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GAP IN SUBSECTIONS 40(3.3) AND (3.4) FOR WOUND-UP TRUST?

Subsections 40(3.3) and (3.4) generally apply to prevent a corporation, partnership, or trust from realizing a pregnant loss on certain non-depreciable capital property by transferring the property within an affiliated group. Where the rules apply, the loss is "suspended" and cannot be claimed by the transferor until a listed trigger event occurs, such as a disposition to an unaffiliated person. Subsections 40(3.3) and (3.4) stipulate whether the two parties remain affiliated after the transferor is dissolved or wound up, but only if the transferor is a corporation or a partnership. Thus, if a trust distributes property to an affiliated beneficiary and winds up immediately after the distribution, it is unclear whether these suspended-loss rules apply. This gap in the legislation may not come up often in practice, since trusts may generally distribute assets to Canadian-resident beneficiaries on a rollover basis under subsection 107(2), but it could be relevant when the distribution is not executed on a rollover basis (for example, pursuant to a subsection 107(2.001) election) or when a trust transfers property to a person who is not a beneficiary.

There are several CRA rulings dealing with alter ego trusts that imply that a transferee cannot be affiliated with a transferor trust once the trust has wound up. In fact, on at least two occasions, the CRA has explicitly stated that a person cannot be affiliated with a trust that has wound up: see CRA document nos. 2007-0221361R3, released October 17, 2008 and 2008-0292121R3, released March 6, 2009. While these statements are fairly explicit, their efficacy may be limited because they are rulings, and not general statements of the CRA's position. Also, because these rulings were heavily redacted, one cannot be sure that there was an affiliation prior to the trusts' windup.

In CRA document no. 2004-0091061E5, March 21, 2007, the CRA was asked whether a previous version of subsection 13(21.2) (an analogous rule to subsections 40(3.3) and (3.4), but for depreciable property) would apply where the transferor trust was wound up within the relevant holding period. The CRA's position was that subsection 13(21.2) would not apply, because the transferor and the transferee would cease to be

the purposes of subsection 40(3.3).

Where does this leave us? We have clear statements from the CRA in rulings saying that a wound-up trust cannot be affiliated with any person, but these are qualified for the reasons above. We also have a clear statement from the CRA saying that this is not the appropriate interpretation of subsection 40(3.3), even though this was its position for the purposes of former subsection 13(21.2). (No reasons were given for this distinction.)

On policy grounds, the CRA position in the rulings appears to be preferable. For corporations, a subsection 88(1) corporate windup is not a trigger event; that is, the loss remains suspended until a "real" trigger event occurs. Presumably, this is because on a subsection 88(1) windup, the parent corporation will generally have access to the wound-up subsidiary's losses, and therefore will be able to utilize the suspended loss on the occurrence of a trigger event. In contrast, a windup that is not under subsection 88(1) is a trigger event.

For partnerships, a dissolved partnership is deemed to continue to exist, and its partners immediately before dissolution are deemed to remain partners, until a trigger event occurs; again, presumably, this is because the partners could claim the suspended loss at that time.

The windup of a trust may be similar to the non-subsection 88(1) corporate windup, since the suspended loss would not be available for the wound-up trust's beneficiaries.

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