the will setting up the singular gift was :"(f) To keep invested the residue of my estate and to pay the net income therefrom to or for my said son, Dr. John Henry Burdett Skinner, at present of Hornpayne,

2009 See *Williams v. I.R.C.*, 1964 13 A.T.D. 398, for the disclaiming of income **but** not the right to receive it.

2010 See *Earl of Longford v. Baron Kensington*, 1902 1 Ch. 203, *Re: Sitwell*, 1913 135 L.T. Jo. 323, & *Parnell v. Boyd*, 1896 2 I.R. 571 (CA).

2011 See *Halsbury's Laws of England*. 4th Ed. Vol. 50 p. 193, as well as *Re: Lysons*, 1912 107 L.T. 140, *Bacon v. Barber*, 110 Vt 280/6 A.2d 9, *Comm. v. Macauley's Estate*, 150 F.2d 847.

2012 1926 N.Z.L.R. 699, at pg. 711,

2013 *Re: Pearce* is an excellent case listing the instances where the above principle has been modified when needed and applied.

2014 1970 O.R. (3d) 35,

Ontario, during his lifetime." If the testatrix had expressly stated in a provision that the beneficiary was to have the right to disclaim for a particular period of time the result would have obviously been different.

In *Re: Coulson*²⁰¹⁵, perhaps one of the more controversial Canadian cases concerning disclaimers, a situation very similar to *Re: Skinner* arose whereby the beneficiary of the trust attempted to disclaim for a one year period, income from the trust which was payable to her as per the provision contained therein: "to pay to each child of any of my brothers surviving the time of such division into shares or parts the net income derived from one of such equal shares or parts **half yearly** or oftener as long as he or she shall live." The Court of Appeal held that she had such an ability to "disclaim" income for a limited period of time although it did not use the criterion established in *Re: Skinner* but instead expressed the opinion that that **case was wrongly decided**, and thus it would appear that most presently, in the Province of Ontario, it is possible to disclaim the acceptance of certain income rights operative only in certain periods without causing the recognition of a renunciation or disposition. In the author's opinion, *Re: Coulson* was wrongly decided in that the beneficiary "disclaiming" the income for the year had done so only after the receipt of income from the trust for some time and even disclaimed a portion of a right which was given as an **indivisible gift; a life income interest**. *Re: Coulson* recognized that a life income beneficiary can "**disclaim**" an income right after it has benefitted from using the reasoning in *Re: Graydon*²⁰¹⁶ which was a case involving the complete ultimate **renunciation** of a right already fully accepted. A "disclaimer" is a technical term and indicates an event quite different, both in substance and in form, from that of a renunciation. In *Coulson* the beneficiary had a life interest which could easily be seen to constitute a singular indivisible gift; this was also the case in *Re: Skinner*, hence logically, if *Re: Skinner* was decided on such a large body of jurisprudence, and *Coulson* found it decided wrongly on the basic issue, then all of the jurisprudence developed on the issue was by association wrong as well. *Re: Coulson* was decided wrongly in the author's opinion.²⁰¹⁷

If the intention of the donor of the interest is expressed so as to recognize that the gift of an income right is that of several severable rights applicable to consecutive years then the beneficiary donee will be able to **disclaim** any particular right in respect of any year however he will have to do so within a reasonable period of time after he first learns that he has such a right since if he doesn't his actions may be interpreted as accepting the right. Understandably this requirement may be capable of being satisfied only at the initial constitution of the trust/reading of the will however where a power of appointment may exist whereby income interests may be subsequently created then there would obviously be more instances where a disclaimer could fine tune income recognition by all of the parties involved.²⁰¹⁸

Retractions.

A disclaimer may be retracted at some time after it has been executed if the disclaiming party is an income beneficiary life tenant and upon the disclaiming action the other existing equitable interests under the trust were not altered nor at any other time any other beneficiary has changed his position with respect to the trust/will due to the disclaimer while if the disclaimer receives consideration for his disclaiming of the right he will not be able to retract it subsequently.²⁰¹⁹ In *Re: Young, Fraser v. Young*²⁰²⁰ **a life tenant**, in effect, renounced, after having realized some benefits therefrom, a right to income under a trust whereby the income was consequently paid to her son. When the son died she attempted to retract her refusal to accept the income while the other beneficiaries contended that she couldn't. The court found that although the main purpose of a disclaimer/renunciation was to allow a beneficiary the ability to avoid taking a bequest against his will it did not have any bearing on whether or not the refusal could not be retracted and that since the

2015 1977, 16 O.R.(2d) 497 (CA)

2016 1942 1 O.W.N. 131,

2017 Not even the severability of the interests involved were addressed in the case and the jurisprudence in *Graydon* was invalidly applied.

2018 For American jurisprudence on disclaimer (other than retraction) see "Postmortem Estate Planning", L. Newman, A. Kalter. America Law Institute L.of C. # 76-4993, where the following cases are cited for authority: In re: Matthiessen's Will, 175 Misc 466, 23 N.Y.S.(2d) 802, Brown v. Routzahn, 63 F.2d 914, Bacon v. Barber 110 Vt. 280, 6 A.2d 9 (1939), Commissioner v. Macaulay's Estate, 150 F.2d 847 (1945).

2019 See Halsbury's Laws of England, 4th Ed. Vol. 50, para. 341.

2020 1913 L.R. Ch. 272,

renouncer had not accepted consideration for the renunciation, and since she was a life tenant, her former equitable rights could still be upheld. If a disclaimer can be retracted then technically income diverting can occur even when the income interest isn't divisible and must be entirely disclaimed. In subsequent period after income has been recognized by the trust or other beneficiary, as long as **no party** has changed his position on the faith of the event, the retraction may occur unhindered to allow the income to be recognized by the original beneficiary.

It's important to be a life tenant or have a life interest: but the retractor must have otherwise had an operative right for the period in which he wishes the disclaimer to have no effect. A retraction in the seventh year after the disclaiming of a right with a life of five years will be useless. In *Re: Cranstoun's Will Trusts*²⁰²¹ a beneficiary renounced the right to a residue of an estate believing that it carried onerous liabilities.²⁰²² When the beneficiary then subsequently tried to retract the renunciation after finding out that the residue was beneficial the persons entitled thereto attempted to maintain that he could not however the court found that:

"From the scanty material available on this principle of renunciation (it might just as well have been a disclaimer) it seems that it was introduced for the benefit of beneficiaries, so that a beneficiary should not be obliged to take what might be an onerous burden; but a natural corollary of the principle is that if anyone acted on the faith of his renunciation and altered his position to his detriment in consequence thereof, the beneficiary would not be allowed to retract his renunciation. Where, as here, no one has altered his position, I cannot see why the claim to retract should not prevail."²⁰²³

In *Naismith v. Schmidt*²⁰²⁴ residue was left to two beneficiaries conditional on their personal payment of an annuity to another and the taxpayers waited two years (ascertaining the extent of the residue) before disclaiming it. Six months later they attempted to retract the disclaimer but the Court held that since they had not performed the condition within a reasonable period of time the gift lapsed and the retraction would not have been to any benefit in such a case though it did recognize the retraction as a valid transaction. It also held that the legal expense/trouble of establishing a beneficial interest in the disclaimed property on the faith of the disclaimer may give rise to an estoppel preventing its retraction. A retraction may not be validly recognized when it attempts to operate in respect of benefits already realized by the other beneficiary.

Retracting disclaimers of income rights may prove to be an effective method of diverting income away from oneself without the recognition of a disposition or transfer while afterwards the income can be recognizable however the author does not know of a single tax case in any jurisdiction where this approach was the topic of litigation. In the Canadian context if CRA suspects that the reason for the disclaimer and retraction were other than "legitimate" they could pounce with section 245. In the case of capital interests this procedure can be very useful at producing capital losses for a party who owns the capital right, and has a legitimate ACB, when the original beneficiary retracts his disclaimer. This however applies only when the beneficiary losing the capital right has not paid consideration for it, (altered his position on the basis of the disclaimer), and thus this procedure may be valid in limited cases, amongst others, where the capital beneficiary has not altered his position but has merely become resident in Canada thus benefiting from the Sec. 128.1(1) ACB bump, or receiving it via a Sec. 107(2) roll through and bumping up the cost. The Sec. 107(2) bump isn't discretionary. Again, CRA could attack this arrangement with section 245 if everything doesn't appear to be "legit." They could also contend that it is a benefit realized by the taxpayer under/from the trust thus includable fully in his income under Sec. 105(1). In the above case the two beneficiaries and the trust could initially be non-resident. Upon one disclaiming the other becomes resident thus benefitting from an enlarged Sec. 128.1(1) bump in respect of the enlarged interest. After becoming resident the non-resident beneficiary could retract the disclaimer and Sec. 105(1) can't apply to non-residents while the Canadian resident will either recognize an immediate capital loss or the ability to subsequently bump the cost of the property rolled through via Sec. 107(2) on terminal distributions. Variations of this procedure could be instituted of course. The interest could

²⁰²¹ 1949 L.R. Ch. 523,

²⁰²² He then subsequently did the exact same thing - thus there were two expressions of disclaimer.

²⁰²³ *Re: Boyd*, 1966 N.Z.L.R. 1109, endorsed the principle but found that a retraction wasn't necessary in the particular case in that an ineffective disclaimer had occurred.

²⁰²⁴ 1968 Q.W.N. 33

also be disclaimed, in the case of a newly created non-resident trust, prior to its holder becoming non-resident, so as to avoid a Sec. 128.1(1) liability. They could also be used to temporarily disrupt the associated corporation rule applications, the preferred beneficiary election provisions, the income attribution rules, etc..

In the author's opinion the principles involving severability of interests/rights would apply where a disclaimer or renunciation is to be retracted so that in the case of a single gift the whole interest comes back to the disclaimer on the retraction while in the case of severable periodic rights the retractor is able to pick and choose. In the case of *inter vivos* trusts the ability to retract disclaimers or renunciations may be negated by the reasoning in *Re: Paradise Motor Co. Ltd.*²⁰²⁵ where it was held that a retraction could not take place. In that case there was a gift *inter vivos* and after the taxpayer had disclaimed it he attempted to retract his disclaimer. The Court held:

"The second argument was based on decisions that, in the case of disclaimer of a benefit under a will, a disclaimer may be withdrawn if no one has changed his position on the faith of it. We do not decide whether these decisions or dicta are correct; they are *In re Young*, *Fraser v. Young*, and *In re Cranstoun*, dec'd., *Gibbs v. Home of Rest for Horses and Others*. It seems to us, however, that disclaimer of an attempt *inter vivos* to make a gift cannot be withdrawn. Maybe a will remains an outstanding offer of a gift. Surely, however, this is not so when the proposing donor, rebuffed, is still alive. Counsel proposed that, if A. tendered to B. by post a deed poll conveyance of property by way of gift, and B. returned it by post with refusal and contumely, but telephoned later to withdraw his refusal, the gift would be effective. We can but say that that would be a remarkable situation which we cannot accept. We see no reason why a rebuffed would-be donor, no longer willing because of the rebuff, should be held to his offer of benevolence. A dead testator is no longer conscious, in worldly terms, of rebuff. Assuming, therefore, the cited cases to be correct, they are quite different, and bear no relation to disclaimer of an attempted gift *inter vivos*,..."²⁰²⁶

With this in mind then it would appear that tax free generation of capital losses through disclaimers and changes in residence can be attempted only in respect of testamentary gifts.²⁰²⁷ Keep in mind however that offensive use may be very limited to where non-tax motivated legitimate conditions and reasons exist. In the author's opinion situations where an interest is disclaimed for capricious reasons subsequent to which it is retracted with the creation of a tax benefit clearly falls within the sights of section 245. Both substance and reason must regulate form,²⁰²⁸ and the reason for the initial disclaimer, the suspicion of onerous liabilities, must be reasonably believable.

Consideration for Disclaimers.

If consideration is received for a renunciation of an interest, be it capital or income in the section 108 technical sense of the term, under a trust, a disposition will be recognizable not by virtue of the fact that the consideration was received but instead due to the fact that the right is being disposed of. Since a disposition is being recognized, depending on the nature of the right, some amount of proceeds would be includable in the renouncer's income.²⁰²⁹ This arises only in the case of a **renunciation and not a disclaimer** and it applies only when the consideration is received from a non-trust/estate party such as another beneficiary. If consideration is received by a disclaimer Sec. 105(1) could apply to it to cause its full inclusion in the recipient's income due to the fact that it is a benefit realized from the trust/estate or other party that is not otherwise required to be included in computing his income and that was not related to the ACB of a capital interest which in common law he would not have. In the case of a renunciation, where the beneficiary releases his rights under the trust regardless of to whose benefit they inure, if he receives consideration from the trust

²⁰²⁵ [1968] 1 W.L.R. 1125 (C.A.),

²⁰²⁶ See also *Wood v. M.N.R.*, 64 D.T.C. 780.

²⁰²⁷ Article 657 of the Quebec Civil Code allows a taxpayer to retract a disclaimer (renunciation) made providing the previously mentioned conditions have been satisfied.

²⁰²⁸ Is it possible for the retraction recognized in common law to confer a benefit on the retractor within the context of Sec. 105(1) so as to require him to include its value in his income? The Department could take this position in order to demolish any tax advantage without relying on section 245 and in this respect it could prove beneficial to ensure that the retractor is non-resident when the adjustment is judicially recognized.

²⁰²⁹ See *Oughtred v. I.R.C.*, 1960 A.C. 206 (HL)

in respect of them Sec. 106(2)-(3) will most likely apply in the case of an income right so as to preclude any proceeds from being included in the recipient's income but only where the proceeds are reasonable in the circumstances otherwise Sec. 105(1) may apply if they are not. If the proceeds are received from a non-trust/estate party then Sec. 105(1) can apply to them due to the fact that **the trust/estate is not making the payment** while if the interest renounced is a capital interest and if the consideration is received from the trust then the section 107 distribution provisions can apply to it. When a non-trust/estate party such as another beneficiary pays the consideration to the renouncer the amount may not necessarily lead to the beneficiary being able to recognize a cost of the enlargement of his interest or the right directly acquired since technically the trust deed/will may be the source from which he derives the right not as consequence of the purchase of the right from the disclaimer/renouncer. If the beneficiary is the assignee of the right, or the renunciation is specifically directed at him then the consideration he pays to the former may be recognized as the cost of the right acquired or enlarged however if the trust deed/will operates unilaterally to enlarge the interest of the beneficiary regardless of the payment to the disclaimer/renouncer then the purchaser/seller relationship required for the effective operation of the Sec. 106(1.1)-107(1.1) mechanics has been severed and inequitable tax consequences will follow.²⁰³⁰ Care should be taken in ascertaining which party will compensate a renouncer or disclaimer.

Renunciations and Releases.

A renunciation, surrender or release of an interest under a trust or estate is dissimilar to a disclaimer of an interest in two important aspects being that the disclaimer generally operates **ab initio** thus avoiding the acceptance of the right while the surrender or release operates by way of the disposition of rights already held thus under a disclaimer the trust deed/will be the source at which the income/capital is diverted to another beneficiary while in the case of surrenders or releases it will be the beneficiary who formerly held the right that will decide to whom it shall subsequently vest even though the trust deed operates to vest the interest in another party without the direction of the beneficiary. The latter distinction is critical in that a renunciation of an interest is regarded as a disposition and thus when the right, or income in respect of it, accrues to the benefit of another beneficiary it can be seen how property has been "transferred" in the general sense of the term, through the operation of the trust deed/will or otherwise, thus the income attribution provisions may apply.²⁰³¹ In *Platt and Ors. v. C.I.R.*²⁰³² an income beneficiary released and surrendered his income interests to the trustees directing that the will trust be read as if he were dead. The will trust was one of successive interests and upon his death his offspring were to become entitled to the income of the trust. It was held that the parent had conveyed his interest to the offspring. In such an instance in accompany to the dicta advanced in *Murphy v. The Queen*²⁰³³ income would be attributable.²⁰³⁴ In *Oughtred v. I.R.C.*²⁰³⁵ a remainderman "released" his interest in a trust's shares upon receipt of consideration from the life tenant and a sale of the interest was recognized by the House of Lords to have occurred and that the interest was subsequently held on constructive trust for the life tenant. Income attribution would occur in such an instance while until the time at which the interest was legally transferred the remainderman would still be subject to the Sec. 256(1) and (1.2)(f) rules in respect of corporate association.

Halsbury's Laws of England defines a release as an act discharging a right of action against another and to be valid it must be supported by consideration received from any party or under seal gratuitously. A renunciation, for purposes of this discussion, includes any number of dispositive acts whereby the legal title to a beneficial right ceases to be vested or held by a beneficiary and it includes instances where the beneficiary releases the right back to the trustees so that it is extinguished, or surrenders it to the trustees on the condition that they direct the benefits therefrom to other specified parties while it is not at all relevant

²⁰³⁰ This wasn't the case in *Oughtred v. I.R.C.* supra where indirect enlargement of an interest on payment to renounce allowed cost to be recognized.

²⁰³¹ See *d'Abreu (Arthur) v. I.R.C.*, 52 T.C. 352.

²⁰³² 46 T.C. 419 Ch

²⁰³³ 80 D.T.C. 6314.

²⁰³⁴ In *Berkeley v. I.R.C.*, 1984 13 N.I.J.B., a residuary legatee released his interest in an unadministered estate in favour of his spouse and a voluntary disposition **wasn't** recognized for tax purposes.

²⁰³⁵ 1960 A.C. 206

whether the right maintains its specific characteristics or ceases to exist. As per the Department in I.T. 305R2 & 385R a renunciation means the abandonment for no consideration and without directive conveyance by the holder of the interest previously held.²⁰³⁶ If consideration is received **from any party** on the release it may be recognized as proceeds of disposition and the release will be recognized as a disposition as per Sec. 54(c)(ii)(B). If the release is made within 36 months after the death creating the interest in the estate or trust and the Sec. 248(9) definition is satisfied, a disposition will not be recognized **for the purposes of the Act**, as per Sec. 248(8)(c).²⁰³⁷

In *T.R. Bulman v. M.N.R.*²⁰³⁸ the taxpayers inherited their son's estate, and while they attempted to disclaim the inheritance so as to cause it to become vested in the two surviving sons as per the B.C. Estates Administration Act, they did so by using specific language indicating that the interest must fall back to the exclusive favor of the two sons. The Minister assessed them on the grounds that they had made a gift to the two sons, taxable at the time, by qualifying the disclaimer. The Tax Appeal Board found that the taxpayers had not made a true disclaimer but had instead assigned their interests by providing that they should be vested in the sons. For a simple technicality, the use of **directive** language, rather than the reliance upon the provincial statutes to vest the estate, the taxpayers were considered to have indirectly made a gift. Such a situation would allow the attribution provisions to apply and cause the taxpayer to recognize a disposition thereof for fair market value proceeds.²⁰³⁹

The difference between a renunciation and disclaimer is not major enough to cause the factors relevant to a disclaimer, such as the ability to retract or the ability to renounce certain portions based on the severability of the rights, to be inapplicable to renunciations, however since the renunciation operates as a disposition of property already accepted the appropriate taxation will result and the application of the income attribution provisions may follow.

Dispositive Powers.

A dispositive/distributive power granted to any person which need not be a beneficiary under the trust nor a trustee, is a power that allows the person to create and alternately extinguish beneficial interests in the trust or its property and thus redirect the subsequent legal ownership of the trust property away from the original beneficiary. Such powers come in three broad forms: powers of appointment, powers of advancement, and powers of encroachment. The other type of power, administrative or managerial, is a power usually given to the trustee/executor allowing him to manage the trust property and thus they include powers of sale, lease, active business, exchange etc. and are generally powers that are entirely related to the functioning of the trust as a separate party, whereas dispositive/distributive powers are those concerning the functioning of the trust as it relates to the interests of the beneficiaries. Although a dispositive power of any of the three broad categories allows the person holding it to determine, possibly as per expressed restrictions, how a beneficial interest will be affected or extinguished it is not an interest in the trust or its property itself nor will it be interpreted as being a capital or income interest technically defined in section 108, however they may be extremely flexible structured so as to allow a trust distribution scheme to be altered and thus are, in the author's opinion, one of the most useful tax avoidance tools available.

Powers of Appointment.

A power of appointment is a power that allows a person to take the beneficial interest in a trust property or trust from a beneficiary in which it is otherwise vested and vest it in another party and thus subsequently settle the legal title of the property on another person, other than that formerly entitled to it under the initial trust

²⁰³⁶ See *Plaxton v. M.N.R.*, 60 D.T.C. 38.

²⁰³⁷ This is also the case with disclaimers but in either case the release cannot be directive.

²⁰³⁸ 62 D.T.C. 593.

²⁰³⁹ See *I.R.C. v. Buchanan*, 1958 Ch. 289 (CA), for the surrender of life interest in favor of a remainderman as well as *I.R.C. v. McLauren*, 1961 N.Z.L.R. 338, a situation very similar to *Bulman* where directive disclaimers were found to be releases of interests already accepted thus consisting of dispositions. It was held: "This disposal clearly controls the destination of the proceeds in a manner which would not arise if a simple disclaimer were being exercised." and in conclusion words that are directive operate as essentially an assignment and not an avoidance notwithstanding prior wording to the latter effect.

terms. It can either grant a beneficial interest in the trust to another party and thus reduce the scope of those already existing or it can take the legal ownership of the property right out from under the trust and vest it in another party.²⁰⁴⁰

The power directly affects the legal or beneficial ownership of the trust property depending on how expressed. It is a power over that ownership but it is separate from the ownership itself.²⁰⁴¹ There are two different broad forms of powers of appointment and they may be exercised under one of two conditions. In the latter instance a **trust power** or **fiduciary power** is a power instilled in the person that is instilled with a fiduciary obligation attached to it compelling the holder to exercise it within the parameters/limitations provided by the grantor while if it isn't then the courts can be called upon to enforce its execution. A bare or mere power is simply a power that is instilled in a person that will allow him to alter the distribution of trust property should he, in his own absolute discretion or otherwise as per expressed parameters, feel he should and thus its exercise cannot be ordered by a court since in effect the settlor/testator is granting a very absolute and broad form of control to the person believing that he will exercise it sincerely. The two basic forms of powers of appointment derive their status from the restrictions, or lack of, placed upon their exercise as per the expressed or implied intentions of the settlor/testator as evidenced in the source document. A "general" power of appointment is one that can be exercised in favor of any party including the holder himself even though it may be otherwise restricted as to how the property will be subsequently distributed or when the beneficial interest thus created will vest indefeasibly or otherwise.²⁰⁴² The essential factor to recognize that distinguishes it is that there is no restriction placed on it as to whom it may be favorably exercised in respect of and thus it presents an extremely broad and virtually limitless delegation of the legal control of the property formerly held by the testator/settlor to the holder allowing him to decide to whom the property will be given.²⁰⁴³ A "special" power of appointment is a power granted which can be exercised only in respect of a class of identifiable potential or existing beneficiaries expressed in the trust deed/will and thus the holder does not enjoy the same favorable position as that of the general power holder in that the testator/settlor has qualified the power so that its exercise can take effect only in respect of certain people expressly referred to in the source document.²⁰⁴⁴ The distinction between a general and special power of appointment is to be derived from the interpretation of the trust deed/will and the manner in which the power is described and granted to the holder. The effect of the difference between them, as will be seen, is astronomical, when sub-trusts and "new" trusts are discussed.

A power of appointment over a property held in trust or subject to the terms of a will is not a form of ownership, (although it can directly affect that ownership), and since it is not a right to or to receive income or

2040 See Halsbury's Laws of England, 4th Ed., Vol. 36, para. 804. The author chooses to respect numerous and meaningful UK precedents on distinctions in natures of powers of appointment here since they have an entire spectrum of consequences and respect the grantor's motivation in creating them. Lumping them all together does not give credence to what was attempted to be accomplished in their creation and even US Estate Tax legislation and their body of case law does make provision for a difference in those general and special: should Canada "catch up"? Are we so infantile in our legislative thought that we think it too complex or too rare to be concerned with? Should we not aim to match fiscal legislation as closely to underlying law as possible: Kim's "A Law applying to other Laws"....

2041 Re: Dobson's Settlement, 1946 V.L.R. 83.

2042 It is the most absolute form of "*jus disponendi*" that the power holder may possess.

2043 As it was held in M.N.R. v. Goyer Estate, 1976 C.T.C. 587:

"A power of appointment is the power granted to a person to dispose of property which does not belong to him. A general power of appointment enables its holder to designate anyone, including himself, as the owner of the property affected by the power."

In Montreal Trust Co. et al. v. M.N.R., 60 D.T.C. 1183, ExCR:

"... the term power in general being associated in legal usage with the description of an authority in respect of property or an interest in property which does not itself belong to the person holding the power. Even when a power to dispose of property is wide enough to enable the holder of the power to exercise it in favour of himself the power itself, in the absence of any exercise of it, is not regarded as equivalent to ownership of the property. Conversely, one scarcely refers to an owner either in ordinary or technical usage as 'a person having a general power to appoint or dispose of his property. But an owner undoubtedly has the right, and, in that sense, the power to dispose of his property.'"

2044 There is a third type of power of appointment, a hybrid power that is not restricted in any form except that it **cannot** be exercised in respect of a class of persons specified and this type of power is of direct importance when one examines the possible effect of Sec. 75(2) on general powers of appointment not expressly restricted in respect of the particular trust property's contributor.

capital from the trust it cannot be equated with being a capital or income interest in respect of the technical definitions of those terms in section 108.²⁰⁴⁵ Those definitions apply only where the right is held by the taxpayer in the capacity of a **beneficiary** and until a power holder has exercised the power favorably in respect of himself he may not be beneficiary. It is the exercise which causes him to gain rights and the status of beneficiary under the trust. The power is however a chose in action in that it gives the holder a discretion and thus clearly falls into the definition of "property" in Sec. 248(1) resulting in the possibility of the recognition of a taxable disposition when it is renounced or extinguished in any other way. Ascertaining the proceeds of disposition of a power of appointment upon its renunciation or disclaimer can be very subjective when the renunciation - disclaimer accrues to the benefit of no one however the power may also be able to directly affect the fair market value of a capital interest which can be beneficial in the instance where the beneficiary holding the interest becomes non-resident. If the power can significantly or completely undermine the interest the interest's fair market value will be reduced for purposes of Sec. 128.1(1) while once the beneficiary plans to become resident in Canada the power may be renounced thus inflating the interest's fair market value for purposes of Sec. 128.1(1) so as to increase its tax free ACB bump. This can also be useful at affecting the Sec. 256(1.2) associated corporation "look through" rules considering they apply on the proportion of the fair market values of the interests involved. The power may be varied into the trust just prior to ceasing to be or becoming resident as need be and it need not be held by an arm's length party however to have the desired effect it must be reasonable to assume that it can be exercised. Powers of appointment suffer from the same factors as beneficial interests in respect of renunciations and disclaimers vis-a-vis severability.²⁰⁴⁶

Understandably there is potential for triple taxation on a power's creation since under the ITA there will be:

- Exposure on the underlying trust property itself – in the hands of the trust,
- Exposure on the beneficiary's interest in that trust property – in the hands of the beneficiary, and
- Exposure on the power that governs both,

and to some extent they can be argued to be completely mutually exclusive. So care should be taken as to exactly what you want to accomplish with them and how.

While a general or special power of appointment may be exercised in favor of its holder giving him a capital or income right, until it is so exercised, whereby it is evidenced through a deed, the holder does not have any rights under the trust in the capacity of a beneficiary and thus does not have a capital or income interest for taxation purposes even though he can be seen to hold "a property". This principle was upheld in *Cossitt v. M.N.R.*²⁰⁴⁷ where a beneficiary had both an income right and a restricted power of appointment over capital exercisable only in respect of himself and for succession duties purposes the Minister attempted to have the possible substance of the power, in effect the entire amount of capital in the trust to which the power related, included in the taxpayer's dutiful amount. The Dominion Succession Duty Act applied succession duties only on "property" passed on death and while the power could have been exercised in respect of its holder it did not constitute "property" under that Act until it was exercised giving the holder a right to the capital. The Act however, and only by means of a provision, provided that, (in section 31):

"Where a general power to appoint any property either by instrument *inter vivos* or by will, or both, is given to any person, the duty levied in respect of the succession thereto shall be payable in the same manner and at the same time as if the property itself had been given, devised or bequeathed, to the person to whom such power is given."

thus the possible substance of the power was caught for duty. If the above targeted provision had not been in the D.S.D.A. since the holder of the power had not received a beneficial right to the capital of the estate the power would not have represented an "entitlement to property" which was the basis of the main charging provision in Sec. 2(m) of that Act, (being equivalent to a capital or income right). The important factor to

²⁰⁴⁵ See Halsbury's Laws of Eng. 4th Ed. Vol. 36, para. 819.

²⁰⁴⁶ One particular fiendish use of powers is to set up an off-shore trust and grant them from within Canada to relatives who are about to emigrate. Since they derive their value from the underlying property they affect their holders have stepped up cost amounts thereof upon becoming resident due to deemed acquisition rules and if they expire after 2-3-5 etc. years they create capital losses of indefinite duration: welcome to Canada, here's a free capital loss to start off the growth of your wealth. And just how many powers of what value can you create with one trust?

²⁰⁴⁷ 49 D.T.C. 617,

appreciate about Cossitt is that it was only through the expressly worded section 31 provision that the power of appointment was caught and although under the ITA there isn't a provision equivalent to it, for purposes of the section 70 rules applicable to the death of a taxpayer, the power still represents property.

In *Wanklyn et. al. v. M.N.R.*²⁰⁴⁸ the Supreme Court of Canada found, in respect of a special power of appointment:

"...but it was only to the extent that he exercised the power that he became beneficially entitled to any portion of such capital and it is conceded that he was liable to pay duty in respect of such portion.

The respondent's argument depends upon the proposition that a person who is given a power over property thereby becomes beneficially entitled to such property but in my view this is not the law and **no words in the statute so provide.**"²⁰⁴⁹

A power of appointment exercisable in respect of its holder exclusively, under the ITA, would appear not to be able to avoid capital gains taxation on the death of the holder in that its fair market value at the time of death, for purposes of Sec. 70(5), would not be reduced due to the death. Subsection 70(5) doesn't require that a taxpayer acquire a taxpayer's property after the death in order to cause a deemed disposition. If the power is held in the capacity of a trustee Sec. 70(5) shouldn't apply to it. If it can be exercised by will, and it can be exercised so as to direct property from one trust into the deceased's estate then it would appear that it should have a fair market value equivalent to the value of the property in respect of which it is enforceable and not the property which is actually affected through its exercise. The cost of the power, as a property, should be determined by Sec. 69(1)(c) in a testamentary or *inter vivos* situation so that at the time of its creation its cost should equal the fair market value of the underlying property adjusted for the restrictions on its exercise.²⁰⁵⁰ In such a instance the giftor will not recognize a disposition since he doesn't formerly own the property and since the trust may still retain the right to dispose of/deal with the property and such a power does not infringe upon the rights of ownership of the property held by the trust: it may affect the interest structure under the trust but it doesn't necessarily affect the trust's ability to deal with the legal ownership of the property.²⁰⁵¹

In general, a power of appointment could be given to a taxpayer which was exercisable in respect of an identifiable class of people including himself, whereby until he exercises the power they all, singularly and as a group, cannot be seen as having any enforceable right to the subject property, (and this facilitates changes in residence of beneficiaries, avoidance of the effect of the new associated corporation "look through" rules, etc.).²⁰⁵² The power holder would then be free to favorably decide, given the amount of property available and its implicit tax characteristics, the power's restrictions, and the tax positions of the potential beneficiaries as well as the trust/estate, who could most beneficially receive the property.²⁰⁵³ On the other hand if the power holder is the contributor of the property he may be caught by Sec. 75(2) and be required to recognize all of the particular property's income/loss etc. since he has the ability to determine to whom that property will pass.²⁰⁵⁴

2048 53 D.T.C. 1167,

2049 See also *Muir v. Muir*, 1943 A.C. 468. per Lord Romer pgs 485, citing *Duke of Marlborough v. Lord Godolphin*, 1750 2 Ves. 61; 28 E.R. 41, *Re: de la Bere's Marriage Settlement Trusts*, 1941 Ch. 443, *Re: Dickinson's Settlements*, 1939 Ch. 27, and *Re: Rush*, 1922 1 Ch. 302, "In fact, those cases are examples of a principle which seems to be perfectly clear, namely, that, where there is a power and a later instrument exercising that power, the interest created by the exercise of the power arises under the later instrument, for, in fact, there never was such an interest until the power was exercised so as to create it." As per Lord Godolphin and Rush there is no relation back in vesting/existence of the interest created by a special power of appointment.

2050 There shouldn't be any reason to hold that the power to determine the destination of legal ownership isn't a gift within that subparagraph's context. This cost will reduce, though may not eliminate, taxation on death under Sec. 70(5). In effect there will be double tax treatment in respect of the power and its underlying property: an increase or decrease in the f.m.v. of the latter will do the same for the former.

2051 Options are also property which may not cause taxation exposure to the grantor when granted, as per Sec. 49(1), if **consideration isn't received**, and it must be pointed out that the subsection was considered necessary by the legislators to create a disposition for the grantor which otherwise wouldn't have occurred. No such provision exists with respect to powers of appointment.

2052 See *Re: Nicholas Trust*, 70 A.C.T.R. 10, *Re: Mitchner*, 1922 Q.S.R. 252.

2053 while it would also be possible to charge the bequest with the payment of a debt/payment to another beneficiary if then power's terms are wide enough.

2054 Though this isn't the case where the contributor isn't resident.

The distinction between a power of appointment and the beneficial interest that it creates as two different forms of property has apparently been maintained and recognized by CRA as per its opinion expressed in I.T. 286R2, para. 4 whereby they provide:

"Although the beneficiaries of a trust may have the power to amend the trust deed at any time so as to cause the income to be payable to them, the mere presence of this unexercised power is not a basis for treating trust income as being payable for purposes of subsections 104(6) and (24). An amount becomes payable only when the power has in fact been exercised and the trust deed amended accordingly."

Obviously not only can the power be exercised at the last moment so as to spread out the beneficial recognition of the income under Sec. 104(13), but the Department seems to recognize the legitimate distinction between a power and the right it creates.

A **general** power of appointment, if properly described in the trust deed and exercised, may be able to either materially amend the operative structure of the trust/estate or take property completely out from under the fiduciary umbrella of the initial settlement and transfer it to a new sub-trust, (or to the beneficiary directly). In the former case the beneficial rights to not just the capital property but also its income may be regranted to alternate beneficiaries on a large scale thus significantly altering the operative mechanics of the existing trust-beneficiary relationship. Since the power of appointment will have, when exercised, undermined existing rights under the trust to the property in specie or in value, the recognition of a disposition of an interest will be unavoidable by the affected beneficiaries as per the statutory definition of "disposition" in Sec. 54(c)(ii)(B), (where a right is canceled: applicable at least in respect of capital interests).²⁰⁵⁵ Where the former "income interest" is being extinguished due to the exercise subsection 106(2) will apply but since there are not any proceeds of disposition realized²⁰⁵⁶ there will not be an income inclusion. If the income interest holder exercises the power that undermines his income interest Sec. 69(1) should apply whereafter Sec. 106(1) may cause tax consequences.²⁰⁵⁷

Where an income interest is thus divested from a former beneficiary he may not realize any proceeds, deemed or actual, and thus technically, although he need not recognize any Sec. 106(2) or 104(13) income inclusion, he can also not deduct the balance of his undeducted income interest cost against other sources of income. This is not the case in respect of capital interests but only when they have legitimately recognizable adjusted cost bases. If the capital interest has an ACB for purposes of Sec. 107(1)(b), the former capital beneficiary will be able to recognize a capital loss on the exercise of the power when his interest is canceled. If that real ACB was created tax free, by virtue of adjusting the consideration given in respect of the trust property when it was purchased or by becoming resident in Canada and undergoing Sec. 128.1(1) then the loss will be tax free as well. A capital or income interest acquired by way of a power of appointment will have an original ACB or deductible cost equal to nil unless, in the case of capital interests, it was issued for consideration provided by the recipient to the trust or to **any** other taxpayer as per Sec. 107(1.1). How would CRA tax an exercise where the recipient pays consideration to the trust to secure a favorable exercise whereby, after he has recognized a cost of his interest under Sec. 107(1.1), the trust operates to grant to, or enlarge a capital interest held by, the power holder? The trust would lose its personal status on the purchase of the interest from the trust and considerable tax consequences would occur from then on. If the recipient pays consideration to a power holder who had a limited capital interest, but could exercise the power to enlarge it or appoint capital to another person, so as to have the power holder favorably exercise the power, Sec. 107(1.1) will apply although the **capital** interest acquired was not owned by the power holder immediately before the acquisition while the power holder would be exposed to a Sec. 105(1) full income inclusion in respect of the proceeds unless he was non-resident.

2055 See *Stanyforth v. I.R.C.*, 1930 A.C. 339, Re: *Dickinson's Settlements*, 1939 Ch. 27, Re: *Brook's Settlement Trusts*, 1939 Ch. 993, Re: *de la Bere's Marriage Settlement Trusts*, 1941 1 Ch. 443, *Inglewood v. I.R.C.*, 1983 S.T.C. 133, for interests being destroyed by exercise, as well as *Halsburys*, 4th Ed. Vol. 36, para. 882.

2056 unless Sec. 69(1) can apply

2057 See *Re: Mills*, 1930 1 Ch. 654 (CA).

*Eilbeck v. Rawling*²⁰⁵⁸ is an excellent case illustration of how powers of appointment over trust property can be used to create artificial capital losses for purchasers of capital interests when they are exercised in a "friendly" way. Rawling, a U.K. resident, purchased a tax scheme for essentially £9985 whereby another party loaned him funds of £543,600 to purchase a reversionary interest in a simple trust which had a fair market value equal to that sum. The interest was charged with the loan and Rawling had his brother create another simple settlement whereunder Rawling received the reversionary interest therein. The trustees of the initial settlement exercised a broad power of appointment and appointed £350,000 to the trustees of the second settlement after Rawling charged the second trust reversionary interest with the loan as well. Reversionary interest number 1 was disposed of for its fair market value of £231,130 which produced a capital loss for U.K. Finance Act purposes of approx. £315,970. Disposal of the second reversionary interest produced the balance of the loaned funds which are returned to the lender and the second disposal did not attract capital gains due to mechanics that are similar to Sec. 107(1)(a) of the ITA. The authorities contended that the capital loss wasn't deductible and wasn't in fact a capital loss. Finally settled in the House of Lords, (starting at pg. 183), Lord Wilberforce would have dismissed the appeal of the taxpayer on the splitting of the interest on the grounds that:

"On the facts, it would be quite wrong, a faulty analysis, to segregate, from what was an integrated and interdependent series of operations, in one step, viz. the sale of the Gibalter reversion (initial settlement), on 3 April 1975, and to attach fiscal consequences to that step regardless of the other steps and operations with which it was integrated."

Lord Fraser of Tullybelton contended that the interest disposed of by the taxpayer in the initial settlement was not the same as that which he had purchased and was in act only part of the initial interest which the author does not agree with and he went further in the author's opinion appropriately, in finding the disposition to be a sham since money never really changed hands and the substance of the arrangement was contrary to the legal form.²⁰⁵⁹

One doesn't have to examine in great detail Sec. 108(1)(d)(ii) to ascertain that a situation similar to that in Rawling could easily be created under the ITA whether the trust is personal or not. A taxpayer could contribute cash to an *inter vivos* trust and have a legitimate ACB of the interest taken back while a power of appointment over the capital could be exercised to appoint capital to another taxpayer and thus drain the trust plunging the fair market value of his interest to zero. On a cancellation a capital loss would be recognized. The power could be instilled in any 'friendly' party.²⁰⁶⁰

A general power of appointment, as distinct from a special power, gives the holder the discretion of determining who may become entitled to certain trust property, how they may become entitled to it, and to what degree they become entitled to it. It is as if the trust deed/will has given the holder virtually limitless control over how the property will be disposed of and it is the holder who is to determine, as granted by the settlor/testator, how the property will be given. A power can thus be used to terminate the trust outright by accelerating all of the interests and distributing the property while it can also be used to create sub-trusts of the initial trust/estate for beneficiaries who need not have been contemplated in the initial settlement and it is this latter aspect that can be particularly useful in "cleansing" a trust of some tax attribute or previously applied qualification that causes undesirable consequences.²⁰⁶¹ It has long been held that a general power of appointment is far more instrumental at creating new trusts, distinct from the initial settlement, than a special power. In the landmark case of *Hart v. Briscoe*²⁰⁶² it was held by Brightman J., on pg. 7, that:

2058 54 T.C. 136

2059 see *Chinn v. Collins*, 1981 S.T.C. 1, for another single composite scheme carried on through many steps where one step wasn't given tax effect separately while *Furness v. Dawson*, 55 T.C. 324, and *Floor v. Davis*, 52 T.C. 609, are also cases that relied on *Eilbeck* jurisprudence.

2060 Of course a Northern Manitobian resident could produce a "bazillion" dollar capital loss annihilating the Canadian tax base and expect to suffer from the jurisprudence of Rawling, serving to negate its deduction, but incidental paper losses "here and there" could be produced in even mediumly complex trust settings having legitimate transactions set up by taking cost bumps/tax free transfers where available.

2061 See *Blausten v. I.R.C.*, 1972 1 All E.R. 41 (CA).

2062 [1979] L.R. Ch. 1

"...if a person be given a general power of appointment over certain property he is virtually the owner of that property. If and when he exercises the power the interests of his appointees **come to them by virtue of and are created by the deed of appointment**. In the case of a special power it is very different. If, for example, property settled on trust for A for life and after his death on trust for such of A's children or remoter issue and in such proportions as B shall by deed appoint, B has no interest in the property whatsoever. He has merely been given the power of saying **on behalf of the settlor** which of the issue of A shall take the property under the settlement and in what proportions. It is as though the settlor had left a blank in the settlement which B fills up for him if and when the power of appointment is exercised. **The appointees interests come to them under the settlement alone and by virtue of the document.**(Not the power.) These remarks apply equally well to the case where the donee of the power of appointment has not only the power of saying which of the class shall take under the trust, but also the power of saying what interests they shall take."

With the exercise of a general power of appointment property can be taken out of the initial trust and settled on a sub-trust without the beneficiary ever holding an interest in the initial trust however if the same were to be done with special restrictive power of appointment the interest given to the secondary trust beneficiary would have as its source the initial trust, not the power of appointment, and thus the sub-trust would also itself be considered an extension of the initial trust, regardless of who its trustees were, how it was structured, and to whom its property was to be eventually conveyed. This is assuming that the initial trust continued to exist and continued to be relevant, or potentially relevant to the holding of the property in the secondary trust. The *Hart v. Briscoe* case centered on the exercise of a power of advancement that created new sub-trusts and **caused all** of the property of the initial trust to be held in them thus effectively terminating the initial trust. A question of whether the sub-trusts and initial trust were distinctive for capital gains purposes arose and *Brightman J.* provided, with respect to whether there had been a change in ownership that would result in the recognition of a disposition:

"If a **special** power of appointment is exercised in such a manner as to vary the age of vesting or to vary the shares in which contingent beneficiaries are to take all the other trusts, powers and provisions of the settlement remaining intact, I would think it beyond doubt that one would regard the settlement and the appointment as together constituting a single settlement. If however, a special power of appointment, drawn in an appropriately wide form, is so exercised that the appointed assets become vested in distinct trustees, and all of the trusts, powers and provisions of the original settlement are **irrevocably gone**, completely new trusts, powers and provisions being created to take their place, **so that no one will ever again need to refer to the original settlement except to confirm that it has ceased to exist**, the trustees of the original settlement being *functus officio* and having nothing whatever to do, I would find it difficult to believe that the original settlement continues in being, whether one uses the word "settlement" in the sense of a trust instrument or in the sense of a series of trusts. In what case I ask myself, can a settlement be said to exist if all trusts, powers and provisions of that settlement have been **irrevocably brought to an end** by the appointment, so that no property remains subject to the trusts of the original settlement and the trustees thereof have no duties to perform? Is it appropriate or necessary that new trustees of this spectral settlement shall be appointed from time to time to do nothing, or can the office be allowed to lapse?... It may be rare, but it is certainly not unknown, for an appointment under a special power to constitute distinct trustees and to create new trusts, powers and provisions which supersede the original trusts, powers and provisions. That moreover, is precisely what happens when an advance is made into an ad hoc settlement so far as concerns the subject matter of the advance. There is, I think, for present purposes, no essential difference between an appointment such as I have supposed and an advance into an ad hoc settlement of the type before me. The conception that in such a case the original settlement comes to an end and a new

settlement comes into existence quoad the advanced assets was recognized by Viscount Radcliffe in several passages in his speech in the Pilkington case."²⁰⁶³

Pilkington v. I.R.C.²⁰⁶⁴ involved an exercise of power of **advancement** which will be discussed in more detail subsequently, however in the present case as per the very basic reasoning in Hart v. Briscoe, it may only be when the original trust has been **irrevocably** and permanently terminated that a trust created by a special power of appointment (or advancement) will be considered as distinctive. The manner in which the trust is irrevocably terminated is by virtue of the fact that there is no other property which is the subject of the initial trust however if the initial trust doesn't terminate due to there being alternate property held which wasn't appointed but continues to be held subject to the terms of the trust then in order for distinct sub-trust to be constituted as such the property realized from the initial trust must be **indefeasibly restricted from ever becoming subject to the initial trust terms ever again.**²⁰⁶⁵

In Roome & al. v. Edwards (Inspector of Taxes)²⁰⁶⁶ the respondents executed what amounted to several avoidance type transactions whereby trustees of a United Kingdom trust appointed part of the main trust's property to be held in sub-trusts whereafter the beneficiaries of the main trust assigned their interests to a non-resident corporation. The United Kingdom trustees were replaced by foreign resident trustees which resulted in a deemed disposition, (as it would in Canada on a change in residence), of the main trust's property. The inspector contended that the property held in the sub-trusts was also subject to the deemed disposition rules; the trustees contended that the sub-trusts were distinctive for all intents and purposes.²⁰⁶⁷ Lord Wilberforce examined the factors that were paramount in establishing the distinctiveness of sub-trusts and provided:

"There are a number of obvious indicia which may help to show whether a settlement or a settlement separate from another settlement, exists. One might expect to find separate and defined property; separate trusts; and separate trustees. One might also expect to find a separate disposition bringing the separate settlement into existence. These indicia may be helpful, but they are not decisive. For example, a single disposition, e.g. a will with a single set of trustees, may create what are clearly separate settlements, relating to different properties, in favor of different beneficiaries, and conversely separate trusts may arise in what is clearly a single settlement, e.g. when the settled property is divided into shares. There are so many possible combinations of fact that even where these indicia or some of them are present, the answer may be doubtful, and may depend upon an appreciation of them as a whole."

...
"...It is established doctrine that the trusts declared by a document exercising a **special** power of appointment are to be read into the original settlement: see Muir (or Williams) v. Muir, [1943] A.C. 468. If such a power is exercised whether or not separate trustees are appointed, I do not think that it would be natural for such a person as I have presupposed to say that a separate settlement had been created; **still less so if it were found that provisions of the original settlement continued to apply to the appointed fund, or that the appointed fund were liable, in certain events, to fall back into the rest of the settled property. On the other hand,** there may be a

2063 In Hart v. Briscoe the Crown argued that:

"For capital gains tax purposes a settlement is a state of affairs in which property is held on trust. One settlement is distinct from another settlement if the property being distinct property is held on distinct trusts by distinct trustees deriving their authority from a distinct disposition. The exercise of a special power of appointment over property by trustees of one settlement so as to cause that property to be held on new trusts will result in that property being held on the trusts of a distinct settlement **if the intention and the effect of that exercise is to discharge the property from the trusts of the first settlement.**"

The taxpayer argued that since the power was in the nature of a special power the original settlement relates back into the first.

2064 1964 A.C. 612

2065 For an excellent case history of the significance of a special power of appointment and the issue of timing and relation back see Re: Bransbury's Will Trusts, 1954 1 All E.R. 605, and Re: Batty, 1952 1 All E.R. 425. Though see also there is significance of the intention of the legislators behind the particular enactment.

2066 1982 A.C. 279

2067 If this were to occur in Canada Sec. 54(c)(v) would cause a deemed disposition of the particular property appointed, only when it is being appointed from **a trust and not an estate.**

power to appoint and appropriate a part or portion of the trust property to beneficiaries and to settle it for their benefit. If such a power is exercised, the natural conclusion might be that a separate settlement was created, **all the more so if a complete new set of trusts were declare as to the appropriated property, and if it could be said that the trusts of the original settlement ceased to apply to it.** There are many variations of these cases each of which will have to be judged on its facts."

"If the original settlement survives and continues to apply to the appointed part it must follow that no separate settlement has been created", and given that the term "settlement" for purposes of that case is much broader and encompasses the trusts created under it, than the trusts themselves, it can be equated from the reasoning that the same rationale should apply to trusts created under a trust.²⁰⁶⁸ If the original trust survives and continues to apply to the appointed part, it should follow that no separate trust has been created. In *Roome v. Edwards* Lord Wilberforce found that the terminology the respondents used to describe the powers of appointment and the two splinter settlements created were indicative of the intention to treat one fund as being held upon the trusts of the original settlement and the way the power is described in the trust deed and the manner in which it is exercised may have paramount importance in its ability to create sub-trusts.²⁰⁶⁹ In *Ewart et. al. v. Taylor*²⁰⁷⁰ the Chancery Division concurred with Lord Wilberforce's opinion in *Roome and Denne v. Edwards* that the conduct of the head trust trustees in respect of the sub-trust was relevant in gauging their intention on the exercise of powers of appointment. In that scheme to appoint non-resident trusts out of a resident trust to avoid taxes it was also held that the fact that the sub-trusts were exhaustive of the head trust was not conclusive as to distinctiveness²⁰⁷¹ while the fact that the power to appoint new trustees to the sub-trust was not carried down to the sub-trust was indicative. How the result was regarded by the trustees through the creation of a completely separate set of accounts was also very indicative.

In *Bond v. Pickford*²⁰⁷² the U.K. Court of Appeal had to ascertain whether a separate trust had been created upon the exercise of a power of **allocation** which as per the deed purported to settle on exhaustive sub-trusts whereby the trustees were to remain the same and administrative powers were to continue to apply. The taxman contended that upon the exercise and creation of the sub-trust a disposition was recognizable while the trustees contended that the two trusts were not distinct. The head trust contained, in two paragraphs two distinct forms of powers, the first to apply the property for the benefit of any of the specified beneficiaries, as well as a power of advancement, while the latter instilled a power to create ad hoc settlements. The trustees exercised **the former** expressly, and the parties "locked horns" over the effect. The dicta advanced by Lord Wilberforce in *Roome & Denne v. Edwards* was approved of while the power of allocation was held, by Nourse J., to be treated as a special power of appointment for the purposes of determining distinctiveness, and on these grounds since the head trust's administrative powers continued to apply and the same trustees continued to have the same responsibilities the sub-trust was considered part of the head trust thus avoiding the disposition of property affected. Slade L.J. considered as a significant factor the differences between discretionary powers allowing the trustees to direct the interests in property in the trust and the power to take property out of the trust and appoint it to other trusts and felt that the former could not be adapted to attain the effect of the latter. Both the nature of the power and the way the trustees use it and the manner they view the exercise are considerations. In this case it was unanimously held that the power was not wide enough to allow for a creation of a separate trust.

Regardless of whether or not a new trust relies upon a former trust's provisions to be contingently functional, if it is created by a **general** power of appointment it cannot be read back into the original trust as if the original settlor/testator were its settlor and thus for purposes of the Canadian Income Tax Act it should be treated as a distinct trust. If the sub-trust is created by an appropriately broadly worded **special** power of

²⁰⁶⁸ He also held that the fact that the trustees of the sub-trust remained the same as those of its parent was relatively insignificant in determining the question of whether the settlement was a mere appendage of the other.

²⁰⁶⁹ It is only incidental in their opinion that should the new trust had failed the property would then be subject to the original settlement thus the "new" trust was not exhaustive and the provisions of the original could continue to apply.

²⁰⁷⁰ 57 T.C. 401,

²⁰⁷¹ pg 468

²⁰⁷² 57 T.C. 301

appointment, special in the sense that it is restricted to class or timing or substance by the power grantor, then usually the sub-trust will be read back into the original trust and be considered as having been created by the original settlor/testator however unless it satisfies the criteria previously commented upon it will not be considered distinct.²⁰⁷³ The parent trust must come to an end or its terms must be such that they can never again apply to the sub-trust's property while the trustees must be conscientious of the effect of the power, its intended effect and the power must actually operate to allow for that effect. The difference between the results of the two powers is very important when one attempts to "cleanse" a "contaminated" trust.

The tax consequences of these events depend upon whether a new trust is created and whether amongst other factors, there has been a change in the beneficial **ownership** of the appointed property. Since the appointment operates to take the property out from under the initial trust and vest legal title in another trust, for purposes of subdivision c, (taxable capital gains and allowable capital losses), the initial trust may recognize a disposition by virtue of Sec. 54(c)(iii) on the transfer of the property.²⁰⁷⁴ If the beneficial title to the property, including the proportionality of all rights to the property **in specie** remain vested in the same beneficiaries then there has not been a change in the beneficial ownership of the property although there has been a change in the legal ownership.²⁰⁷⁵ In this case Sec. 54(c)(v) will apply, where the sub-trust is resident in Canada, so as to preclude the recognition of a disposition. If the sub-trust is non-resident then a disposition will be recognizable.²⁰⁷⁶

There may be significant advantages in granting a beneficial interest in the original trust to the new sub-trust rather than transferring the legal title to the property altogether to the new trust, especially where the beneficiaries of the new trust are different from those of the original and the transfer would have otherwise caused the recognition of a disposition of the subject property.²⁰⁷⁷ If the new trust received such a capital or income interest it could realize the property in specie or benefits from it, as less tax costly distributions and depending on the status of the original trust, (ie personal or not), it could be possible to bump up the cost of the particular property once it is ultimately distributed, depending on whether it has been possible to artificially inflate the ACB of the interest. Since the capital interest would have been acquired by the new trust for no consideration payable, as per Sec. 107(1.1) its initial ACB would be nil however if the trust disposed of its interest, again assuming that the original trust was a personal trust, it could receive proceeds, as per Sec. 107(1)(a), of an amount up to and equivalent to the aggregate net tax cost value of the trust's property in relation to the interest, computed as per Sec. 108(1)(d)(ii), without incurring any tax consequences.²⁰⁷⁸

2073 It has been held for U.K. succession duties purposes that a party exercising a power of appointment to carve off a portion of his interest in the head trust and execute a resettlement will be recognized as the settlor of that settlement and the head settlement will not be recognized as the settlor. See *A.G. v. Baker*, 4 Hurl. & Nor. 19, Re: *Jenkinson*, 24 Beav. 64, *Braybrooke v. A.G.*, 1861 11 E.R. 689, para. 159, though this depends on the origin of the power to resettle. If it was varied into the arrangement with the mutual consent of the appropriate parties the above applies while if it wasn't and the general or special power was created by the testator the settlor could be held to be the estate or testator respectively. See also *A.G. v. Smythe*, 1862 11 E.R. 823, *A.G. v. Foyer*, 1862 11 E.R. 814, *Charlton and Meyrick v. A.G.*, 1879 4 App. Cas. 427. The manner in which the legislation describes how trusts can arise will understandably be of concern.

2074 This was precisely the case in *Stanyforth v. I.R.C.*, 1930 A.C. 339.

2075 This assumes that the beneficiaries previously had what could be considered legitimate beneficial **ownership** in the first place.

2076 If beneficial ownership is not held by the beneficiaries it would appear that the exercise may operate to cause a disposition of the interests under the initial trust for consideration being the interests in the latter trust, and this would produce tax consequences for the beneficiaries under Sec. 107(1)(a) though also allowing their subsequent interests to have a cost equal to their fair market value as per Sec. 107(1.1). Would the latter trust be non-personal? Has the beneficiary paid consideration to it or its contributor, the power holder?

2077 First of all there has been little jurisprudence developed on whether an exercise of a power of appointment which immediately transfers legal title from a trust to another party is or is not a commutation of a capital interest or whether it operates independently of the beneficiary status whereby the recipient never gains the status of beneficiary. Even when the exercise operates to transfer title immediately the recipient could be argued to still receive it as a beneficiary who has just received an immediately enforceable interest that is being satisfied in specie. Powers of appointment can only create beneficial recipients with respect to a trust; although they can also determine whether they have immediately, contingently or absolutely enforceable interests. Could one legitimately argue that since the trust recipient must hold the property on trust for its beneficiary it cannot receive as a beneficiary within the Sec. 108(1)(d) definition? Apparently the legislators have recognized the latter when they recognized that a Sec. 54(c)(v) *inter vivos* trust transfer can occur to avoid the deemed dispositions under Sec. 104(4) and took steps to prevent such in Sec. 104(7.2).

2078 Have the trust cease to be resident in Canada (which won't produce tax consequences if all of its property consists of taxable Canadian property), and then grant interests to non-residents who then become resident, benefitting from Sec. 128.1(1), prior to the trust becoming resident. On a roll-out of the property the tax cost of the taxable Canadian property gets

An exercise of a power of appointment, special or general, in respect of a capital or income interest held by another person thereby granting a capital or income interest to another person should normally not attract the application of the income attribution provisions **unless** its exercise had the effect of granting a beneficial interest to a qualified party in relation to the power holder **and** the power holder had contributed the subject property or any subject property to the trust.²⁰⁷⁹ If the power holder was the person who contributed the subject property to the trust, or contributed any property to the trust, then as per Sec. 75(2)(a)(ii) the income/gain/loss from that property would be attributed back to the contributor without precluding the trust from also recognizing it (unless the contributor is non-resident). The power holder has the ability to determine to whom the property will subsequently pass. If the power had the effect of granting a beneficial interest to a qualified party in respect of the contributor of the property, or any property, to the trust, regardless of whether or not it was through the imposition of another trust, sections 74.1, 74.2, and 74.3 would apply since the effect would be, generally, that the property was transferred directly or indirectly for the benefit of the qualified party. If the power holder is not the contributor of the property or any property, and the power did not exist at the time that the property was contributed to the trust but was varied in afterwards it cannot be said that the attribution provisions will apply since the contributor did not transfer the property for the benefit of the qualified party and it was beyond his control that that person subsequently received a beneficial interest in the trust.²⁰⁸⁰

The most valuable feature about the uses of powers of appointment, be they general or special, is that they allow for the creation of a new and distinctive sub-trust that, given the proper conditions, cannot be equated with the original trust, while in the case of special powers, can be said to have been created by the original settlor/testator, without incurring substantial tax cost. By splintering of new trusts with a power of appointment the deemed disposition rules in Sec. 104(4) can be easily reduced in certain instances in impact while the Sec. 104(14)-(15) preferred beneficiary election, and the effect thereupon by certain discretionary powers, can be altered. Since subsections 107(4) and (4.1) apply only in respect of particular trusts that were subject to the Sec. 104(4) or 75(2) provisions, by creating a distinctive new trust out of such distributions of property out of them can be executed at less tax expense. By creating a new distinctive trust with the power of appointment contained in a testamentary trust described in Sec. 108(1)(i) the resulting trust will be an *inter vivos* trust since it did not "arise upon and in consequence of the death of an individual" hence only trusts that can be read back into the original settlement by virtue of the fact that they were created by the exercise of a special power of appointment will retain the testamentary trust status. This does not preclude them from also being new and separate from the original testamentary trust out of which they arose.²⁰⁸¹ If the power isn't in trust and is mere and general and was varied in the party who cuts down his own interest on its exercise may be regarded as the settlor.

The exercise of a power of appointment which results in the creation of a distinctive new trust out of the assets of a former trust may be an effective means of circumventing the personal trust definition in Sec. 248(1) and cleansing a previously tainted trust. A personal trust is a testamentary trust or an *inter vivos* trust, no beneficial interest in which was acquired for consideration payable directly or indirectly to the (particular) trust or any person who has made a contribution to the (particular) trust by way of transfer, assignment or other disposition of property, however if a person makes a contribution of property to a trust whereby a taxpayer acquires an interest in that particular trust for consideration payable to the contributor of that particular trust, and a power of appointment is exercised so as to take certain property out from under the trust and resettle it on a distinct trust, an interest in which has been granted to the former purchaser beneficiary, is that second distinctive trust a personal trust? The question orbits around the fact that the Sec. 248(1) definition comments on and captures instances where the consideration was payable **directly or indirectly** to the particular trust in which the interest relates or any person who has made, apparently, a **direct** contribution to the **particular**

bumped to f.m.v. via Sec. 107(2)(b).

²⁰⁷⁹ See *Stanyforth v. I.R.C.*, 1930 A.C. 339, for equitable interest powers.

²⁰⁸⁰ If the beneficiary exercises a power over property that substantiates his interest in default to transfer the property to another such constitutes a disposition and could form the basis for income attribution. See *Northumberland v. I.R.C.*, 1911 2 K.B. 343 at 356.

²⁰⁸¹ The special power trust will not relate back to the time of the original trust's creation.

trust. In the above example the party who was the original contributor of the property to the initial trust, who received the payment as consideration for the interest in the initial trust, did not technically make a contribution to the second trust, (in the case of a general power of appointment), but instead it was the original trust itself which made such a contribution. Since the general power does not cause the original settlor to be seen to have created the second trust unless he is exercising it and by default the property would substantiate his interest, and the second trust is distinctive from the first, technically it would seem the second cannot be seen to the second trust cannot be non-personal. If the Sec. 248(1) definition commented on and captured instances where the property was **indirectly** contributed to the subject trust then the house of cards would collapse however from a strict interpretation of the provision, which is the proper approach, it would seem that a non-personal trust can be cleansed through the above arrangement. The general power can be varied into the offending trust after it has received the contributions however it should be noted that the beneficiary will not be able to recognize a cost of his interest as per the Sec. 107(1.1) or 106(1.1) provisions since he has not paid consideration to the particular trust or to a former **beneficiary** in respect of **the interest** he has acquired.

Powers of appointment may be disclaimed or released if the fiduciary circumstances allow for it and the effect of such will be to increase or decrease the fair market value of existing interests. Powers instilled in any person with the fiduciary duty to exercise them or at least consider their exercise cannot be disclaimed since to do so would be to act against the testator's/settlor's intentions however this would not be the case where the power is exercisable only in respect of its holder.²⁰⁸² Whether a collateral power can be disclaimed depends on whether the holder is under an obligation to act upon it or give it consideration and whether the provision for a gift over on default exists so as to preclude the contention that the settlor intended the power to be exercised.²⁰⁸³ Since the power cannot be a capital or income interest within the section 108 technical definitions its release will result in the recognition of the disposition of a category of property described in Sec. 248(1). The proceeds of disposition of such a property **may** be determinable by Sec. 69(1)(b)(i), especially if the power is terminated via a favorable exercise in respect of its holder. Through the release of the power some beneficiaries' rights have become more secure though their previous rights were not held by the power holder. If harsh tax consequences result when the Department decides to attack such alteration to cause fair market dispositions to the exerciser/releaser at least two approaches can be used to eliminate the power without the disposition. Either the beneficiary who could benefit from its exercise could irrevocably disclaim any benefits the power could confer or the beneficiaries of the trust could arrange for a statutory variation to destroy it. In the former case the power becomes effectively canceled since it can never confer a benefit and this may be arranged only when there is an otherwise valid gift over on default while in the latter case a variation could occur without the power holder's consent unless he is also a beneficiary. In either case the power holder should not recognize a taxable disposition, taxable at least under Sec. 69(1)(b).²⁰⁸⁴

One can see how useful a power can be at inflating the costs of capital interests of residence hoppers. A Canadian resident beneficiary under a resident trust becomes non-resident avoiding Sec. 128.1(1) in respect of his interest. Shortly afterwards his spouse-trustee also becomes non-resident. The non-resident beneficiary then becomes resident **after** any powers have been released so as to inflate the fair market value of his interest to the maximum and take advantage of Sec. 128.1(1). If the underlying trust property is taxable Canadian property its cost amount may be boosted to its fair market value on a Sec. 107(2) roll out.

If a trust is set up with a power of appointment over property specified that is held by a non-resident appointor property that is subsequently contributed to it can inflate the tax costs of all of the **existing** interests determined under Sec. 108(1)(d) and Sec. 107(4.1) doesn't apply to the trust, thus facilitating a less costly disposition of any particular interest: the power doesn't create a capital interest to be taken into consideration

2082 See Re: Gulbenkian's Settlements, 1970 Ch. 408, Re: Gestetner Settlement, 1953 Ch. 672, Re: Will's Trust Deeds, 1964 Ch. 219, Re: Evered, 1910 2 Ch. 147, Re: Brown's Settlement, 1939 3 All E.R. 391, Re: Mills, 1930 1 Ch. 654 (CA) & "Renunciation of Dispositive Powers", E. & T. Q., 1976 Vol. 3 #1, Maurice Cullity.

2083 See Re: D'Angibau, 1880 15 Ch.D. 228.

2084 A power may also have the characteristics that will allow it to be terminated via the satisfaction of its purpose, the determination of its purpose, or simply through its exercise: see Halsbury, 4th Ed., Vol. 36, para. 980, 981, 982, respectively.

under Sec. 108(1)(d)(ii), nor does it affect the relative fair market values of the interests, only their cost amounts. A taxpayer with sharply appreciating shares transfers them to an *inter vivos* trust in accompany with a certain amount of cash subject to a general power of appointment held by a non-resident or non-contributor party. The power is such that it cannot be exercised in respect of the contributor. The beneficiaries not content with their deferred interests in the shares specifically held for them dispose of the interests for their fair market values based on the fair market value of the shares **but the interests' cost amounts are boosted by the cash** and subsequent to the sale the power is exercised and the cash is appointed to a party related to the contributor subsequent to which the trust terminates to give the secondary beneficiary a Sec. 107(2)(b) bump in the cost of the shares. The Department has one method of attacking such an arrangement, (other than section 245): using Sec. 105(1) to include an appointee's realizations in his income (which was fully provided for in the pre 1988 reform provision), however if the appointee is non-resident Sec. 105(1) cannot apply while if the Department does take such a route it would still be possible to appoint to minors/loss entities connected with the settlor/contributor so as to absorb their unused tax credits - losses that would otherwise not be absorbed or "fall into the moat". If instead of an appointment of **legal title an equitable interest** is created **non-satisfying** distributions can be made in respect of the right so as to benefit from the **hypothetical** application of Sec. 53(2)(h) preventing the income inclusion under Sec. 105(1).²⁰⁸⁵

Retraction of Erroneous Exercises of Powers of Appointment.

While it is almost always advisable to obtain a Ruling from the relevant tax authorities before exercising any "dangerous" – and that is a subjective word, power of appointment, if it is exercised and the wrong results occur for taxation purposes it is possible to petition the relevant court to have the exercise reversed pursuant to *Sieff and Ors v. Fox and Ors*.²⁰⁸⁶ In that case the trustees exercised a power of appointment to divide the trust into two others and were not properly informed of the capital gains tax consequences which resulted. Upon petitioning the court for reversal of the exercise it was upheld that the trustees had a duty to consider tax consequences in their exercise and when they did not, properly, the exercise could be reversed. This case is well worth reviewing in detail since it is replete with issues to consider in an exercise that could go astray.²⁰⁸⁷ In *Patricia Madge Pitt, David Neville Waite Shores v. David Langford Holt and The Commissioners For Her Majesty's Revenue and Customs*²⁰⁸⁸ the UK Ct. of Appeal subsequently reconsidered the issue and without fully expanding on the case it should definitely be read since it expands on the enormously divergent streams of jurisprudence related to the issue.²⁰⁸⁹

Powers of Advancement.

A power of advancement, though not as universally useful as a power of appointment is another type of power conveyed in the trust deed/will to a person, usually a trustee, that allows him to exercise a specific form of control over certain specified property so as to make advances to beneficiaries in respect of their interests that have not yet become enforceable. In *Pilkington v. I.R.C.*²⁰⁹⁰ a power of advancement was used to resettle property under one trust onto another distinctive trust in an attempt to avoid death duties applied to the value of the property held in the trust. It is an excellent landmark case describing the inherent limitations in the use of such a power. Halsbury's Laws of England, 4th Ed. Vol. 36 para. 873 describes a power of advancement as an authorization for the use of money which will improve the material situation of a

²⁰⁸⁵ Though in this case one may expect a notice of assessment with "section 245" in bold print typed in a few areas.

²⁰⁸⁶ [2005] 3 All E.R. 693 ChD

²⁰⁸⁷ See also *Re: Barr's Settlement Trusts* [2003] 1 All E.R. 763 ChD where it was held that unforeseen consequences were not allowable as a basis for a retraction of an exercise though failing to consider them was: this was a case of an error in an exercise.

²⁰⁸⁸ [2011] EWCA Civ 197

²⁰⁸⁹ See also the recent UK case of *Futter & Anor v. Futter & Ors* [2010] EWHC 449 (Ch) (11 March 2010) where, again, numerous issues regarding this scenario were examined, while the UK case of *Jiggins & Anor v. Low & Anor* [2010] EWHC 1566 (Ch) (29 June 2010) is another. See also *Pitt & Anor v Holt & Anor* [2011] EWCA Civ 197 (09 March 2011) for UK Appeal Ct. study of the issue.

²⁰⁹⁰ 1964 A.C. 612,

beneficiary... In *Re: Morris's Settlement Trusts*²⁰⁹¹ a power of advancement was found to be, as per Jenkins J.J.:

"... a purely ancillary power, enabling the trustees to anticipate by means of an advance under it the date of actual enjoyment by a beneficiary selected by the appointor of the interest appointed to him or her, and it can only affect the destination of the fund indirectly in the event of the person advanced failing to attain a vested interest,"

A power of advancement is a power given to a person that allows him to distribute property to a beneficiary whose right to property may not necessarily become vested, that effectively allows the beneficiary to gain from the right before he otherwise would have as per the terms of the trust deed and thus it is substantially different, both in form and in function, from a power of appointment in that it cannot be used to grant beneficial rights to beneficiaries only accelerate them. It may be exercised in respect of contingent beneficiaries whose rights have not yet been vested due to the failure of the manifestation of the contingent event however understandably, if property is so advanced, and the contingent event fails to occur thus causing the beneficiary to never acquire the right to the property, the trust will be drained of an amount of its capital that would otherwise have been available to substantiate other beneficiaries' claims. This is the prime danger involved with the use of the power of advancement. In *Pilkington v. I.R.C.*²⁰⁹² Viscount Radcliffe commented on the power and its implicit hazards:

"No one doubts that such a power was frequently conferred upon trustees under settlements of personalty and that its general purpose was to enable them in a proper case to anticipate the vesting in possession of an intended beneficiary's contingent or reversionary interest by raising money **on account of his interest** and paying or applying it immediately for his benefit. By so doing they released it from the trusts of the settlement and accelerated the enjoyment of his interest (though normally only with the consent of a prior tenant for life); and, where the contingency, upon which the vesting of the beneficiary's title depended failed to mature or there was a later defeasance or, in some cases, a great shrinkage in the value of the remaining trust funds, the trusts as declared by the settlement were materially varied through the operation of the power of advancement. This possibility was recognized and accepted as an incidental risk attendant upon the exercise of such a power, whose presence was felt on the whole to be advantageous in the system in which the possession of property interests was often deferred long beyond adult years."²⁰⁹³

A power of advancement can obviously be instrumental in allowing the beneficiary to receive benefits from the trust before his interest becomes enforceable and thus when a distribution is made in respect of the interest, and the interest is partially or wholly satisfied then the section 107 distribution provisions can apply. If commutation does not occur then the payment will not necessarily lead to a Sec. 105(1) full income inclusion since it will be made in respect of the capital interest held, (even though it is contingent), as per the highlighted quote, and thus in the case of a personal trust the payment will slip through the Sec. 53(2)-105(1) mechanism tax free when it is paid in respect of an interest in a personal trust that wasn't acquired for consideration payable.

Property in specie need not be advanced out of the trust but instead capital may be raised through mortgaging of the assets expressly identified whereby once the capital is advanced the Sec. 108(1)(d) cost amount of the capital interests in the trust will drop which will have effect on subsequent dispositions of interests.²⁰⁹⁴ Since the Sec. 108(1)(d) computation of cost amount of a capital interest is determined with respect to the **tax cost** of the trust property **and not its fair market value** it should be quick to follow that advanced property in specie should, if possible, consist of trust property with the fair market value most in excess of ACB/cost in that more may be advanced without affecting the other beneficiaries' interests. Understandably the beneficiary may then mortgage it himself, or sustain any implicit tax liabilities should he decide

2091 [1951] 2 All E.R. 528 (CA),

2092 1964 A.C. 612, at pg. 633,

2093 See *Patterson v. Royal Trust Co.*, 1973 4 W.W.R. 490, *Re: Clore's Settlement Trusts*, 1966 1 W.L.R. 955, & *Re: Pauling's Settlement Trusts*, 1964 Ch. 303, for unfortunate depletions.

2094 Thus where interest dispositions are expected advances should not be made.

to dispose of it, and the latter should be a consideration examined in ascertaining which property to distribute.²⁰⁹⁵

An exercise of the power has the effect of taking the property advanced out from under the effect of the trust and although it must be thereafter vested so as to be of a benefit for the beneficiary it need not be conveyed directly to him; the result being that it can be conveyed to an already existing trust created for his benefit previously, or the exercise can have the effect of creating a sub-trust for the beneficiary's benefit.²⁰⁹⁶ The use of the power will understandably, similarly to a power of appointment, be restricted as per the specific terms used in the will/trust deed instilling it in the holder. In effect, as long as the affected beneficiary's interest has somehow been accelerated, though not necessarily up to the immediate enjoyment thereof being established, the power will be accepted as being exercised in a bona fide manner. In *Pilkington v. I.R.C.* an exercise of a power of advancement was drawn into question when through its exercise a new sub-trust was created to accept the property advanced and there was a major raucous over whether the new trust was distinct enough from the original trust, and legitimately created, so as to avoid the application of death duties to the advanced property held in the new trust. Viscount Radcliffe commented, at pg. 638:

"The commissioners' objections seem to be concentrated upon such propositions as that the proposed transaction is 'nothing less than a resettlement and that a power of advancement cannot be used so as to alter or vary the trusts created by the settlement from which it is derived. Such a transaction, they say, amounts to using the power of advancement as a way of appointing or declaring new trusts different from those of the (original) settlement. The reason why I do not find that these propositions have any compulsive effect upon my mind is that they seem to me merely vivid ways of describing the substantial effect of that which is proposed to be done and they do not in themselves amount to convincing arguments against doing it. Of course, whenever money is raised for advancement on terms that it is to be settled on the beneficiary, the money only passes from one settlement to be caught by the other. It is therefore the same thing as a resettlement. But unless one is to say that such moneys can never be applied by way of settlement, an argument which, as I have shown, has few supporters and is contrary to authority, it merely describes the inevitable effect of such an advancement to say that it is nothing less than a resettlement. Similarly, if it is part of the trusts and powers created by one settlement that the trustees of it should have the power to raise money and to make it available for a beneficiary upon new trusts approved by them, then they are in substance given the power to free the money from one trust and to subject it to another. So be it: but, unless they cannot require a settlement of it at all, the transaction they carry out is the same thing in effect as an appointment of new trusts... **The law is not that trustees cannot delegate(powers): it is that trustees cannot delegate unless they have authority to do so.** If the power of advancement which they possess is so read as to allow them to raise money for the purposes of having it settled, then they do have the necessary authority to let the money pass out of the old settlement into the new trusts. No question of delegation of their powers or trusts arises. If, on the other hand, their power of advancement is read so as to exclude settled advances, cadit quaestio."

The distinctiveness of the advanced trust and the original trust in *Pilkington* was attacked by the Inland Revenue Commissioners on the grounds that the new trust resulting from the exercise of the power of advancement, the results of which must always be read back into the original settlement, infringed upon the rule against perpetuities.²⁰⁹⁷ It was held that a power of advancement **must** be considered as a "special"

2095 If need be inter-beneficiary agreements may be reached without a variation in the trust deed itself so as to facilitate less tax costly advancements in specie. Whether or not an advance can be made in such a manner as to not sever beneficial ownership (when it initially resides with the beneficiary) and not be regarded as a commutation of an interest or part thereof is a question of fact which would allow a tax free transfer without reliance on section 107. If beneficial ownership is severed on the distribution Sec. 54(c) but not Sec. 107(2) should apply to create a disposition for the trust.

2096 If the terms of the power are wide enough.

2097 The interests created via a special power must vest within 21 years of the lives in being when the power was created regardless of when it's exercised and those created under general powers must vest within 21 years of the lives in being at the time of the exercise of the power. Re: Manning, 1978 19 O.R. (2d) 257, Re: Gooderham, 1971 2 O.R. (2d) 369, Re: Johnson's Trusts, 1943 Ch. 341, Re: Legh's Resettlement Trusts, 1938 1 Ch. 39 (CA), Re: Fasken, 1961 O.R. 891 (HC). As per Re: Abraham's Will Trusts, 1969 1 Ch. 463, if the violation of the rule against remoteness of vesting is relatively small in

power of disposition similar to a special power of appointment hence the same tests and factors relating to special powers of appointment were to apply to it. Since the trust created by the power had to be accepted as being a trust created by the original testamentary disposition, the vesting requirements were violated when the timely vesting of the property didn't occur. Viscount Radcliffe provided, on pg. 642, in his closing commentary:

"When one asks what person can be regarded as the settlor of Miss Penelope's proposed settlement, (the sub-trust), I do not see how it is possible to say that she is herself or that the trustees are. She is a passive recipient of the benefit extracted for her from the original trusts; the trustees are merely exercising a fiduciary power in arranging for the desired limitations. **It is not their property that constitutes the funds of Miss Penelope's settlement; it is the property subjected to the trusts by the will of the testator and passed over into the new settlement through the instrumentality of a power which by statute is made appendant to those trusts. I do not think, therefore, that it is important to this issue that money raised under a power of advancement passes entirely out of the reach of the existing trusts and makes as it were a new start under fresh limitations,** the kind of thing that happened under the old family resettlement when the tenant in tail in remainder barred the entail with the consent of the protector of the settlement. I think that the important point **for the purpose of the rule against perpetuities** is that the new settlement is only affected by the operation of the fiduciary power which **itself "belongs" to the old settlement.**"

If the new trust had not offended the rule against perpetuities then the Commissioners would not have had it as a basis to say that the new trust was part of the old trust and instead, quite likely, they would have had to approach the matter with the factors concerning the distinctiveness of trusts created by powers of appointment, previously described; the ability of the old trust to continue to apply contingently or otherwise to the appointed property.²⁰⁹⁸ In Pilkington it was clearly observed that a power of appointment properly structured could create new trusts in a bona fide execution however the unique conditions existing thereafter would have to be evaluated to determine if the new trust was indeed distinct from the trust upon which the power was exercised.²⁰⁹⁹ Following the criteria in relation to powers of appointment; if the exercise of the power has the effect of terminating the original trust through draining it of all of its property whereby the office of the trusteeship lapses and/or the trust can never again in any manner apply to the property, the exercise is irrevocable, and the new trust is created in such a way so as to avoid reliance upon any of the old trust's provisions such as a basis for the sub-trust's dispositive powers etc. it would seem difficult for the tax courts to wander so far from the basic trust law rules as to find the "new" trust an extension of the old.

As to whether a disposition will be recognized or attribution will result when property is advanced to a new alternate trust, the conditions would have to be examined. Since the power is being exercised in respect of a beneficiary's existing capital interest one would have to examine if the transfer caused a satisfaction of part of the interest, or if there was a change in the beneficial ownership of the property. If the advancement operates so as to extinguish part or all of the beneficiary's capital interest then the section 107 distribution provisions would apply **only if the legal title of the transferred property was received by the beneficiary in person and in his personal capacity.** If the property is transferred to a sub-trust and the interest, or part thereof is extinguished then the transaction will not be regarded as a pure section 107 distribution and instead the beneficiary will be required to recognize a disposition of his capital interest as per Sec. 54(c)(ii)(B). The property transferred to the sub-trust could also be looked upon as an indirect benefit to the beneficiary which could be wholly includable in his income under Sec. 105(1), while since the payment is not being made to the

relation to the result of the exercise only that part which is clearly in violation will be held void, not the whole exercise. See also *In re: Liverton*, 1951 N.Z.L.R. 351, *O'Donohue v. Comp. of Stamps*, 1969 V.R. 431. Likewise the common law precedents may be negated by provincial statute law (Perpetuities Act) or adapted to differing ends.

²⁰⁹⁸ See also *Hastings-Bass v. I.R.C.*, 1975 1 Ch. 25, for another instance of attempts to avoid death duties through distribution to sub-trusts with problems with rules against perpetuities as well as *Muir v. C.I.R.*, 43 T.C. 367 (CA), for invalid exercise offending rule when sub-trust created.

²⁰⁹⁹ See *Hart v. Briscoe*, [1979] L.R. Ch. 1, and arguments submitted in *Pilkington* and *Hoare v. Gardner (I.T.)*, [1979] L.R. Ch. 10, as well: for **advanced** commentary see "The Creation of Sub-trusts under a Power of Advancement." D.W.M. Waters, *The Conveyancer and Property Lawyer*, Jan.-Feb. 1959.

beneficiary by the head trust a Sec. 53(2)(h) adjustment cannot occur and Sec. 105(1) may be fully applicable. Could the taxpayer beneficiary be hit by both a required recognition of a disposition of his interest as per Sec. 54(c)(ii)(B) and the whole income inclusion? If the property is transferred to another trust, and the legal ownership of it changes, then a disposition will be recognizable when the trust receiving it is a non-resident or the beneficial ownership of the property changes as well.²¹⁰⁰ If there is the slightest change in the beneficial ownership of the capital element of the advanced property, such as the addition of even a contingent capital beneficiary other than those previously interested and entitled to the property in specie, then a disposition would be recognizable by the original trust, as per Sec. 54(c)(iii). If such doesn't occur then **neither** section 107 nor Sec. 54(c)(iii) will apply to cause capital gains through the recognition of a disposition by the trust of the property but Sec. 105(1) may apply, though not when the beneficiary is non-resident.

If the power exercised causes a property to be distributed to a beneficiary who was a subject party in relation to the property's contributor then any gain, income, loss, may be attributable back to the contributor if the other attribution conditions existed. Since a power of advancement operates with respect to capital rights, where it is exercised and the trust recognizes a disposition of the capital property, and the property has been contributed by the particular contributor, or/and the beneficiary recognizes a disposition of a part of his capital interest on the advancement, any capital gain may be attributable back to the contributor by virtue of Sec. 74.3(1) or sections 74.1 or 74.2. Obviously attribution of income/gain on an advancement is entirely possible.

Powers of Encroachment.

A power of encroachment given to a person by the settlor/testator allows that person to distribute capital property in respect of, though not necessarily in satisfaction of, a beneficiary's income right which may not have been vested or when income is insufficient and thus it is similar to a power of advancement in that it allows for the acceleration of the enjoyment of the income interest. The power itself may be structured so as to allow the exerciser to ensure that the stated beneficiary receives a minimal amount of income per period whereby if the income of the trust is reduced for some unforeseeable reason and the beneficiary's income right is enforceable, the power holder will be able to draw on capital so as to maintain the income beneficiary. The power is similar to the power of advancement in that once the capital is distributed, regardless of the potential future income of the trust, it is "gone for good" however many instruments expressly allow the power holder to retain a portion of the income from subsequent periods so as to inflate the amount of capital of the trust back up to its original amount and this has considerable tax disadvantages as will be seen.²¹⁰¹

A power of encroachment, when exercised, like a power of advancement, does not normally extinguish the income right per se but instead is simply an advance made against the income that the right will ultimately be enforceable against. It is this aspect that usually causes the settlor/testator to provide in the trust deed/will that advances should be recouped from subsequent income otherwise the income beneficiary could receive more than the actual income realized through advances. Until the income beneficiary receives the capital raised and transferred through an advance he has not received a benefit nor does he ever acquire a capital interest until the power is exercised.²¹⁰²

Since the power exercised operates to extend a benefit in respect of the income interest of the beneficiary, unless some part of the right is satisfied upon the distribution, the capital distributed will be recognized as income by the beneficiary, (as per the reasoning in *Brodie v. I.R.C.*), and will thus be includable in his income under Sec. 105(1) while the trust will not gain any actual deduction against its taxable income for the period in respect of it. The income beneficiary may not have a capital interest in the section 108 sense of the term

²¹⁰⁰ Since the substance of the Sec. 54(c)(v) paragraph operates only for purposes of subdivision c, (taxable capital gains and allowable capital losses), it would seem that the beneficial ownership referred to is that of the capital element of the property and not the income that is realized from it.

²¹⁰¹ See *Saunders v. Halom*, 25 E.T.R. 186, for no recoupment.

²¹⁰² This latter aspect needs qualification in that some powers of encroachment are imposed with a fiduciary obligation compelling the trustee to exercise them so as to distribute capital should income not be sufficient in a specific term hence if need be the income beneficiary can have or acquire rights, as a beneficiary, to the capital of the trust and these rights may be enforceable in court should the trustees feel that an encroachment is not necessary when in fact it is. The right may be contingent in the sense that it manifests only if the trustees do not act accordingly but it is a right none-the-less.

and thus the capital cannot flow through the Sec. 105(1)-53(2)(h) mechanism tax free since it is not being paid in respect of a capital interest, will not be able to ever hypothetically effect the ACB of a capital interest the beneficiary doesn't have, and has not yet been included in computing his income.²¹⁰³ When the trustees then recoup an equivalent amount from subsequently realized income, (if the trust deed allows them), the trust will not be able to avail itself of the Sec. 104(6) deduction in respect of it and the income will be taxed in the trust's hands. By encroaching upon capital the trustees have brought it back into the tax base fully and thus exposed it to additional taxation, (though this will not occur in the case of non-resident beneficiaries since Sec. 105(1) cannot apply to cause withholding tax).

One of the only ways that this can be avoided is if the capital is distributed and the income interest is satisfied/extinguished and disposed of by the income beneficiary, (something that he may not wish to do for various reasons), so that Sec. 106(3)-(2) can apply to allow the beneficiary to receive the capital as non-taxable proceeds on the extinguishment of the interest. The proceeds are not includable in the beneficiary's income and if cash is distributed the trust will not recognize any significant tax consequences. Once again one has to be wary of the possible application of Sec. 105(1) to an obviously offensive distribution of capital in respect of the value of the income interest. If this is the only way that a power of encroachment can operate effectively so as to not cause double taxation of the capital advanced it would be beneficial to have the trust deed contain a power of appointment over the income rights so that if they are "disposed of or extinguished" the power can be exercised so as to vest them in the same income beneficiaries. When the income beneficiary is non-resident the fear of double taxation is not as pronounced since Sec. 212(1)(c) will preclude the capital from being taxed under Part XIII on a distribution, (as if Sec. 212(1)(c) could capture it anyway being that that provision applies only to Sec. 104(13) income inclusions, something the payment could never be). If the amount is derived from capital dividends from Canadian corporations however it will be subject to withholding as per Sec. 212(1)(c)(ii). If CRA chooses not to allow the Sec. 104(13.1) election to be made in respect of non-residents, (something that is implied in the present legislation), the power of encroachment and accompanying recouping ability could prove effective at insuring that any loss realized by the trust in respect of the income beneficiary's right could be absorbed through a subsequent recouping of income and alteration into capital.²¹⁰⁴

Variation of Trusts Statutes and the Common Law Rule of Saunders v. Vautier.

Since a trust can be looked upon as a gift of property to the beneficiaries deferred over a length of time in respect of delivery it would seem understandable that if all of the beneficiaries consented, and the trust terms did not expressly preclude it, the trust could be wound-up under the common law rule of *Saunders v. Vautier*²¹⁰⁵. This rule allows the beneficiaries to dissolve a trust, **and not vary its terms**, should the trust terms not expressly or implicitly preclude it.²¹⁰⁶ The rule can be invoked in almost all of the provinces where all of the beneficiaries under the trust are ascertained, agree to the dissolution and are all legally competent to do so and can give valid discharge to the trustee hence where a beneficiary is under the age of majority, or has not yet been born, or is mentally incompetent, or if any one beneficiary doesn't agree to the dissolution,

²¹⁰³ It may be possible to structure a trust so that the income beneficiary does have a contingent capital interest conditional on the level of income so as to allow tax free distributions: supplements will thus not extinguish the right and hypothetical Sec. 53(2)(h) adjustments will occur so as to prevent a Sec. 105(1) inclusion.

²¹⁰⁴ In *Re: Ropner's Settlement Trusts*, 1956 1 W.L.R. 902, it was held that a power to encroach on capital could be used to create sub-trusts with distinctive characteristics though pursuant thereto and in accompany with *re: Rutherford and Rutherford*, 1961 O.R. 108, the implicit restrictions on the power inferred from expressions used/intention of the testator must regulate the exercise and invalidate disqualifying exercises. As per *Re: Powles*, 1954 1 All E.R. 516, it is possible to exhaust the trust through excessive exercises, if the terms of the power are wide enough, and technically cancel the existing interests.

²¹⁰⁵ [1841] Cr. & Ph. 240

²¹⁰⁶ See *Re: Better*, 14 E.T.R. 189 (OHC), *Yeoman v. Yeoman Estate*, 23 E.T.R. 136, *Re: Blow*, 2 E.T.R. 209, *Re: Brockbank*, 1948 Ch. 206, *Re: Campeau Family Trust v. Bell*, 17 E.T.R. 297, and *Halsbury's Laws of England* 4th Ed., Vol. 48, para. 637. See also the recent Aust. case of *Re Dobrotwir* [2011] VSC 402 (31 August 2011) for additional material.

it cannot proceed under the common law rule which can be executed outside of court.²¹⁰⁷ ²¹⁰⁸ If due to age, non-existence, or legal incompetence, a beneficiary cannot give binding consent the rule cannot be used and instead the beneficiaries will have to fall back to the statute law procedure of making an application to court to obtain a court order under the appropriate provincial Variation of Trusts Act whereby the court will consent on behalf of the non-existent, minor, or impaired beneficiary, and it does so, in all cases, if it can be shown that the variation in terms or dissolution is of a determinable benefit to the beneficiary for whom consent is judicially given.²¹⁰⁹ Common to both the statutory Variation Acts and the common law rule of termination is the fact that they are both voluntary actions initiated by the beneficiaries which/who have unilaterally acted so as to bring about a termination or disposition and change in character of their interests.²¹¹⁰

A variation of the trust terms, whereby the right structure under the trust is altered can obviously have beneficial results to the trust-beneficiary relationship for purposes of taxation in that it may allow the recognition of the income of the trust to be handled by parties in more favorable positions while it also can allow certain beneficiaries to receive more capital from the trust than what they would otherwise be entitled to.²¹¹¹

When a trust is varied, so that the rights of the beneficiaries are altered, a disposition by them of their respective rights may only be recognized if the rights they have after the variation are different in substance and scope than what they previously had or the rights they have have not been altered in substance but have only been limited or reduced in the amount of property that they refer to, (their scope).²¹¹² When a variation is executed it is done so voluntarily but not all variations alter interests/rights under the trust. In order for a disposition of an interest to be recognizable by a particular beneficiary after he has consented to the variation the particular interest that he previously had must be materially altered, for instance; so that it doesn't apply to the same property, or so that it is limited in the amount that it can realize, etcetera. Understandably, if the variation operates so as to alter ancillary powers of the trustees without affecting immediately the interest structure of the trust dispositions by the beneficiaries will not be recognizable while the recognition of dispositions of interests will not be avoided if the variation operates to instill in the trustees, or some other person, a power of appointment, advancement or encroachment at that particular time altering the interest structure.²¹¹³ If the powers are subsequently exercised by the third party to cause a disposition of an interest via its cancellation or undermining the beneficiary will not recognize a voluntary transfer of the interest when it is instilled in another person, **in the author's opinion, only if he did not consent to the creation of that power.** If he didn't own the particular or **any interest at the time that the power was varied into the trust** then it cannot be contended that he consented to the transfer or could reasonably suspect that the power could be used in a series of transactions to transfer the subject property from him to another.²¹¹⁴ Until such a

2107 Where the gift is absolute with direction to accumulate income therefrom and distribute to the same beneficiary in the future the rule can be applied: *Wharton v. Masterman*, 1895 A.C. 186 (HL), *Whitman v. Hudgins*, 19 E.T.R. 316. See also *Buschau v. Rogers Communications Inc.*, 2006 SCC 28, [2006] 1 S.C.R. 973 where the rule was considered in the wind-up of a pension trust when the provincial heavily regulated structure disallowed the rule to apply.

2108 See "Report on the Variation and Termination of Trusts: Committee on the Modernization of The Trustee Act" by A Project Committee of the BC Law Institute, *Estates, Trusts and Pensions*, Vol. 23, Pg. 126 for a study of some fundamental issues.

2109 *Farrington v. Rogers*, 6 E.T.R. 156, Re: *Tweedie*, 1976 3 W.W.R. 1, Re: *Harris*, 1974 6 W.W.R. 97, Re: *Dent*, 18 E.T.R. 252, *Public Trustee v. Packet Estate*, 23 E.T.R. 111. In certain instances the provincial Dependant's Relief Act, Family Law Act etc., will provide for the allowance of the court to create a trust or to vary one that has been created *inter vivos* or via a testamentary disposition and these procedures can be initiated without the consent of the actual beneficiaries under the trusts.

2110 See the Aust. case of *Dulhunty v Dulhunty* [2010] NSWSC 1465 (17 December 2010) concerning agreements such as this where minority trustees protest.

2111 In the UK case of *Thorpe v HMRC* [2010] EWCA Civ 339 (15 March 2010) it was held that a court could wind up a trust for tax purposes without the interference of the tax authorities.

2112 See Re: *Druce's Settlement Trusts*, 1962 1 All E.R. 563, for alterations in interests. See also "Variations of Trusts: An Analysis of the Effects of Variations of Trusts Under the Provisions of the Income Tax Act" by William Innes and Joel T. Cuperfain in the *Canadian Tax Journal*, 1995 Vol. 43 Pg 15, for a review of some of the issues.

2113 thereby causing an interest under the trust to become defeasible to any extent by the power's exercise. If the power already exists but is merely extended to include other objects this will still be the case.

2114 See *I.R.C. v. Macpherson*, 1988 2 W.L.R. 1261 (HL).

dispositive power is exercised the beneficiary will not recognize a disposition with respect to his interest latently affected.²¹¹⁵

In *Thorn v. I.R.C.*²¹¹⁶ a trust was varied whereby a daughter of the settlor relinquished 20% of her absolute share of one half of the life interest and took back a discretionary interest in the remaining 80% of her former half share, and the Commissioners attempted to assess stamp duty on the voluntary conveyancing of the substance of the rights that she had foregone which then substantiated the entitlement of other beneficiaries. Walton, J. commented that:

"In the context of a family arrangement of this nature, I think the proper way to regard the actions of a person who gives a fixed and certain interest in exchange for the somewhat spectral interest of being included in a class of discretionary beneficiaries is that the interest has been given up for the benefit of those who obtain the benefit of it under the scheme, the benefit conferred by the discretionary trust being much more in the nature of a long stop, in case anything should go seriously wrong with the finances of the person giving up the interest thereafter, rather than as a seriously intended quid pro quo. Mr. Price pointed out that this was the only manner in which the settlor's daughter could hope to obtain any capital out of the trust. This is, of course, in one sense, completely accurate, but if that was what she wanted she could quite simply have bargained for some modest slice of capital when the scheme was on foot. This she quite deliberately did not do; and I do not think I can objectively regard the prospect of the trustees exercising their powers in favor to give her capital as representing, in any real sense, any entitlement to capital in her."

The daughter in this instance recognized a disposition of that portion of the interest.²¹¹⁷ If a power of appointment had instead been given to the trustees through the variation, whereafter the trustees exercised it to the detriment of the daughter and to the benefit of the other beneficiaries quite likely the voluntary nature of the variation, and indirectly the result of the exercise of the power, would not have been so "buried" as to be irrelevant.

If a power of appointment, encroachment, or advancement is varied into a trust at least one beneficiary has sustained a disposition of his right originally held and has received a right substantially dissimilar to the original.²¹¹⁸ Where a dispositive power, (even with income recouping provisions in the case of encroachments), is varied into a settlement the particular beneficiary who formerly held an absolute or contingent right to the capital will cease to hold such and instead will hold only a contingent right in remainder that may be exhausted by the power's exercise.²¹¹⁹ That beneficiary will recognize a consensual disposition in the author's opinion. Regardless of whether all of the interests are futurely enforceable or contingently **or even discretionary**, at least one beneficiary will, by implication, realize a disposition of a right of a certain character on a varying in of a dispositive power that can vary the interest composition. Fortunately not all rights are equivalent and an "interest" may consist of a bundle of rights only some of which may be reduced/eliminated upon the varying in of the power. Since they are not to be bundled as a singular property and are not identical property the disposition of one right may not create excessive capital gains etc. in certain instances.²¹²⁰

A variation that does not upset the interest structure of the trust but instead alters the criterion upon which the interests themselves are based may not lead to a recognizable disposition for tax purposes and an example of this could be the case where the distribution scheme in respect of the capital interests is accelerated so as to reduce the time during which the property is held in trust, as well as when the schedule

²¹¹⁵ The difference between a consensual and involuntary disposition of property is extremely important for purposes of attribution of income or gain.

²¹¹⁶ [1976] 1. W.L.R. 915,

²¹¹⁷ This case also examined whether the beneficiary obtained money's worth for the disposition of her interest which may be relevant in ascertaining whether a benefit described under Sec. 105(1) has been conferred on another beneficiary.

²¹¹⁸ See *Perp. Trustees W.A. Ltd. v. Corp. West Mgt. Ltd.*, 1989 W.A.R. 117, and *Graham Aust. Pty. Ltd. v. Perp. Trustees W.A. Ltd.*, 1989 1 W.A.R. 65.

²¹¹⁹ As per *Public Trustee v. Wolf*, 1923 A.C. 544 (HL), the existence of a power of appointment doesn't prevent vesting though see *Commr. of S.D. v. Spragne*, 101 C.L.R. 184, and *Commr. of S.D. v. Bradhurst*, 81 C.L.R. 199, for the termination of a power not causing change in interest in certain instances perhaps only for certain purposes.

²¹²⁰ As per *C.I.R. v. Chubb's Trustees*, 47 T.C. 353, variation expenses sustained by an estate were deductible against deemed income realized due to the variation. Which party pays for the expenses is obviously important.

is "decelerated" so as to stretch the time in which the property is to be held in trust thereby allowing it to produce income for the income beneficiaries.²¹²¹ In both instances the fair market values of the affected interests are significantly reduced or increased but there has been no change in the scope of the right or what it relates to under the trust. Can the extension of the date of the distribution of property be equated with the disposition of the capital interest in respect of which the property is to be distributed?²¹²² Can the extension be argued to be an instance where an immediately enforceable right has been transferred for consideration in the form of a right that is enforceable in respect of the same property in the same manner only in the future? The question is significant when a capital beneficiary is about to become non-resident and his capital interest will be caught by Sec. 128.1(1) and deemed disposed of for its fair market value.²¹²³ In the author's opinion such an extension in distribution date will not cause a disposition for purposes of subdivision c when the right relates to property in specie since beneficial ownership, the right to specific property, may not have been severed regardless of the effect of the variation. Although dispositions of interests may be avoided upon a deferral of, or acceleration of, distribution dates via a variation Sec. 105(1) **may** apply to those Canadian resident beneficiaries who realize a benefit from such an arrangement: this was provided in the pre 1988 reform provision, however the inclusion will be only to the extent of the benefit realized.²¹²⁴

Whether or not a variation will cause the application of the income attribution provisions upon the resulting arrangement depends a great deal upon the relationships of the beneficiaries whose interests were affected and those who gained an interest. It was found, in *Murphy v. The Queen*²¹²⁵ at the Federal Trial Court level, that where a variation of a trust had been executed under a provincial Variation of Trusts Act and a right to income of a beneficiary had been given up and a discretionary income interest had been granted to the beneficiary's spouse the income recognized by the spouse could be attributed back to the former holder of the absolute right thereto, (if the general attribution conditions existed). In *Murphy* the applicability of both the Sec. 56(2) attribution provision and the Sec. 74(1) provision were drawn into question, the Minister attempting to base his assessment on one or the other or both. Cattanach, J. recited the four criteria needed for the application of Sec. 56(2) and the two common conditions between it and Sec. 74(1) however he went on to draw notice to the fact that while Sec. 56(2) specifically provided that the property must be transferred at the direction of or with the concurrence of the transferor, Sec. 74(1) did not. He further provided that:

"Under subsection 74(1) there is no specific provision that the transfer of property must be at the direction or with the concurrence of the transferor. In the facts of the present appeals no particular significance attaches to the absence of this language in subsection 74(1) **in that the condition is**

2121 See *Moran Nominees Pty. Ltd. v. Comp. of Stamps*, 1982 13 A.T.R. 947, and *JAW & S Prop. Mgmt Non. Pty. Ltd. v. Commr. of S.D.*, 1989 1 Qd. R. 530, for some issues. In T.I. 5-901838 provided by the Financial Industries Division in Nov. 1990 it was provided:

"We are not aware, at the present time, of any sections of the Income Tax Act which would cause a deemed disposition arising from renouncing or a variance in the provision of the will trust deed whereby the capital gains realized by the trust would be allocated to the capital beneficiaries of the trust and may even be distributed to the beneficiaries."

2122 This discussion concerns instances only where beneficial ownership of the underlying property **does not** reside with the particular beneficiary.

2123 More importantly will the variation be so extensive as to constitute a new trust giving rise to the situation where a beneficiary has paid consideration, in the form of his former interest, to the trust to acquire an interest in the new trust?

2124 A deferral can reduce the fair market value of interests and disrupt the associated corporation rules, the application of Sec. 128.1(1) in respect of non-resident trusts, etc.. Can it be possible for a beneficiary consenting to a variation to both realize and recognize a disposition of his interest and recognize a benefit if the interest received is of a greater value than that previously held even though pre 1988 reform Sec. 105(1) did not refer explicitly to it per se but to "arrangements"? Would the beneficiary not be giving up value to acquire property of a **greater** value thus not only realize a disposition of the former but also a "benefit" "from or under" a trust within the context of Sec. 105(1)? Within the context of Sec. 105(1) will the taxpayer realize the benefit from another beneficiary consenting to the diminution of his interest when the trust created by the deed of arrangement was initiated by the beneficiaries and it is one of them who is providing the substance of the benefit? It would appear that even though it is the other beneficiary who is providing the benefit and not the trust per se, it could be argued, within the context of Sec. 105(1), that the benefit is still captured since such is also the case with the exercise of powers of appointment and instituting of arrangements cited in the pre 1988 reform Sec. 105(1) subsection. The tax man's assessing practice in this respect is utterly non-existent; he's thus free to pick and choose as to one, the other, or both as he please's being in the first instance.

2125 80 D.T.C. 6314,

that the person must transfer property. That being so it is implied therein that the animus if the transferor was to direct and concur in the transfer."

Effectively, at that point of the reasoning, he had equated the variation of the trust, which was only possible with the consent of each beneficiary, as being the transfer and although he was in a sense correct the author cannot agree with the unqualified statement in the first sentence of the quote. In the author's opinion there is an **expressed** requirement in subsection 74(1), (and consequently all of the present day attribution provisions), that the transferor direct or concur with the transfer made. A transfer is not the same as an incidental involuntary disposition and reacquisition of property by some other person in that a transfer is directed by the transferor and is propelled by **his** intentions.²¹²⁶

Subsections 74(1), (2), 74.1(1), (2), 74.3(1) etcetera do not base the charging measure on phrases such as 'where property has been transferred from one person to another...' or '...from one individual to another...'. They explicitly charge in phrases such as 'Where **a person has transferred** property directly or indirectly...' or 'Where **an individual has transferred or loaned** property...' and from the general use of the English language, and the principles fully established particularly appropriately in Fasken and Dunkelman, it should be utterly obvious that if the taxpayer or the individual referred to does not initiate the actions which divest the legal title from him, or does not direct the dealing in the property interest, then although he has recognized a disposition when the property is divested from him he has not made a 'transfer' for purposes of the income attribution provisions.²¹²⁷ There is the obvious weakness in this 'house of cards' whereby consensual variations of trusts do not receive the same sheltering from attribution as unilaterally exercised powers of appointment. As per Lord Reid in *Re: Holmden's Settlement Trusts*²¹²⁸ speaking on what party causes a statutory variation:

"Under the Variation of Trusts Act the court does not itself amend or vary the trusts of the original settlement. The beneficiaries are not bound by variations because the court has made the variation. **Each beneficiary is bound because he has consented to the variation.** If he was not of full age when the arrangement was made he is bound because the court was authorized by the Act to approve of it on his behalf and did so by making an order. If he was of full age and did not in fact consent he is not affected by the order of the court and he is not bound. **So the arrangement must be regarded as an arrangement made by the beneficiaries themselves.** The court merely acted on behalf of or as representing those beneficiaries who were not in a position to give their own consent and approval."²¹²⁹

In *Murphy v. The Queen* a variation resulted in income that was otherwise previously recognizable by a beneficiary being instead recognized by his spouse and although the specific property that the taxpayer gave up which produced the income, which was a full income interest, did not become vested in the spouse under the variation, she became a discretionary beneficiary capable of receiving it. Immediately prior to the variation the taxpayer had a vested one half interest in the income of the estate and the spouse had no possible way of ever receiving income since she had no rights to speak of. Upon giving up the interest through the variation the taxpayer, as well as his wife were made discretionary beneficiaries. "The action by the trustees, (in the exercise of their discretion), is but the concluding link in the chain of circumstances set up by the plaintiff's participation in the family agreement." As per Cattanach J. on Sec. 74(1):

"... a transferor and a transfer of property by him by means to his wife. It is not necessary, in order to fall within this wording, that all of the rights to property transferred became immediately or even eventually the property of the spouse."

²¹²⁶ See also the recent UK case of *Harris v Revenue & Customs* [2010] UKFTT 385 (TC) (18 August 2010) where it was held that a variation of a will to cause a charitable contribution was recognized as a gift. The case is well worth a read.

²¹²⁷ It would be ridiculous to believe that the purpose of the attribution provisions in general is to pose as anti-avoidance legislation for all transactions which operate to divest taxpayers of income producing property and consequently reduce their tax liability. They are targeted for transactions purposefully **entered into by the transferor only.**

²¹²⁸ [1968] A.C. 685.

²¹²⁹ See also *Re: Ball's Settlement*, 1968 2 All E.R. 438, *Re: Holt's Settlement*, 1968 1 All E.R. 470, & *Spens v. I.R.C.*, 1970 3 All E.R. 295.

In respect of the transfer of property to a trust for the benefit of discretionary objects the above was followed in *Heller v. M.N.R.*²¹³⁰ specifically.²¹³¹

The fact remains that in order for the trustees to have exercised the discretionary power in the favor of the spouse she must have been a discretionary beneficiary as expressed in the varied will and she gained this status only from the variation **which the transferor consented to**. If the status of discretionary beneficiary or absolute vested beneficiary had instead been granted to her by a general power of appointment exercised by another non-spousal person, and the power had been instilled in the person by a variation to which the spousal party had consented income attribution could still be applied since the transferor could have suspected that the power would have been favorably applied in respect of his spouse when he consented to its insertion in the deed.²¹³²

In *Murphy* it was found that the Sec. 74(1) attribution provision applied fully to an instance where the taxpayer had indirectly transferred the property to the spouse, the property being the right to receive income from the estate and its substitute the right to be considered as a discretionary beneficiary. Even though it was the action of the trustees that substantiated her otherwise potential right, it was received by her from the substance of the absolute right that the taxpayer had given up. Judge Cattnach did not comment upon the other basis of the Minister's assessment being Sec. 56(2) however he did list the four main characteristics thereof being; 1) that there must be a payment or transfer of property to a person other than the taxpayer, 2) that the payment or transfer is pursuant to the direction of or with the concurrence of the taxpayer, 3) that the payment or transfer be for the benefit of the taxpayer or for the benefit of the person on whom the taxpayer wished to have it conferred, and 4) that the payment or transfer would have been included in computing the taxpayer's income if it had been received by him instead of the other person. Obviously the Sec. 56(2) provision could have been equally applicable to *Murphy* in that all that is required is that the transfer be made, not necessarily by the taxpayer himself, but with his **consent** or direction and the substance of the transfer would otherwise have been included in his income. By consenting to the variation giving the spouse the discretionary income interest the taxpayer could have obviously been argued to have given his consent to pay her income that otherwise would have been recognizable by him.²¹³³ If the income had been paid to him it would have been included in computing his income, even though the amount would have been payable by a different means being in respect of an absolute right thereto rather than a discretionary interest. Once again the same avoidance could have been obtainable via a power of appointment rather than the inclusion of the spouse, or any other party, as a discretionary beneficiary in the variation since in the former case, when the power is exercised favorably, it is not with the taxpayer's consent or with his direction, (unless the power rests with him or he can influence the holder), while in the latter case he clearly has consented.

Where, through a variation, the characteristics of a trust are altered then one has to ask if the trust resulting after the variation is the same trust as that created by the original trust's settlor/testator or whether through the unanimous consent of the beneficiaries under the former trust, it has been terminated and a new trust created in its place. In *Holt's Settlement*²¹³⁴ trusts were to be revoked under the English Variation of Trusts Act and new trusts were to be settled with the property that was vested under the former trusts. Relying on the interpretation of the scope of that Act as commented on in *Re: T's Settlement Trusts*²¹³⁵ the court held that although the transactions were that of a complete revocation and declaration of new trusts, the latter not explicitly within the jurisdiction of the court, as provided in the Act, in substance the arrangement amounted to a variation. This says nothing for whether or not there was the creation of distinctively new trusts out of the former. There was some question however as to whether the trusts after the variation were distinct enough to be recognized as coming into being at the date of the order thus being allowed to benefit from a prospective

²¹³⁰ 30 E.T.R. 54,

²¹³¹ See also *Re: Drury's Marriage Settlement*, 1888 21 Q.B.D. 466, and latterly *Carmody v. I.R.C.*, 1975 1 N.Z.L.R. 118, for similar instance in respect of surrenders and exercises of powers of advancement for gift tax purposes.

²¹³² See *I.R.C. v. Macpherson*, 1988 2 W.L.R. 1261 (H.L.), for such "associated operations", as well as *Northumberland v. I.R.C.*, 1911 2 K.B. 343 and *Braybrooke v. A.G.*, 1861 11 E.R. 684.

²¹³³ Why else would he give her a discretionary income interest?

²¹³⁴ [1969] 1 Ch. 100,

²¹³⁵ [1964] Ch. 158,

implementation of statutes concerning the rules against perpetuities and accumulations. Concerning the creation of "new trusts" by the approval of the court Megarry, J. provided, with respect to the scope of the variation statute:

"This merely empowers the court to approve an arrangement 'varying or revoking all or any of the trusts', and so, it is said, the court cannot approve an arrangement which, instead of merely 'revoking' or merely 'varying' proceeds to revoke and then set up new trusts, thereby producing an effect equivalent to the process of settlement and resettlement. The section, it is argued, says nothing of establishing new trusts for old. As a matter of principle, however, I do not really think that there is anything in this point, at all events in this case. Here the new trusts are in many respects **similar** to the old. In my judgment, the old trusts may fairly be said to have been varied by the arrangement whether the variation is effected directly, by leaving some of the old words standing and altering others, or indirectly, by revoking all of the old words and then setting up new trusts partly, though not wholly, in likeness of the old. One must not confuse machinery with substance; **and it is the substance that matters**. Comparing the position before and after the arrangement takes effect, I am satisfied that the result is a variation of the old trusts, even though effected by the machinery or revocation and resettlement.

Mr. Brooks pressed me with the discussion in T.'s Settlement Trusts. He accepts that the point is not the mere matter of form, that is, whether in form there is a mere series of variations of the existing trusts, or whether in form there is a revocation and declaration of new trusts; but he says that the form gives indication as to whether there is a mere variation or not. For myself, I cannot see much force in this; for so much depends on the individual draftsman who prepares the arrangement. One draftsman may choose to effect the arrangement by a series of variations of the existing trusts. Another may prefer to effect precisely the same variations by the formally more radical process of revocation and new declaration."

One has to wonder if upon making the last statement Megarry J. had in the back of his mind considerable regard for the scope of the variation statutes vis-a-vis revoking and variation as compared to revocation, variation and **declaration**.

In *Re: Towler's Settlement Trusts*²¹³⁶ a parent petitioned the court to make a variation order under the U.K. Act approving a transfer of an immature offspring's share of a trust to a protective trust giving her a life interest with gift over to her offspring. The Chancery Court found that the "variation" could not be approved since it was not in the court's jurisdiction to create a trust. In *Re: Harris*²¹³⁷ a widow applied to have a will trust varied whereunder the offspring were unequally interested on the grounds that otherwise such would produce emotional duress if disclosed to them. Fulton J. considered the application consisting of an arrangement whereunder all offspring would share equally, as ineligible for approval since, effectively, the court order would redispense of the testator's property, not within the jurisdiction of the court:

"As to the question of whether the proposal for which approval is sought is truly a variation so as to be within my jurisdiction to approve I do not think it is. It seems to me that what the court is asked to approve is not a variation of a disposition made by the testator, such as to enlarge or vary the powers of investment of the trustees, or to vary the time at which contingent interests shall vest, but to make a new disposition of the testator's assets by changing the substance of the disposition that he has made as between the actual and potential beneficiaries. Of those beneficiaries, the four children have vested interests in the proportions directed by the testator, and I am asked to change those proportions.

...

Here the proposal would revoke the disposition which the testator has made, reduce the interest of R.P. and his unborn children from five-eighths to one-quarter and redistribute the difference between the three other children and their children. This would be, as I see it, to create a new trust."

2136 1964 Ch. 158
2137 1974 47 D.L.R. (3d) 142 (BCSC)

In re: Ball's Settlement Trusts²¹³⁸ Megarry V.C. provided a perhaps very subjective test:

"If an arrangement changes the whole "substratum" of the trust, then it may well be that it cannot be regarded merely as varying that trust."²¹³⁹

In re: Seale's Marriage Settlement²¹⁴⁰ a U.K. Variation of Trust application was made to revoke the U.K. trusts whereby the property would be transferred to a practically identical Canadian trust and although Buckley J. concurred that he had no jurisdiction to create a trust he had the power to approve an arrangement which appointed a non-resident trustee subsequent to which the old trust would be revoked thus effectively creating a new trust, the relative beneficial interests in which would not change. The property in such a case would not be redispensed of. This method was adopted again in Weston's Settlements²¹⁴¹ but failed **only** due to the lack of net benefit to be conferred on the beneficiaries the approval of which was to be judicially provided.²¹⁴²

Concerning the question of whether the varied trusts could then take advantage of the prospective rules against perpetuities and accumulations Judge Megarry in Holt's commented upon the ability of powers and variation court orders and the results thereof as being or not being part of the original settlement:

"The mischief attacked by the rule against perpetuities in the case of powers of appointment, and now, since *Pilkington v. Inland Revenue Commissioners*, in the case of powers of advancement as well, is that the property is tied up ab initio. The power(special) is conferred by the settlement, and the person exercising the power can do so only within the pre-ordained limits. The power indeed "belongs" to the old settlement, if I may respectfully adopt the language of Lord Radcliffe in the *Pilkington* case. Under the Act of 1958, there are no such limits. The property, as it seems to me, is freely disposable. Under an arrangement approved by the court the trusts may be brought wholly to an end. On the other hand, they may be varied; there is no limit, other than the discretion of the court and the agreement of the parties, to the variation that may be made. **Any variation owes its authority not to anything in the initial settlement but to the statute and the consent of the adults coming, as it were, ab extra.**"

In Re: Holmden's Settlement Trusts²¹⁴³ a variation order was approved extending the period of a trust so as to avoid estate duty on the death of a beneficiary, which would have brought the trust to an end, thus attracting the duty. The Commissioners contended that the effect of the variation order was to bring the initial trust to an end and thus cause it to be chargeable anyway. For purposes of this discussion Lord Wilberforce held that:

"If all the beneficiaries under the settlement had been sui juris, they could, in my opinion, have joined together with the trustees and declared different trusts which supersede those originally contained in the settlement. Those new trusts would operate *proprio ignore*, by virtue of the self-contained instrument - namely, the deed or arrangement or variation. **The original settlement would have lost any force or relevance.** The effect of an order made under the Variation of Trusts Act 1958, is to make good by an act of the court any want of capacity to enter into a binding arrangement of any beneficiary not capable of binding himself and of any beneficiary unborn: the nature and effect of any arrangement so sanctioned is the same as that I have described. So far there is really no dispute; the difference between the Crown and the respondents and between the two views of the Court of Appeal(27) is on the question whether this is in fact what the arrangement has done. I have set out c11.2 and 3 (see p. 158 letter E, ante): to my mind they cannot be read as an affirmation of the trusts of the settlement plus an addition: they can only be read as a true "variation"- the

2138 1968 2 All E.R. 438

2139 "Substratum" in this instance could be argued to be the fulfillment of the precise intention of the testator/settlor with respect to the quantity and quality of benefit taken and it could be argued to be rudimentary enough so as to allow variations to occur that materially vary the trust via the removing of administrative and perhaps dispositive powers thus clearly causing the varied trust to be different from the original.

2140 1961 1 Ch. 574

2141 1969 1 Ch. 223

2142 It would appear possible to splinter a mass trust into a class of sub-trusts with the dicta of Seale's and Weston by appointing trustees to hold the head trust's property substantiating the beneficiaries' respective interests and then to revoke the trust. A tax benefit could serve as a valid motive for such a variation and as long as the substance of the settlor's disposition isn't altered "the tree could be stripped into a multitude of ribbons while retaining the root".

2143 [1968] 1 All E.R. 148,

substitution by binding agreement of a new period for the old. One may test this by asking what the trusts as to the income were after the arrangement and before Lady Holmden's death: were they the same as before, or were they different? In my opinion, they were clearly different..."²¹⁴⁴

The point to be made here is that if a "variation" is approved that has the effect of distinctively terminating the old trusts and creating the new ones the new trust will be regarded for the purpose of the rule against perpetuities and accumulations as coming into existence only at the date of the variation court approval hence although in respect of the variations statutes it is recognized that the court cannot approve declarations of trusts, it can still cause to be recognized as distinctively constituted those that resulted from its variation approval. It would seem necessary, however, similar to the exercise of powers of appointment, to ensure that upon the creation of the new distinctive trusts through a variation application that to allow recognition of distinctiveness the old trusts must have been irrevocably disqualified from ever applying to the subject property.

An important technical note must be highlighted with respect to the above being that since a court order only has the ability to approve of a variation that has been consented to by all of the relevant beneficiaries excluding those for which it acts it would seem that if structured a certain way upon the termination of the old trusts and constituting of the new the beneficiaries themselves have realized the property from the old trust at one point. The court acts upon the consent of the beneficiaries as being the initiating and compelling right and it is only the beneficiaries who may apply for the variation hence it follows that it may be they who are creating the new trust and it is they who are contributing property to it. When the terms of the old trust are varied the trust retains legal ownership of the property; when the trusts are terminated and reconstituted at some point in time, for a small instance in time, the legal ownership of the old trust's property vests with the beneficiaries. This aspect is obviously critical when a variation is planned and the variation application; ie the proposed terms, are being put to writing since if varied one way the beneficiaries will be recognized as contributors to the new trust while if varied the other the old trust should be recognizable as the contributor. Understandably this can cause some consideration to be paid to which route to be taken when one examines the tax considerations appendant to the preferred beneficiary election, Sec. 104(2), minimum tax, etc.²¹⁴⁵.

Understandably the question of whether a new trust is created or whether a former trust has simply been varied will have to be answered with respect to the particular facts of the situation on a case by case basis however if the consent of the beneficiaries results in a variation whereby the nature of their rights under the original trust are altered then understandably they should have to recognize a disposition of those rights for tax purposes followed by a recognition of the acquisition of rights they acquired by the variation. If there is no material change in the beneficial ownership of the capital element of the subject property then the recognition by the beneficiary of a disposition of that property may be avoided as per Sec. 54(c)(v).

An interesting alternative, whereby the entire issue of new verses old trusts can be circumvented, is to apply for a variation whereby, either incidentally or as the main objective, a power of appointment or of advancement is to be written into the varied trust. It should be noted however that the explicit powers conferred upon the courts by the provincial variation of Trusts Acts are limited to "varying or revoking" the trusts or enlarging the "powers of the trustees of managing or administering" the property of the trust and in this regard the dispositive power may not be within the scope of the legislation that would allow the court to approve its inclusion. The courts do not explicitly have the power to enlarge or approve of dispositive powers, but they do have the ability to authorize a variation so as to accept the new general or special powers required by the beneficiaries. Once again in order to accept and approve the application the court must be satisfied that the application and variation as a whole will be to the non-exclusive benefit of the incompetent beneficiary for whom it acts. Once the power is written into the deed it may itself be exercised so as to terminate the original trust and constitute distinct new ones, under the principles in regard of the exercise of dispositive

²¹⁴⁴ See Re: Brockbank, [1948] Ch. 206, Re: T's Settlement Trusts, [1964] Ch. 158, "Resettlements: A Muddle", [1980] Brit. Tax R. 174, Re: Irving, 1976 66 D.L.R. (3d) 387, Re: Steed's Will Trusts, 1960 1 All E.R. 487, & Re: Lloyd's Settlement, 1967 2 All E.R. 314.

²¹⁴⁵ See Seale's Marriage Settlement and Weston's Settlement supra. for direct transfers to new trusts.

powers previously discussed. A variation operates by the consent of the beneficiaries hence income attribution would definitely pose a danger.

Finnell v. Schumacher Estate²¹⁴⁶ is an excellent case illustrating the potential complexity of a statutory variation and how, it would seem, an application to vary a testamentary trust whereby tax savings are the primary motivation, will be **initially** accepted by the court. In that case the trust was varied so as to allow it to establish a holding company as well as a parallel trust the main purpose of which was to reduce the effect of the impending application of the deemed disposition rules in Sec. 104(4).²¹⁴⁷ The variation arrangement itself was slightly complex and provides some interesting technical reading.²¹⁴⁸

Re: Irving²¹⁴⁹ was referred to in Finnell on appeal to examine the inherent requirements to be satisfied in making applications under provincial Variation of Trusts Acts:

"The search in all these cases was to find the intention of the founder of the trust and then to decide whether the proposed arrangement remains within the ambit of the intention.

...

The Court is concerned whether the arrangement as a whole, in all the circumstances, is such that it is proper to approve it. By way of a brief prefatory summation then, and further to the powers conferred under s. 1 of the Variation of Trusts Act, approval is to be measured, inter alia, by reference to these considerations: First, does it keep alive the basic intention of the testator? Second, is there a benefit to be obtained on behalf of infants and of all persons who are or may become interested under the trusts of the will? And third, is the benefit to be obtained on behalf of those for whom the Court is acting such that a prudent adult motivated by intelligent self-interest and sustained consideration of the expectancies and risk and the proposal made, would be likely to accept?

...

The spirit of the Act, as I read it, permits pruning of the trust in order to promote fruitfulness, but the root is to be preserved."

As per the first point Re: Towler's Settlement Trusts²¹⁵⁰ and Re: Ball's Settlement²¹⁵¹ are authority that the court cannot materially rewrite a will or trust.

A variation of a trust can be revoked with permission of the court if it has created unintended tax consequences. This was the case of Ashcroft v Barnsdale & Ors²¹⁵².

Trust Variation Loss Continuity, Interest Valuation, and Variation Expense Deductibility

The reduction of taxation was accepted as a valid reason for a variation in numerous cases such as: Re: Sainsbury's Settlement²¹⁵³ Re: Clitheroe's Settlement Trusts²¹⁵⁴ and Re: Burns²¹⁵⁵.

²¹⁴⁶ 66 O.R. (2d) 301,

²¹⁴⁷ What is even more remarkable about the case is that the trustees had obtained an advance tax ruling from CRA whereby the proposed variation was recognized as acceptable even though it allowed for the ultimate reduction in the trust's tax bill by about 400,000\$. Unfortunately the case does not describe how the Minister taxed the variation, but confirms only that he consented to it. The High Court judge provided that the ruling was favorable but did not describe how the Minister would tax the arrangement. It must have been, on the whole, favorable since the variation application wouldn't have been entertained if it would have caused immediate excessive taxation in relation to that wished to be avoided.

²¹⁴⁸ See also Re: A.S. Sykes, 1974 1 N.S.W.L.R. 597, for a variation in a spousal trust to allow the incorporation of assets as well as Johnson v. C.S.D., 1957 S.R. (N.S.W.) 313, for another incorporation variation order. The former provides a brief discussion of historic case law. The High Court decision in Finnell v. Schumacher Estate was overturned by the Court of Appeal subsequently (37 E.T.R. 170) on the grounds that its result did not adhere to the testator's intention and to proceed would excessively disrupt/rearrange the beneficiaries' entitlements, and inequitably shift the tax incidence to certain parties. Save for the grounds upon which it was overturned (essentially converting trust law capital into an income receipt) the **other** liberal variations were not challenged.

²¹⁴⁹ 1975 11 O.R. (2d) 443

²¹⁵⁰ 1963 3 All E.R. 759

²¹⁵¹ 1968 2 All E.R. 438

²¹⁵² [2010] EWHC 1948 (Ch) (30 July 2010)

²¹⁵³ 1967 1 All E.R. 878,

²¹⁵⁴ 1959 3 All E.R. 789,

²¹⁵⁵ 11 D.L.R. (3d) 378

In *Re: Weston's Settlements*²¹⁵⁶ the U.K. Court of Appeal held that the endorsing of a variation scheme whereby an appointment of non-resident trustees, whereafter the U.K. trust would transfer its property thereto and terminate, (thus avoiding capital gains taxes), was not in the interests of the beneficiaries to be benefitted. In order for the arrangement to achieve its objective the beneficiaries of the trust would have to become non-resident over an extended period of time which would upset their development and although the court acknowledged that tax avoidance was a valid reason for it the variation on the whole would be to the detriment of the beneficiaries it was to ultimately benefit. The order wasn't awarded, (and Lord Denning held: "The avoidance of Tax may be lawful, but it is not yet a virtue."). Variations that cause beneficiaries, (only those on whose behalf the court acts), to retain less secure positions as beneficiaries or reduce the scope of their entitlements may not be endorsable if the underlying reason for the variation is the avoidance of tax, perhaps no matter how significant.²¹⁵⁷

It has been determined in *CMMR of Stamp Duties (NSW) v. Buckle*²¹⁵⁸ that the value of interests in a trust that is varied are not to be computed with reference to the full value of property in the trust upon which they are referenced but also including any debt and reflecting the vicissitudes which are relevant in the trust structure. How much flexibility exists here is anyone's guess.²¹⁵⁹

In *Leda Pty Ltd and Anor v Weerden (No 2)*²¹⁶⁰ there was litigation over competent tax advice on the buying of trust losses by another trust when "things went wrong". The case is worth reading for possible professional exposure on how to give your client advice on what can be aggressive tax exposure manipulation. There are no amalgamation provisions applicable to the joining of trusts such as those afforded corporations under the ITA. Once a loss is sustained in a trust it can only be subsequently available to that trust.

It can be, of course, beneficial to prompt for a variation to crystallize gains/losses in both the trust's and beneficiaries' hands depending on the situation, and even pursuant to Sec. 108(6)(c) it is possible to have resulting set-up of interest costs and there is maintaining of the personal trust character. That subsection applies for **very limited purposes** and it does not interfere with capital gain/loss provisions on the disposition of interests but merely preserves the personal character of the trust if it goes through a variation. It also preserves the exemption from Sec. 53(2)(h) capital interest cost mechanics if the interest was/wasn't acquired for consideration payable. It speaks nothing of the computation of gains/losses on interests disposed of. But there are all sorts of complications involving section 69 and "gifts", in particular to non-arm's length parties previously noted in the initial section on Variations.. Subsection 108(6) also speaks nothing for the possible application of a Sec. 105(1) in-direct benefit that can pop-up in the most unsuspecting hands as well.

Pursuant to Sec. 248(25.1), for purposes of the whole Act, inter-trust transfers in the circumstances cited result in the property being held statutorily by the same trust, BUT, such occurs only when there has not be a change in **beneficial ownership** which is a far larger degree of interest than in mere beneficial interest.

²¹⁵⁶ 1968 3 All E.R. 338.

²¹⁵⁷ See *Faye v. Faye*, 1973 W.A.R. 66, for less material variation in interests removing protective features. A benefit of a statutory variation must inure to the beneficiaries for whom the Court consents. A tax benefit to the trust-beneficiaries as a whole will not gain approval unless it materially improves the benefits to the particular person for whom the court acts: *Re: Assie Estate*, 24 E.T.R. 278 (Sask. QB). The "benefit" which is the objective of the variation may also be a benefit for purposes of Sec. 105(1). Subsection 105(1) presently doesn't apply to non-residents. For more in-depth commentary see "Variation of Trusts in England and Canada" A.J. McClean, 1965 C.B.R. 181.

²¹⁵⁸ [1998] 192 C.L.R. 226 HCA

²¹⁵⁹ See also the Aust. case of *Menkens & Anor v Wintour* [2011] QCA 201 (19 August 2011) for case on trust interest valuation issues.

²¹⁶⁰ [2006] NSWSC 125 (10 March 2006)

As per *C.I.R. v. Chubb's Trustees*²¹⁶¹ variation expenses sustained by an estate were deductible against deemed income realized due to the variation. Which party pays for the expenses is obviously important.²¹⁶²

It has been argued by the Aust. Fed. Comm. of Taxation, in *FCT v. Commercial Nominees*²¹⁶³ that a variation in a trust can sever its loss continuity though in that case the Aust. Federal Court considered the *statutory provisions* and allowed them to be maintained.²¹⁶⁴ One must be careful as to not so vary a trust so as to upset its substratum to cause it to be a separate trust for purposes of the Act since such would allow for a severing of its loss continuity.^{2165, 2166}

In *Comm. Of Tax. v. Helen and David Clark*²¹⁶⁷ the Australian Federal Court—Appeal had to consider whether a trust that had sustained capital losses 20 years previous was the same one that realized capital gains subsequently, after the trustee and beneficiaries had changed. It held:

“Continuity of the trust estate is not demonstrated by showing that property was held upon certain trusts in 1990-1993, and that other property was held upon the same trusts in 1997 or 2001. Property held at an earlier time may have been dealt with in such a way as to produce other property held at a later time, demonstrating continuity of the trust estate. Where, as here, the trust deed contemplates augmentation of the trust estate, there may be circumstances in which additional moneys can be seen as comprising, with the original fund, the trust estate and, together, incurring losses or deriving income. Where the affairs of a trust have been effectively wound up by disposing of all assets and resolving all outstanding liabilities, the position is quite different. The only available inference from the facts of this case is that Mr Denoon, Mr Clark and their companies intended that the Trust start again with a new trustee, new beneficiaries (subject to the possibility that Mr Denoon might be able to participate in re-funding the Trust), but upon substantially the same terms, and that such intention was carried into effect. No doubt they hoped that the Trust would continue to the extent necessary in order that the accumulated losses be available for Mr Clark’s purpose. Such expectation or hope says nothing about the identity of the trust estate. Changes in the ownership of units were clearly contemplated by the trust deed. Changes in the terms of the trust were also contemplated, as was augmentation of the fund. But where a trust has been effectively deprived of all assets and re-endowed, I see no way in which it can be said that the original trust estate has continued.

...

77. The Commissioner’s case that there was a lack of continuity, indeed ‘substantial discontinuity’, between the trust estate, the trustee of which made the capital gain in the 2001 year of income from the sale of the Gladstone properties, and the trust estate, the trustee of which incurred the capital losses in the 1991, 1992 and 1993 years of income, insofar as it relied on the reasons for judgment of the High Court in *Federal Commissioner of Taxation v Commercial Nominees of Australia Limited* [2001] HCA 33; (2001) 75 ALJR 1172, in particular at [36], where a similar issue arose, albeit in respect of revenue losses, in the case of a superannuation fund in

²¹⁶¹ 47 T.C. 353

²¹⁶² If the estate is lacking liquidity to do this then the testamentary beneficiaries can pay for it as “an expenditure” cited in Sec. 69(1.1)(b) and have it deductible against a right or thing realization if such is the case. Alternatively arguable, since the interest in the estate/trust is being disposed of the legal expenses should be considered as an “outlay or expense” for capital gains disposition purposes.

²¹⁶³ 179 A.L.R. 655, HCA

²¹⁶⁴ See notes above on the extent to which a trust can be resettled and still be maintained as the same trust since if I were earning a CRA salary I’d certainly want lose of loss-carry forwards when there were overwhelming tax savings on another front.

²¹⁶⁵ Catherine Brown has written a rather comprehensive piece, “Trusts, Losses and Affiliated Persons: The New Legislation: What the Prudent Trust or Estate Practitioner Should Know” in *Estates, Trusts and Pensions*, Vol. 24, Pg. 98 that addresses stop-loss rules on trust-settlor-beneficiary transfers and the new affiliated person rules.

²¹⁶⁶ See also “Income Tax Consequences of Trust Variation, Revocable Trusts and Powers of Appointment”, *Estates, Trusts and Pensions*, Vol. 24 Pg. 141 by Timothy G. Youdan, for concerns over variations and some lessor detail on powers of appointment.

²¹⁶⁷ [2011] FCAFC 5 (21 January 2011). The case is well worth reading for bringing into effect a considerable amount of other jurisprudence.

the context of the provisions of Pt IX of the 1936 Act, was a misconstruction of those reasons. The case came up to the High Court via the Administrative Appeals Tribunal and a Full Court of this Court, and after considering the resettlement analysis considered and rejected by the Full Court as 'not to the point' ((1999) 167 ALR 147 at [47]), Gleeson CJ, Gaudron, McHugh, Kirby and Callinan JJ said at [36]:

'As the Full Court, and the Administrative Appeals Tribunal held, the question is one of continuity, to be considered in the context of a superannuation fund which, of its nature, may be expected to undergo change. The question is whether the eligible entity which derived the taxable income in the year ended 30 June 1995 is a different entity from the eligible entity that incurred losses in the earlier years. If, as the appellant contends, it is a different entity, there is a question as to what happened to the original entity. The three main indicia of continuity for the purposes of Pt IX are **the constitution of the trusts** under which the fund (if a trust fund) operated, **the trust property**, and **membership**. **Changes in one or more of those matters must be such as to terminate the existence of the eligible entity, or to produce the result that it does not derive the income in question**, to destroy the necessary continuity. The trusts under which the fund operated in 1994–95 were constituted by the original trust deed in 1988 as varied by the exercise, in 1993, of a power of amendment. The property the subject of the trusts did not alter at the time the amendments took effect. Persons who were members of the fund before the amendments remained members of the fund after the amendments. The fund, both before and after the amendments, was administered as a single fund, and treated in that way by the regulatory authority.' (Emphasis added.)

78. In doing so, their Honours cited, with apparent approval (although the Commissioner disputes this), the following passage from the reasons of the Full Court:

[48] In their application to a trust established as part of a superannuation scheme, ss 79E and 80 cannot be construed literally. The "taxpayer" referred to in the sections, when applied to a trust, must be taken to refer to the trustee for the time being of the trust. Thus, in so far as s 272 has the effect that taxable income of a superannuation fund is to be calculated *as if* the trustee were a taxpayer, there must be an underlying assumption that the reference is to the person that from time to time acts in the capacity as trustee of the superannuation fund. In a sense, there is a notional person treated as continuing to exist, being the trustee for the time being. Accordingly, the fact that the identity of a trustee, whether individual or corporate, changes from year of income to year of income, would not exclude the availability as a deduction of losses under s 79E or s 80.

[49] While the propositions just articulated were accepted by the Commissioner, the Commissioner's contentions do not adequately deal with the consequences of those propositions. Thus, the fact that lack of continuity in the identity of the trustee from income year to income year would not prevent losses in an earlier year being available as deductions from assessable income of a later year, means that criteria must be established for determining when there is sufficient identity of the trusts involved to warrant such deductions being allowable. **The Commissioner was not able to refer to any express statutory requirement of continuity, or to any relevant statement of applicable criteria in the legislation.**

[50] The approach of the Assessment Act in relation to trusts is to direct attention to the trust property. "Fund" when used in Pt IX must mean a "stock or sum of money, especially if set apart for a particular purpose" (*New Shorter Oxford Dictionary*) or a "stock of money or pecuniary resources": *Macquarie Dictionary*. The use of the term "trust estate", which is not defined in the Assessment Act, is analogous to the use of the expression "fund" as that expression is defined and used in Pt IX.

[51] Neither refers to a legal person. Both terms must be taken to refer to the conglomeration of property in respect of which trust obligations and corresponding rights exist from time to time. Putting it another way, a trust estate or a superannuation fund will be that property the

ownership of which is divided between trustee and beneficiary. The trustee will always be ascertainable. However, the class of beneficiaries, while identifiable, will not necessarily be closed and all beneficiaries may, of course, not be ascertainable.

[52] The trust obligations of the trustee and the corresponding rights of the beneficiaries may vary from time to time, in accordance with law. Similarly, the property that is the subject of such obligations and rights will not be static. Parts of the property might be distributed so as to cease to be subject to trust obligations. Further property may accrue as income or by further settlement so as to become subject to obligations where previously that additional property was not.

[53] However, at any given time it will be possible to identify the property that is the subject of the trust obligations and in respect of which the rights of beneficiaries exist. It is the income which accrues from that property, less outgoings from that property, that go to make up the *taxable income* of the trust estate or fund. Thus, the Assessment Act requires a calculation of taxable income in respect of the trust property, to which it sometimes refers as the *trust estate* and at other times as the *fund* (in Pt IX).

[54] The Assessment Act then imposes a liability either on the beneficiaries or, in some cases, on the trustee in a representative capacity. "Superannuation fund", as that term is defined in the SIS Act and the Assessment Act, contemplates a continuing regime regulating the manner in which a fund may be added to and the manner in which payments may be made from it. So long as one can identify a continuity of that regime, that will be sufficient.

[55] Thus, in order to determine whether losses of particular trust property are allowable as a deduction from income accruing to that trust property in a subsequent income year, **it will be necessary to establish some degree of continuity of the trust property** or corpus that earns the income from the income year of loss to the year of income. **It will also be necessary to establish continuity of the regime of trust obligations** affecting the property in the sense that, while amendment of those obligations might occur, any amendment must be in accordance with the terms of the original trust.

[56] **So long as any amendment of the trust obligations relating to such trust property is made in accordance with any power conferred by the instrument creating the obligations, and continuity of the property that is the subject of trust obligation is established, there will be identity of the "taxpayer" for the purposes of s 278 and ss 79E(3) and 80(2), notwithstanding any amendment of the trust obligation and any change in the property itself.**

[57] In the present case, there has been continuity of the regime regulating the fund. The amendment that took place in 1993 was in accordance with the provisions of the original trust deed. Further, it is a straightforward matter to trace the continuity of the property that has been the subject of that regime since the 1989 and 1990 income years. Accordingly, there has been sufficient continuity of the fund from the 1989 and 1990 income years to the 1995 income year. The change of name in 1990 and the change of rules from time to time did not interfere with the continuity of the fund that was established in 1988. It is relevant to note that the Act expressly recognises the legislative regime governing superannuation, and takes that as it finds it. If any concept of continuity is implicit in the relevant provisions of the Act, it more naturally relates to continuity under the separate provisions. If that be the test, it is satisfied here. It follows that there is available, in calculating the taxable income of the fund for the 1995 income year, the losses incurred in the 1989 and 1990 income years.'

(Italics in original; bold emphasis added.)

79. As indicated above, the Commissioner disputed that the High Court at [36] of its reasons endorsed this passage from the reasons of the Full Court but, in our view, it is clear that it did. First, the High Court referred to the fact that the original trust deed as constituted in 1988 was varied by the exercise in 1993 of a power of amendment. That was, in our view, an express endorsement of what the Full Court said in [56] of its reasons. The Commissioner referred to the

High Court's references to no alterations in trust property at the time the amendments took effect and to common identity of some membership before and after the amendments as indicating such changes could break the continuum necessary to maintain the existence of the eligible entity or trust estate. But in our view it was no more than the High Court illustrating that there could be no doubt as to the continuity of the trust property and membership indicia in the case before it because the identity of the trust property had not even altered at the time of the amendments and there was even common identity of some membership either side of the amendments.

80. The Commissioner articulated his case on appeal that there was a 'substantial discontinuity' with respect to each of the three main indicia identified by the High Court in *Commercial Nominees* in the following way:

(1) So far as the constitution of the trusts was concerned, there were two significant changes:
(i) First, the trustee waived its right of indemnity – the effect of this waiver was the creation of a new trust.

(ii) Second, by reason of a deed between the Clark and Denoon interests, the rights to income of the trust ceased to be completely governed by the terms of the trust deed.

(2) So far as trust property was concerned, there was a substantial change. Prior to the relevant transactions the trustee's liabilities exceeded the trust assets by \$3,910,880. In that sense, there was no trust property because there were no assets to which beneficiaries could be entitled once the trustee's liabilities had been discharged and its indemnity satisfied. After the relevant transactions, the trust had the settlement sum of \$10 and \$1.8m in cash provided by the Clark interests, both of which were free of the former trustee's right of indemnity. There was now trust property.

(3) So far as membership was concerned, immediately after the relevant transactions, the Denoon interests effectively ceased to have any enforceable rights as unit holders in the trust. That position was put beyond doubt when the Denoon interests transferred their units to the Clark interests for the nominal sum of \$5.00 in 1996. In short, there was a completely different set of unit holders in place in the 2001 year when the capital losses were said to be set-off against the capital gain from the sale of the Gladstone properties in 2001, from that which was in place just before the events of June 1993.

81. Dealing with each of these in turn.

Constitution of the Trusts

82. Carringbush's waiver of its right to be indemnified out of the CU Trust in respect of liabilities incurred by it in properly discharging its powers and duties as trustee, no more created a new trust estate than it terminated an existing one. At the very most, it may have extinguished a 'beneficial interest' in the trust assets which Carringbush had by virtue of that right: *Octavo Investments Pty Ltd v Knight* [1979] HCA 61; (1979) 144 CLR 360 at 367 per Stephen, Mason, Aickin and Wilson JJ, but even that is not clear. As noted in [30] above, there was no alteration to the terms of the trusts embodied in the Deed of Trust and no exclusion of the right of indemnity under that document by way of amendment. Even if Carringbush's beneficial interest in the trust assets was extinguished by the waiver it did no more than extinguish an interest which ranked in priority to those of the beneficiaries; the beneficiaries' interests are not "encumbered" by the trustee's right': *Chief Commissioner of Stamp Duties (NSW) v Buckle* [1998] HCA 4; (1998) 192 CLR 226 at 247, and in some way altered by the extinguishment.

83. The contention that, by reason of a deed between the Clark and Denoon interests, the rights to income of the CU Trust ceased to be completely governed by the terms of the Deed of Trust is also misconceived. The rights under the Deed of Trust were not affected. It was the exercise of those rights which were the subject of the arrangements between the Clark and Denoon interests pending the matching contribution of \$1.8 million by Denoon interests. These arrangements did not vary the trusts of the CU Trust let alone terminate them or bring a new trust estate into existence.

Trust Property and Membership

84. At [32] of its reasons in *Commercial Nominees*, the High Court observed that the nature of an eligible entity was such that changes in the incidents of the trust relationship established on its creation are not only possible, but in some respects probable. The Court went on to say:

‘In the case of an indefinitely continuing superannuation fund, operating under the regulatory scheme in the SIS Act, the trustee might change from time to time. The trust property would almost certainly be in a constant state of change, as contributions were received and employee benefits were paid. The identity of the persons entitled to benefit under the trust would be likely to change over time, as new members came into the scheme and others left. The nature of the benefits provided by the scheme might alter over the years, in response to industrial or market pressures, or regulatory requirements. In the case of a public offer superannuation fund, there would be likely to be substantial changes of membership over time, as new participating employers brought their employees in.’

...

87. We cannot accept the Commissioner’s contention. When the High Court in *Commercial Nominees* spoke of trust property and membership as providing two of the indicia for the continued existence of the eligible entity or trust estate, the Court was not suggesting that there had to be a strict or even partial identity of property for the first and objects for the second. It was speaking more generally: that there had to be a continuum of property and membership, which could be identified at any time, even if different from time to time; and without severance of one or both leading to the termination of the trust in question. In the present case, the Commissioner never contended, nor on the evidence could he, that there was a severance in the continuum of trust property and objects of the CU Trust. Their identity changed from time to time, but not their continuum.

88. Such an approach is consistent with the position at general law in relation to the four essential indicia of the existence of a trust: the trustee, trust property, the beneficiary and an equitable obligation annexed to the trust property: JD Heydon & MJ Leeming: *Jacobs’ Law of Trusts in Australia* (2006) 7th ed, at [104] – [110]. In *Commercial Nominees* both the Full Court, at [49] of its reasons, and the High Court, at [35] of its reasons, pointed out that there was nothing in Pt IX, nor in the 1936 Act generally, which imposed some statutory requirement of continuity for determining when there is a sufficient identity of the trusts involved. With respect, the same applies in the case of Div 6 of Pt III of the 1936 Act.”

There are no en mass deemed disposition provisions applicable to trust property that undergoes a variation but is it possible to vary only those in relation to some of its property so that it is only that property that is considered disposed of and reacquired without affecting the other property? Can the same be said for interests affected?

“Variation of trust – Sec. 108(6)”

(6) Where at any time the terms of a trust are varied

(a) for the purposes of subsections 104(4), (5) and (5.2) and subject to paragraph (b), the trust is, at and after that time, deemed to be the same trust as, and a continuation of, the trust immediately before that time;

(b) for greater certainty, paragraph (a) does not affect the application of paragraph 104(4)(a.1); and

(c) for the purposes of paragraph 53(2)(h), subsection 107(1), paragraph (j) of the definition “excluded right or interest” in subsection 128.1(10) and the definition “personal trust” in subsection 248(1), no interest of a beneficiary under the trust before it was varied is considered to be consideration for the interest of the beneficiary in the trust as varied.

“Trust-to-trust transfers – Sec. 248(25.1)”

(25.1) If, at any time, a particular trust transfers property to another trust (other than a trust governed by a registered retirement savings plan or by a registered retirement income fund) in circumstances to which paragraph (f) of the definition “disposition” in subsection (1) applies, without affecting the personal liabilities under this Act of the trustees of either trust or the application of subsection 104(5.8) and paragraph 122(2)(f),

(a) the other trust is deemed to be after that time the same trust as, and a continuation of, the particular trust; and

(b) for greater certainty, if, as a result of a transaction or event, the property was deemed to be taxable Canadian property of the particular trust by any of paragraphs 51(1)(f), 85(1)(i) and 85.1(1)(a), subsection 85.1(5), paragraph 85.1(8)(b), subsections 87(4) and (5) and paragraphs 97(2)(c) and 107(3.1)(d), the property is also deemed to be, at any time that is within 60 months after the transaction or event, taxable Canadian property of the other trust.

It should be noted that when one sees the term variation in a trust to cause it to have the same identity as that from which it was varied such doesn't apply to a special power of appointment that operates to resettle the property under a different trust per the parameters of the special power grantor. It is recognized that the beneficiaries or statute law are not making the variation, but the property is being resettled pursuant to the intentions of the settlor inherent in the special power. When the power is special and not general, it is the settlor who is recognized in common-law to be the transferor of the property, not the trust from which it is taken. Exercises thus avoid all provisions that target variations.

““disposition” – Sec. 248(1)”

“disposition” of any property, except as expressly otherwise provided, includes

(a) any transaction or event entitling a taxpayer to proceeds of disposition of the property,

(b) any transaction or event by which,

(i) where the property is a share, bond, debenture, note, certificate, mortgage, agreement of sale or similar property, or an interest in it, the property is redeemed in whole or in part or is cancelled,

(ii) where the property is a debt or any other right to receive an amount, the debt or other right is settled or cancelled,

(iii) where the property is a share, the share is converted because of an amalgamation or merger,

(iv) where the property is an option to acquire or dispose of property, the option expires, and

(v) a trust, that can reasonably be considered to act as agent for all the beneficiaries under the trust with respect to all dealings with all of the trust's property (unless the trust is described in any of paragraphs (a) to (e.1) of the definition “trust” in subsection 108(1)), ceases to act as agent for a beneficiary under the trust with respect to any

dealing with any of the trust's property,

(c) any transfer of the property to a trust or, where the property is property of a trust, any transfer of the property to any beneficiary under the trust, except as provided by paragraph (f) or (k), and

(d) where the property is, or is part of, a taxpayer's capital interest in a trust, except as provided by paragraph (h) or (i), a payment made after 1999 to the taxpayer from the trust that can reasonably be considered to have been made because of the taxpayer's capital interest in the trust, but does not include

(e) any transfer of the property as a consequence of which there is no change in the beneficial ownership of the property, except where the transfer is

(i) from a person or a partnership to a trust for the benefit of the person or the partnership,

(ii) from a trust to a beneficiary under the trust, or

(iii) from one trust maintained for the benefit of one or more beneficiaries under the trust to another trust maintained for the benefit of the same beneficiaries,

(f) any transfer of the property as a consequence of which there is no change in the beneficial ownership of the property, where

(i) the transferor and the transferee are trusts,

(ii) the transfer is not by a trust resident in Canada to a non-resident trust,

(iii) the transferee does not receive the property in satisfaction of the transferee's right as a beneficiary under the transferor trust,

(iv) the transferee held no property immediately before the transfer (other than property the cost of which is not included, for the purposes of this Act, in computing a balance of undeducted outlays, expenses or other amounts in respect of the transferee),

(v) the transferee does not file a written election with the Minister on or before the filing-due date for its taxation year in which the transfer is made (or on such later date as is acceptable to the Minister) that this paragraph not apply,

(vi) if the transferor is an amateur athlete trust, a cemetery care trust, an employee trust, an *inter vivos* trust deemed by subsection 143(1) to exist in respect of a congregation that is a constituent part of a religious organization, a related segregated fund trust (in this paragraph having the meaning assigned by section 138.1), a trust described in paragraph 149(1)(o.4) or a trust governed by an eligible funeral arrangement, an employees profit sharing plan, a registered disability savings plan, a registered education savings plan, a registered supplementary unemployment benefit plan or a TFSA, the transferee is the same type of trust, and

(vii) the transfer results, or is part of a series of transactions or events that results, in

the transferor ceasing to exist and, immediately before the time of the transfer or the beginning of that series, as the case may be, the transferee never held any property or held only property having a nominal value,

(g) [Repealed, 2005, c. 30, s. 17]

(h) where the property is part of a capital interest of a taxpayer in a trust (other than a personal trust or a trust prescribed for the purpose of subsection 107(2)) that is described by reference to units issued by the trust, a payment after 1999 from the trust in respect of the capital interest, where the number of units in the trust that are owned by the taxpayer is not reduced because of the payment,

(i) where the property is a taxpayer's capital interest in a trust, a payment to the taxpayer after 1999 in respect of the capital interest to the extent that the payment

(i) is out of the income of the trust (determined without reference to subsection 104(6)) for a taxation year or out of the capital gains of the trust for the year, if the payment was made in the year or the right to the payment was acquired by the taxpayer in the year, or

(ii) is in respect of an amount designated in respect of the taxpayer by the trust under subsection 104(20),

(j) any transfer of the property for the purpose only of securing a debt or a loan, or any transfer by a creditor for the purpose only of returning property that had been used as security for a debt or a loan,

(k) any transfer of the property to a trust as a consequence of which there is no change in the beneficial ownership of the property, where the main purpose of the transfer is

(i) to effect payment under a debt or loan,

(ii) to provide assurance that an absolute or contingent obligation of the transferor will be satisfied, or

(iii) to facilitate either the provision of compensation or the enforcement of a penalty, in the event that an absolute or contingent obligation of the transferor is not satisfied,

(l) any issue of a bond, debenture, note, certificate, mortgage or hypothecary claim, and

(m) any issue by a corporation of a share of its capital stock, or any other transaction that, but for this paragraph, would be a disposition by a corporation of a share of its capital stock;