Tax Notes

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THE EFFECTIVE USE OF TRUSTS IN CONNECTION WITH INCOME SPLITTING (PART III OF IV)

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Part I of this series of articles reviewed some of the basic tax requirements for using trusts to split income, and Part II discussed a number of tax planning opportunities that can be accessible through the use of *inter vivos* trusts. The focus of this third instalment of the series will be traditional testamentary trust income splitting planning and the upheaval to trusts, wills, and estates practices caused by the December 16, 2014 enactment of Bill C-43, *Economic Action Plan 2014 Act, No. 2* ("Bill C-43").

Testamentary Trust Planning

Non-Tax Matters

Income splitting is also a benefit that can be enjoyed when planning involves "testamentary trusts", which are trusts formed upon or as a consequence of the death of an individual and which have not received property contributions by anyone other than the deceased individual,[1] and include a deceased's estate and trusts formed under the terms of a deceased's will. However, these trusts serve numerous other non-tax purposes.

By law, a deceased's assets will be dealt with by his administrators under his will or, if there is no valid will, under the provincial rules that govern an intestacy. The vehicle for holding the assets will be a form of trust that is referred to as an estate. Assuming the deceased's last wishes are governed by a will, the will would normally instruct his administrators on how to satisfy the obligations he owed and how to dispose of the property he owned at the time of his death. In this way the estate serves a number of practical purposes, including providing a vehicle to collect taxes owing by the deceased at the time of his death and while the assets remain within the estate.

Eventually, the estate should be fully administered and the property may be distributed outright to the deceased's beneficiaries or the terms of the will might create and fund other trusts that, if properly structured, should be testamentary trusts for purposes of the Act. For example, a spousal trust will often be used to maintain control over a deceased's assets for the benefit of her spouse, while the spouse is alive, so as to maintain the spouse's lifestyle and also to protect and preserve family assets for distribution to the deceased's children, grandchildren, and so on. Also, the deceased's will might give rise to more traditional family trusts, insurance trusts, or protective trusts such as Henson trusts that can be created for disabled beneficiaries or spendthrift trusts.

[1] The term "testamentary trust" is defined in much greater detail in subsection 108(1) of the *Income Tax Act* (the "Act"). Unless otherwise noted all statutory references are to the Act.

Wolters Kluwer

Although well beyond the scope of this article, there are many good US tax and non-tax reasons to form trusts for US beneficiaries that are either created prior to the death of an individual and funded out of a Canadian estate or, depending on the US adviser one engages, even created in the will itself.

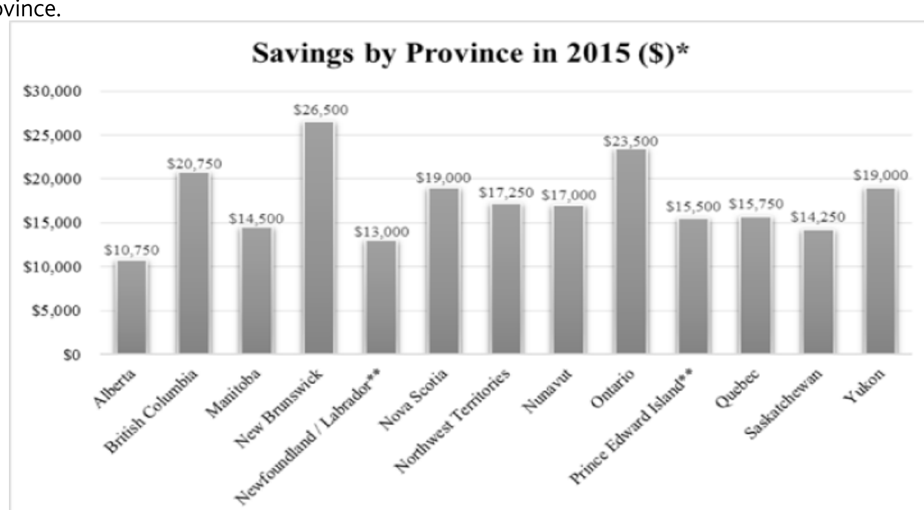
Traditional Canadian Income Tax Advantages of Using Testamentary Trusts

There has traditionally been a number of Canadian income tax advantages associated with the use of testamentary trusts.

First, a bequest left to a properly drafted spousal trust will defer death taxes until the death of the surviving spouse. This could also have been the case if the property had been bequeathed outright to the surviving spouse and held by the survivor until his death. However, by leaving the property in the trust, it is possible for the deceased, through her executors or trustees, to ensure control over the estate property to make sure that it is not used in a manner contrary to the deceased's wishes and/or that it is preserved for the benefit of the surviving spouse and future generations.[2]

Second, as was the case with non-testamentary trusts, properly drafted testamentary trusts can allow the income of a trust to be taxed in the hands of the beneficiaries at their marginal rates.

Finally, the taxation of testamentary trusts differ in a number of other favourable ways from the taxation of ordinary *inter vivos* trusts ("Pure Testamentary Trust Tax Benefits"). Probably the most significant of these tax differences is that testamentary trusts have traditionally been taxed at graduated rates as though they were a separate individual.[3] The annual tax savings available to a testamentary trust varies by province but can be significant. In this regard, the chart below shows the 2015 testamentary trust savings on the first $135,000[4] of income on a province-by-province basis,[5] as compared to a situation where that same $135,000 of income had been taxed at the top marginal rate in each particular province.



** All figures rounded. ** 2015 Budget not yet released at time of writing.*

As illustrated, based on the assumptions in the chart, 2015 savings will range from a low of about $10,750 in Alberta to a high of about $26,500 in New Brunswick. In addition, since British Columbia, New Brunswick, Nova Scotia, and the Yukon all have marginal provincial tax rates that exceed the top federal tax bracket, 2015 testamentary trust benefits may be even greater than those shown in the chart.

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[2] Similar results apply to *inter vivos* spousal trusts, but creating such trusts while a person is alive gives rise to tax and non-tax issues that are beyond the scope of this article.

[3] As was discussed in Part II of this series of articles, rules in subsections 104(13.1) and (13.2) might also have been used to designate amounts paid by a trust to a beneficiary as being taxable only in the trust, which could have given rise to a number of income splitting benefits, including allowing designated amounts paid out to beneficiaries to still enjoy the testamentary trust's graduated tax rates. However, due to the enactment of Bill C-43, effective for the 2016 and subsequent taxation years, the ability to utilize the designations provided under these provisions will be restricted so that designations can only be made to permit trusts to use up losses.

[4] This figure was chosen to approximate the top federal tax rate in 2015. As at the date of writing this article, Manitoba, Newfoundland and Labrador, and Prince Edward Island had not yet released their 2015 budgets, so rates used in the chart continue to be 2014 tax rates.

[5] Because not all credits available to individuals are available to testamentary trusts, the tax savings associated with a testamentary trust's graduated rates is a bit lower than for individuals.

A Whole New World — The End of Testamentary Trust Planning?

In 2013 the Department of Finance proposed to eliminate most Pure Testamentary Trust Tax Benefits, including the benefits of unlimited access to graduated tax rates for testamentary trusts. In particular, beginning in 2016 it was proposed that the graduated tax rate advantage would only be permitted for a maximum of the first 36 months of an estate. In addition, following that 36-month period the proposals were intended to strip testamentary trusts of their other unique benefits by eliminating exemptions from income tax installment rules, rules requiring ordinary trusts to have a calendar taxation year, and the alternative minimum tax rules. In addition, while in the past testamentary trusts were not subject to tax under Part XII.2 of the Act, which applies to ensure non-resident beneficiaries of trusts do not avoid tax on certain types of Canadian income, this preferential tax treatment was to be eliminated. Also, rules that would automatically qualify testamentary trusts as personal trusts and which would allow trusts to make investment tax credits available to beneficiaries were to be eliminated (collectively, all of these benefits, including the graduated rate benefit, are referred to herein as "Traditional Testamentary Trust Benefits").

Notwithstanding much critical commentary, the 2014 Budget announced plans to implement the proposals, and draft legislation was released on August 29, 2014. The draft legislation, which contained no grandfathering provisions, not only proposed to implement the proposals but went far beyond the original proposals in ways that will broadly and generally negatively impact traditional testamentary and other non-testamentary trust planning.[6] Despite additional submissions having been made to the Department of Finance by, among others, the Joint Committee and STEP, with very few substantive changes from the draft legislation, Bill C-43 was introduced for first reading on October 23, 2014. On December 16, 2014, Bill C-43 was enacted as the law of the land, though the implementation of the provisions of Bill C-43 relating to testamentary spousal trusts as well as to other trusts and particularly to "lifetime trusts" (these are self-benefit trusts, *alter ego* trusts, and joint partner trusts) will generally be delayed until 2016.

Although there is no way to adequately address the legislative changes in Bill C-43 in this series of articles,[7] some of the more critical changes that will impact testamentary spousal trusts and lifetime trusts are highlighted below.

(1) Testamentary spousal trusts and lifetime trusts will all now have deemed year-ends on the date of death of the individual or last spouse or common law partner to die, as the case may be.[8]

(2) The income earned by a trust subject to the new deemed disposition rules for its taxation year that ends on the deemed year end will be deemed to be that of the deceased trust beneficiary and not the income of the trust.[9]

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[6] To be fair, the draft legislation contained a few beneficial provisions. In particular, the proposals (now law) will make it easier for certain testamentary trusts to make use of charitable donation credits and will allow some relief from the rules that will otherwise limit access to testamentary graduated rates for certain testamentary trusts formed to benefit disabled individuals who are eligible for the disability tax credit.

[7] For those interested in further reading on the proposed changes see, for example, Ross, A. M. (2014, October). Proposed Tax Legislation Affects Trusts and Donations on Death. *Conference for Advanced Life Underwriting*. CALU, North York, ON.

[8] See new paragraph 104(13.4)(*a*).

[9] This rule may result in significant inequitable results where the deceased beneficiary's heirs are different from the residuary beneficiaries of the trust. It should be noted that the estate will continue to have liability for this taxable income pursuant to subsection 104(13.4). The interaction of these rules with trustee fiduciary obligations has been discussed by Elena Hoffstein and Pearl E. Schusheim in the following presentation: Hoffstein, E., & Schusheim, P. E. (2014, November 18). New Testamentary Trust Rules. *Jewish Community Foundation Professional Advisory Committee Seminar*. Lipa Green Centre, Tamari Family Hall, Toronto, ON. There also appear to be technical drafting errors in the rules that, unless corrected, would appear to cause the last-to die spouse's estate to be taxed on income rather than capital account. It can only be hoped that this is unintended and will be corrected (on February 3, 2015, Joan Jung of Minden Gross LLP made a submission to the Department of Finance in connection with this matter).

(3) Access to many traditional testamentary tax planning practices such as planning involving subsections 164(6) and 112(3.2),[10] certain beneficial charitable planning opportunities,[11] preferential charitable donation tax rates,[12] and all of the Traditional Testamentary Trust Benefits will only be available to trusts that qualify as graduated rate estates ("GREs").[13]

(4) Pursuant to new subsection 104(13.3), the ability to make designations under subsection 104(13.1) and (13.2) will be restricted to situations where any trust — including testamentary spousal trusts and lifetime trusts — has unused losses.

Another significant problem with Bill C-43 is that it was enacted without provisions that would "grandfather" situations where wills can no longer be changed (e.g., because the maker of the will is dead or incapacitated). Consequently, in these situations it may not be possible to take any steps to address the legislative changes, which could give rise to adverse tax results and, in some situations, potentially lead to unnecessary litigation.

We understand that lobbying bodies and practitioners continue to make presentations and submissions to the Department of Finance, the Minister of Finance, and whoever might be willing to listen in hopes of causing the Department of Finance to fix Bill C-43 before it comes into force in 2016. Stay tuned to find out if they will be successful.

In the meantime, what are practitioners to do? Unfortunately, the most that can be said is that all advisers should consider whether it is appropriate to contact some or all of their will clients to encourage them to review their wills in 2015. As well, since the changes enacted in Bill C-43 will impact lifetime trust planning, advisers who employ such trusts should also consider encouraging their clients to review whether those trusts will continue to meet their client's planning needs in the future.

Unfortunately, solutions to problems caused by Bill C-43 will not always be straightforward and, as mentioned earlier, it remains unclear whether changes could still be made to the legislation before its January 1, 2016 effective date. As a result, the whole exercise may prove to be an unsatisfactory one.

Assuming Bill C-43 does come into force on January 1, 2016, and results in the elimination of most of the Pure Testamentary Trust Tax Benefits, leaving only modest ongoing tax benefits akin to those available to ordinary *inter vivos* trusts, or in some cases even potentially leading to significant tax problems, is there a future for testamentary and lifetime trusts? In situations where such trusts are implemented with proper care and attention to details and the non-tax benefits warrant their use, the answer certainly appears to be yes.

BILL C-59 RECEIVES SECOND READING

On May 25, 2015, Bill C-59, *An Act to implement certain provisions of the budget tabled in Parliament on April 21, 2015 and other measures*, received second reading in the House of Commons. This 172-page Bill contains the provisions that were released in the Notice of Ways and Means Motion on May 4, 2015 (Wolters Kluwer *Special Report* No. 085H). The Department of Finance issued a news release on May 7, 2015 that listed the packages of draft legislation that Bill C-59 includes. An excerpt from the news release relating to the tax issues contained in the Bill is reproduced below.

[10] Planning involving subsection 164(6) would traditionally be used to carry capital losses realized in the first taxation year of an estate back to the deceased's terminal taxation year to offset against capital gains in that taxation year. Often such capital losses are realized in connection with the redemption of shares, which itself may give rise to taxable dividends in the estate. Where capital losses would otherwise have been realized on shares on which capital dividends have been paid, those losses can be restricted pursuant to a number of provisions in section 112. Subsection 112(3.2) provides estates with important exceptions to these stop-loss rules. From January 1, 2016 onward these beneficial provisions will only be available to GREs.

[11] Including those briefly discussed in footnote 5 above.

[12] For example, the "zero" inclusion rate for taxable capital gains in paragraph 38(*a*.1).

[13] A deceased person is only able to have one GRE, which is that person's estate. Only that GRE can benefit from the 36 month period of access to testamentary graduated rates and the other Traditional Testamentary Trust Benefits. Although, based on informal discussions with the Department of Finance, we understand that multiple will structures involving identical trustees in each will should generally not result in a person having more than one estate, it appears that no other testamentary trusts, including insurance trusts, would qualify as GREs. At the end of 2015 for current testamentary trusts or at the end of the 36-month period of existence of the GRE, whichever is later, a year-end will occur pursuant to new subsection 249(4.1).

[. . .]

The Act also includes the measures contained in Bill C-57, the *Support for Families Act* and Bill C-58, the *Support for Veterans and Their Families Act*, which were tabled in the House of Commons in March 2015.

Highlights include:

Balancing the Budget:

- Balanced budget legislation is being tabled to enshrine in law the Harper Government's responsible fiscal management policy that is creating jobs and putting more money back into the pockets of Canadians.
- A balanced budget allows the Government of Canada to cut taxes further for Canadian families, individuals and businesses.

Supporting Jobs and Growth:

- Reducing the small business tax rate to 9 per cent by 2019 — lowering taxes for job-creating small businesses and their owners by $2.7 billion between now and 2019–20.
- Providing manufacturers with a 10-year accelerated capital cost allowance to encourage productivity-enhancing investment in machinery and equipment.
- Increasing the Lifetime Capital Gains Exemption to $1 million for owners of farm and fishing businesses.
- Extending the Mineral Exploration Tax Credit until March 31, 2016.
- Improving access to financing for Canadian small businesses through the Canada Small Business Financing Program.

Helping Families and Communities Prosper:

- Increasing the Tax-Free Savings Account annual contribution limit to $10,000, effective for 2015 and subsequent years.
- Implementing the Family Tax Cut, a federal tax credit that will allow a higher-income spouse to, in effect, transfer up to $50,000 of taxable income to a spouse in a lower tax bracket, effective for the 2014 tax year.
- Increasing the Universal Child Care Benefit (UCCB) for children under age 6. As of January 1, 2015, parents are eligible for a benefit of $160 per month for each child under the age of 6 — up from $100 per month.
- Expanding the UCCB to children aged 6 through 17. As of January 1, 2015, under the expanded UCCB, parents are eligible for a benefit of $60 per month for children aged 6 through 17.
- Increasing the Child Care Expense Deduction dollar limits by $1,000, effective for the 2015 tax year. The maximum amounts that can be claimed will increase to $8,000 (from $7,000) for children under age 7, to $5,000 (from $4,000) for children aged 7 through 16, and to $11,000 (from $10,000) for children who are eligible for the Disability Tax Credit.
- Reducing the minimum withdrawal factors for Registered Retirement Income Funds to permit seniors to preserve more of their retirement savings to better support their retirement income needs.
- Supporting seniors and persons with disabilities by introducing the Home Accessibility Tax Credit to help with renovation costs to make their homes safer and more accessible, so that they can live independently and remain in their homes.
- Ensuring veterans and their families receive the support they need by: providing a new Retirement Income Security Benefit to moderately to severely disabled veterans; expanding access to the Permanent Impairment Allowance for disabled veterans; and creating a new tax-free Family Caregiver Relief Benefit to recognize caregivers.
- Extending Employment Insurance Compassionate Care Benefits from six weeks to six months to better support Canadians caring for gravely ill and dying family members.

[. . .]

NEW INCOME TAX FOLIO S4-F16-C1: WHAT IS A PARTNERSHIP?

On May 4, 2015, the Canada Revenue Agency ("CRA") released new Income Tax Folio, S4-F16-C1: What is a Partnership?, effective May 5, 2015, that replaces and cancels Interpretation Bulletin IT-90, What is a Partnership? Suggestions and comments regarding this new Folio may be emailed to folios@cra-arc.gc.ca before August 6, 2015. The new Folio sets out the criteria that the CRA uses to determine the existence of a partnership.

STATISTICS CANADA RELEASES NEW DATA ON CANADA'S UNDERGROUND ECONOMY

On April 29, 2015, Statistics Canada released its report on the impact that the underground economy has on the Canadian economy. The report is updated to reflect on the years 1992 to 2012.

The report focuses on the trends in underground activities for different sectors of the economy, as well as the breakdown between various provinces and districts. Ways of combatting the underground economy and what the Canada Revenue Agency ("CRA") is doing for its part are also highlighted.

Additional information on the report can be found at: www.statcan.gc.ca/dai-quo/index-eng.htm.

More information on what the CRA is doing in response to the underground economy can be found at: www.cra.gc.ca/undergroundeconomy.

FOCUS ON CURRENT CASES

This is a regular feature examining recent cases of special interest, coordinated by *John C. Yuan* and *Christopher L.T. Falk* of McCarthy Tétrault LLP. The contributors to this feature are from McCarthy Tétrault LLP, Montreal, Toronto, Calgary, and Vancouver.

Tax Court Finds Self-Directed RRSP Plan Trustee To Be a Purchaser Subject to Section 116 Obligations

***Olympia Trust Company v. The Queen*, 2015 DTC 1044 (Tax Court of Canada)**

The issue in this case was whether a trustee of a self-directed registered retirement savings plan ("RRSP") could be viewed as the "purchaser" as that expression is used in subsection 116(3) of the *Income Tax Act* (the "Act"), such that it had an obligation to withhold and remit amounts to the Receiver General pursuant to subsection 116(5) of the Act on a purchase of shares for the self-directed RRSP plan where the shares were taxable Canadian property and the vendor was a non-resident of Canada.

This case came before the Tax Court by way of an application under Rule 58 of the *Tax Court of Canada Rules (General Procedure)*. Rule 58 provides for an expedited procedure for having the Tax Court decide a question of fact, law, or mixed law and fact if the determination of the question prior to the hearing of an appeal would dispose of some or all of the appeal or result in a substantially shorter hearing. The appeals in this case were of the Minister's assessments of the corporate trustee, Olympia Trust Company, for having failed to withhold and remit a portion of the purchase price paid to various non-resident vendors on purchases of shares that were taxable Canadian property during the 2000 to 2004 period.

By way of background, when a "purchaser" acquires taxable Canadian property from a non-resident, section 116 of the Act obligates the "purchaser" to withhold and remit a portion of the purchase price within 30 days after the end of the month in which the sale took place. Section 116 sets out various circumstances under which the purchaser may be relieved of its obligation to withhold and remit from the sale proceeds but, if none of the relieving circumstances exist, the Minister is entitled to assess the purchaser for the amount that should have been withheld and remitted plus applicable penalties and interest.

The trust company advanced several arguments in support of the position that it was not the "purchaser" for purposes of section 116. First, the trustee argued that it was not factually a purchaser as it was not a party to the relevant share purchase agreements entered into by the various RRSP annuitants and the non-resident vendors. The trustee also argued that it would be "intuitively inappropriate" to legally characterize the trustee as a purchaser since the legal authority had never applied the section 116 obligations to a trustee. The trustee maintained that its only involvement in the transaction was to transfer the purchase moneys from the RRSP plan to the vendor, receive the delivery of the purchased shares, and hold the shares as property of the RRSP plan, all of which were done on the annuitant's directions. Finally, the trustee submitted that section 116 did not apply to hold an agent or administrator liable for the unremitted amount on the basis that, if Parliament had intended for such liability to attach to the trustee, it would have expressly done so, as it had done in section 159, which provides for personal tax liability attaching to a personal representative in respect of a distribution of trust property.

The Minister submitted that the trustee acquired legal title and held other incidents of ownership in respect of the shares. As trustee of the self-directed RRSP plans, it had the authority and discretion to choose to act on the annuitant's directions; the trustee took possession and control of the purchase moneys, received the shares under its name, and took possession and control over the shares that became a part of the trust property. Further, unlike other provisions in the Act dealing with the taxation of trusts, such as sections 104 and 159, section 116 deals with the tax liability of the non-resident vendor and provides an enforcement mechanism by which the Minister may assess the party who becomes the legal owner of title to taxable Canadian property sold to it by a non-resident vendor. Where the purchaser fails to collect and remit the amounts mandated by section 116, the purchaser will be responsible to pay the uncollected amounts. As such, the Minister contended that the trustee of a self-directed RRSP plan should be properly considered a purchaser for purposes of the section 116 obligations.

In his analysis, Justice Bocock first reviewed the RRSP plan documents, the share transaction documents, and the statutory regime for RRSP plans. While the share purchase agreements did not name the trustee as purchaser, its role as trustee was embedded in the transaction and RRSP plan documents. The plan documents indicated that legal title to all securities within the RRSP plan needed to be held by the trustee, who had the ability to reject a securities sell order and impose an obligation on the annuitant to indemnify the trustee for fees and other amounts arising from the arrangement. The statutory regime governing self-directed RRSP plans required legal ownership of any property in the trust to remain with the trustee until the trust property is converted into a cash payment to the annuitant in the form of an annuity. In other words, the annuitant did not (and could not) obtain possession of the actual shares without adverse tax consequences applying. The Court concluded that the trustee of the RRSP plan was solely seized of and the registered legal owner of the shares which became a part of the trust property comprising the RRSP plan. Therefore, it could be said that the non-resident vendor disposed of the shares constituting taxable Canadian property to the trustee.

Having found that the non-resident vendor disposed of the shares to the trustee, the Court then considered whether the trustee was the "purchaser" under the definition set out in subsection 116(3) and whether it was liable under subsection 116(5) as a "purchaser" who has "acquired" the taxable Canadian property. The Court noted that the purchase moneys were in the possession of and in the name of the taxpayer, and paid by the trustee to the non-resident vendor. This resulted in the trustee legally, but not beneficially, acquiring the shares from the non-resident vendor. While the "true owner" of the enjoyment and wealth of the RRSP plan is the annuitant, the shares purchased from the non-resident vendor that became a part of the trust property underlying the RRSP plan were acquired by the trustee. The Court agreed with the Minister that section 116 does not relate to the personal tax liability of the trustee who is a purchaser of the shares. Rather, section 116 transfers liability for the non-resident vendor's tax owing on the disposition of taxable Canadian property to the purchaser if the parties fail to comply with mechanisms available under section 116 to relieve the purchaser of its withholding obligation. For those reasons, the Court held that the trust company was a purchaser as defined in subsection 116(3) for purposes of subsection 116(5).

This decision illustrates that section 116 liability may apply to a person who does not become the beneficial owner of the property but who acquires some incidents of ownership, such as possession, title, and control. Consequently, any person, including a bare trustee, involved in a purchase of taxable Canadian property from a non-resident vendor should ensure compliance with his or her obligations under section 116. The Tax Court may not have the last word in this case, however, as the taxpayer appealed the decision to the Federal Court of Appeal.

—*Jeremy Ho*

Court Orders Variation of Trust, but on a Prospective Basis Only

***Shinewald v. Shinewald Family Trust*, 2015 DTC 5029 (Court of Queen's Bench of Manitoba)**

In *Shinewald*, the Manitoba Court of Queen's Bench was asked to order the variation of a trust and to have the order take effect retroactively, as permitted by the provisions of *The Trustee Act* (Manitoba) (the "Trustee Act").

The matter before the Court arose in respect of a trust that the applicant had settled in 1995 for the benefit of her son and his family. The trust provided that the son, his wife, and their children were capital beneficiaries, and that the wife and children (but not the son) were income beneficiaries.

Following the death of the wife in 2009, trust income had been distributed to the son notwithstanding that he was not an income beneficiary. During a Canada Revenue Agency ("CRA") audit, the payment of income to the son was raised as being unauthorized based upon the provisions of the trust. As a consequence, in early 2013, the applicant brought an application pursuant to the Trustee Act for an order varying the trust by adding the son as an income beneficiary retroactive to the date of death of the wife. The applicant swore an affidavit stating that the death of the wife had created unintended consequences as it was not intended that the income be distributed only to the children.

The application was supported by the son, the children, and the trustees. However, the CRA, which was an intervenor in the proceedings, maintained that any order made should become effective no earlier than the date of the application.

Dewar J began his analysis by first noting that variations of trust were contemplated by section 59 of the Trustee Act. Pursuant to that provision, such variations required approval of the court even where, as was the case in this matter, all persons beneficially interested consented to the application. The court was required to determine that the variations appeared to be "of a justifiable character".

Dewar J noted that since the trust had been intended to benefit the son through trust income paid to his wife, her death deprived the son of that opportunity, and the variation would restore the opportunity. Dewar J was prepared to order the variation, at least on a prospective basis, given that there was no objection to the proposed variation by any of the persons who were beneficially interested in the trust.

In respect of the effective date of the arrangement, subsection 59(11) of the Trustee Act provided that a variation would take effect on the date of the order unless some other date was set out in the court's order. In this matter, Dewar J declined to make his order retroactive and, instead, provided that the order would take effect on the date on which the application was made.

In declining to make the order retroactive, the Court noted that if the result being sought by the son was important, the application should have been filed shortly after the wife's death. Importantly, Dewar J found no evidence to suggest an initial intention that the son be an income beneficiary (e.g., evidence of a clerical mistake made at the time that the trust was created in omitting the son as an income beneficiary). In reaching his decision, Dewar J relied upon a fundamental principle as set out by the Federal Court of Appeal in *Perrault* (78 DTC 6272) that "we must determine the issue of taxability on the basis of what was in fact done".

Shinewald demonstrates the willingness of the courts to rectify a trust arrangement on a prospective basis, provided that the variation is consistent with the intention of the settlor and is supported by the interested parties. However, where no mistake has been demonstrated, the courts will likely refuse to make a rectification order retroactive to help avoid an adverse tax result. *Shinewald* therefore illustrates the importance of applying for such orders on a timely basis.

— *Yara Nosikova, Summer Student*

RECENT CASES

Directors' liability confirmed — Hoping that funds will come in is not exercising due diligence

The taxpayer was a professional engineer who carried on business through various companies: a general contractor ("TEC") which entered into contracts, a company that carried out the engineering work ("TRAK E"), and a payroll company ("TRAK P"). In August 2005, TEC entered into a contract with Happy Valley Resort to design and build a mechanical system for a condominium project. Happy Valley refused to pay its bills on time and receivables went as high as $700,000. By June 2007, TEC stopped working for Happy Valley. Despite collection proceedings and the execution of a lien on the project, the taxpayer had not recovered the money it was owed. The taxpayer appealed directors' liability assessments for unpaid source deductions and net taxes for TRAK E and TRAK P for the 2007 taxation year.

The appeals were allowed in part to reduce the liability to the amounts in the certificates. Directors are jointly and severally liable for unpaid deductions and taxes if certificates of the corporations' liabilities have been registered in the Federal Court and their execution has been unsatisfied in whole or in part. Directors are not held liable if they can show they exercised due diligence. Due diligence means that the director acted to prevent the failure to remit. It is an objective standard. The taxpayer knew by early 2007 that his companies were experiencing significant cash flow problems due to the failure of Happy Valley to pay its amounts owing. The taxpayer continued working on the Happy Valley project until June 2007, paying its employees, but stopped making tax remittances. It argued that it believed Happy Valley would pay its debt for several reasons. Happy Valley needed an engineering certificate before the project could be occupied, it had annual revenues of about $10 million, and putting a lien on the project would stop construction. In reality, Happy Valley hired another engineering firm that issued the occupancy certificate. The taxpayer argued those were extraordinary circumstances that could not be anticipated. The taxpayer made a conscious decision to stop remittances with the hope that Happy Valley would pay its outstanding liabilities, but took no steps to prevent the failure to remit. Hoping that funds will come in is not a defence. A taxpayer cannot finance its activities with Crown monies in the hope that funds will eventually come in with which to pay tax remittances. The taxpayer failed to exercise due diligence. The amounts assessed exceeded the amounts in the certificates filed in the Federal Court and the taxpayers' liability is limited to the amounts in the certificates.

Maxwell, 2015 DTC 1102

Refunds declared but not paid out of the RDTOH account by the taxpayer remained intact

The taxpayer paid taxable dividends in each year from 2004 to 2006 and claimed refunds under subsection 129(1) of the *Income Tax Act*, which the Minister denied because the taxpayer had not filed its tax returns within three years of its year end as required. In calculating the taxpayer's refundable dividend tax on hand ("RDTOH") for 2005 to 2007, the Minister deducted the amount of the refunds claimed but not received in 2004 to 2006, thereby lowering the RDTOH balance moving forward. In each year from 2010 to 2012, the taxpayer paid a taxable dividend and claimed a refund out of its RDTOH. At issue was whether the Minister erred in deducting the subsection 129(1) refunds claimed but not received by the taxpayer in 2004 to 2006 when determining its RDTOH balance for 2005 to 2007.

The taxpayer's appeal was allowed with costs. The term "dividend refund" in paragraph 129(1)(*a*) means the refund of the amount determined by the formula set out therein; accordingly, since the taxpayer did not receive a refund, its RDTOH balance remained intact. The taxpayer's RDTOH balances at the end of 2005, 2006, and 2007 were $193,746, $322,103, and $431,336, respectively.

Presidential MSH Corporation, 2015 DTC 1101

Taxpayer could not claim principal residence exemption without written separation agreement from former spouse

The taxpayer, the estate of the late H, was appealing income tax assessments for 2003 to claim the principal residence exemption on a former property of H, who had passed away in 2005. The property was sold in 2003 after it had been transferred to H's husband in 1991. Due to lack of consideration, the gain was attributed back to H. The Minister did not allow for the principal residence exemption to apply, as H's husband had claimed the exemption on another property during the relevant period. The taxpayer argued that H and her husband were separated at that time and were living separate and apart, thus no other family member had made the designation.

The taxpayer's appeal was dismissed. Based on the testimony of their son and due to a lack of a formal, written separation agreement, there was a serious omission and a key requirement to claim the principal residence exemption in the circumstances.

Estate of Balanko, 2015 DTC 1099

Corporate taxpayer not entitled to SR&ED-related investment tax credits relating to development of software program

The corporate taxpayer's business involved providing computer software services. It had expertise in programming websites. In assessing the taxpayer for 2012, the Minister disallowed its claim for investment tax credits relating to expenses incurred in developing a computer software program that was capable of inspecting and verifying websites. The Minister of National Revenue (the "Minister") refused to characterize the taxpayer's development expenses as SR&ED, but did permit their deduction as ordinary business expenses. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was dismissed. In *C.W. Agencies Inc. v. The Queen*, the Federal Court of Appeal set out the following criteria for determining whether development expenses can be characterized as SR&ED: (a) the existence of technological uncertainty, which cannot be removed by resorting to current studies; (b) research work that is actually directed at solving this technological uncertainty and carried on using scientific methodology, which is properly recorded; and (c) a resulting technological advance. The taxpayer's activities in developing its software in this case did not meet the foregoing criteria or the definition of SR&ED in subsection 248(1) of the *Income Tax Act*. In particular, these activities constituted nothing more than normal analyses carried out by competent programmers using current technology and techniques, and, hence, did not involve SR&ED. The Minister's assessment was affirmed accordingly.

Hypercube Inc., 2015 DTC 1089

Common-law duty of procedural fairness did not allow for extension of time for taxpayer to file a notice of objection

The taxpayer filed an application requesting an extension of time to serve a notice of objection on the Minister of National Revenue (the "Minister") for 2009 and 2010. The application was filed on September 2, 2014. On November 5, 2015, the taxpayer filed an amended application requesting that the application apply only to 2010. The Minister opposed the application because it was filed more than one year and 90 days after the notice of assessment was issued. The taxpayer argued that the common-law duty of procedural fairness should apply.

The taxpayer's appeal was dismissed. Common-law duty does not override the objections process under the *Income Tax Act*. Paragraph 166.2(5)(*a*) provides a strict deadline for filing an extension, which was not met, and the doctrine of discoverability did not apply.

Odebala-Fregene, 2015 DTC 1087

Minister correctly assessed taxpayer for repayment of OAS amount

The taxpayer was appealing a determination by the Minister of National Revenue (the "Minister") that he was to repay $3,269 of old age security ("OAS") pension received in 2012. In 1969, while working for Sydney Steel, the taxpayer was burned by molten steel, resulting in a bad injury and continued pain. He made a claim to the Workers' Compensation Board ("WCB") in 2011, and in 2012 he received a retroactive lump-sum award of $53,816. This sum was included in his income leading to the assessment for the repayment of OAS. The taxpayer had not included the WCB award in income, arguing it was a non-economic loss award for pain suffered from a 1969 work injury.

The appeal was dismissed. Compensation received from the WCB is to be included in the calculation of income if it is received "in respect of an injury". "In respect of" is to be interpreted broadly and includes pain suffered as a result of an injury. The award received by the taxpayer was in respect of the 1969 work injury and was for scars and pain suffered from that injury. If there had been no injury there would have been no award and, as such, the award was to be included in income. The lump sum was to be included in the taxpayer's income in order to calculate the tax under

Part I.2 of the *Income Tax Act*. The Minister correctly determined that the taxpayer was to repay the OAS pension amounts.

Butler, 2015 DTC 1092

Taxpayer required to include support payments received from former spouse in income

The taxpayer and her husband, H, separated and began divorce proceedings. The executed minutes of settlement (the "Minutes") and a related court order referring to those Minutes both provided for monthly support payments (the "Payments") to be made to the taxpayer by H, although both documents described the Payments as "non-taxable". The taxpayer appealed the Minister's reassessment, which included the Payments in her income for 2012, alleging that the Payments were payments in lieu of equalization payments and, hence, should not be included in her income as support payments.

The taxpayer's appeal was dismissed. The language in the Minutes and the court order left no doubt that the Payments were intended to be support payments. In addition, they met all of the *indicia* of support payments set out in the definition of "support amount" in subsection 56.1(4) of the *Income Tax Act*, including the statutory requirements that they be periodic in amount and that the taxpayer be free to use them as she saw fit. It was also irrelevant that the Payments were erroneously described as "non-taxable" in both the Minutes and the related court order. The Minister's reassessment was affirmed accordingly.

McBride, 2015 DTC 1091

TAX NOTES

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