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CRA STEP Roundtable 2019 – June 7, 2019

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Unless otherwise stated, every reference herein to a part, section, subsection, paragraph or a subparagraph is a reference to the relevant provision of the *Income Tax Act* (the "Act"), as amended to the date hereof.

Question 1: Non-resident trust ceasing to be a deemed resident

In an article in the 2016 Canadian Tax Journal titled, "Non-Resident Trusts: Selected Interpretive and Planning Issues—Part 1" by Elie S. Roth and Kim Brown, the authors indicated that some of the statements made by the CRA in technical interpretation 2013-0509111E5, dated February 24, 2014 were unclear.

The hypothetical fact situation described in the 2014 technical interpretation was as follows:

- In 2010, Trust A, a factual non-resident trust was deemed a resident by reason of subsection 94(3) of the Act because Corp X, a Canadian resident corporation, issued 100 common shares to Trust A thereby triggering paragraph 94(2)(g) and making Corp X a resident contributor of Trust A. Trust A is not an exempt foreign trust.
- In calendar 2011, none of the trust circumstances changed except that Trust A ceased to have a resident contributor when the trust sold its 100 common shares of Corp X at fair market value to an unrelated third party on August 15th, 2011 in a transaction, the terms of which met the requirements of paragraph 94(2)(t) of the Act.

Can the CRA please confirm their position and if necessary, correct any inaccurate statements made in the 2014 technical interpretation?

CRA Response:

The following passage is taken from the technical notes provided by the Department of Finance regarding paragraph 94(2)(t) of the Act:

> "Paragraph 94(2)(t) generally expunges a contribution of shares or indebtedness of a Canadian corporation from the corporation to a trust if the corporation issued (in circumstances described in subparagraph 94(2)(g)(i) or (iv)) the shares or the debt to the trust and the trust later sells the shares or indebtedness in circumstances in which the parties to the sale deal with each other on an arm's length basis. However, the application of paragraph 94(2)(t) will not affect the application of paragraph 94(2)(g) in respect of the original transfer by the corporation to the trust or the other person or partnership: such transfers will continue to be treated as transfers under section 94."

It is our view that paragraph 94(2)(t) applies to expunge the contribution after the time of the sale (i.e., from the time of the sale forward, the contribution is considered to have never occurred). As such, at the end of the 2011 taxation year (i.e., December 31,

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2011) of Trust A, paragraph 94(3)(a) would not apply as there is no resident contributor. Conversely, subsection 94(5) would apply since the conditions therein are met, including that at the end of the 2011 taxation year, there is no resident contributor.

Accordingly, pursuant to subsection 94(5) of the Act, Trust A is deemed to cease to be a resident when it ceases to have any resident contributor. As a result, subsection 128.1(4) applies to create a deemed year-end immediately before that time. Trust A would be deemed resident under subsection 94(3) for the taxation year ending August 15th, 2011 since at the end of that particular taxation year, there is a resident contributor. However, Trust A would not be deemed resident for its taxation year beginning on August 16th, 2011 and ending December 31st, 2011 since at the end of that particular taxation year, there is no resident contributor.

As such, the following statement made in the 2014 technical interpretation is inaccurate and should be disregarded:

> "Pursuant to paragraph 94(3)(a) of the Act, in the absence of subsection 94(5), Trust A would have remained deemed resident throughout the 2011 taxation year and would not have ceased to be deemed resident until December 31st, 2011."

Question 2: Alter ego trust and donations

An alter ego trust owns a portfolio of publicly traded securities which have appreciated in value. The Settlor (Contributor) to the alter ego trust dies and the alter ego trust has a deemed year-end at the end of the day on which the individual dies pursuant to subsection 104(13.4). The trust realizes a capital gain at that time pursuant to subsection 104(4).

a) Assume that the residual beneficiary, after the death of the Contributor, is a registered charity, and a distribution is made to that registered charity. In these circumstances, can the alter ego trust claim the amount as a charitable gift that is eligible for the donation tax credit?

b) Assume that the residual beneficiaries are a class of registered charities as determined by the trustees, and that the trustees may make payments over a period of time, say the next 3 years, to those various registered charities. At the end of 3 years, the capital remaining is to be distributed to registered charities. In these circumstances, can a charitable donation be claimed by the alter ego trust?

c) If the donation by the alter ego trust is made by donating the publicly traded securities, is the taxable capital gain nil as would be the case for an individual?

CRA Response:

a) When the settlor of an alter ego trust dies, the trust has a deemed year-end at the end of the day on which the death occurs pursuant to subsection 104(13.4). In the situation described above, the trust realizes a capital gain at that time pursuant to subsection 104(4). Clause (c)(ii)(C) of the definition of "total charitable gifts" in subsection 118.1(1) was added to the *Income Tax Act*, applicable for taxation years after 2015, to allow for the inclusion, in the trust's total charitable gifts, of the eligible amount of a gift made by the trust in a shortened taxation year as a result of a deemed year-end triggered by paragraph 104(13.4)(a). As such, based on the situation described above, it is our understanding that the trust would like to claim a donation tax credit to offset the capital gain that occurs in the trust's taxation year in which the Contributor dies.

Under the common law, "a gift is a voluntary transfer of property owned by a donor to a donee, in return for which no benefit or consideration flows to the donor" (*The Queen v Friedberg*, [1992] 1 CTC 1, 92 DTC 6031 (FCA)). Generally, for purposes of sections 110.1 and 118.1, a gift under common law is made if a taxpayer has donative intent, and all three of the following conditions are satisfied:

- there must be a voluntary transfer of property to a qualified donee;
- the property transferred must be owned by the donor; and
- no benefit or consideration must flow to the donor.

In a situation where an alter ego trust makes a payment to a registered charity, it is a mixed question of fact and law whether the payment is a charitable gift by the trust that is eligible for a donation tax credit pursuant to subsection 118.1(3), or a distribution of income or capital to a beneficiary of the trust. The determination depends upon the specific wording of the trust agreement and the intentions of the trustee in making the payment to the charity.

Where the facts lead to a determination that the trustee has no discretion as to whether the payment is made to the charity, the CRA would not consider the payment to qualify as a gift. Consequently, the payment by the trust would not be eligible for the donation tax credit.

On the other hand, the CRA has accepted that, where the facts lead to a determination that the trustee is clearly given the discretion to decide if a payment is to be made to a charity or to have the funds used in some other manner, the payment is considered voluntary. Accordingly, the payment by the trust to the charity would be considered a charitable gift that is eligible for the donation tax credit provided that the other conditions of the subsection are satisfied.

b) The comments provided in response (a) above are also applicable to this example. Where a trust makes a payment to a charity, it is a mixed question of fact and law whether the payment is a charitable gift by the trust that is eligible for a donation tax credit pursuant to subsection 118.1(3), or a distribution of capital or income to a beneficiary of the trust.

In the situation described above, the trustee "may" make payments over the next three years. This suggests that the trustee may have discretion and that the payments may be voluntary. Accordingly, the payments by the trust to the charities over the three years may be eligible for the donation tax credit provided that the other conditions of the subsection are satisfied.

Once the three years has passed, the capital remaining is to be distributed to charities. This wording suggests that the trustee may not have discretion with regard to this payment and as such, the payment by the trust may not be eligible for the donation tax credit.

c) In part, subparagraph 38(a.1)(i) provides that a taxpayer's taxable capital gain for a taxation year from the disposition of a property is equal to zero if the disposition is the making of a gift to a qualified donee of certain publicly-traded securities as described therein.

As noted in responses (a) and (b) above, whether a payment to a charity is a gift is a question of fact. However, in this example, if the facts lead to a determination that the disposition of the property from the alter ego trust is a gift to a qualified donee of securities described in subparagraph 38(a.1)(i), the trust's taxable capital gain that results from the disposition of the gift of such securities would be equal to zero.

Question 3: TOSI and Hours Worked

A safe harbour for purposes of the Excluded Business definition applies where a person works on average at least 20 hours a week during the part of the year that the business is carried on. If this test is met, then the business is considered an Excluded Business and the TOSI rules do not apply by virtue of the amount being an Excluded Amount.

It is noted that the 20 hour week rule is a safe harbour. Working less than 20 hours per week might still meet the requirement for an Excluded Business, since the wording is general in nature, using the phrase "actively engaged on a regular, continuous and substantial basis in the activities of the business".

Suppose a business is carried on through a corporation owned by husband and wife. Both husband and wife contribute an equal amount of effort but the business only requires 10 hours of work per week on average, with each spouse contributing 5 hours. In these circumstances, can the business be an Excluded Business?

CRA Response:

One of the safe harbour exclusions from TOSI is for income received by a "specified individual" from an "excluded business". The definition of excluded business is set out in subsection 120.4(1). In general, a business is an excluded business of a specified individual for a taxation year if the specified individual is actively engaged on a regular, continuous and substantial basis in the activities of the business in either: (a) the relevant taxation year; or (b) any five prior taxation years of the specified individual. Whether an individual has been actively engaged in the activities of a business on a "regular, continuous and substantial basis" in a particular year will depend on the circumstances, including the nature of the individual's involvement in the business (i.e., the work and energy that the individual devotes to the business) and the nature of the business itself. The more an individual is involved in the management and/or current activities of the business, the more likely it is that the individual will be considered to participate in the business on a regular, continuous and substantial basis.

However, without limiting the generality of the "regular, continuous and substantial basis" test described above, a specified individual will be deemed under paragraph 120.4(1.1)(a) to have been actively engaged on a regular, continuous and substantial basis in the activities of a business in a taxation year of the individual if the individual works in the business at least an average of 20 hours per week during the portion of the year in which the business operates. Paragraph 120.4(1.1)(a) is considered as a "bright line deeming rule" that is intended to eliminate some of the uncertainty inherent in the "excluded business" definition described above.

With respect to the scenario provided in the question, as the husband and wife don't work in the business at least an average of 20 hours per week during the portion of the year in which the business operates the bright line test in paragraph 120.4(1.1)(a) is not met.

Accordingly, the other factors used to determine if the specified individual is actively engaged in the activities of the business must be considered.

In Example 9 in our Guidance on the Application of the Split Income Rules for Adults, we considered a similar scenario to the one posed in this question. In that example, Spouse A and Spouse B were the only shareholders of Opco that carried on a business of developing mobile applications. Spouse A and Spouse B both had other jobs and/or attended university and only worked in the business of Opco on evenings and weekends for less than an average of 20 hours per week. There was no need for other employees or more involvement from either Spouse A and Spouse B to work in Opco's business. We concluded in that fact situation that the specified individuals could be considered as being actively engaged in the activities of the business of Opco on a regular, continuous and substantial basis.

Therefore, in the above scenario both the husband and wife could be considered to be actively engaged in the activities of the business on a regular, continuous and substantial basis even though the bright line test in paragraph 120.4(1.1)(a) is not met by either individual. It is a question of fact as to whether the husband and wife would be considered to meet the excluded business test for a particular taxation year (or continue to meet such test in any subsequent taxation year) as consideration must be given to the ongoing nature, and labour requirements of the corporation's business.

Additional guidance on the TOSI Rules can be found on the Canada Revenue Agency (CRA) website at: https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/federal-government-budgets/income-sprinkling/guidance-split-income-rules-adults.html.

Question 4: TOSI and the Meaning of "Excluded Business"

A resident of Canada ("Individual") carries on a professional practice through a professional corporation ("XCo"). Individual owns all the voting common shares of XCo and the spouse of Individual ("Spouse"), who is also an adult resident of Canada, owns non-voting preferred shares of XCo. Spouse acts as a part-time receptionist for XCo and on average, works at least 20 hours per week. Typically, a part-time receptionist working similar hours would be paid a salary of $18,000 per annum, however, Spouse, by virtue of being a shareholder of XCo, receives a dividend of $150,000 each year.

Can the CRA provide confirmation that the dividend income received by Spouse from XCo on the non-voting preferred shares will not be subject to tax on split income ("TOSI")? Specifically, can the CRA confirm that the dividend income received by Spouse will be considered an "excluded amount" pursuant to subparagraph (e)(ii) of that definition found in subsection 120.4(1) of the Income Tax Act (Canada) (the "Act") by virtue of the fact that paragraph (a) of the "excluded business" exception will apply because Spouse works at least 20 hours a week as a part-time receptionist for XCo?

CRA Response:

In the situation described above, Spouse is a "specified individual" as defined in subsection 120.4(1) and Individual is a "source individual" (also as defined in subsection 120.4(1)) in respect of Spouse. The business carried on by XCo is a "related business" in respect of Spouse for the relevant taxation year (see subparagraph (a)(ii) and paragraph (c) of the definition of "related business" in subsection 120.4(1)).

As such, if Spouse receives dividends on the non-voting preferred shares of XCo in a particular taxation year, such dividends will be "split income" unless it is an "excluded amount". Pursuant to subparagraph (e)(ii) of the definition of "excluded amount" in subsection 120.4(1), such dividends could be an excluded amount if such amount is derived directly or indirectly from an "excluded business" of the individual for the year. The term "excluded business" is also defined in subsection 120.4(1) and generally includes a business in which the specified individual is actively engaged on a regular, continuous and substantial basis in the year (see paragraph (a) of the definition of "excluded business").

It is a question of fact as to whether an individual is "actively engaged on a regular, continuous and substantial basis". Whether an individual has been actively engaged in the activities of a business on a regular, continuous and substantial basis in a particular year will depend on the circumstances, including the nature of the individual's involvement in the business and the nature of the business itself. Whether an individual is actively engaged in a business will generally turn on the time, energy and work the individual devotes to the business. The more an individual is involved in the management and/or current activities of the business, the more likely it is that the individual will be considered to participate in the business on a regular, continuous and substantial basis. Likewise, the more an individual's contributions are integral to the success of the business, the more substantial they would be.

However, without limiting the generality of the "regular, continuous and substantial" test described above, paragraph 120.4(1.1)(a) will deem a specified individual to be actively engaged on a regular, continuous and substantial basis in the activities of a particular

business for a particular year if that individual works an average of 20 hours per week of work throughout the portion of the year when the business operates.

Assuming Spouse works for XCo on average at least 20 hours a week throughout the portion of the year when that business operates, the bright-line test in paragraph 120.4(1.1)(a) is met. As such, the dividend income received by Spouse would be considered an "excluded amount" because the exception in subparagraph (e)(ii) of that definition in subsection 120.4(1) for an amount derived from an excluded business is met. Accordingly, the dividend income received by Spouse would not be subject to TOSI.

Question 5: TOSI and the Exclusion for Surviving Spouse/Spouse Age 65+

A specified individual's income or taxable capital gain for a taxation year will be an excluded amount if the amount would have been an excluded amount in respect of an individual who was, immediately before their death, the specified individual's spouse or common-law partner, assuming such amount were included in the spouse or common-law partner's income for that year.

However, there is a question of whether this exemption will apply where the deceased spouse qualified under the "excluded shares" exception based on direct ownership of the shares, and the surviving spouse holds the shares through a holding company or trust. The issue is whether the surviving spouse's indirect ownership arrangement needs to be imputed to the deceased in determining whether he or she would have qualified for an exemption from the TOSI rules.

As well, split income received by a specified individual in a year will be deemed to be an excluded amount if that person's spouse or common-law partner has attained the age of 65 in the year, and the split income would be an excluded amount if that amount had been received by the spouse or common-law partner in the year.

Again, there may be a question as to whether this exemption will apply where the spouse qualifies for the excluded shares exemption, but the specified individual does not directly own the shares in the corporation. In effect, does the specified individual's ownership arrangement impact the application of this deeming rule for purposes of the excluded shares exemption?

CRA Response:

The question raises the issue of how paragraph 120.4(1.1)(c) applies, if at all, to deem an amount to be an excluded amount in respect of a specified individual where the excluded amount to be relied on for purposes of that paragraph is the one for excluded shares.

The Applicable Law

Subsection 120.4(2) levies an additional tax on the split income of a specified individual except to the extent of such income that is an excluded amount.

A specified individual is defined in subsection 120.4 and includes an individual who is a resident of Canada at the end of the year.

Split income is defined in subsection 120.4(1) and includes income of a specified individual from, or taxable capital gains from the disposition of, shares of a corporation (other than shares of a class listed on a designated stock exchange or shares of the capital stock of a mutual fund corporation).

Split income is also defined to not include an excluded amount.

Excluded amount is defined in subsection 120.4(1) and includes, under paragraph (g) of the definition, income from, or a taxable capital gain from the disposition of, excluded shares where the individual has attained the age of 24 before the year.

Shares are excluded shares of a specified individual at any time if such shares meet the income/corporate status and ownership requirements described in paragraphs (a) to (c) of the definition of that term in subsection 120.4(1).

In particular, paragraph (b) of the definition of excluded share requires that the specified individual owns shares of the capital stock of the corporation that immediately before the time

(i) gives the holder thereof 10% or more of the votes that could be cast at an annual meeting of the shareholders of the corporation; and

(ii) have a fair market value of 10% or more of the fair market value of all of the issued and outstanding shares of the capital stock of the corporation.

A special rule in paragraph 120.4(1.1)(c) deems income or a taxable capital gain that would otherwise be split income of a specified individual to be an excluded amount in respect of the individual for a taxation year where certain requirements are met.

In particular, paragraph 120.4(1.1)(c) deems an amount of split income to be an excluded amount if either:

(i) the following conditions are met:

(A) the amount would be an excluded amount in respect of the specified individual's spouse or common-law partner for the year, if the amount were included in computing the spouse or common-law partner's income for the year, and

(B) the spouse or common-law partner has attained the age of 64 years before the year, or

(ii) the amount would have been an excluded amount in respect of an individual who was, immediately before their death, the specified individual's spouse or common-law partner, if the amount were included in computing the spouse or common-law partner's income for their last taxation year (determined as if this section applies in respect of that year);

Discussion

The application of the deeming rule in paragraph 120.4(1.1)(c) can be illustrated through the following hypothetical.

Assume A is the deceased spouse or common-law partner of a specified individual (the "Specified Individual"), and owned shares of Canco, a taxable Canadian corporation that is a private corporation, that were excluded shares of A, as that term is defined in subsection 120.4(1), throughout A's last taxation year before death. The Specified Individual is a beneficiary of a Canadian resident trust that owns a class of shares of Canco. A and the Specified Individual are residents of Canada. Canco carries on a business that was a related business of A and is a related business of the Specified Individual. The Canco shares owned by the trust were acquired during A's lifetime and were not acquired for the benefit of the Specified Individual as a consequence of A's death. Canco pays a dividend (the "Dividend") to the trust which is then distributed by the trust to the Specified Individual. By reason of subsections 104(13) and (19) and subparagraph (a)(i) of the definition of split income in subsection 120.4(1), the income (i.e. the Dividend) of the Specified Individual will be split income of the Specified Individual unless it is an excluded amount. In the circumstances, the Dividend will not be an excluded amount as income from excluded shares of the Specified Individual because the Specified Individual does not meet the ownership requirement in paragraph (b) of the definition as the Specified Individual does not directly own any shares of Canco. For purposes of this discussion, we have also assumed that the Dividend would not otherwise be an excluded amount of the Specified Individual under any other category of excluded amount listed in the definition in subsection 120.4(1).

Based on the foregoing, the Dividend will be split income of the Specified Individual unless it is deemed to be an excluded amount under subparagraph 120.4(1.1)(c)(ii) because the amount of the Dividend would have been an excluded amount if it had been included in computing A's income for A's last taxation year in the circumstances described in that subparagraph.

In general, for purposes of determining whether an amount would have been an excluded amount in respect of the deceased spouse or common-law partner (the "Spouse") of a specified individual under subparagraph 120.4(1.1)(c)(ii) if the amount had been included in the Spouse's income, consideration should be given to all of such Spouse's relevant facts and circumstances in the applicable taxation year, including in the case of determining whether an amount is an excluded amount because it is income is from excluded shares, any shares of a corporation owned by such Spouse.

Thus, in our view, the ownership requirement in paragraph (b) of the definition of excluded shares for purposes of paragraphs 120.4(1.1)(c) is based on the actual ownership of the shares of the dividend payor by the Spouse of the specified individual in the relevant year or taxation year described in subparagraphs 120.4(1.1)(c)(i) and (ii).

Based on the foregoing, subparagraph 120.4(1.1)(c)(ii) will then apply to the hypothetical as follows. The subparagraph will deem the Dividend to be an excluded amount of the Specified Individual if the amount would have been an excluded amount of A if the Dividend had been notionally included in computing A's income in A's last taxation year before death. In our circumstances, the excluded amount that is being relied on for A is the one for income from excluded shares. Whether the amount of the Dividend would have been income from excluded shares of A should take into consideration the following: (1) A owned shares of Canco throughout A's last taxation year before death; (2) such shares met the requirements for being excluded shares under subsection 120.4(1) during that period; and (3) we will consider the amount of the Dividend that was notionally included in computing A's income for purposes of subparagraph 120.4(1.1)(c)(ii) to be income from such shares. Based on the foregoing, the amount of the Dividend would have been an excluded amount in respect of A if the amount had been included in computing A's income in A's last taxation year as income from excluded shares. Accordingly, the Dividend should be deemed to be an excluded amount in respect of the Specified Individual under subparagraph 120.4(1.1)(c)(ii).

A similar analysis would apply for purposes of subparagraph 120.4(1.1)(c)(i) where the spouse or common-law partner is age 65 or over in the applicable year.

The foregoing is intended to illustrate a general approach to applying paragraph 120.4(1.1)(c) in the context of excluded shares to a relatively straightforward set of circumstances involving a basic and common share ownership structure. It is unclear whether the same approach could apply in the case of more complex structures, including structures involving holding corporations. In those cases, taxpayers should consider seeking confirmation of whether this general approach would apply to their particular fact situation. As well, the GAAR may apply where artificial transactions are undertaken to achieve a similar but inappropriate result.

Finally, note that while the foregoing discussion has been limited to the excluded amount for income from excluded shares, the deeming rule in paragraph 120.4(1.1)(c) could also generally apply based on one or more of the other categories of excluded amount listed in the definition of that term in subsection 120.4(1) which should be considered in any fact circumstance.

Question 6(a): Tracing of Owner or Property Attributes

It is unclear how the rules in subsection 120.4(1.1) will work where there have been multiple deaths. For example, assume Mr. and Mrs. A own all the shares of Opco, which operates a services business. Mrs. A has been actively engaged in the business for at least five years, whereas Mr. A has not been actively engaged in the business. Mrs. A passes away and all her shares are gifted through her will to Mr. A. Subsequent distributions from Opco to Mr. A would not be split income as Opco would be deemed to be an excluded business in respect of Mr. A, even if he is not actively engaged in the business. But how will the deeming rules apply if Mr. A subsequently dies and those shares are gifted to the children. Will they be deemed to have made the same contributions as Mrs. A? Or do the deeming rules only reference Mr. A's contributions? If the latter, then the children could become subject to the TOSI rules unless they can rely on another exemption.

CRA Response:

Subparagraph 120.4(1.1)(b)(ii) provides a continuity rule that may apply for the purposes of this subparagraph and the definition of "excluded business" in subsection 120.4(1). This rule can apply where the property (in this case the inherited shares) was acquired by, or for the benefit of, the specified individual as a consequence of the death of another person. If this rule applies, the specified individual's income on the inherited property will qualify as an "excluded amount" under subparagraph 120.4(1)(e)(ii) to the extent that the deceased individual was otherwise actively engaged on a regular, continuous and substantial basis in the activities of the particular business throughout five previous taxation years, and will not be subject to the tax on split income (TOSI). It remains a question of fact as to whether a particular individual acquired property as a consequence of the death of another individual and whether that other individual was otherwise actively engaged on a regular, continuous and substantial basis in the activities of such business throughout five previous taxation years.

With respect to the acquisition of Mrs. A's Opco shares by Mr. A as a consequence of her death, Mr. A will be deemed to have been actively engaged on a regular, continuous and substantial basis in the activities of Opco's business throughout five previous taxation years for the purposes of the "excluded business" definition for all taxation years commencing with the year in which such Opco shares were so acquired. Therefore, any dividends arising on any Opco shares owned by Mr. A for a taxation year commencing with the year in which such shares were acquired as a consequence of Mrs. A's death will not be subject to the TOSI.

Similarly, in our view, the effect of the previous application of the deeming rule in subparagraph 120.4(1.1)(b)(ii) could extend to a subsequent acquisition of property as a consequence of death of another individual. This would be the case where in respect of a particular property the particular deceased individual was previously deemed by subparagraph 120.4(1.1)(b)(ii) to have been actively engaged on a regular, continuous and substantial basis in the activities of that particular business throughout five previous taxation years.

For instance, for the purposes of subparagraph 120.4(1.1)(b)(ii) and the definition of "excluded business" in subsection 120.4(1), Mr. A was deemed by this subparagraph to have been actively engaged on a regular, continuous and substantial basis in the activities of Opco's business throughout five previous taxation years when he acquired shares of Opco as a consequence of Mrs. A's death. Similarly, when the children inherit Mr. A's Opco shares as a consequence of his death, subparagraph 120.4(1.1)(b)(ii) will apply to deem each of the children to have been actively engaged on a regular, substantial and continuous basis in the business of Opco throughout five prior taxation years since Mr. A was also deemed by subparagraph 120.4(1.1)(b)(ii) to have met that requirement. As a result, the income from Opco, which would otherwise be subject to TOSI, would be an excluded amount under the excluded business definition, as discussed above. Therefore, any dividends arising on any of the shares of Opco owned by the children, for any taxation year commencing with the taxation year in which they inherited Mr. A's Opco shares, will not be subject to the TOSI.

Question 6(b): Tracing of Attributes (Continued)

Consider the situation where Mr. A passed away in Year 1 and Mrs. A passed away in Year 2. In each of their will, they each bequest ½ of their shares of Opco to each of their 2 inactive children. As a result, each child received ½ of his/her shares of Opco from Mr. A and the other ½ from Mrs. A. Is each child entitled to the excluded business exemption in respect of all future dividends received from Opco?

CRA Response:

As noted above, Mr. A was not actively engaged on a regular, continuous and substantial basis in the activities of Opco's business throughout five previous taxation years before his death and he did not inherit any of Mrs. A's Opco shares before his death. As such, when his children acquire his shares of Opco, as a consequence of his death, the conditions in subparagraph 120.4(1.1)(b)(ii) would not be met. Therefore, the "excluded business" exemption will not apply at that time, and any dividends arising on the shares of Opco they inherited from Mr. A will initially be subject to the TOSI (unless another exception applies).

However, beginning with the taxation year in which the children inherit Mrs. A's Opco shares as a consequence of her death, subparagraph 120.4(1.1)(b)(ii) will apply such that each of the children will be deemed to have been actively engaged on a regular, substantial and continuous basis in the business of Opco throughout five prior taxation years. Based on the foregoing, income from Opco that would otherwise be subject to TOSI would be an excluded amount under the "excluded business" definition as discussed above. Therefore, once the children inherit shares of Opco from Mrs. A, any dividends received on any of the Opco shares (including those previously acquired on Mr. A's death) will not be subject to TOSI from that taxation year onward.

Additional guidance on the TOSI rules can be found on the Canada Revenue Agency (CRA) website at: https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/federal-government-budgets/income-sprinkling/guidance-split-income-rules-adults.html

Question 7: Nature of Income of Author/Musician

A) The case of *Roco Gagliese Productions Inc. v. The Queen*, 2018 TCC 136 involved determining the nature of copyright royalties received by an author/musician. The question was whether the income was royalty income (which would be from a specified investment business) or income from services (which would be active business income). It was held that the income was income from services because the person who derived the income was earning the income in the normal course of his business. Does CRA agree with the decision in this case?

B) If so, how does the decision apply to a mortgage lending business that earns interest income on a business of renting real estate?

CRA Response:

A) A specified investment business ("SIB") is defined in subsection 125(7) of the Income Tax Act ("Act") as a business the principal purpose of which is to derive income from property (e.g., interest, dividends, real estate rentals and royalties), subject to certain exclusions which are not relevant for the purposes of this discussion.

We agree with the Tax Court of Canada (TCC) decision in *Rocco Gagliese Productions Inc. v The Queen* 2018 TCC 136. In particular, we agree with the court's decision to allow the appeal on the basis of the factual findings of that case: that the principal purpose of the taxpayer's music composing business was to derive income from the provision of services, and that the residual income from music tracks aired in reruns of television episodes was incident to and pertained to the taxpayer's active business.

Our position as stated in technical interpretation 9722915 and confirmed in document 2007-0238221E5 remains unchanged. Although royalty income is generally considered to be income from property, such income will be considered to be income from an active business where it can be established that the income is related to an active business carried on by the recipient taxpayer in the year, or the recipient taxpayer is, in the year, in the business of originating property from which the royalties are received.

If a taxpayer is in the business of composing music, the income it earns with respect to its copyrighted music would generally be considered active business income. The fact that such income is in the form of royalties is not, in and by itself, sufficient to conclude that it is property income. Whether royalties are income from property or from an active business will depend on the circumstances of the particular case.

B) It is unclear from the question what is the interconnection between the mortgage lending business and the real estate rental business. We can, however, provide some general comments.

Our position as stated in document 2002-0168576 remains unchanged:

"Pursuant to subsection 125(7) of the Act, the expression "income of the corporation for the year from an active business" generally refers to income from an active business carried on by it, including any income for the year pertaining to or incident to that business. As indicated in paragraph 5 of IT-73R6, the expressions "pertains to" or "incident to" involve a financial relationship of dependence of some substance between a property and an active business before the property is considered to be incident to or to pertain to the active business carried on by the corporation. In addition, the operations of the business have to have some reliance on the property such that the property is a back-up asset that could support the business operations either on a regular basis or from time to time.

Moreover, the courts have also held that when a corporation derived income from an activity that was inseparable from its normal active business, such income may properly be classified as active business income. If the income is part of the normal business activity of the corporation, and it is inextricably linked with an active business, it will be considered active business income."

If the principal purpose of a corporation's business is to derive income from property, (such as interest or rental income), it does not employ more than five full time employees, and none of the other exceptions apply, the income will be considered to be income from a specified investment business. The question posed does not identify an active business, so, in our view, the interest and rental income does not "pertain to", and is not "incident to", "inseparable from" or "inextricably linked" an active business carried on by the corporation.

Question 8: CRA's Views on Contingency Fees and WIP

As a result of recent changes to the taxation of WIP for certain professionals, the CRA has published the following statement as it relates to contingency fee arrangements made by certain professionals under FAQ #5 at https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/federal-government-budgets/budget-2017-building-a-strong-middle-class/billed-basis-accounting.html :

Under the terms of a contingency fee arrangement, all or a portion of a designated professional's fees may only become known and billable at some time after the taxation year in which the professional provided services under the arrangement (e.g., where, under the terms of a written contingency fee agreement between a personal injury lawyer and a client, legal fees are only billable by the lawyer on a periodic basis as amounts are received by the client under a negotiated settlement or a court judgment). Until such time, there is often no liability on the professional's client to pay any fee; consequently, no amount is receivable by the professional until the right to collect the amount is established. Under these circumstances, for purposes of determining the value of the professional's work in progress at the end of the year, no amount would normally be recognized. As a result, the proposed change to eliminate the ability of designated professionals to elect to use billed-basis accounting is not expected to have any impact on these types of contingency fee arrangements where the terms and conditions of such arrangements are bona fide.

While this position is very generous for the professional that has entered into a contingent fee arrangement, we question whether this position is correct. Specifically paragraph 10(4)(a) of the Act states:

work in progress at the end of a taxation year of a business that is a profession means <u>the amount that can reasonably be expected to become receivable</u> in respect thereof after the end of the year;

Accordingly, the amount of WIP that a professional is required to value is the amount that can reasonably be expected to become receivable after the end of the year. It would not seem unreasonable that a professional should be able to value its contingent fee files to determine what amounts could reasonably be expected to become receivable after the end of the year. Can the CRA reconcile its administrative position to the law?

CRA Response:

In computing income from a business, a taxpayer must generally take their work in process (WIP) into account. Subsection 10(5) of the Income Tax Act (the Act) provides that WIP of a business that is a profession is inventory. Consequently, under subsection 10(1) of the Act, inventories of WIP shall be valued at the end of the year at the cost at which the taxpayer acquired the WIP or the fair market value (FMV) of the WIP at the end of the year, whichever is lower, or in a prescribed manner.

Paragraph 10(4)(a) provides, with certain exceptions, that the FMV of WIP at the end of a taxation year of a business that is a profession means the amount that can reasonably be expected to become receivable in respect thereof after the end of the year.

When a designated professional, as part of an agreement, undertakes to provide services in exchange for contingency fees, sometimes, a portion or all of these fees cannot be known or determined until after an event or a time occurring after the taxation year during which

the designated professional provided the services under the terms of the agreement. In this situation, at the end of the taxation year, the FMV of such WIP of the designated professional would be nil. However, in certain situations, it is possible, at the end of the year, to establish an amount that can reasonably be expected to become receivable in respect of this WIP after the end of the taxation year. In this case, the CRA's view is that the FMV of this WIP should correspond to this amount.

Question 9: Estate immigrating to Canada

A non-resident individual passed away in June 2016. The Estate which arose on the death ("Estate") was non-resident at that time and section 94 does not apply to it.

On January 1, 2018, the non-resident trustee of the Estate resigned and a new trustee was appointed. The new trustee was a resident of Canada and from that time onward the management and control of the Estate took place in Canada. As such, the Estate became factually resident in Canada and pursuant to subparagraph 128.1(1)(a)(i) of the Act, a new taxation year of the Estate commenced at the time of the Estate's immigration to Canada, and the taxation year which would have otherwise included that time, ceased.

The Estate will file its first tax return in Canada for the period January 1, 2018 to December 31, 2018. The taxation year is no more than 36 months after the death.

a) Can the Estate designate itself as the graduated rate estate ("GRE") of the individual when filing its first tax return under Part I of the Act?

b) If the individual had not, before the death, been assigned a Social Insurance Number ("SIN"), what other information is acceptable to the Minister for purposes of paragraph (c) of the definition of GRE in subsection 248(1) of the Act?

CRA Response:

a) Pursuant to the definition of a GRE in subsection 248(1), an estate that arose on and as a consequence of the death of an individual can only be the GRE in respect of that individual if all of the requirements in paragraphs (a) through (e) of the definition are met.

Specifically, paragraph (d) requires that the estate designates itself as the GRE of the individual in its return of income under Part I for its first taxation year that ends after 2015. In our view, this requirement will be met where the designation is made in the return of income under Part I for the first taxation year that ends after 2015 in which the estate is required to file a return of income under Part I.

In the example provided, there are no facts which suggest that the Estate was required to file a return of income under Part I before the 2018 taxation year. Therefore, assuming all of the other requirements of the GRE definition are met, the Estate could designate itself as the GRE of the individual when filing its return of income under Part I for its 2018 taxation year.

b) Paragraph (c) of the definition of GRE in subsection 248(1) requires that the individual's SIN (or if the individual had not, before the death, been assigned a SIN, such other information as is acceptable to the Minister) is provided in the estate's return of income under Part I for each taxation year.

If the individual had not, before the death, been assigned a SIN, the Minister would accept a Temporary Tax Number (TTN) or an Individual Tax Number (ITN). An ITN can be obtained by filing Form T1261, "Application for a Canada Revenue Agency Individual Tax Number (ITN) for Non-Residents". The application requires supporting certified documents. In situations such as the example provided, a death certificate would be an appropriate supporting certified document.

Question 10: Graduated Rate Estate and Non-resident individual

An individual who was a U.S. citizen and resident in the U.S. throughout their life owned real estate in Canada at the time of their death. The individual had never worked in Canada and as such did not have a Social Insurance Number ("SIN"). Assume that the executor of the estate is resident in the U.S. and all decisions related to the estate are made in the U.S. such that the estate is factually resident in the U.S. The executor filed a T1 return for the deceased, reporting a capital gain in respect of the deemed disposition of the real property at death. The executor anticipates that the estate will also realize a gain on the disposition of the property.

Does the requirement for a SIN or "such other information as is acceptable" in paragraph (c) of the definition of a graduated rate estate ("GRE") in subsection 248(1) preclude an estate from meeting the definition of a GRE in its first taxation year where the deceased person is a non-resident? Can an estate be a GRE where the estate is not resident in Canada? If GRE status is possible in these situations, what

would the CRA consider as “such other information as is acceptable” to meet the requirement in paragraph (c) of the definition of graduated rate estate?

CRA Response:

The conditions within the GRE definition in subsection 248(1) do not require that an estate or individual (immediately before their death) be resident in Canada. Instead, the condition for the estate to provide the SIN or “such other information as is acceptable” in paragraph (c) of the definition of a GRE relates to the fact that a deceased individual can only have one estate. This requirement allows the CRA to ensure that only one GRE designation can be made for a deceased individual.

We have confirmed with the CRA T3 Trust Returns Assessing Section that in order to meet the “other such information” condition, an estate may provide a temporary tax number (TTN) or individual tax number (ITN) for the deceased individual on the trust return, if a SIN is not available.

Question 11: Graduated Rate Estate and Qualified Disability Trust

Consider a situation in which an individual’s will provides that the residue of their estate is bequeathed to a single beneficiary. Assume that for the first 36 months of the estate it qualifies as a graduated rate estate (GRE) and the appropriate GRE designations are made in the estate’s T3 returns. The nature of some of the property of the estate is such that it is not converted into cash until late in the third year after the individual’s death.

During the 36 month GRE period, the beneficiary becomes disabled such that they are eligible to claim the disability tax credit for the foreseeable future. Can the estate continue indefinitely and elect to be treated as a qualified disability trust each year such that the graduated tax rates will continue to apply?

CRA Response:

Generally, where an estate and the particular beneficiary meet the requirements in the definition of a qualified disability trust (“QDT”) within subsection 122(3) the estate may be a QDT.

That being said, there are certain questions of fact and law that must be considered. Generally, the administration of an estate includes collecting the deceased’s assets, paying the deceased’s debts including any taxes of the deceased or estate, and distributing the residue of the estate to the beneficiaries specified under the will or pursuant to provincial intestacy laws. Although this is a question of fact dependent on the particular provincial laws and the will instrument, estate administration typically does not include the ongoing management of assets that have been bequeathed to a particular individual. In the scenario provided, the will directs the executor to pay the residue of the estate to the beneficiary, and as a result it would be difficult to argue that the administration of the estate be extended indefinitely. To the extent that the particular facts and law suggest that the estate administration is complete and beneficial ownership has passed to the residual beneficiaries who are entitled to the property, there will be no income earned within the estate.

Alternatively, to the extent that the particular facts and law suggest the beneficiary is able to enforce payment of the income earned within the estate, there would be no income taxable in the estate as it would all be considered to be payable to the beneficiary under subsection 104(13), consistent with subsection 104(24).

To ensure the benefits of being a QDT are available, it would be prudent for taxpayers to have the appropriate language in their will that provides for the establishment of a testamentary trust which qualifies as a QDT and is separate from their estate.

Question 12: Attribution under subsection 75(2)

Income attribution rules, generally speaking, operate so that income of one person (the actual recipient of the income) is attributed to and becomes income of another person (the transferor). Section 74.1(and other provisions) use this type of language. However, subsection 75(2) does not employ this language. Under subsection 75(2), income is considered to be the income of another taxpayer (the contributor of property to the trust) without explicitly stating that the income is removed from the trust itself.

Whether or not income which is subject to subsection 75(2) is first and foremost income of the trust itself can be significant for the following reasons:

i. How the trust return is prepared; or

ii. Whether or not a liability for alternative minimum tax could arise (if the income is removed from the trust by way of deduction at line 471 of the T3 Return)

The treatment of income where subsection 75(2) applies was considered in the case of *Fiducie Financiere Satoma v Canada* ("Satoma"; 2018 DTC 5052, Federal Court of Appeal "FCA"). There it was concluded that the dividend income attributed under subsection 75(2) was not income of the trust.

In light of the comments made in the judgment concerning how subsection 75(2) operates, does CRA now accept that income (and capital gains) subject to subsection 75(2) is never income of the trust in the first place? If so, would it be appropriate to simply omit from the trust return the income which is subject to subsection 75(2)? Further, does the CRA now agree that there would be no need to prepare a T3 slip for the attributed income as the CRA's administrative position currently requires?

CRA Response:

Firstly, we note that the *Satoma* case involved a situation in which the CRA reassessed the trust under the GAAR where a series of transactions led to an abuse of subsections 75(2) and 112(1) of the Act. A series of transactions was undertaken to ensure that subsection 75(2) would apply to the trust such that the dividend income received by the trust would be attributed to a corporation (referred to in the case as "9134"). The corporation was able to claim a deduction under subsection 112(1) and as a result, the income was not taxed in either the trust or in the corporation. The Federal Court of Appeal affirmed the decision of the Tax Court of Canada ("TCC") and upheld the CRA's GAAR reassessment.

It appears that your comment in respect of *Satoma* is based on paragraphs 33 to 37 and 53 of the FCA decision. In paragraph 35, Justice Noel referred to the TCC decision and whether the wording of subsection 75(2) supported the exclusion of the dividends from the Satoma Trust's income in comparison to the wording of other attribution rules (for example section 74.1) which specifically provide that when income is deemed to be the income of a taxpayer, it is deemed not to be income of another person. Noel C.J., noted that subsection 75(2) is silent in regard to the exclusion provided in other attribution provisions. However, he opined that those kinds of express exclusions are inserted for greater certainty. He also noted that in respect of dividend income, subsection 82(2) further provides that where a dividend is attributed to another person pursuant to subsection 75(2), that person is also deemed to receive it. Noel C.J. concluded by noting that the same dividend cannot be received by two persons at once.

While we acknowledge the comments in *Satoma*, we note that the comments are not specifically aimed at the trust return reporting requirements. As such, we must emphasize, as in previous roundtable responses, that the T3 Return is an information return in addition to being a return of income. The T3 return serves to report information about the trust itself along with information that affects the taxation of persons who have some connection to the trust.

The longstanding CRA position for trusts holding property subject to subsection 75(2) is that section 204 of the Regulations imposes a requirement to file a T3 return where the trustee has control of or receives income, gains or profits in the trustee's fiduciary capacity, even if the trustee computes nil income for the trust for tax purposes. This includes circumstances where the trust has no income for tax purposes because subsection 75(2) applies to recognize amounts as another person's income for tax purposes. This is noted in several CRA documents, including CRA Roundtable responses at the 2006, 2016 and 2017 STEP Conferences (documents 2006-0185561C6, 2016-0645811C6, and 2017-0693371C6). The requirement to report income in this manner ensures proper administration of the tax system including the assessment of the tax payable of a settlor or contributor of property to a trust.

Page 45 of the 2018 T4013 - T3 Trust Guide notes that amounts attributed pursuant to subsection 75(2) "are considered to belong to the contributor during the contributor's life or existence while a resident of Canada. The trust must still report the amount on the trust's T3 return and issue a T3 slip reporting the amount as that of the contributor of the property".

Schedule 9, Income Allocations and Designations to Beneficiaries is used to report any income that is being attributed and amounts on Schedule 9 are then transferred to Line 471 on the T3 Return as a deduction from the trust's income. While this approach may be suitable for the majority of trusts holding property that is subject to subsection 75(2), we will consider whether the approach is appropriate especially in the context of the calculation of minimum tax on the T3 Schedule 12. We will also consider whether the T3 Trust Guide should be revised and any adjustments to the T3 assessing system are required.

Question 13: TOSI and Preferred Beneficiary Election

The preferred beneficiary election is made jointly by a trust and a preferred beneficiary pursuant to subsection 104(14). The term "preferred beneficiary" is defined in subsection 108(1) to be an individual resident in Canada who is a beneficiary of a trust who has either a severe and prolonged impairment in physical or mental functions that qualifies for the disability amount, or, if at least age 18, is dependent on another individual because of mental or physical infirmity and whose income does not exceed an amount referenced to

the basic personal tax credit for single status. In addition, the individual must be a settlor of the trust, a spouse, common law partner or former spouse or common law partner of the settlor, or a child, grandchild or great grandchild of the settlor, or the spouse or common law partner of such person.

The preferred beneficiary election allows the trust to "allocate" income of the trust to the preferred beneficiary, whereupon the trust can take a deduction and the amount is included in the income of the preferred beneficiary.

The question is whether an amount included in a beneficiary's income under a preferred beneficiary election is split income or not under paragraph (c) of the definition of "split income" in the TOSI rules. Paragraph (c) refers to an amount included in a beneficiary's income because of the application of subsection 104(13) or 105(2) and does not refer to the preferred beneficiary election where the designated amount is included in the beneficiary's income pursuant to subsection 104(14).

CRA Response:

The definition of "split income" in subsection 120.4(1) is relevant in determining income of a specified individual that is subject to the tax on split income, as provided for in subsection 120.4(2). The "split income" definition requires that the total of each amount which is to be included pursuant to paragraphs (a) through (e) be determined for a given taxation year.

In general terms, the preamble to paragraph (c) provides for the inclusion in the split income calculation of the portion of certain trust income described in subparagraphs (i) and (ii) that is included in the income of the specified individual pursuant to subsection 104(13) or 105(2). The amount of income which is allocated to a preferred beneficiary in a given year is included in that beneficiary's income for that year pursuant to subsection 104(14). Accordingly, paragraph (c) of the "split income" definition is not applicable to this amount.

However, one must also consider subparagraph (a)(i) of the definition, which provides for the inclusion of certain taxable dividends received by the specified individual. If the income allocated to a preferred beneficiary election is also subject to a subsection 104(19) designation, the amount so designated is deemed to be a taxable dividend received by the preferred beneficiary, for purposes of the Act (other than Part XIII). Accordingly, the amount designated under subsection 104(19), if not an "excluded amount" as defined in subsection 120.4(1), and not in respect of shares listed on a designated stock exchange or on shares of a mutual fund corporation, must be considered in the split income calculation.

Question 14: TOSI and the Preferred Beneficiary Election

In the Summary portion of Technical Interpretation 2018-0759521E5, the CRA indicated that if a designation under subsection 104(19) is made in respect of a preferred beneficiary income amount resulting from an election under subsection 104(14), the amount would be includable in the definition of "split income" by virtue of paragraph (a) of that definition. However, the CRA did not provide any explanation for this statement in the body of the External Interpretation document. By referring only to trust income under subsections 104(13) and 105(2) in paragraph (c) of the split income definition, it appears to us that the provision was deliberately drafted to exclude a preferred beneficiary elected income amount, and this has been the case since the introduction of the kiddie tax rules in 2000. We submit that it was always common practice to make the subsection 104(19) designation in respect of any dividend income allocation made under a preferred beneficiary election to allow the beneficiary to access the gross-up and dividend tax credit regime, and in fact, all major tax return preparation software automatically preserve dividend characterization (in effect making the subsection 104(19) designation) whenever a trust receives dividend income that is allocated to a preferred beneficiary. Can the CRA (i) elaborate on its reasoning behind its comment regarding subsection 104(19) in Technical Interpretation 2018-0759521E5, (ii) confirm its position on this matter for minor preferred beneficiaries for years prior to 2018, (iii) provide guidance on how a T3 return and slip should be prepared to avoid a subsection 104(19) designation when allocating a taxable dividend to a preferred beneficiary, and (iv) consider granting relief for all historical preferred beneficiary elections made?

CRA Response:

i) The fact scenario that we were asked to comment on in Technical Interpretation 2018-0759521E5 was such that there was no dividend income received by the trust that made the subsection 104(14) election.

Accordingly, our response noted that the amount included in the income of the preferred beneficiary in that case would not be considered to be split income by virtue of paragraph (c) of the "split income" definition.

The Summary section of Technical Interpretation 2018-0759521E5 qualifies the statements made in the body of the letter to highlight what might be best categorized as an exception to the general conclusion that amounts subject to a preferred beneficiary election are not considered to be split income, by virtue of paragraph (c) of the "split income" definition. An election by a trust and a preferred beneficiary to include such part of the accumulating income of the trust in the preferred beneficiary's income would not be subject to

TOSI unless a designation is made under subsection 104(19) in respect of that income, as indicated in our response in Question 13. This comment was made upon considering that:

- subparagraph (a)(i) of the definition of "split income" in 120.4 includes in computing income an amount "in respect of taxable dividends received by the individual in respect of shares of the capital stock ...";
- subsection 104(19) deems the amount so designated to be a taxable dividend received by the taxpayer (the preferred beneficiary) for all purposes of the Act other than Part XIII; and
- there is no legislated exclusion from TOSI for dividends designated under subsection 104(19).

ii) This position is not a new interpretation. It is consistent with the statements made in Technical Interpretation 2000-0056385, which was published in 2000. In addition, it should be noted that the 2018 T3 Guide (Publication T4013) points out on page 44 that:

> "The tax on split income applies to all of the following:
>
> > taxable dividends allocated by the trust (other than dividends from shares of a class listed on a designated stock exchange and those of a mutual fund corporation)"

This wording is consistent with the wording contained in each T3 Guide since 2000, the year the Kiddie Tax (now TOSI) legislation became effective.

iii) In order to "avoid" a subsection 104(19) designation when allocating a taxable dividend to a preferred beneficiary the T3 slip can be prepared showing the amount so allocated in box 26 "Other Income".

iv) We have discussed this issue with the Department of Finance and have confirmed that our interpretation of this matter is consistent with tax policy. As such, the CRA will not be granting relief for all historical preferred beneficiary elections made.

Question 15: CPP/EI Rulings

Many small businesses hire "contractors" to assist in the day-to-day business operations. It is a question of fact whether the CRA considers such "contractors" to be employees or self-employed workers. Accordingly, in order to reduce withholding risks, many small business owners request a ruling from CPP/EI to ensure proper treatment. However, some STEP members have recently become aware that the CRA has an internal policy of conducting a trust account examination (for example payroll and GST HST remittance accounts), after a ruling determination. This trust examination can result in additional ruling requests along with additional payroll taxes, interest and penalties, and the possibility of additional professional fees associated with representations to the CRA. Can the CRA confirm that it is indeed their internal policy to review trust accounts of the payer after a CPP/EI ruling has been completed?

CRA Response:

A CPP/EI ruling is an official decision that an authorized officer of the Canada Revenue Agency (CRA) makes. It confirms whether a worker is an employee or is self-employed, and whether the worker's employment is pensionable or insurable for purposes of the Canada Pension Plan and the Employment Insurance Act. A payer can ask the CRA for a ruling if they are not sure whether they should deduct CPP contributions and EI premiums from a worker's pay. And a worker can also request a ruling to ask whether CPP contributions and EI premiums should be deducted from their pay.

The responsibilities of the payers are different if the CRA determines that there is an employer/employee relationship or if the worker is self-employed. Employers are liable for deducting and remitting the income tax, Canada Pension Plan contributions, and employment insurance premiums on the wages made to the employees if the employment is determined to be pensionable or insurable, or both.

When the CPP/EI Rulings Division receives a ruling request from a payer or a worker, it does not automatically send a referral to the Trust Accounts Examination Division after the ruling is completed. A referral is sent in specific situations and solely to ensure compliance from the employer. For example:

- If the ruling changed the employment status of the worker from self-employed to employee or from employee to self-employed
- If, after examining all the circumstances of the employment of a worker who is related to the employer, the CRA determined that they were dealing at arm's length and that the employment was insurable, but the employer did not remit EI premiums for the worker

- Or for example if the ruling confirmed there was an employer/employee relationship and no source deductions have been made and the payer has not reported the wages or issued T4 slips in the name of the worker

As per the established policy, when the Collections and Verification Branch receives a referral from the CPP/EI Rulings Division for a completed ruling, the employer account is assigned for a trust accounts examination . The examination officer will contact the employer for an appointment so that the officer can examine the employer's payroll books and records. The examination officer is to confirm/validate that the employer has deducted and remitted the required CPP and/or required EI for the ruled employee for the period stated in the CPP/EI Rulings Division's letter that was sent to the employer.

When a trust accounts examination referral is received from the CPP/EI Rulings Division for a payroll examination, the examination officer will also review the GST/HST account on the CRA database to determine whether there are any outstanding returns. If the GST/HST account is non-compliant, the examination officer will then examine the employer/registrants payroll and GST/HST books and records.

Question 16: Small Business Deduction and Passive Income

Effective for taxation years beginning in 2019, the amount that can be claimed under the small business deduction will be reduced if investment income (adjusted aggregate investment income) of the corporation and associated corporations for taxation years ending in the preceding calendar year exceeds $50,000.

An anti-avoidance rule (subsection 125(5.2)) deems corporations which are related but not associated to be associated for the purposes of this rule where it may reasonably be considered that one of the reasons for a loan or transfer was to reduce investment income and increase the amount which can be claimed under the small business deduction.

Assume that a corporation (Opco) is owned by five corporations (Holdco 1 through Holdco 5). All corporations are related to one another but not associated.

Opco has established a pattern in the past of paying dividends equal to substantially all of its annual income. The Holdco's have built up large amounts of investment funds.

In these circumstances, would CRA generally accept that the anti-avoidance rule in subsection 125(5.2) would not apply if Opco continues its practice of paying annual dividends?

This anti-avoidance provision also specifies that these transfers include transfers via a trust. There are conceivably numerous situations in which a taxpayer may want to transfer property to a trust or entities controlled by a trust for estate planning reasons unrelated to the SBD.

Can the CRA please provide guidance on how CRA plans to enforce this rule for the large number of transfers to trusts which may result in a dissociation of assets previously held in a corporation and a reduction in AAII?

CRA Response:

A corporation's entitlement to the small business deduction for a particular taxation year is determined by reference, among other things, to the business limit of the corporation for the particular taxation year that is otherwise determined under section 125 of the Income Tax Act.

Subsection 125(5.1) of the Act is amended to provide an additional restriction to a corporation's business limit based on certain investment income of the corporation and its associated corporations. The corporation's business limit will now be reduced by the greater of the reduction provided under the existing rule (the taxable capital reduction), now contained in paragraph 125(5.1)(a), and the new "passive income reduction," contained in paragraph 125(5.1)(b).

The passive income reduction reduces a corporation's business limit for a taxation year (as otherwise determined) by five dollars for every dollar by which the corporation's "adjusted aggregate investment income" (as newly defined in subsection 125(7)), and that of its associated corporations, for taxation years ending in the preceding calendar year exceeds $50,000.

The passive income reduction will apply to taxation years that begin after 2018. However, the passive income reduction may also apply to a taxation year beginning before 2019 if certain planning is undertaken to defer the application of either the passive income reduction or the amendments to section 129.

Subsection 125(5.2) contains an anti-avoidance rule that applies to a loan or transfer of property between corporations that are related but not associated.

Subsection 125(5.2) operates to deem two corporations associated with each other when they are otherwise not associated. It applies where the corporations are related to each other, one corporation (directly or indirectly) transfers assets to the other corporation and one of the reasons for the transfer can reasonably be considered to be to reduce the amount of the adjusted aggregate investment income of the associated group for the purposes of the passive income reduction rule in paragraph 125(5.1)(b).

Whether subsection 125(5.2) would apply in any given situation remains a question of fact that can only be made once all the relevant facts of a particular situation are known and have been fully considered. However, if it may reasonably be considered that one of the reasons that the payment of dividends was made was to reduce the adjusted aggregate investment income as determined in paragraph E of paragraph (5.1)(b) in respect of Opco, or of any corporation with which Opco is associated, then in our view the anti-avoidance rule in subsection 125(5.2) could apply.

When the Canada Revenue Agency detects an aggressive tax plan or a potentially abusive transaction, it will consider whether a technical provision and/or a specific anti-avoidance provision in the Act can be applied. The determination of any specific audit approach is dependent on the specific facts and circumstances of each situation.

Question 17: Part XVIII of the Act

Can the CRA provide recent statistical data with respect to data that it is required to collect and transmit to the US IRS pursuant to Part XVIII of the Act and the Inter-Governmental Agreement between the US and Canada? For example, how many accounts' information was transmitted during the last transmission period? Has the US requested any further information in respect of any of the transmitted data?

CRA Response:

As of April 1, 2019, the CRA had sent over 700,000 records to the Internal Revenue Service (IRS) under the Canada/U.S. Intergovernmental Agreement (IGA) for the 2017 tax year. Apart from standard automated notifications to identify file and record level errors, no further information has been requested by the U.S. with respect to this data.

Question 18: Update re DTS

The Canada Revenue Agency (CRA) launched a new dedicated telephone service for income tax service providers in July of 2017. Service providers are accountants and other professionals (such as bookkeepers and lawyers) who provide general audit, accounting, tax, and other advisory services to individuals and businesses. In the previous 2018 STEP Roundtable update, the CRA indicated that if the pilot was successful, it would consider expanding the DTS nationwide and to more income tax service providers on a permanent basis.

Can the CRA provide an update on the status of the DTS pilot project?

CRA Response:

The CRA understands that income tax service providers are highly influential in promoting income tax compliance in Canada. In Budget 2016, the Government announced that the CRA would pilot a new dedicated telephone support line for income tax service providers. After putting the necessary infrastructure into place, the CRA launched the Dedicated Telephone Service (DTS) pilot project in July of 2017. The objective of the DTS is to assist professionals in the business of preparing income tax returns by providing them with access to experienced CRA staff who can help with more complex technical issues.

Initially offered to eligible Chartered Professional Accountants (CPAs) in Ontario and Quebec, the DTS quickly expanded to include CPAs in Manitoba and New Brunswick, provided they prepared income tax returns for clients and met the eligibility requirements (sole proprietors or a partner or shareholder of a firm with up to three partners or shareholders). In March of 2018, the DTS was further expanded to include all eligible non-CPAs (such as bookkeepers and other tax preparers) in Ontario, Quebec, Manitoba and New Brunswick.

The DTS expanded nationally in January of 2019 to include all small and medium-sized income tax service providers across Canada (those in firms with 50 partners or less). More than 4,000 service providers were registered and had access to the DTS in time for the busy tax filing season. Feedback has been very positive, with an overwhelming majority of the respondents strongly agreeing that they are satisfied with the information and service being provided.

Based upon its success and reception by the tax service industry, the Government announced in Budget 2019 that it would provide ongoing funding to make the well-received DTS program permanent, improving service for the millions of Canadians who work with tax service providers each year.

Building on its achievements thus far, the DTS project team is currently making preparations to transition the pilot into a permanent program. This includes establishing new performance objectives as well as formulating strategies to enhance and build new relationships with industry partners and associations.

Income tax service providers who are interested in registering can visit the DTS web page for more information, including the revised eligibility criteria and details on how to register: www.canada.ca/en/revenue-agency/campaigns/dedicated-telephone-service.html