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PART XII.2 TAX APPLICABLE TO TRUSTS: A POTENTIALLY EXPENSIVE TAX WHIChis OFTEN OVERLOOKED

Luc Pariseau

Several years after the creation of an *inter vivos* trust, the tax residence of one or several beneficiaries who were initially residents of Canada may change. For example, a beneficiary child may become a resident of the United States to study and possibly remain there, thus severing his or her residential ties with Canada. In such a case, Part XII.2 tax may apply[1] to the trust whichis a resident of Canada since one or several of its beneficiaries have become non-residents of Canada under the *Income Tax Act* ("**ITA**").

The purpose of Part XII.2 tax in the ITA is to avoid situations whereby non-residents of Canada reduce their tax burden by holding assets or operating a business in Canada through a trust whichis a resident of Canada for tax purposes instead of directly holding the assets or operating the business. In fact, a non-resident who operates a business in Canada and later disposes of it and realizes a capital gain will be taxable in Canada at the same rate as a Canadian resident on his or her business income and on the capital gain thus realized. In the absence of the Part XII.2 tax, the non-resident could operate his or Part XII.2 tax applicable to trusts: a potentially exp ensive tax whic his often overlooked her business and hold the business assets through a trust resident in Canada to avoid being himself or herself liable for Part I tax.

Where the conditions are met, Part XII.2 tax applies at the rate of 36%, most particularly on the income from a business operated in Canada earned by a trust, on income from real property located in Canada and on the taxable capital gains from the disposition of taxable Canadian property ("**TCP**"). A TCP includes, among other things, shares of private corporation to the extent that, during the 60 month period preceding the time of disposition, more than 50% of the fair market value of the shares is directly or indirectly attributable to real or immovable property located in Canada[2]. Thus, the presence of a non-resident beneficiary somewhat contaminates the trust resident in Canada because when the income earned by the trust is taxable under Part XII.2 of the ITA, the tax is payable irrespective of whether the income is attributed to a resident beneficiary or not[3].

Part XII.2 tax must be paid by the trust in the 90 days following the end of the fiscal year[4]. The beneficiaries who reside in Canada may generally claim a refundable tax credit representing Part XII.2 tax paid by the trust on the portion of income attributed to them. Thus, Canadian beneficiaries should generally not be penalized for the Part XII.2 tax paid by the trust. However, since the trust must first pay the Part XII.2 tax and the Canadian beneficiaries can only claim a refundable tax credit in their own tax return several months later, Part XII.2 tax may result in certain cash flow difficulties. As for the non-resident beneficiaries, Part XII.2 tax may represent a net cost if the non-resident beneficiary resides in a foreign country which taxes the income attributed by the trust residing in Canada without providing foreign tax credits or other mechanisms to enable taxpayers to avoid double taxation.

Some planning may be considered when it is anticipated that the beneficiary of a trust will become a non-resident of Canada in order to reduce or avoid Part XII.2 tax. In such situation, it is important to consult a tax advisor to assess the choices that could be made.

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[1] Part XII.2 tax may apply in other situations which are not covered in this bulletin.

[2] Under the ITA, a gain from the disposition of real or immovable property located in Canada or Canadian resource property also constitute a TCP. Timber resource property and in certain circumstances, shares of the share capital of a corporation listed on a designated stock exchange may also be considered as TCP.

[3] The expression "beneficiary" not being defined in the ITA, some issues may be raised as to the status as a beneficiary of a non-resident person who does not receive any income or capital from the trust in a given fiscal year.

[4] Paragraph 104(30) ITA also provides that Part XII.2 tax paid by a trust for a fiscal year must be deducted from its income for the year.

APPLICATION OF THE ANTI-AVOIDANCE RULE IN SUBSECTION 83(2.1): CAUTION IS REQUIRED IN THE CONTEXT OF THE ACQUISITION OF A PRIVATE CORPORATION
Éric Gélinas

Most accountants and lawyers are aware of the fact that a private corporation can pay dividends to its shareholders with no tax impact on them if the dividends are paid out of the capital dividend account ("CDA"). This tax account may consist, among other things, of the nontaxable portion of capital gains realized by a private corporation, life insurance proceeds received by this type of corporation, or capital dividends received from another private corporation. The purpose of the CDA is essentially to ensure that these amounts, which would not be taxable if they were received by the shareholder directly, are treated in the same manner when they are realized through a private corporation. The CDA is therefore a very valuable mechanism because of the favourable tax treatment attached to it.

Subsection 83(2.1) of the *Income Tax Act* (Canada) ("ITA") provides for an anti-avoidance rule whose purpose is to prevent the shares of a private corporation from being purchased in order to benefit from the available CDA. It reads as follows:

(2.1) Notwithstanding subsection 83(2), where a dividend that, but for this subsection, would be a capital dividend is paid on a share of the capital stock of a corporation and the share (or another share for which the share was substituted) was acquired by its holder in a transaction or as part of a series of transactions one of the main purposes of which was to receive the dividend,

(a) the dividend shall, for the purposes of this Act (other than for the purposes of Part III and computing the capital dividend account of the corporation), be deemed to be received by the shareholder and paid by the corporation as a taxable dividend and not as a capital dividend; and

(b) paragraph 83(2)(b) does not apply in respect of the dividend.

In a recent decision in the matter of *Groupe Honco Inc. et al. v. The Queen* (fi le no. 2009- 2134 (IT)G), rendered on September 4, 2012, the Tax Court of Canada specifi cally considered subsection 83(2.1) ITA. The Court held that subsection 83(2.1) ITA applies in a situation in which the shares of a corporation (the "Target") were acquired where the Target was the beneficiary of an insurance policy in the amount of $750,000 on the life of the seller, who was very sick at the time of sale of the shares. Since the seller died shortly after the transaction, the insurance proceeds were received by the Target after the acquisition, thereby creating a significant CDA for the Target. Dividends from the CDA, thus created, were subsequently paid by the Target (since merged) to its shareholders. These dividends were redefi ned as taxable dividends by the Canada Revenue Agency on the basis of subsection 83(2.1) ITA.

The taxpayers unsuccessfully attempted to argue that the main purpose for the acquisition of the Target's shares was not to receive the capital dividends, but rather that it was done for other business and tax reasons (e.g. to benefit from the Target's accumulated losses).

However, the Court concluded that subsection 83(2.1) ITA applied and, accordingly, that the dividends paid were in fact taxable dividends.

This decision underscores the importance of considering the potential application of subsection 83(2.1) ITA in any situation involving the acquisition of a private corporation in which a CDA remains unused or may be created subsequent to the acquisition.

REVENU QUÉBEC TO SCRUTINIZE TRUSTS

Diana Darilus

The Government of Quebec recently decided to give Revenu Québec new tools so that it can ensure that trusts having operations or rental properties in Quebec are in compliance with the tax legislation. In Quebec's last budget tabled on November 20, 2012, the Quebec government announced amendments designed to require certain trusts that are subject to Quebec tax to file a tax or information return (hereinafter referred to as the "**New Rules**"). These changes will apply to taxation years starting after November 20, 2012.

The New Rules will require certain trusts subject to Quebec tax to file a tax return in three new situations and an information return in one new situation.

However, some types of trusts are excluded from the application of the New Rules, for example, estates and testamentary trusts residing in Quebec on the last day of their taxation year if the total of the cost amounts of their property for the entire taxation year of the trust is less than $1 million.

CHANGES TO THE FILING OF TAX RETURNS

Allocation of income to a beneficiary whether resident or not resident in Quebec

Where a trust subject to Quebec tax for a taxation year deducts an amount allocated to a non-resident beneficiary in the calculation of its income for the taxation year, it must now file a tax return for that taxation year. Previously, it was only required to do so where the amount was allocated to an individual resident in Quebec or a corporation with an establishment there.

Thus, where a trust resident in Quebec allocates its income to beneficiaries not resident in Quebec, it must henceforth file a tax return even if it has no tax to pay, realizes no capital gains, and does not dispose of any capital property during the taxation year.

Trust resident in Quebec owning property the total of whose cost amounts exceeds $250,000

A trust subject to Quebec tax must henceforth file a tax return if it resides in Quebec on the last day of the taxation year and it owns property, at any time during the taxation year, the total of whose cost amounts exceeds $250,000.

Trust not resident in Quebec owning business property the total of whose cost amounts exceeds $250,000

A trust subject to Quebec tax must henceforth file a tax return if it does not reside in Quebec on the last day of the taxation year and it owns property, at any time during the taxation year, which it uses to carry on a business in Quebec the total of whose cost amounts exceeds $250,000.

CHANGES TO THE FILING OF INFORMATION RETURNS

Trust resident in Canada outside Quebec holding a rental property in Quebec

From now on, a trust residing in Canada outside Quebec which owns a rental property[1] located in Quebec, or whichis a member of a partnership[2] that owns such a property, must file an information return.

For example, a trust residing in Canada outside Quebec which receives passive property income (as opposed to business income) from a rental property located in Quebec must henceforth file an information return in Quebec.

The New Rules impose additional obligations on certain trusts that were not previously required to file a tax return or information return. The failure to comply with these New Rules may result in the imposition of penalties and interest.

[1] The New Rules use the expression “specifi ed immovable property” which means an immovable property located in Quebec (or a right in such immovable property) that is used mainly for the purposes of earning or producing gross revenue that constitutes rent.

[2] These New Rules also apply to a trust that is a member of a partnership that itself is a member, directly or indirectly, through one or more other partnerships, of a partnership that owns a specifi ed immovable property.

DIRECTORS’ LIABILITY FOR THE DEBTS OF A CORPORATION PAYABLE TO EMPLOYEES FOR SERVICES RENDERED DURING THE DIRECTORS’ TERM OF OFFICE
Catherine Méthot

The Quebec Court of Appeal rendered a decision on November 14, 2012 confi rming the state of the law on the scope of section 119 of the *Canada Business Corporations Act* (the “**CBCA**”), which provides as follows: “Directors of a corporation are jointly and severally, or solidarily, liable to employees of the corporation for all debts not exceeding six months wages payable to each such employee for services performed for the corporation while they are such directors respectively.” (my emphasis)

In this case, Justice Dalphond found from the evidence that the three respondents, Myhill, Cochrane and Lilge, were not only the elected directors in accordance with the resolutions and records of Société Inter-Canadien (1991) Inc. (“**Inter**”) until their collective resignation in May or June 1999, but also that they had in fact behaved as Inter’s directors, despite the existence of a declaration by Inter’s sole shareholder divesting them of their powers. Inter terminated its operations on October 27, 1999 and declared bankruptcy on March 27, 2000. Inter’s employees claimed several million dollars in unpaid wages by Inter from the directors under section 119 CBCA.

Justice Dalphond noted that section 119 CBCA, [translation] “which enacts a liability exceeding that ordinarily prescribed by the law, without proof of fault, must by its nature be interpreted narrowly [as the case law has consistently held].” The debts payable by a corporation for services performed by the employees on its behalf during the term of office of a director constitute the promised, but unpaid, consideration for the work done during the director’s term of office. This includes wages, the reimbursement of expenses incurred, and any amount earned as a result of the services rendered by the employee whose payment was deferred, such as vacation pay. On the other hand, the debts payable for services performed by the employees on behalf of the corporation do not include all the debts borne by a corporation in relation to its employees.

Thus, Justice Dalphond found that the directors could not be held liable for: (i) claims for medical expenses due to the employer’s failure to pay the premiums to the insurers, (ii) pay in lieu of notice for the termination of employment under collective agreements because such pay constituted damages for wrongful breach of employment, and (iii) 40 weeks of severance pay claimed by the employees because this was not a form of deferred compensation, but a guarantee of employment security. However, the judge did find the directors liable for deductions made by the corporation out of the employees’ wages for contributions to the group insurance and for the purchase of bonds, which had not been paid to third parties in accordance with the employees’ instructions, because these amounts were still owed by Inter to the employees as a form of unpaid wages.

Justice Dalphond therefore recognized the employees’ right to claim the compensation referred to above jointly and severally from the directors [translation] “if unpaid at the time the actions were instituted, not exceeding an amount equal to six months gross wages per employee". This was in addition to the amounts that were not contested in the case, namely, back wages, unpaid wage increases, unpaid overtime, unreimbursed expenses, vacation pay, holiday pay and sick leave credits.