for the entire duration of the trust. Income and capital distributions may also vary depending on the beneficiary's age and needs, or be at the entire discretion of the trustees. As for capital, the settlor may provide that it will be shared equally or unequally among the beneficiaries. Again, the deed may refer to a minimum, a maximum, or amounts based on the age of the beneficiary, or the circumstances, or leave the capital distributions at the discretion of the trustees. The trustee may have total discretion as to payment of capital or its preservation.

When the Act refers to income and capital, it does so by referring to the concepts of "income interest" and "capital interest". There is no specific definition of the words "income" and "capital" in the ITA. As discussed below, subsection 108(3) of the ITA defines "income", for specified provisions of the Act, as income under trust law, not income under the Act. We must then refer to property and private law to determine what is income of a trust and what is capital of a trust.

It is important to understand the distinctions between income under trust law and income under the Act. For example, the distinction needs to be understood to ensure that the income will actually be paid to the income beneficiary chosen by the settlor. In addition, a mischaracterization of what constitutes income can affect the tax qualification of certain trusts, such as a spousal trust or self-benefit trust, and therefore the ability to transfer assets to the trust on a tax-deferred basis. For example, under subsection 70(6) of the ITA, one of the conditions for a testamentary spousal trust to benefit from the tax rollover is that the spouse must be entitled to receive all the income of the trust arising before the spouse's death. In this context, income is determined under trust law, and can exclude some dividends described under subsection 108(3), as discussed below.

¶16,100 Income and Capital Interest for Tax Purposes

¶16,110 Income Interest

The concept of "income interest" under the Act makes reference to the notion of "personal trust". We begin our analysis by examining more closely the concepts of "income interest" and "personal trust" before determining what constitutes income of a trust.

¶16,112 Statutory Definition of "Income Interest"

The expression "income interest"[1] is defined as

> . . . 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.

¶16,114 Concept of "Personal Trust"

A "personal trust"[2]

> . . . means a trust (other than a trust that is, or was at any time after 1999, a unit trust) that is
>
> (*a*) a graduated rate estate, or
>
> (*b*) a trust in which no beneficial interest was acquired for consideration payable directly or indirectly to
>
> (i) the trust, or
>
> (ii) any person or partnership that has made a contribution to the trust by way of transfer, assignment or other disposition of property.

The definition of "personal trust" was modified for 2016 and subsequent taxation years to now include graduated rate estates. All trusts are now covered under (*b*) whereas only *inter vivos* trusts were covered under the prior definition.

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[1] ITA, s. 108(1), definition of "income interest".

[2] ITA, s. 248(1), definition of "personal trust".

¶16,116 Definition of "Income" of a Trust

The Act defines "income" in certain specific contexts.[3] It indicates that for the purposes of the definition of "income interest" in subsection 108(1) of the ITA, the income of a trust is its income, computed without reference to the Act. The legislator therefore relies on the notion of what constitutes income and capital under trust law.

This is discussed at ¶16,400, "Income and Capital Under Trust Law".

¶16,118 Application of Subsection 108(3) of the ITA to Certain Provisions of the Act

Subsection 108(3) of the ITA also indicates that for the purposes of paragraphs 70(6)(*b*) and (6.1)(*b*), 73(1.01)(*c*), and 104(4)(*a*) of the ITA, the income of a trust is its income computed without reference to the Act, minus any dividends included in that income that are capital dividends not included in the income of the trust due to the application of section 83 of the Act, and dividends described in subsection 131(1) of the ITA, capital gains dividends from a mutual fund corporation, and dividends to which subsection 131(1) applies because of the application of subsection 130(2). Amounts to which section 83 or subsection 131(1) apply are essentially capital gains. Under trust law, capital gains would not be considered income. For trust accounting purposes, capital gains are "capital", not income.

This means, for example, that a trust will not be precluded from qualifying as a spousal trust because of the fact that, under the terms of the trust, such dividends are not required to be paid to the spouse.

With respect to a capital dividend, an election, in prescribed manner and prescribed form, must be filed by the corporation to designate the dividend as a capital dividend.[4] Such an election has the effect of excluding the capital dividend from the concept of income as described in subsection 108(3).

[3] ITA, s. 108(3).
[4] ITA s. 83(2).

¶16,120 Capital Interest

The term "capital interest" is defined in subsection 108(1) of the Act to clarify that it includes a right of the beneficiary to enforce payment of an amount by the trust, but does not include any income interest in the trust.

¶16,400 Income and Capital Under Trust Law

Whether an amount is income for trust law purposes is generally determined with reference to the trust indenture and applicable private law. Generally accepted accounting principles may assist in determining whether an amount is income or capital.[5] As mentioned above, unless the trust instrument provides otherwise, capital gains are "capital" for trust law purposes. With respect to corporate distributions, the form rule generally applies. It is understood to be as follows (subject to the terms of the particular trust):[6]

(1) Dividends paid in cash, in kind, or by promissory note, including capital dividends, will generally be treated as income for trust law purposes.

(2) Stock dividends, proceeds of redemption or purchase for cancellation of shares, and distribution on winding-up of a corporation will be treated as capital for trust law purposes.

(3) Deemed dividends and deemed capital gains (referred to as "phantom income") are not recognized for trust law purposes. Phantom income is a nothing for trust law purposes.[7] If phantom income is not addressed in the trust agreement, then the amount must be taxed in the trust (at the top marginal rate), rather than being taxed in the hands of a beneficiary (perhaps at a lower marginal rate).

With respect to capital dividends in general, the CRA states:[8]

[5] Technical Interpretation 2001-0113735, March 5, 2002.
[6] Joan E. Jung, "Income and Payment: Key Trust Law and Income Tax Differences," STEP Canada, 18th National Conference, June 10, 2016.
[7] Technical Interpretations 2004-0069951C6, June 21, 2004; and 9425345, February 24, 1995.
[8] Technical Interpretation 2004-0060161E5, September 17, 2004.

As indicated by the Supreme Court in the case of *Waters v. Toronto General Trusts Corporation*, [1959] S.C.R. 889, "it may be said that while, for the purposes of the *Income Tax Act*, a company's undistributed profits may be 'capitalized', such need not be the result for all purposes." Where the trust indenture does not specifically provide which beneficiary is entitled to receive dividends and the trust is governed by civil law, we have opined in 2001-007684 that a capital dividend paid out of the retained earnings is income and that proceeds from the redemption of shares are capital. Similarly, where the trust indenture does not specifically track the amount of a capital dividend to a given beneficiary and the trust is governed by Canadian common law, the *Waters* case, stands for the proposition that a cash dividend is income and that the distribution of a stock dividend is on capital account because "here form is substance; and the moment form has changed the character of the earnings as assets, the intention follows that change".

Where the trust indenture does indicate which beneficiary is entitled to receive dividends and the trust is governed by Canadian common law, the cases of *Smith Estate v. Smith Estate*, 37 E.T.R. (2d) 151 and *Re Welsh*, (1980) 28 O.R. (2d), 403 stand for the proposition that a cash capital dividend received by a trust governed by Canadian common law is capital where two conditions are met.

First, the amount being distributed by way of cash capital dividend must arise from the disposition of assets which have been bequeathed or transferred to a trust as capital. *Smith Estate* dealt with the transfer by a deceased of shares of a company which, in the process of being wound up a few months after the testator's passing, disposed of its main asset and distributed a capital dividend to the estate. *Re Welsh* dealt with an individual bequeathing his shares of a corporation, the assets of the corporation being disposed of shortly after the testator's passing and the corporation distributing those proceeds by paying dividend to the estate three years after that moment. In both cases, the Court concluded that the dividend was of a capital nature.

Second, the trust indenture shall clearly and specifically provide that the settlor/testator's intention was to have the proceeds of disposition or the value of those assets treated as capital. The length of the time lapse between the creation of the trust/estate and the moment of that disposition will play a determining role in making that determination. Rand J. suggests that this condition would have been met in the *Waters* case had the testator "made it clear that the shares, in the value based on the assets then existing, were to be treated as capital and the income thereafter to be related to subsequent earnings only; but he did not do that; what he did was to bequeath the 'income'". In the *Smith Estate* case, the terms of the trust directed all stock dividends to

be dealt with as capital and authorized the trustees to retain such shares or the proceeds thereof as they see fit. The Court indicated that "it is clear from that clause that the testator intended that the proceeds on the shares of stock be dealt with as capital".

Absent one of those two conditions, the cases where cash capital dividends are characterized as income at law are consistent with the approach dictated by the Supreme Court of Canada and such dividends are on income account, irrespective of the source of the money being distributed by way of dividend and of the fact that the dividend stems out of a capital account for tax purposes (*Re Zacks*, 17 E.T.R. 206, *National Victoria & Grey Trust Co. Ltd. v. Baker*, 24 E.T.R. 306, *Re Allan's Trust*, (1986), 37 Man. R. (2d) 203).

As indicated in 2001-0076845, we do not recognize the exercise by a trustee of a power to characterize the nature of the amounts that it receives as income or capital, unless the trustee applies the above mentioned principles.

¶16,500 Income and Capital Under Civil Law

The Civil Code provides certain rules for distinguishing capital from income[9] and determining how the benefits and costs must be apportioned between the revenue account and the capital account.[10] There are important differences between what constitutes income for tax purposes and what constitutes income for civil law purposes.

The CCQ indicates[11] that property, according to its relation to other property, is divided into capital, and fruits and revenues. Section 909 of the CCQ defines capital as:

> Property that produces fruits and revenues, property appropriated for the service or operation of an enterprise, shares of the capital stock or common shares of a legal person or partnership, the reinvestment of the fruits and revenues, the price for any disposal of capital or its reinvestment, and expropriation or insurance indemnities in replacement of capital, are capital.

As an example of reinvestment of revenues, we can think about compounded interest. "Capital also includes . . . bonds and other loan certificates payable in cash and rights the exercise of which tends to increase the capital, such as the right to subscribe to securities of a legal person, limited partnership or trust."

[9] Such as sections 908–910 of the CCQ.
[10] CCQ, s. 1345–1350.
[11] CCQ, s. 908.

capital gains are payable by the trust upon the date that is the earlier of the sale of such property and the death of the surviving spouse pursuant to paragraph 104(4)(*a*).

As a consequence to the changes to the taxation of income of testamentary trusts that were enacted in 2016, certain changes were made to subsection 104(6) of the ITA and new subsection 104(13.4) of the ITA was enacted to allow income that should have been taxed in a testamentary spousal trust upon the death of the spouse beneficiary at the highest marginal tax rate, to rather be taxed in the hands of the spouse beneficiary. The objective of these measures was to allow the spouse beneficiary to pay tax at graduated rates instead of having the trust pay tax at the highest marginal tax rate. However, considering the issues this new measure was causing, in the 2016 Budget, the Minister of Finance confirmed the intention of the government to proceed with draft legislative proposals to modify the income tax treatment of certain trusts and their beneficiaries, and ensuring income arising in certain trusts (including testamentary spousal trusts) on the death of the primary beneficiary would be taxed in the hands of the trust and not the beneficiary.

Amendments were then made to subsection 104(13.4) of the ITA to ensure that income arising upon the death of the surviving spouse would be taxed at the trust level and not in the hands of the beneficiary, as it was the case before January 1, 2016.

Paragraphs (*a*) to (*b*.1) of subsection 104(13.4) of the ITA now read as follows:

> 104(13.4) **Death of beneficiary — spousal and similar trusts.** If an individual's death occurs on a day in a particular taxation year of a trust and the death is the death or later death, as the case may be, referred to in paragraph (4)(*a*), (*a*.1) or (*a*.4) in respect of the trust,
>
> (*a*) the particular year is deemed to end at the end of that day, a new taxation year of the trust is deemed to begin immediately after that day and, for the purpose of determining the trust's fiscal period after the new taxation year began, the trust is deemed not to have established a fiscal period before the new taxation year began;
>
> (*b*) subject to paragraph (*b*.1), the trust's income (determined without reference to subsections (6) and (12)) for the particular year is, notwithstanding subsection (24), deemed
>
> (i) to have become payable in the year to the individual, and
>
> (ii) not
>
> (A) to have become payable to another beneficiary, or
>
> (B) to be included under subsection 105(2) in computing the individual's income;
>
> (*b*.1) paragraph (*b*) does not apply in respect of the trust for the particular year, unless
>
> (i) the individual is resident in Canada immediately before the death,
>
> (ii) the trust is, immediately before the death, a testamentary trust that
>
> (A) is a post-1971 spousal or common-law partner trust, and
>
> (B) was created by the will of a taxpayer who died before 2017, and
>
> (iii) an election — made jointly between the trust and the legal representative administering the individual's graduated rate estate in prescribed form — that paragraph (*b*) applies is filed with
>
> (A) the individual's return of income under this Part for the individual's year, and
>
> (B) the trust's return of income under this Part for the particular year;

As mentioned in the editorial notes found in IntelliConnect under subsection 104(13.4) of the ITA, beginning in 2016, a spousal or common-law partner trust is deemed to have a taxation year end at the end of the day on which the spouse beneficiary dies. The income of the trust for that taxation year that is not payable to the spouse beneficiary is included in the trust's income and cannot be deducted even if payable to another beneficiary. In the limited circumstances in which paragraph 104(13.4)(*b*) applies (see paragraph 104(13.4)(*b*.1)), all of the income of the trust for that year is deemed to be payable to the spouse beneficiary and therefore included in that beneficiary's income rather than the trust's income.

So, it may be possible to make an election under subsection 104(13.4) to have the testamentary spousal trust income taxed in the hands of the beneficiary provided that the testator died before

2017. Of course, the possibility to make this election will arise only upon death of the surviving spouse which may occur in many years.

For example, if the spouse has unused capital losses or could claim the capital gains exemption upon the sale of QSBC shares, it may be appropriate to have the trust income taxed in the hands of the spouse beneficiary, especially if the trust capital beneficiaries are the children of the beneficiary spouse. However, this election is an all or nothing designation. It is not possible to make the election only on capital gains, for example, and have the other types of income taxed at the trust level.

Upon death of the spouse beneficiary, the trustees will have to look back to the year of death of the testator to assess whether or not the election is available.

New subsection 160(1.4) of the ITA makes the trust and the estate of the spouse beneficiary jointly and severally liable for taxes. Under the explanatory notes released in October 2014, we understand that the minister would apply subsection 160(2) of the ITA as though the trust was primarily liable for the taxes.

It also has to be noted that subsection 110.6(12) of the ITA was repealed in 2016. This provision allowed a testamentary spousal trust to claim the capital gains exemption. As such, a testamentary spousal trust can no longer access the unused capital gains exemption of the beneficiary spouse for the year in which the spouse dies. When doing the estate planning, we must now consider whether transactions should be made while the spouse is alive to still claim the capital gains exemption, or should QSBC shares be bequeathed outright to the spouse, or depending on their value, be bequeathed partly to the spouse outright and partly to the testamentary spousal trust.

Referring to an alter ego trust, the CRA indicated that where an amount of trust income has become payable to the primary beneficiary of an alter ego trust before that beneficiary's death, paragraph 104(6) of the ITA will apply to the trust. As such, the trust can claim a deduction. However, no deduction is available in respect of capital gains and other amounts recognized by the trust upon the

death of the beneficiary, considering the element B of the formula in paragraph 104(6)(*b*)) of the ITA. For the trust's year end in which the primary beneficiary dies, subclause (i)(B)(I) ensures that no deduction is available to the trust in respect of any amount included in the trust's income because of the application of subsections 104(4) to (5.2) which refer to the deemed disposition rules.[1]

As such, capital gains would be taxable inside the alter ego trust and as a trust cannot claim the capital gains exemption, the exemption is lost.

The same reasoning would apply to a testamentary spousal trust as paragraphs 104(13)(*a*) and 104(6)(*b*) of the ITA also apply to testamentary spousal trusts.[2]

¶24,100 Freezing the Testamentary Spousal Trust

The amount of tax payable on the death of the surviving spouse is a function of the nature of the property held by the testamentary spousal trust (the deemed disposition rule applies to capital property and to land included in the inventory of a business of the trust) and the increase in value of such property during the period when the spouse was a beneficiary of the trust. Although the surviving spouse must receive all of the income of the trust in order for the trust to qualify as a testamentary spousal trust, the fact remains that if the trust holds shares of private or public companies, or holds real estate properties, the difference between the FMV of such assets upon the death of the surviving spouse, and the adjusted cost base ("ACB"), may give rise to a significant tax bill.

As such, implementing a freeze of the assets held by the testamentary spousal trust is an option to consider in order to minimize the tax that will ultimately be triggered following the death of the surviving spouse. The purpose of an estate freeze is to transfer the future growth in value of the assets to another entity.

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[1] Technical Interpretation 2017-0717831E5, May 30, 2018.
[2] STEP/CRA Roundtable, Question 11, May 29, 2018.

In an advance income tax ruling,[3] the CRA commented on the legitimacy of such a transaction that limited the exposure of the testamentary spousal trust to capital gains tax on the spouse's death, and maximized the value transferred to the grandchildren of the spouse who were to be the ultimate capital beneficiaries.

In the situation submitted to the CRA, the testamentary spousal trust held common shares of a private company and publicly traded stocks. The object of the transaction was to freeze the value of the shares held by the testamentary spousal trust in order to minimize the taxes payable upon the death of the surviving spouse. To achieve this result, a new corporation ("Newco") was to be incorporated to acquire the shares held by the testamentary spousal trust. The trust would then transfer its shares to Newco and receive in exchange preferred shares of Newco, redeemable for an amount equal to the FMV of the private and publicly traded shares transferred. An election under section 85 of the Act would apply to such a transfer. The testamentary spousal trust would then subscribe for Class A voting, redeemable, retractable preferred shares of Newco. An *inter vivos* trust would be set up, the terms of which would be identical to those set out in the testamentary spousal trust. More specifically, the spouse would be entitled to all of the income of the new trust and no one other than the spouse could receive capital from the trust during the lifetime of the spouse. On the spouse's death, the remaining capital of the trust would then be divided in equal shares among the spouse's grandchildren. The newly created *inter vivos* trust would subscribe for common shares of Newco, allowing it to benefit from any future increase in value of the private and publicly traded shares held by Newco. The question submitted to the CRA was whether the testamentary spousal trust could lose its status as a testamentary spousal trust following such proposed transactions. The CRA concluded that in spite of the proposed transactions, the testamentary spousal trust would keep its status as a "testamentary trust" pursuant to subsection 108(1), and would not cease to be a trust described under subsection 70(6) and paragraph 104(4)(*a*) of

[3] Technical Interpretation 2004-0089251R3, November 1, 2006.

the ITA. The CRA also stated that sections 245 and 246 of the Act would not apply to the proposed transactions herein described.

This may be an interesting strategy to limit the taxes payable upon death of the surviving spouse. The general deemed disposition rule would apply to the newly created *inter vivos* trust. The new trust would be an *inter vivos* trust as defined in subsection 108(1) and subject to the provisions of paragraph 104(4)(*b*) of the ITA.

The CRA also mentioned in this tax ruling that neither the testamentary spousal trust nor its trustees would, for the purposes of subsection 74.4(2) of the ITA, be considered individuals who have transferred or lent property to a corporation for the benefit of a designated person in respect of an individual. We refer the reader to Chapter 11 of this book for more detail regarding subsection 74.4(2). The CRA added that sections 245 and 246 of the ITA will not apply to the proposed transactions in and by themselves.

¶24,200 Capital Gains Exemption and QSBC Shares

As discussed in Chapter 13 at ¶60,650, in general, a trust can attribute capital gains to its beneficiaries or shares of a private company so that such beneficiaries can claim their unused capital gains exemption.

As a general rule, a trust cannot claim the capital gains exemption provided at subsections 110.6(2) and 110.6(2.2) (qualified farm or fishing property) and subsection 110.6(2.1) (QSBC shares) of the Act. These provisions authorize only an individual, other than a trust, to claim such exemption. However, subsection 110.6(12) allowed a testamentary spousal trust to claim the capital gains exemption following the deemed disposition (namely, the death of the surviving spouse) of qualified farm or fishing properties or QSBC shares held by the trust, subject to the exemption already claimed by the spouse. This subsection was included in the Act to prevent an unfair result. More specifically, without the existence of this provision, only a spouse who received shares in outright ownership rather than through a testamentary trust could have benefited

from the capital gains exemption on the disposition of such property.[4]

Thus, notwithstanding paragraph 104(6)(*b*), a testamentary spousal trust could claim a deduction in computing its income in an amount equal to the lesser of the unused lifetime capital gains exemption limit of the deceased spouse and the amount of the taxable gain of the trust determined under that subsection.

This effectively permitted claiming the same exemption that would have been available had the trust actually sold the property immediately before the spouse or common-law partner's death and the appropriate designations were made under subsections 104(21) and 104(21.2).

However, alter ego trusts and joint spousal or common-law partner trusts were not entitled to claim the capital gains exemption for the year of death of the beneficiary.

As mentioned above, subsection 110.6(12) was repealed as of January 1, 2016, due to the introduction of subsection 104(13.4) of the ITA, which initially provided that the gains and other income arising from the deemed disposition of the trust property upon the spouse's death would be deemed to be payable to the spouse in the spouse's terminal taxation year. As a result, it would have been included in the spouse's income and, if the spouse had a remaining capital gains exemption, it could have been applied to capital gains from property eligible for the exemption. As explained above, the capital gains exemption can still be claimed by the beneficiary spouse if an election is made under paragraph 104(13.4)(*b*.1) of the ITA, provided that the testator died before 2017.

Regarding shares of a private corporation, in order to claim the exemption, the shares disposed of must qualify as QSBC shares. The definition of QSBC shares in subsection 110.6(1) requires, among other things, that throughout the 24-month period immediately preceding the time of the disposition by an individual, the shares not be

[4] We refer the reader to Technical Interpretation 2003-0030105, October 10, 2003, which illustrates the relation between section 74.2 and subsections 73(1), 104(4), and 110.6(12) of the ITA.

owned by anyone other than the individual or a person or partnership related to the individual. Subparagraph 110.6(14)(*c*)(ii) sets out the criteria to determine which persons are deemed related to a personal trust in connection with the 24-month holding period. In the case of shares bequeathed by an individual to a testamentary spousal trust, the CRA indicated[5] as follows:

> For the purposes of the definition "qualified small business corporation share", in section 110.6, the spouse trust will be deemed to be related to the deceased spouse if, at the time the trust disposed of the shares, all of the beneficiaries of the spouse trust are related to the deceased spouse or would have been so related if the deceased spouse were living at that time, pursuant to subparagraph 110.6(14)(*c*)(ii) of the Act.

As such, for purposes of the definition of QSBC shares, a personal trust is deemed "in respect of shares of the capital stock of a corporation, to be related to the person from whom it acquired those shares where, at the time the trust disposed of the shares, all of the beneficiaries (other than registered charities) of the trust were related to that person or would have been so related if that person were living at that time."[6] Further, subparagraph 110.6(14)(*c*)(i) provides that the trust is deemed to be related to its beneficiaries.

¶24,300 Preventing Double Taxation

Where a testamentary spousal trust holds shares of a private corporation, we must consider whether there is a risk of double taxation, in particular, following the death of the surviving spouse. In such an event, certain concepts particular to corporate taxation must be considered, namely, the fact that the cost of the assets owned by the corporation is determined independently from the cost of the shares owned by the shareholders. Hence, in some cases, transferring the proceeds of disposition received by the corporation on the disposition of its property to its shareholders may not be achieved without a cost. As discussed above, based on the January 15, 2016, legislative proposals, the taxes triggered upon the death of the surviving spouse will be payable by the trust.

[5] Technical Interpretation 9228450, October 16, 1992.
[6] ITA, s. 110.6(14)(*c*)(ii).

Upon the death of the surviving spouse, the testamentary spousal trust is deemed to dispose of all of its property pursuant to the provisions of paragraph 104(4)(*a*) of the ITA. This usually triggers a capital gain inside the trust. Where the trust holds shares in the capital stock of a private company, the increase in value of the assets owned by the company is reflected in the FMV of the shares held by the trust. Notwithstanding the taxation on the capital gain realized by the trust on such shares, there is no corresponding increase in the ACB of the property held by the company. If, subsequently, the company sells its assets, there is a risk of double taxation to the extent that the increase in value of the assets held by the company would be taxed upon the deemed disposition of the shares (first capital gain), and subsequently upon the disposition of the assets (second capital gain).

While various solutions exist to mitigate the potential for double taxation, we must be cautious in their application. The appropriate steps must be taken and proper elections must be filed within the prescribed delays.

Some of the solutions available include the loss carry-back plan discussed at ¶24,310 and the tax cost step-up or "bump" discussed at ¶24,330. The latter technique may involve the distribution of shares held by the trust to its beneficiaries, as discussed at ¶24,332, or the use of two classes of shares in order to separate voting rights from other features related to the shares, as explained at ¶24,334.

¶24,310 Loss Carry-Back

As a general rule, where a taxpayer, on death, owns shares of a closely-held Canadian-controlled private corporation, the legal representative of the estate (referred to as a liquidator for Quebec civil law purposes) may, by way of the repurchase of the shares by the corporation or the winding-up of the corporation, eliminate the risk of double taxation. Subsection 164(6) planning could be implemented to deal with potential double tax to the estate/beneficiaries; a capital loss realized in the course of this planning can be carried back to the taxpayer's final taxation year and used to offset the capital gain in the taxpayer's terminal year, the whole to the extent

that the filing requirements set out at subsection 164(6) of the Act are met, and provided that the estate qualifies as a graduated rate estate under subsection 248(1) of the ITA.

A testamentary spousal trust cannot make an election under subsection 164(6), however. As such, where a testamentary spousal trust holds shares of a private corporation, as seen at ¶24,300, there is a risk of double taxation; one must look to another relieving provision to eliminate this potential for double taxation.

As previously mentioned, upon the death of the surviving spouse, the deemed capital gain cannot normally be deducted in computing the trust income to be allocated or transferred to the surviving spouse and taxed in his or her hands.[7] The capital gain resulting from the deemed disposition of assets, including shares of a private corporation, is taxed at the testamentary spousal trust level. The ACB of the shares held by the testamentary spousal trust is then increased to the FMV of the shares. Paragraph 104(4)(*a*) of the ITA refers to a disposition of property by the trust for proceeds of disposition equal to the FMV and the reacquisition for an amount equal to that FMV. Where the winding-up of the company creates the cancellation of its shares, this also results in a disposition for tax purposes.[8] As the winding-up dividends do not form part of the proceeds of disposition of a share in accordance with paragraph (*j*) of the term "proceeds of disposition" as defined in section 54 of the Act, a shareholder will often realize a capital loss at the time of the winding-up.

To alleviate the double tax, one could consider winding-up the corporation following the death of the surviving spouse. In such a case, it is usually possible to carry back the capital loss created on the disposition resulting from the repurchase of the shares to offset the deemed capital gain relying on paragraph 111(1)(*b*) of the ITA and reduce the taxable capital gain of the trust, so long as the trust itself continues to exist, as discussed below at paragraph ¶24,320. Paragraph 111(1)(*b*) does not include the strict qualifications found

[7] ITA, s. 104(6)(*b*).

[8] The definition of "disposition" pursuant to subsection 248(1) of the ITA includes the redemption or cancellation of shares.

to the child, will it reduce his or her benefits received from the government? If so, to what extent? Who will be the best person to manage property left as an inheritance to this child? In such cases, it is important to consider whether or not it would be advisable to establish a trust to secure the child's future. The question as to whether a trust should be created becomes even more important when the financial resources of the parents are limited. Parents may choose to reduce the bequests to their non-disabled children so as to ensure that their disabled child will have enough resources to live on, or leave it to the government or to their other children to see to the welfare of the disabled child. Some trusts, such as lifetime benefit trusts or testamentary trusts, may prove to be invaluable in this context.

This chapter discusses, primarily, rollover provisions applicable to a registered retirement savings plan ("RRSP"), registered retirement income fund ("RRIF"), or registered pension plan ("RPP") in favour of a qualifying trust, including the lifetime benefit trust and qualifying trust annuity. Incidentally, this chapter discusses other types of trusts, whether *inter vivos* or testamentary, which may be put in place to ensure comfort and support for a child with special needs, including the qualified disability trust. The impact of the use of trusts on government programs available to a child is briefly covered in this chapter.

¶40,100 Transfer of an RRSP, RRIF, or RPP at Death

¶40,110 Transfer From an RRSP Upon the Annuitant's Death

Where the annuitant under an RRSP dies, he or she is deemed to have received as benefits under an RRSP, an amount equal to the FMV of the property included in the plan at the time of death. The RRSP amount is brought back into the income reported on the deceased's terminal tax return under paragraph 56(1)(*h*) and subsection 146(8.8) of the ITA. Under subsection 146(8.9), there may be deducted from the taxable income of the deceased the refunds of premiums[1] paid out of the RRSP, following the death of the annuitant, as a lump-sum payment to the spouse or common-law partner of the annuitant (before the maturity date of the plan), or to a child or grandchild of the annuitant (before or after the maturity date) who was, immediately before the annuitant's death, financially dependent[2] on the annuitant.

[1] ITA, s. 146(1), definition of "refund of premiums".

Amounts received by the spouse or common-law partner that qualify as refund of premiums can be transferred to the spouse's RRSP, or used to purchase an annuity pursuant to paragraph 60(*l*) of the ITA, and give rise to an offsetting deduction.

The payment of tax on money received is delayed until withdrawals from the RRSP are made by the spouse, or until his or her death. Otherwise, the refund of premiums is taxable to the beneficiary under subsection 146(8) and paragraph 56(1)(*h*) of the Act.

In addition, clause 60(*l*)(ii)(B) provides the opportunity to use the refund of premiums to purchase an annuity for the benefit of a child or grandchild of the deceased for a period not exceeding the difference between age 18 and the age of the beneficiary at the time of purchase of the annuity. The annuitant under this type of annuity may be a child or grandchild who was dependent on the deceased taxpayer, or a trust under which the child or grandchild who was financially dependent on the deceased person is the sole person beneficially interested in amounts payable under the annuity (hereinafter called "fixed-term annuity"). An offsetting deduction may then be claimed, which allows spreading out the tax payments over several years.[3]

¶40,120 Transfer From an RRIF Upon the Annuitant's Death

Where an annuitant who was receiving benefits from a RRIF dies, he or she is deemed to have received, immediately before death, an

[2] ITA, s. 146(1.1).

[3] Certain elections may be made by the deceased's legal representative so that amounts paid to the estate qualify as a refund of premiums under subsection 146(8.1) of the ITA. It must be noted that this subsection was amended so that payments made to a trust that is a beneficiary under the deceased's estate can qualify as if the payments were made directly to the beneficiary. This subsection now makes reference to a beneficiary, as defined in subsection 108(1) of the ITA, under the deceased's estate. As such, it includes a person beneficially interested in a trust as defined under subsection 248(25) of the ITA.

amount equal to the FMV of the RRIF at the date of his or her death.[4] Similar to the regime applicable to RRSPs, rollover provisions allow, in some cases, the transfer of "designated benefits"[5] in favour of a spouse or common-law partner, or to children or grandchildren who are financially dependent on the annuitant. As a result, the estate of the deceased may deduct designated benefits paid to these persons from the RRIF amount otherwise taxable. The amount received by the beneficiary is to be included in his or her income under subsection 146.3(5) and paragraph 56(1)(*t*) of the ITA. However, any amount received that qualifies as a designated benefit may, in certain cases, give rise to an offsetting deduction under paragraph 60(*l*) and subsection 146.3(6.11) of the Act.[6]

For example, a spouse or common-law partner may claim an offsetting deduction if the RRIF received is transferred to his or her own RRIF and, consequently, delay the payment of tax on that amount.

An offsetting deduction is also available where designated benefits are utilized for the purchase of a fixed-term annuity for the benefit of a child or grandchild financially dependent on the annuitant, similar to the rules for RRSPs.

¶40,130 Transfer From an RPP Upon the Annuitant's Death

Regarding an RPP, the beneficiary who receives money under this plan must include it in computing his or her income.[7]

A rollover is available if the funds are transferred for the benefit of a spouse or common-law partner of the deceased to an RPP, RRSP, or RRIF where the spouse or common-law partner is the annuitant.[8]

Under paragraph 60(*l*) of the ITA, the amount received under an RPP by a child or grandchild financially dependent on the annuitant, as a result of the latter's death, can be used to purchase a fixed-term annuity and permit an offsetting deduction in a manner similar to the rules on transfer from an RRSP.[9]

[4] ITA, s. 146.3(5) and (6).
[5] ITA, s. 146.3(1), definition of "designated benefits".
[6] As an example, see Technical Interpretation 2016-0627341R3 (published in 2016).
[7] ITA, s. 56(1)(*a*)(i).
[8] ITA, s. 147.3(7) and (9).

¶40,200 Offsetting Deduction Under Paragraph 60(*l*) of the ITA

As mentioned above, under certain conditions, RRSPs, RRIFs, and RPPs can be rolled over to a spouse, or dependent minor child or grandchild, through an inclusion/deduction mechanism. As discussed at ¶40,110 for RRSPs, at ¶40,120 for RRIFs, and at ¶40,130 for RPPs, an eligible taxpayer must include, in computing his or her taxable income, certain lump-sum payments received as a result of the death of his or her spouse or common-law partner. Similar rules apply following the death of the father, mother, grandfather, or grandmother of a taxpayer who was dependent on one of those persons.

When all the conditions are met, paragraph 60(*l*) enables such a taxpayer to claim an offsetting deduction in respect of, *inter alia*, a payment made by him or her, or on his or her behalf, to purchase an annuity that meets the requirements in this paragraph.

The offsetting deduction may be claimed in respect of a life annuity under clause 60(*l*)(ii)(A), under which the taxpayer is the annuitant. It may also be in respect of a fixed-term annuity for the benefit of a minor for a term not exceeding the difference between age 18 and the age of the annuitant at the time of the acquisition of the annuity, as provided under clause 60(*l*)(ii)(B). Clause 60(*l*)(ii)(B) requires that the minor be the annuitant under the annuity. This has the effect of allowing the offsetting deduction only in respect of a fixed-term annuity having a minor child as the annuitant.

However, under section 60.011 of the Act, the offsetting deduction under paragraph 60(*l*) may be claimed with respect to three types of annuities under subsection 60.011(2) ("qualifying trust annuities"). This deduction is available provided that a trust (under which the taxpayer is a beneficiary) is designated as the annuitant,

[9] See paragraph 104(27)(*c*) of the ITA if the payment from the RPP is made to a testamentary trust.

and that the annuity is purchased with funds from an RRSP, RRIF, or RPP following the death of the spouse, common-law partner, father, mother, grandfather, or grandmother of the taxpayer. These funds must firstly be included in computing the income of the taxpayer. These three types of annuities are discussed below.

¶40,300 Offsetting Deduction Under Paragraph 60(*l*) of the ITA and Qualifying Trust Annuity

A lump sum received from an RRSP, RRIF, or RPP following the death of the annuitant may be transferred on a rollover basis to one of the trusts prescribed under subsection 60.011(2) of the ITA, which deals with qualifying trust annuities. The offsetting deduction that permits this result is found under paragraph 60(*l*). Section 60.011 clarifies the application of this offsetting deduction in situations where a trust is named as the annuitant under an annuity purchased with funds from an RRSP, RRIF, or RPP.

In addition, subsection 60.011(3) allows the taxpayer who is a beneficiary of the trust to claim the offsetting deduction under paragraph 60(*l*), even though he or she is not the annuitant under the annuity contract or if the annuity is purchased by the trust or the estate of the deceased individual rather than being paid by the taxpayer or on his or her behalf. This paragraph was enacted specifically so that the beneficiary of the trust is not denied the offsetting deduction under paragraph 60(*l*). The taxpayer must make the election to have subsection 60.011(3) apply in his or her tax return filed for the year in respect of which the amount would have been deductible by virtue of paragraph 60(*l*) if he or she had paid the purchase price of the annuity. A transitory measure provides that an election is deemed to have been made for a taxation year ending before 2005 if the taxpayer claims in his or her tax return a deduction under paragraph 60(*l*).

Where a trust is named as the beneficiary of the annuity, one must therefore refer to section 60.011.

Subsection 60.011(2) describes what constitutes a qualifying trust annuity with respect to a taxpayer. The three types of annuities are discussed below at ¶40,310, ¶40,350, and ¶40,360.

¶40,310 Qualifying Trust Annuity — After 2005

Mental Infirmity

Paragraph 60.011(2)(*a*) of the ITA deals with annuities purchased after 2005 and under which the annuitant is a trust that is, at the time the annuity is acquired, a lifetime benefit trust with respect to the taxpayer and the estate of a deceased individual. The lifetime benefit trust is defined in section 60.011. This is a trust under which a mentally infirm surviving spouse or common-law partner, or a child or grandchild who was dependent on the deceased for support because of mental infirmity (the taxpayer), is the sole beneficiary. It is important to note that physical disability is not covered. Children who are physically disabled but mentally capable may not access this provision.

Trust and Annuity Provisions

To qualify as a lifetime benefit trust, the trust must be a personal trust with trustees who are empowered to pay amounts from the trust to the taxpayer, and who are required, in determining whether to pay an amount to the taxpayer, to consider the needs of the taxpayer, including his or her comfort, care, and maintenance.

The annuity can be a lifetime annuity with or without a guaranteed period, or a fixed-term annuity to the age of 90 of the taxpayer. If the annuity has a guaranteed period or is a fixed-term annuity, its terms must provide that in the event of the death of the taxpayer during the term of the annuity, amounts otherwise payable after the death of the taxpayer will be commuted into a single payment.

Under a life benefit trust, no person other than the taxpayer may receive or otherwise obtain the use of, during the taxpayer's lifetime, any of the income or capital of the trust. This means that even though the trustee is not obliged to pay all the income or capital to the beneficiary, no person other than the beneficiary may

in whole years of the taxpayer at the time of purchase of the annuity. The annuity must be purchased after 1988, and the annuitant must be a trust under which the taxpayer is the sole person beneficially interested in amounts payable under the annuity. To that effect, the right of a person to receive an amount from the trust only on or after the death of the taxpayer is not considered. When the annuity is purchased after 2005, its terms must provide that in the event of the death of the taxpayer during the fixed term, any amounts that would be payable after the death of the taxpayer be commuted into a single payment. This means that if the minor dies before all annuity payments are received, a lump-sum payment representing the present value of future payments must be made. In such an event, the normal pension cannot continue to be paid to the heirs of the child.

¶40,360 Qualifying Trust Annuity — Mental or Physical Infirmity (2000–2004) and Mental Infirmity (2000–2005)

Paragraph 60.011(2)(*c*) of the ITA focuses on the life annuity that is acquired after 2000 and under which the annuitant is a trust under which the taxpayer is the sole person beneficially interested in amounts payable under the annuity. The annuity can also be a fixed-term annuity having a term equal to 90 years minus the age of the taxpayer at the time the annuity is acquired. To this end, the right of a person to receive an amount from the trust only on or after the death of the taxpayer is not considered. The taxpayer had to have an infirmity at the time of purchase of the annuity, and the annuity had to be purchased before 2005 if he or she had a physical infirmity, and before 2006 if he or she had a mental infirmity. These are transitional rules.

¶40,500 Attribution Rule

Section 75.2 of the Act contains an attribution rule that applies to a qualifying trust annuity covered under subsection 60.011(2) of the ITA, and deductible under paragraph 60(*l*) of the ITA in computing the taxpayer's income. Any amount paid out of or under the annuity after 2005, and before the death of the minor beneficiary or the beneficiary having an infirmity, is deemed to have been received at

that time by the taxpayer rather than by the trust.[14] The annuity is not taken into account in computing the income of the trust. There is, therefore, no possibility of splitting the annuity income between the trust and the beneficiary.

Where the beneficiary dies after 2005, an amount equal to the FMV of the annuity at the time of death is deemed to have been received by the beneficiary immediately before death. To prevent the beneficiary from being subject to double taxation with respect to the annuity, the value of the annuity is ignored in the calculation of the FMV of his or her interest in the trust, as a result of the deemed disposition of his or her interest immediately before death for the purpose of subsection 70(5) of the ITA.

Accordingly, all income of the trust must be reported on the income tax return of the beneficiary, whether received or not. These amounts are potentially accessible to government agencies and ministries for the purposes of determining the beneficiary's eligibility for "means-tested" disability support programs.

¶40,600 Impact of a Trust on Government Support Programs

Many parents face challenges when trying to plan for a disabled beneficiary. Trust planning must consider how best to structure income and capital payments from the trust to ensure that the disabled beneficiary is adequately cared for and, where needed, maintains government benefits. Whether the trust is a lifetime benefit trust or another type of trust, the terms of the trust may impact opportunities for the beneficiary to receive government benefits. Most government disability payments bear relation to the amount of income being received by the disabled person. One could possibly think that by setting up a discretionary trust for the disabled person, his or her interest in the trust should have no impact on his or her government benefit entitlements. As a general rule, the trustees would have total discretion to pay or not to pay income or capital to the beneficiary. Out of a sense of extra caution, other beneficiaries could be named under the trust in addition to the

[14] ITA, s. 56(1)(*d*.2).

disabled person. In such a case, if the trust is provided in a will, the testator could express to the trustees, in a separate document (letter of wishes), his or her wishes regarding how the trust assets should be distributed.

A type of trust called the "Henson trust" will often be used in order to protect the beneficiary's government benefits.

Legislation in several of the provincial and territorial jurisdictions provides disability benefits for disabled persons. Provisions defining what is included in the calculation of a person's "assets" usually include a beneficial interest in a trust. As such, if a trust gives a disabled person a vested beneficial interest, such as a life interest, or includes a requirement that the trustees provide for the maintenance of the disabled person, the value of that beneficial interest will be included in the asset calculation and may make the disabled person no longer eligible for benefits under legislation.

One method that seems to address this problem is to give the trustees an absolute discretion to make a payment out of the income or capital of the trust in favour of the disabled person. Since the trustees have an absolute discretion, the disabled person has no right to enforce payment from the trustees and therefore has no vested interest in trust funds until they are paid out to him or her. Provincial legislation has to be reviewed before implementing a discretionary trust to maintain government benefits.

In Ontario, this strategy is recognized, and the Henson trust is a type of trust often used to protect government benefits. The Henson trust finds its source in the Ontario case of *Ontario v. Henson*.[15]

In *Henson*, regulations under the *Family Benefits Act* at the time provided that a person was not entitled to an allowance under the legislation if the person had liquid assets in excess of $3,000. The definition of "liquid assets" included, among others: cash, bonds, an interest in real property, a beneficial interest in assets held in trust and available to be used for maintenance, and any other assets readily convertible into cash.

[15] (1987), 28 E.T.R. 121, aff'd (1989), 36 E.T.R. 192 (Ont. CA).

The father of Audrey Joan Henson, a mentally handicapped person, had included a trust for her benefit in his will. The trust was totally discretionary. In paying income and capital, the trustees could exercise their absolute and unfettered discretion and pay what they considered advisable from time to time for the benefit of Audrey. The representative of the Ministry of Community and Social Services argued that Audrey was not entitled to maintenance under the *Family Benefits Act* since she had assets worth more than $3,000, consisting primarily of the value of her interest in the trust.

The decision of the Divisional Court, which the Court of Appeal agreed with, was to the effect that as the provisions of the will give the trustees absolute and unfettered discretion, Audrey could not compel the trustees to make payments to her if there were not funds available to her under the *Family Benefits Act*, sufficient to meet her needs. Therefore, according to the Court, Audrey did not have a beneficial interest, as that term is used in the definition of liquid assets.

In *Henson*, the Court came to the conclusion that assets held in a discretionary trust for a disabled beneficiary were not included as assets for purposes of eligibility for the Ontario Disability Support Program, since the beneficiary had no rights to income or capital apart from what was paid to him or her.

As a result of this case, the term "Henson trust" is now used in Ontario to describe trusts which are drafted in such a way as to avoid the trust being declared as an asset of a handicapped person. This term is not used in other provinces, although many provinces have similar rules, including British Columbia.

It should be noted that although a discretionary trust may allow the beneficiary to receive provincial disability benefits, the trust assets may affect eligibility for other types of assistance.

The BC Court of Appeal decision in *S.A. v. Metro Vancouver Housing Corporation*[16] is an example. S.A. is a person with disabilities who was living in a subsidized rental residence provided by the

[16] 2017 BCCA 2.

gains exemption on the sale of QSBC shares. The creation of a trust may also appeal to a professional who wishes to incorporate his or her practice, a business owner who is planning an estate freeze, or an individual who would like to split income with family members via a trust funded with a low or no-interest loan. In almost all scenarios involving an *inter vivos* family trust, the attribution rules must be analyzed to determine whether or not they may have an impact on the anticipated plan.

Chapter 11 of this book discusses the attribution rules in general, the conditions for their application, and exceptions to those rules. This chapter addresses recent CRA technical interpretations, more specific scenarios, and strategies aimed at preventing the application of the attributions rules.

¶62,100 Attribution Rules and Suspended Losses — Subsection 74.1(1) and Section 74.2 of the ITA

The CRA was asked[1] to comment on the following situation. Ms. A and Mr. B each hold 50% of the common stock of Opco. Ms. A also owns preferred shares of Opco with an FMV of $2 million, paid-up capital of $200, and ACB of $1 million. Ms. A transferred half of her preferred shares to Mr. B on a rollover basis, pursuant to subsection 73(1) of the ITA. Five years later, the preferred shares held by Mr. B are redeemed by Opco for $1 million. The redemption triggered a deemed dividend and a capital loss. The deemed dividend was attributed back to Ms. A. The question the CRA was asked to answer was whether the capital loss should be attributed to Ms. A under paragraph 74.2(1)(*b*), or if the loss should be added to the ACB of the common shares held by Mr. B, pursuant to paragraph 40(3.6)(*b*) of the Act.

The CRA indicated that the capital loss would not be attributed back to Ms. A, but would rather be denied under paragraph 40(3.6)(*a*). The capital loss would be added to the ACB of the common shares held by Mr. B. Upon the sale of the common shares,

[1] Technical Interpretation 2011-0427461E5, January 9, 2012. See Technical Interpretation 2009-0317041E5, July 20, 2009, for a discussion on spousal attribution where a joint line of credit is used.

any capital gain or capital loss would not be allocated to Ms. A under subsection 74.2(1), as the common shares do not represent property (or property substituted therefor) lent, or transferred by Ms. A to Mr. B.

¶62,106 Discretionary Dividend Shares and Attribution Rules

In Technical Interpretation 2016-0626781E5, dated March 14, 2016, the CRA was asked about the tax consequences for the shareholders of a corporation and the tax consequences for the corporation itself that may arise on the issuance of shares that carry an entitlement to discretionary dividends for nominal consideration and the payment of any discretionary dividends from such shares. A shareholder of a private company wanted his corporation to issue discretionary dividend shares to his spouse for a nominal amount.

The facts are as follows:

- Mr. A owns 100% of the issued and outstanding shares of Opco (i.e., one Class A common share).
- The Class A common share has a fair market value of $1,000,000.
- Opco has $500,000 of retained earnings.
- Opco is looking at issuing one Class B preferred share to Mr. A's spouse (Mrs. A) for nominal consideration.

Following the issuance of the Class B preferred share to Mrs. A, two scenarios are considered:

- Scenario 1: Opco immediately declares and pays out a $100,000 dividend on the Class B preferred share. Such dividend would then reduce the FMV of Opco and the one Class A common share by the same amount.
- Scenario 2: Opco declares and pays out a $100,000 dividend on the Class B preferred share, but only after earning an additional $100,000 of income subsequent to the issuance of the Class B preferred share to Mrs. A and only as long as the FMV of Opco after such dividend is not less than $1,000,000.

After analyzing the proposed scenarios, the CRA indicated that subsection 56(2) of the ITA should not apply under the circumstances, provided that proper consideration was given for the Class B preferred share when issued. But the CRA does not comment on whether or not the consideration paid for the Class B preferred share was appropriate. According to the CRA, the tax consequences related to the issuance of the Class B share will depend on the FMV of the share at that time. The CRA could conclude that subsection 15(1) of the ITA applies upon the issuance of the Class B preferred share, particularly if the amount that is being paid by Mrs. A as consideration for the share does not represent the FMV of such share at the time of subscription.

Alternatively, it may be possible to conclude that Mr. A rather than Opco is conferring the benefit to Mrs. A. If it could be demonstrated that there was a transfer of economic interest in Opco from Mr. A to Mrs. A, Mr. A would be considered to have disposed of a right, interest, or right to dividends in Opco to Mrs. A. Consequently, since Mr. A and Mrs. A are spouses, the automatic rollover provision in subsection 73(1) would apply such that the disposition of Mr. A's economic interest would be at cost (unless they elect out of the rollover under subsection 73(1) of the ITA).

If the rollover applies, subsection 74.1(1) of the ITA would apply to attribute back to Mr. A any dividends paid on the Class B preferred share held by Mrs. A.

¶62,110 Corporate Attribution Rules — Subsection 74.4(2) of the ITA

The CRA was asked for its views on five scenarios concerning the application of subsection 74.4(2) of the ITA, which is a deemed interest rule. This rule comes into play frequently in the context of an estate freeze.

As discussed in Chapter 11 of this book, for the corporate attribution rule to apply, we first need a loan or transfer of property from an individual to a corporation. Transfers or loans between two corporations are not captured by the corporate attribution rule.

Second, it must be reasonable to consider that one of the main purposes of the transfer or loan is to reduce the income of the transferor and to benefit, directly or indirectly, a person who is a designated person in respect of the transferor. For the purposes of the Act, a designated person is defined as the spouse or common-law partner of the individual or a person who is under 18 years of age and who does not deal with the individual at arm's length, or who is the niece or nephew of the individual.[2]

Third, the designated person must be a specified shareholder of the corporation. Generally, a specified shareholder is a person who, directly or indirectly, holds at least 10% of the issued shares of any class of shares of the capital stock of the corporation. For this purpose, a beneficiary of a discretionary trust is deemed to own 100% of the shares held by the trust in a corporation.[3] Finally, the corporation is not an SBC pursuant to subsection 248(1) of the ITA. Lawyers and notaries who draft trust deeds must exercise great creativity to protect their clients against the adverse tax impacts often related to the corporate attribution rule. In a context where there is no assurance that the corporation that implements an estate freeze will at all times retain its status as an SBC, the application of subsection 74.4(2) is not only theoretical. As mentioned above, this attribution rule is a deemed interest rule. Thus, the transferor or lender must include, in computing his or her income, a deemed interest corresponding to interest calculated at the prescribed rate. The deemed interest amount is equal to the prescribed rate, multiplied by either the value of the shares received in exchange for the property transferred or the amount of the loan outstanding, as applicable. This amount may be reduced with interest received on the loan, or if taxable dividends under subsection 82(1) (i.e., the gross-up dividend) or 90(1) of the ITA are paid by the corporation to the transferor. Interestingly, this attribution rule applies even if no income is paid to designated persons.

The corporate attribution rule will not apply, however, if the conditions under subsection 74.4(4) of the Act are met. If under the trust's terms the designated person may not receive or otherwise

[2] Subsection 74.4(1), which refers to subsection 74.5(5) of the ITA.
[3] ITA, s. 74.4(2) and 248(1), definition of "specified shareholder".

obtain the use of any of the trust's income or capital while the person is a designated person in relation to the individual lender or transferor, then the corporate attribution rule will not apply.

Relying on the subsection 74.4(4) exception, however, has the effect of preventing income-splitting opportunities with a spouse and restricting those with minor children. More specifically, the corporate attribution rule does not normally apply where the trust deed provides that a spouse or minor child (or, more precisely, a 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 and the designated person has not, in fact, received or otherwise obtained the use of any of the income or capital of the trust, provided that the trust has not made any deduction in computing its income in respect of any income that has been paid to such designated person. If the designated person is a minor child (or niece or nephew), this provision will apply until the minor attains 18 years of age. With respect to a spouse or common-law partner, this provision will apply as long as the designated person is the spouse or common-law partner of the transferor. This means that as long as the transferor is alive, the spouse or common-law partner cannot receive any income or capital from the trust, unless there is a breakdown of their marriage or common-law partnership, as provided under subsection 74.5(4). Accordingly, it would not be possible to attribute taxable capital gains to a minor beneficiary if that clause is included in the trust deed. With respect to dividends, the tax on split income already restricts splitting dividend income received from a private company. As for the spouse or common-law partner, the only benefit to naming him or her as a beneficiary of a trust that includes the subsection 74.4(4) safe harbour provision would be in the case of a breakdown of the relationship, where the transferor, nevertheless, wishes to benefit his or her former spouse or common-law partner following the breakdown of the relationship or following his or her death. Otherwise, the spouse is a designated person.

The five previously-mentioned scenarios concerning the application of subsection 74.4(2) of the ITA submitted to the CRA were analyzed in the following technical interpretations.

Technical Interpretation 2015-0613401E5, Dated December 8, 2015

Under scenario 1, X would hold all the shares of Opco and his spouse would be the sole shareholder of Holdco. Opco would use surplus cash to purchase preferred shares of Holdco. Holdco is not an SBC.

The question was whether or not subsection 74.4(2) of the ITA would apply to this scenario.

After reviewing the conditions that have to be met under subsection 74.4(2), the CRA indicated that under this scenario, the surplus cash used to purchase the Holdco shares never belonged to X. X would not be deemed to have transferred assets to Holdco. Subsection 74.4(2) of the ITA would not apply. The CRA referred to another technical interpretation that indicated:[4]

> . . . generally speaking, in situations where a controlling shareholder/director of a particular corporation approves a transfer or loan of property by the particular corporation to another corporation and the property transferred or loaned may be considered to come from the particular corporation's retained earnings (for example, internally generated cash or investments of the particular corporation) such that the property would not represent property paid or transferred to the particular corporation, directly or indirectly, by the individual, it is our view that the transfer or loan of property to the other corporation would not be considered to have been made, indirectly, by the individual for the purposes of subsection 74.4(2) of the Act.

Under scenario 2, X would hold all the shares of Opco and his spouse would be the sole shareholder of Holdco. Opco would declare and pay a dividend on X's common shares using high-low preferred shares. As such, the preferred shares would have a nominal paid-up capital and a high redemption value. X would transfer his high-low shares held in Opco in favour of Holdco in consideration of Holdco preferred shares using the rollover provision under subsection 85(1) of the ITA. Opco would use its surplus cash to redeem its preferred shares held by Holdco, which is never an SBC.

The question was whether or not subsection 74.4(2) of the ITA would apply to this scenario.

[4] Technical Interpretation 2002-0147325, January 15, 2003.

The CRA stated that under this scenario, X transferred shares to a corporation that does not qualify as a small business corporation. X's spouse would be a designated person with respect to X. Subsection 74.4(2) of the ITA could therefore apply to this transfer provided all the other conditions for subsection 74.4(2) to apply are met.

Under scenario 3, X would be the sole shareholder of Opco, which is not an SBC. Opco would declare and pay a stock dividend using high-low preferred shares. X's spouse would then subscribe to Opco common shares.

Regarding the third scenario, the CRA stated that, technically, subsection 74.4(2) would not apply to the issuance of shares for the purpose of paying stock dividends.

Technical Interpretation 2015-0601561E5, Dated December 11, 2015

Under scenario 1, X is the sole shareholder of Opco. X implements an estate freeze in favour of a family trust. Following the freeze, the family trust owns all the common shares of Opco. The trust beneficiaries are X's spouse and children and Holdco, which is incorporated by the trust. To maintain its status as a small business corporation, Opco declares a dividend each year on the common shares that the trust designates as dividends paid to Holdco by the trust.

Regarding this scenario, the CRA stated that subsection 74.4(2) of the ITA should not apply as long as Opco remains a small business corporation.

Under scenario 2, X transfers his business assets to Opco under a section 85 rollover in exchange for shares. Separate classes of participating shares of Opco are issued to X's spouse, their minor child, and Holdco. X, his spouse, and their minor child would subscribe to shares of Holdco. Each year, to maintain its small business corporation status, Opco declares dividends on the class of shares held by Holdco.

The CRA stated that as long as Opco remains a small business corporation, subsection 74.4(2) of the ITA should not apply to X's

transfer of assets to Opco or to the consideration paid by X's spouse for the acquisition of Opco shares. However, the consideration paid by X and his spouse for the acquisition of shares of Holdco, which is not a small business corporation, would technically constitute a transfer of property by an individual (X or his spouse) to a corporation other than a small business corporation. Consequently, subsection 74.4(2) of the ITA could apply, depending on the other facts and circumstances applicable.

Exception Under Subsection 74.4(4) of the ITA

The CRA was asked to review, in two scenarios where a trust has an indirect interest in a corporation, whether the condition provided in paragraph 74.4(4)(*a*) is met.[5] This paragraph refers to the situation where the only interest that the designated person has in the corporation is a beneficial interest in shares of the corporation held by a trust.

Under scenario 1, X is the sole shareholder of Opco. An *inter vivos* discretionary trust owns all the shares of Holdco. The trust beneficiaries are X's minor children. X exchanges all his common shares of Opco in consideration for preferred shares of Opco. Holdco then subscribes the new common shares of Opco.

The question to the CRA was whether or not the condition under paragraph 74.4(4)(*a*) of the ITA would be met to the extent that the transfer would be made by X in favour of Opco and that the trust would own shares of Opco through Holdco.

The CRA stated that as the shares of Opco would not be held by the trust but would be held by Holdco, the condition under paragraph 74.4(4)(*a*) of the ITA would not be met. This situation could be corrected, however, should the trust, and not Holdco, subscribe the new common shares of Opco.

In the second scenario, X owns all the common shares of Opco 1 and Opco 2. Opco 1 owns preferred shares in Opco 2. X exchanges all his common shares of Opco 1 in consideration for

[5] Technical Interpretation 2014-0549571E5, November 7, 2014.

preferred shares of Opco 1. An *inter vivos* discretionary trust would then subscribe to the new common shares of Opco 1. The trust beneficiaries are X's minor children. X exchanges all his common shares of Opco 2 in consideration for preferred shares of Opco 2. The discretionary trust would then subscribe to the new common shares of Opco 2.

The question to the CRA was whether or not the condition under paragraph 74.4(4)(*a*) of the ITA would be met with respect to the transfer made by X in favour of Opco 2, to the extent that the trust would own shares of Opco 2 directly and indirectly through Opco 1.

With respect to the second situation, the CRA stated that the designated person would have two interests in Opco 2.[6] Regarding the interest that the designated person has in Opco 2 through Opco 1, the condition under paragraph 74.4(4)(*a*) of the ITA would not be met as the preferred shares of Opco 2 would be held by Opco 1 and not by the trust.

In addition, paragraph 74.4(4)(*a*) requires that the only interest that the designated person has in Opco 2 is a beneficial interest in shares of Opco 2 held by a trust. Consequently, since the interest of the designated person in Opco 2 is held through Opco 1 and not by the trust, the condition under paragraph 74.4(4)(*a*) would not be met.

Computation of the Deemed Interest

The CRA had to review the following scenario[7] and comment on how to compute the amount to be included in X's income by virtue of subsection 74.4(2).

X is the sole shareholder of Opco. X would like to implement an estate freeze under which he would exchange all of his shares held in Opco in consideration for redeemable preferred shares of

[6] However, the fact that a child would be the beneficiary of two trusts holding shares of the capital stock of an operating company would not, in and by itself, render subsection 74.4(4) inapplicable. See Technical Interpretation 2007-0254311E5, April 30, 2008.

[7] Technical Interpretation 2012-0449871E5, July 31, 2012.

Opco having a fair market value of $1,000,000. Following this share exchange, a family trust (which includes X's spouse and children as beneficiaries) would subscribe to new common shares of Opco for a nominal amount. X would then transfer his frozen shares to Holdco in consideration for common shares of Holdco. X would be the sole shareholder of Holdco. The assumption is that subsection 74.4(2) of the ITA would apply to the estate freeze.

Following those transactions, Opco would redeem shares held by Holdco in its share capital over time and would pay dividends on those shares before paying dividends on the shares held by the trust.

The CRA was asked the following questions:

(1) Whether or not X would have to include a deemed interest in his income under subsection 74.4(2) of the ITA?

(2) If so, should the deemed interest be computed on the value of the frozen shares held by Holdco in Opco or on the common shares held by X in Holdco?

(3) Would the redemption of preferred shares by Opco reduce the outstanding amount on which the deemed interest is calculated?

(4) Do the dividends paid on the common shares held in Holdco reduce the deemed interest under subsection 74.4(2) of the ITA?

The CRA mentioned that to determine the amount that may have to be included in X income, the prescribed rate has to be multiplied by the outstanding amount of the asset transferred. In this situation, the common shares that were exchanged by X would constitute the transferred asset. The value of those shares is $1,000,000. Then we need to examine if this value can be reduced under subparagraphs 74.4(3)(*a*)(i) and (ii). As the consideration received for the common shares would be an excluded amount, there would be no reduction under subparagraphs 74.4(3)(*a*)(i) and (ii).

The fact that Opco would redeem shares held by Holdco has no impact on the deemed interest to be included in X's income as the redemption amount would be paid to Holdco and not to X.

The outstanding amount would remain at $1,000,000 and X would have to include a deemed interest under subsection 74.4(2) of the ITA. The only dividends that could reduce this amount would be dividends paid to X by Opco on the preferred shares received in consideration for the Opco common shares or dividends received from Holdco on the common shares held by X in its share capital.

¶62,115 Strategies To Prevent the Application of the Corporate Attribution Rule

In October 2007,[8] the CRA was asked to review three scenarios involving the application of subsection 74.4(2). The questions submitted to the CRA were to determine whether the strategies outlined could prevent the application of the corporate attribution rule.

Each of the three scenarios presented to the CRA described a method whereby the taxpayer sought to prevent the attribution rules' application.

The main question was: Is the CRA of the opinion that the three methods described in the request would cause the application of the provisions of subsection 74.4(2) of the ITA when a corporation is not an SBC?

Unfortunately, none have been well received by the CRA.

First Method

A discretionary *inter vivos* trust is created as part of an estate freeze to hold shares of a private company. The spouse of the author of the transfer is a discretionary income and capital beneficiary of the trust. It is impossible to know with certainty whether the corporation would retain its status as an SBC during the time that the trust would hold the shares of the corporation. The trust indenture provides that from the time that the corporation loses its SBC status for a period of more than 30 days during a calendar year, the interest of the spouse in the trust is modified so that the requirements of paragraphs 74.4(4)(*a*) to (*c*) are satisfied. Accordingly, the spouse

[8] Technical Interpretation 2007-0243191C6, October 5, 2007.

ceases to be entitled to income and capital of the trust during the transferor's lifetime.

Response From the CRA

The CRA noted first that, given the wording of the trust, the spouse could receive income or capital of the trust while he or she was a designated person in relation to the author of the transfer. Therefore, subsection 74.4(4) was of no help.

Moreover, despite the changes to the trust indenture, since the spouse's share of the trust income or capital would still depend on the exercise or non-exercise of a discretionary power granted to the trustees, the spouse would be a specified shareholder for the period beginning at the creation of the trust, and ending at the death of the author of the transfer.

Under this method, subsection 74.4(2) could therefore apply from the moment the corporation is no longer an SBC and beyond.

Second Method

The facts are the same as in the first method but with a slight difference: Under this method, when the corporation loses its status as an SBC for more than 30 days in a calendar year, the indenture provides that the spouse's interest in the trust is set at 9.9% and is no longer discretionary both before and after the death of the author of the transfer.

Response From the CRA

In this scenario, we could have expected a favourable response from the CRA. Despite the 9.9% limit, the CRA raises that the spouse could be a specified shareholder during the period when his or her interest is fixed, if for example, the exercise of a discretionary power in respect of another beneficiary of the trust had an impact on the spouse's share of the income or capital. The CRA stated that the spouse of the author of the transfer could be a specified shareholder by reason of paragraph (*e*) of the definition of "specified shareholder" in subsection 248(1) of the ITA, during the period in which he or

she would have a fixed and non-discretionary interest. This paragraph provides that:

> . . . notwithstanding paragraph (*b*), where a beneficiary's share of the income or capital of the trust depends on the exercise by any person of, or the failure by any person to exercise, any discretionary power, the beneficiary shall be deemed to own each share of the capital stock of a corporation owned at that time by the trust;

Thus, depending on the circumstances, subsection 74.4(2) could be applicable from the time that the corporation is no longer an SBC, and thereafter.

Third Method

In the last scenario, the interest of the spouse is limited at the outset to a fixed income and capital interest of 9.9% until the time of the death of the author of the transfer. Thereafter, the interest becomes discretionary.

Response From the CRA

The CRA indicated that it could be argued, in spite of appearances, that the capital interest of the spouse in the trust was not fixed. The CRA stated that they find it difficult to imagine that a capital interest of 9.9% in a trust can be considered to be fixed for a particular period, if this interest becomes totally discretionary at a particular time thereafter.

It follows from this technical interpretation that the concept of "specified shareholder" has a very broad scope, which complicates the writing of trust indentures for corporations that fail to retain their SBC status.[9]

[9] See Advance Income Tax Ruling 2008-0267251R, October 22, 2008, which discusses a provision in a trust deed that meets the exception in subsection 74.4(4) of the ITA.

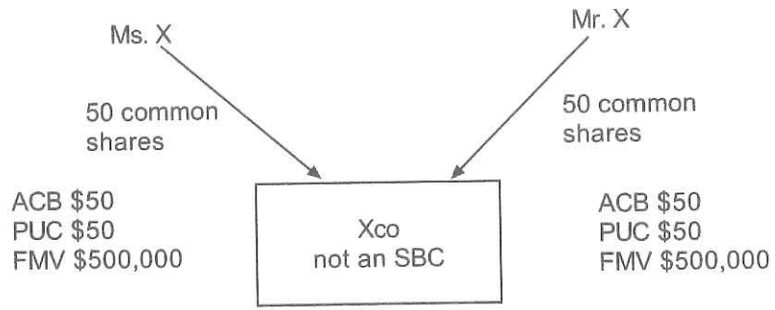
¶62,120 Transfer or Loan to a Corporation — Application of Subsection 74.4(2) of the ITA

At the 2008 APFF Annual Conference,[10] the CRA had to comment on the following situations.

Situation 1

Mr. and Ms. X each own 50 shares of the capital stock of a Canadian-controlled private corporation ("CCPC") that is not an SBC. The 50 shares of each spouse have a paid-up capital ("PUC") and an ACB of $50, and an FMV of $500,000. The spouses want to undertake an estate freeze for the benefit of a discretionary trust.

Current Scenario



Mr. and Ms. X exchanged their common shares for preferred shares. Mr. and Ms. X each received preferred shares redeemable for an amount of $500,000. This exchange was made pursuant to section 51 of the ITA. An *inter vivos* discretionary family trust subscribed for 100 new common shares for $100. The beneficiaries of the trust are Mr. and Ms. X and their adult children.

[10] Technical Interpretation 2008-0285091C6, October 10, 2008.