STEP Canada
ADVISING FAMILIES ACROSS GENERATIONS

December 23, 2025

Lindsay Gwyer
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Via email: Lindsay.Gwyer@fin.gc.ca

cc: Lauchlin MacEachern <Lauchlin.MacEachern@fin.gc.ca>

Dear Ms. Gwyer,

RE: Technical Amendment Request – Part IV Determination for Assessable Dividends Distributed by a Trust

The STEP Canada Tax Technical Committee respectfully submits this request for a technical amendment to the *Income Tax Act* ("the Act") to address a legislative gap in the application of Part IV tax to dividends flowing through trusts, as highlighted by the Federal Court of Appeal in *Canada v. Vefghi Holding Corporation* (2025 FCA 143) ("*Vefghi*"). Our submission is grounded in the principle that the Act should operate with internal consistency and fairness. This request seeks a technical correction, not a change to the scheme or policy of the Act.

Background and Legislative Context
Subsection 186(6) was introduced in June 1988 as part of a comprehensive update to the Part IV tax rules, following the 1987 Tax Reform White Paper under the leadership of the Honourable Michael H. Wilson. The White Paper repeatedly emphasized the need for an "internally consistent" tax system. Subsection 186(6) was designed to ensure that, for Part IV purposes, dividends received by a partnership flow through to its partners, with each partner being deemed to own a proportionate share of the partnership's shares based on their share of dividends received.

Importantly, the same 1988 Bill also made major updates to the flowthrough provisions for trusts, including subsections 104(19) to (21), (22), and (27), clearly intending parallel treatment for both partnerships and trusts so that income passing through these intermediaries would be taxed consistently in the hands of the ultimate recipient.

The Federal Court of Appeal Decision in *Vefghi*
In *Vefghi*, the Federal Court of Appeal held that the relevant time for determining whether a payer corporation is "connected" with a corporate beneficiary receiving the dividend income through a trust is not the date on which the dividend is paid, but rather the last day of the trust's taxation year, because that is the day subsection 104(19) deems the corporate beneficiary to receive a taxable dividend and, by extension, an "assessable

dividend" to which Part IV tax applies. In *Vefghi*, the payer corporation was sold to an arm's-length buyer during the year, making it impossible for it to be connected with the corporate beneficiary on the last day of the trust's taxation year.

Not only is this result at odds with the 1988 Bill's intent for parallel treatment, but it also creates a disparity between partnerships and trusts that is both inequitable and commercially disruptive. We believe that this is a technical anomaly, not a deliberate policy outcome.

Practical and Policy Implications

The impact of this legislative gap is not theoretical. As outlined in our enclosed October 8, 2025 letter supporting Vefghi's application for leave to appeal to the Supreme Court of Canada, the decision has immediate and adverse effects on commercial transactions and trust structures across Canada. The uncertainty is compounded by recent commentary by the Canada Revenue Agency in its paper presented at the 2023 Canadian Tax Foundation Annual Tax Conference, "CRA Update on Subsection 55(2) and Safe Income," which appears to cast doubt on the ability to stream safe income on discretionary dividend shares.[1] This uncertainty is particularly acute in pre-sale purification transactions, where, to bypass the trust in order to avoid Part IV tax in light of *Vefghi*, shares of a separate class carrying slightly more than 10% of votes and value may be rolled into a holding corporation to pay out the pre-sale dividend.

Moreover, the *Vefghi* decision introduces complications for Finance's proposed dividend suspension rules in subsections 129(1.3) and (1.31) (Federal Budget 2025). Where dividends are paid through trusts, the beneficiary is deemed to receive the dividend only at the trust's year-end, potentially triggering dividend suspension even where the payer and the beneficiary have aligned but non-calendar year-ends.

We also want to highlight the important distinction between "assessable dividend" and "taxable dividend," which the Federal Court of Appeal appears to have treated as interchangeable. In our view, this conflation overlooks Parliament's likely intent in 1988 to preserve a clear difference between these terms when amending subsection 104(19) and the Part IV tax rules. The Act defines "assessable dividend" in subsection 186(3) as an amount received "*as, on account of, in lieu of payment of or in satisfaction of, a taxable dividend*," making it broader than the concept of a "taxable dividend." Moreover, paragraph 186(1)(b) extends the scope of Part IV tax as it applies to amounts received from a connected payer corporation to "*an amount in respect of an assessable dividend*." It is well established in the jurisprudence that the phrase "in respect of" is an expression of the widest possible scope.

Even if subsection 104(19) deems the amount received by the corporate beneficiary to be a "taxable dividend" on the last day of the trust's taxation year, the Federal Court of Appeal did not fully consider the possibility that, before this deemed receipt, the corporate beneficiary may have actually received an amount from the trust that could reasonably be characterized as an "assessable dividend" since it is received "as, on account of, in lieu of payment of or in satisfaction of" a taxable dividend that is later

[1] Jordan Fournier and Jean-Benoit Thivierge, "Allocation of Safe Income: Change in the Application of the Global Approach?" (2025) 25:3 *Tax for the Owner-Manager* 14-15.

deemed to be received under subsection 104(19), or as an amount "in respect of" such an assessable dividend. The appropriate time to test the connected status of the payer and recipient corporations for Part IV tax purposes should be when an amount in respect of an assessable dividend is received, as contemplated by paragraph 186(1)(b). We submit that it is unlikely that Parliament intended the interpretation adopted in *Vefghi*, which now causes Part IV tax to apply in this manner.

Recommendation
Specifically, we recommend either one of the two following amendments to the Act:

Option 1:
Subsection 186(4) be amended to add a new paragraph (c) as follows:
"or (c) where the particular corporation received the dividend indirectly through a trust as a beneficiary, the trust made the designation under 104(19) and either (a) or (b) would be met if at the time the trust received the dividend, the reference to "particular corporation" is read as "trust in which the particular corporation was a beneficiary of".

Option 2:
Subsection 104(19) be amended to allow the trust, in its designation in the return of income, to specify a particular taxable dividend (the "specified taxable dividend") received by the trust in its taxation year on a share of the capital stock of a taxable Canadian corporation, to be deemed a taxable dividend on the share received by the beneficiary who is including an amount in income under paragraph 104(13)(a), subsection 104(14) or section 105, at the time the specified taxable dividend was received by the trust.

Correspondingly, section 186 should be amended so that where a taxpayer is including in computing income for a taxation year an amount because of paragraph 104(13)(a), subsection 104(14) or section 105, and all or a portion of that amount is subject to a designation by a trust under subsection 104(19) in its return of income for a taxation year:

a) for any portion of the amount that is not a specified taxable dividend in the trust's designation, section 186 is determined as if the taxpayer received such portion as of the end of the trust's taxation year;
b) for any specified taxable dividend so designated, section 186 is determined as if the taxpayer is deemed to have received the taxable dividend at the time the trust received that specified taxable dividend.

For Option 2, we also recommend that similar amendments be made in respect of designations under subsection 104(20) for non-taxable dividends and under 104(21) for taxable capital gains.

Either amendment would restore the intended symmetry between partnerships and trusts, promote consistency and fairness in the application of Part IV tax, and ensure that the policy intent of the connected corporation rules is respected in trust structures. It would also provide much-needed certainty for taxpayers and practitioners.

Conclusion
The current state of the law, as revealed by *Vefghi*, is a technical trap that Parliament never intended. We urge the Department of Finance to address this gap with a targeted, technical amendment, and to reaffirm the principle of internal consistency that has long guided Canadian tax policy.

We would be pleased to discuss this submission further or provide additional technical input as required.

Kindly direct any enquiries to Michael Dodick, Chief Operating Officer, at mdodick@step.ca.

Yours truly,

Richard Niedermayer, KC, TEP
Chair, STEP Canada

Kenneth Keung, CA, CPA, CPA (CO), CFP, MTAX, LLB, TEP
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We would like to acknowledge the contributions of the following subcommittee members for their assistance in preparing this submission:

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Encl: October 8, 2025 – STEP Canada letter of support RE: Application for Leave to Appeal to the Supreme Court of Canada in The King v. Vefghi Holding Corp. and The King v. S.O.N.S. Environmental Ltd.

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October 8th, 2025

Robert Carvalho
Thorsteinssons LLP
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Via email: rcarvalho@thor.ca

RE: Application for Leave to Appeal to the Supreme Court of Canada in *The King v. Vefghi Holding Corp.* and *The King v. S.O.N.S. Environmental Ltd.*

Dear Mr. Carvalho,

The decision rendered by the Federal Court of Appeal in *The King v. Vefghi Holding Corp.* and *The King v. S.O.N.S. Environmental Ltd.*, 2025 FCA 143 (the "FCA Decision"), has far reaching implications that will negatively impact countless Canadians that use trusts. On behalf of The Society for Trust and Estate Practitioners (Canada) ("STEP Canada"), we write in strong support of the application for leave to appeal by Vefghi Holding Corp. and S.O.N.S. Environmental Ltd. (the "Applicants") to the Supreme Court of Canada.

About STEP Canada

STEP Canada was founded in 1998 as a branch of STEP Worldwide to provide regional assistance to STEP's Canadian membership. Today, STEP Canada is recognized as the preeminent organization for estate and trust professionals in Canada and currently we have almost 4,000 members. Our work and relationship with the federal and provincial governments has allowed STEP Canada to propose legislative changes and we are regularly invited to engage on policy initiatives, submitting over 30 formal submissions to the Department of Finance and Canada Revenue Agency since 2016. STEP's membership represents a broad cross-section of professional advisors operating in the estate planning and business succession planning fields. Many STEP members contend daily with provisions of trust and tax law relating to the structure, operation, and tax reporting of business enterprises and their ownership groups.

The FCA Decision's holding of when connectedness is determined for Part IV tax purposes disincentivizes Canadians from using trusts, potentially creates punitive tax consequences, and increases uncertainty for Canadian family businesses where shares are owned by a trust. Parliament did not intend for such arbitrary and punitive results to arise from the mere use of trust in a corporate structure.

FCA Decision Penalizes Taxpayers for Using Trusts

STEP Canada's primary concern with the FCA Decision is that, if left standing, it creates an unjustifiable lack of neutrality between corporate structures involving trusts and those that do not. Trusts are widely used in business planning for both tax and non-tax reasons. A common example is the estate freeze, where a trust is introduced to hold common shares so that future growth accrues to the next generation – often the very individuals driving that growth. "Henson" trusts established for disabled beneficiaries also regularly own private company shares. These structures are not limited to large enterprises; they are frequently employed by small family businesses of all industries across Canada.

The FCA Decision casts a long shadow over structuring decisions. Trusts are used not only for tax planning, but also for succession, governance, and control. The FCA Decision creates a strong disincentive to use trusts in ownership structures, pushing taxpayers toward alternative, less efficient structures – not because it aligns with the family's wishes but solely to avoid arbitrary tax results.

This is not a theoretical concern. Many private businesses, especially family-run enterprises, use trusts without access to specialized tax counsel. The FCA Decision creates a trap into which such businesses can easily fall during a sale year, resulting in costly and avoidable tax consequences. It violates Parliament's tax policy. It is not principled. And it is not right.

Impact on Commercial Transactions

Some specific more technical examples of the far-reaching uncertainty that will flow from the FCA Decision include the following.

Pre-sale Purification Transactions

Corporations must often pay dividends to their shareholders prior to a sale of its shares to remove assets the purchaser does not wish to purchase and to ensure its shares qualify as "qualified small business corporation" shares (which enables trust beneficiaries to access the lifetime capital gains exemption). The FCA Decision introduces a troubling consequence: if such dividends are paid to a trust, then distributed to a corporate beneficiary and the sale of the shares closes in the same taxation year, Part IV tax would likely be triggered. The parties may have to delay closing the sale to the following year to avoid such an outcome. Such delays are often commercially infeasible– and can foreseeably result in sales failing to complete. The outcome is arbitrary and frustrates Parliament's intent in enacting (and extending to trusts) the lifetime capital gains exemption regime.

Pre-Divorce Corporate Asset Divisions

Similar to a sale to a third party, corporate assets are often distributed from one corporation to another prior to a divorce in order to allocate assets between spouses. If the distributing corporation is owned by a trust, the FCA Decision raises concerns akin to those discussed in the context of pre-sale purification. At year-end, former spouses are no longer related, and whether they continue to "deal at arm's length" becomes a fact-specific inquiry. In many cases, they do deal at arm's length, which may result in the two corporations no longer being connected—thereby triggering Part IV tax. In fact, the situation becomes even more problematic for parties in a common-law relationship. For them, their related-party status can automatically (i.e., without choice) be deemed to end 90 days after beginning to live apart, exacerbating this timing issue without either individual realizing.

Part IV Tax: refundability does not eliminate harm

While Part IV tax is technically refundable, the harm remains. The scheme of the Act permits corporate after-tax funds to remain within a corporate group without triggering personal tax. The FCA Decision undermines this principle by imposing Part IV Tax, which is a tax designed to mimic personal-level tax consequences, and is imposed at the significant rate of 38 1/3%, on corporate surplus moved between corporations. In practice, full recovery of Part IV tax is not always achievable; for example, where the corporate beneficiary has insufficient net assets due to its liabilities. Many other times, dividends are paid through share capital adjustments without any distribution of cash necessary to pay the resultant Part IV tax. This distorts proper established planning outcomes and penalizes reinvestment. Even if the tax can be recovered in the future, this will still result in the corporate beneficiary having significantly less funds to reinvest.

FCA decision impacting timing of when capital dividends are added to capital dividend account

While the FCA Decision addresses a trust's designation under subsection 104(19) for taxable dividends, its reasoning may also apply to subsection 104(20), which governs capital dividends and uses similar statutory language. As a result of the FCA Decision, the time at which a trust's capital dividend designation flows to a corporate beneficiary's capital dividend account will be deferred until the trust's year end. This delay affects the corporate beneficiary's ability to pay out capital dividends to shareholders. Worse, a capital loss incurred by the corporate beneficiary before the trust's year-end may offset historical gains and, in cases where it had paid historical capital dividends, permanently impair the ability to pay out the tax-free capital dividends it received from the trust. Such outcomes likely do not align with the legislative intention of the drafters.

Potential double income taxation on dividend

The implications of the FCA Decision could extend beyond Part IV tax. Where a Canadian-resident corporation pays a dividend to a trust and is wound up before the trust's taxation year, the beneficiary corporation may be denied the intercorporate dividend deduction under subsection 112(1). This is because, at the time the dividend is deemed to be received (under the FCA Decision), the payor corporation no longer exists and thus cannot be "controlled" by the dividend recipient. Paragraph 112(1)(b) could therefore be inapplicable. The result – which could arise in any situation where the recipient loses control of a Canadian-resident payor corporation (other than a taxable Canadian corporation) prior to the trust's year end – is that an otherwise tax-free intercorporate dividend, paid out of after-tax retained earnings, is subject to corporate income tax again.

Analysis by the Supreme Court of Canada is required to ensure trusts are not unfairly castigated, and prevent even more uncertainty for Canadian businesses

In the wake of the FCA Decision, guidance is needed from the Supreme Court of Canada regarding the taxation of trusts and their generally-regarded natures as flow-through entities for tax purposes. STEP Canada is deeply concerned that the FCA Decision, if left unaddressed, will hinder economically beneficial transactions in Canada, discourage the use of trusts in legitimate succession and governance planning, and lead to the unwinding of long-standing and otherwise effective trust structures. STEP Canada is similarly concerned about the potential for increased, unproductive use of scarce taxpayer and judicial resources on matters arising from the uncertainties resulting from the FCA Decision.

For all these reasons, STEP Canada strongly supports the Applicants' application for leave to appeal the FCA Decision to the Supreme Court of Canada.

These comments were prepared under the auspices of STEP Canada's Tax Technical Committee, whose Chair is Kenneth Keung. If you have questions about these comments, please contact Mr. Keung at 1 604-443-2187 or Kenneth.keung@doane.gt.ca.

Yours truly,

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Chair STEP Canada

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