Tax Law for Lawyers

Estate Planning and The Taxation of Trusts

The Canadian Bar Association
The Continuing Legal Education Committee and
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Introduction: Legal Principles & Tax Concepts

The Trust

- historical origins / principles governing trusts have evolved over centuries and continue to evolve
- original use - with respect to wills and property
- over time used commercially - joint ventures, pension plans, financing vehicles, investment vehicles

Uses of Trusts

- Tax reasons
  - income splitting - transfer tax burden from a high bracket taxpayer to taxpayer in lower tax bracket
  - use enhanced capital gains exemption of various family members
  - access lower tax rates of different provinces / jurisdictions
  - in case of testamentary trusts - to multiply ability to access lower tax rates

Uses of trusts (Con't)

- Non-tax reasons
  - asset protection
  - provide for disabled, minor beneficiaries
  - probate tax savings
  - provide for successive interests
  - give benefits of ownership but retain control

Types of Trusts

- Inter vivos / testamentary
- Discretionary / Non-discretionary
- Personal / Commercial
- Revocable / Irrevocable
- Bare
- Spousal
- Alter ego / Joint spousal or common law partner trusts

Trusts vs. Other Relationships

- Separates legal and beneficial ownership
- Not legal entity
- Not a contract
- Not an agency relationship
- Three certainties
  - Intention
  - subject matter
  - objects

The Three Certainties - Antle

Summary

- “Capital property step up strategy”
- Shifting of capital property with an accumulated gain from husband to Barbados spousal trust
- Spousal trust sells property to wife and wife sells property to third party and uses proceeds to pay off the trust
- Trust distributes funds to wife as beneficiary and trust dissolves.

The Three Certainties - Antle

Additional Facts

- 1998: Shares acquired by husband in a transaction whereby he promised Seller 50% of profits of future sale; promise secured by delivery of share certificates to Seller endorsed in blank
- Sept 1999: Husband and partner negotiate sale to third party and enter into letter of intent
- Oct and Nov 1999: negotiations with Seller to release security and discussions regarding intention of husband to engage in tax planning

The Three Certainties - Antle

Trust Settlement (Additional Facts)

- Barbados Trustee signs deed of trust on Oct 27, 1999 but trust deed dated Dec 5, 1999
- Transfer of shares to trust planned for Dec 5, 1999
- Transfer from trust to spouse intended for Dec 8, 1999
- Antle signs all docs authorizing transfer of share to Trust on Dec 14, 1999 (including Trust deed, directors' resolutions authorizing transfer of shares to the Trust etc)
- Sale closes on Dec 14 and proceeds received directly by husband's counsel.

The Three Certainties - Antle

MNR Arguments

1. Trust not validly constituted and gain on sale to third party is taxable to husband (MNR wins)
2. Trust was a sham (MNR lost…there was no deception)
3. Taxable capital gains taxable in Canada on basis that trust resident in Canada 94(1)(c) (MNR lost)
4. SS. 73(1) not available so no rollover to spousal trust (MNR lost)
5. GAAR applies: abuse of 73(1), 74.2(2), 94(1)(c) (MNR wins)

The Three Certainties - Antle

Validity of Trust: Certainty of Intention

- No certainty of intention
- Court not restricted to reviewing the documents in determining certainty of intention
- Trust settled only on Dec 14 when husband signed the trust deed.
- Prior to Dec 14, terms of ultimate sale transaction had been settled
- Trustee was compliant trustee and at most an agent for the transfer to the spouse
- No intention to settle trust, thus Barbadian trustee not really the trustee

The Three Certainties - Antle

Validity of Trust: Certainty of Subject Matter

- The obligation of husband to pay Seller to release shares meant that husband retained some interest in the shares
- Husband made duress claim for recovery of the amounts paid to Seller
- Seller was paid out of proceeds of sale of shares to third party
- Result: lack of certainty regarding what constituted subject matter of trust

The Three Certainties - Antle

Validity of Trust: No Actual Transfer

- Directors resolution dated “as of December 5” but directors didn’t meet till Dec 14
- Share certificates endorsed but not delivered till Dec 14 closing and never actually delivered to the Barbadian Trustee
- Conclusion: No valid trust. Husband sold shares to wife and gain on sale attributed back to husband

Residence of a Trust

- Trust not a legal entity but considered a taxpayer under ITA
- Act is silent on residence of trust
- Residence – a question of fact
  - Thibodeau – residence of Trustees
  - Garron – central management and control

Residence of a Trust - Garron

Garron Family Trust v. Her Majesty the Queen 2009 (TCC)

- At issue was the residence of two trusts settled by a resident of St. Vincent Islands during the reorganization of a Canadian resident corporation
- Sole Trustee was a regulated trust company resident in Barbados
- Each trust had a protector resident in St. Vincent who could remove and replace the trustee at any time, provided that the protector could be replaced by a majority of the beneficiaries
- Beneficiaries were Canadian residents

Residence of a Trust - Garron

- Corporate reorganization similar to an estate freeze was carried out whereby the common shares of the Canadian resident corporation were converted into preference shares and common shares were issued to two new Canadian holding companies
- The common shares of these holding companies were then issued to the two trusts
- When the trusts disposed of the majority of their shares in the holding companies there were realized capital gains of over $450,000,000

Residence of a Trust - Garron

- Pursuant to the treaty, subject to certain exceptions, capital gains may only be taxed in the jurisdiction in which the taxpayer is resident
- Reassessments of the trusts were issued on the basis that the treaty exemption did not apply

Residence of a Trust - Garron

Arguments

- MNR argued that the trusts were resident in Canada under the central management and control test, that the Barbados trustee was "compliant" and that the actual management and control resided with persons in Canada
- The Appellants argued that the trust was not resident in Canada under the *Thibodeau* test of residency and that the central management and control test was not applicable

Residence of a Trust - Garron

<u>Decision</u>

- Justice Woods found that the residence of a trust is where central management and control of the trust resides – adoption of this test to the question of trust residence promotes consistency and fairness
- Limited *Thibodeau's* rejection of the management and control test to its particular facts and to its assumption that the management and control of a trust must reside with the trustee because the trustee has a fiduciary obligation to manage and control the trust.
- Justice Woods found, this assumption is inappropriate because it assumes that trustees always comply with their fiduciary obligations.

Residence of a Trust - Garron

Decision

- In a trust context, management and control of a trust resides with the person who makes the "key decisions" for the trust
- Decision found that the management and control of the trusts resided with the Canadian beneficiaries and not the Bermuda trustee because:
  - The trustee was selected to provide administrative services
  - No evidence to suggest the trustee was expected to have decision making responsibility
  - Evidence suggested trustee had limited role
  - The limited role of the trustee's was enforceable through protector provisions – i.e., protector could replace trustee and Canadian beneficiaries could replace the protector

Residence of a Trust - Garron

Decision

- Justice Woods concluded that had the Trusts not been resident in Canada by reason of the central management and control test, but deemed resident pursuant to s.94 of the Act, this deeming would not result in the trusts being “resident” for treaty purposes.
- Justice Woods concluded that the transactions did not constitute an abuse or misuse of the Treaty and the GAAR did not apply.

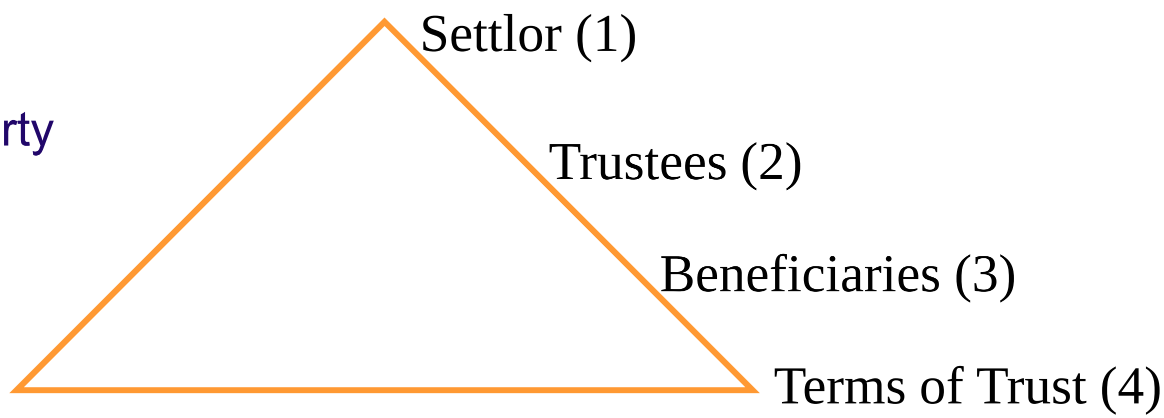
Residence of a Trust - Garron

Decision

- Decision indicates that the residence of trustees will no longer automatically determine the residence of a trust
- Evidence of management and control of a trust will be necessary in order to determine residency on a going forward basis
- Proper documentation of decision making and activities of trustee will become increasingly more important

Taxation of Trusts

a) Taxation of property transferred to trust



b) Taxation of income / capital gains / losses at trust level

c) Taxation of income / capital gains / distributed to beneficiaries

d) Taxation of property transferred to beneficiaries

Components of a Trust

- Settlor ⟶ Testamentary
  Inter Vivos
  - Relevant to PBE
  - Avoid attribution Rules 74.1-74.5
  - Avoid s.75(2) ⟶ 107(4.1)

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Components of a Trust

- Trustees
  - Legal ownership and management, voting powers, etc.
  - Residence (*Garron*)
  - Avoid attribution rules
  - Avoid s.75(2), ITA
  - Powers may need to be curtailed in some cases
    - Ex. spousal trusts; lending powers

Components of a Trust

- Beneficiaries
  - Enjoy beneficial use, enjoyment
- Nature of interest
  - income / capital
  - fixed / discretionary
  - vested
  - contingent

Components of a Trust

- Terms of Trust
  - Specific rules for operation of trust and duties of trustees
  - Common law, Trustee Act (provincial)

Taxation of Trusts, Beneficiaries

- Transfer to Trust – Disposition
- Most transfers to and from trusts qualify as disposition (defined in s. 248(1)).
- Exceptions - no change in beneficial ownership unless transfer:
  - from person/partnership to trust for benefit of former
  - from trust to beneficiary
  - from one trust to another where both have same beneficiaries.
- More exceptions in paragraphs (f),(g),(h),(i),(k).

Taxation of Trust, Beneficiaries

- Trust – Taxable entity
  - Inter vivos (top marginal rate applies)
  - Amounts paid/payable to beneficiaries taxed in hands of beneficiaries
- A trust is also a conduit (limited)
  - Interest
  - Capital gains
  - Dividends

Taxation of Trust, Beneficiaries

- Attribution Rules
  - May apply to income / Capital gains
    - Retained in the trust
    - Distributed to beneficiaries

When is Income of Trust taxed in hands of Beneficiary?

- Paid to beneficiary
- Payable to beneficiary
- Preferred Beneficiary Election (limited use)
- Payments in respect of property for use of a beneficiary or life tenant pursuant to s.105(2), ITA

What does Payable mean?

- Entitled to enforce payment s.104(24), ITA
  - By terms of trust
  - By exercise of discretion
- Payments to third parties?
  - See Income Tax Technical News #11

Income: Trust law vs. Tax law

- Income for trust law purposes is not the same as income for tax purposes
- In trust law, form rules
  - E.g., cash dividend (including capital dividend) is income
  - E.g., stock dividend or proceeds from share redemption is capital

Income: Trust law vs. Tax law

- Settlor can provide in trust agreement for characterization
  - By explicit reference to certain types of corporate distributions
  - By adopting a tax law definition of income

Why is this relevant?

- If income and capital beneficiaries are the same, then not an issue
- If income and capital beneficiaries are different, then characterization of receipts will affect trustee's ability to pay to the particular person (depending on nature of receipt)

Why is this relevant?

- Phantom income for tax purposes is a nothing for trust law purposes
  - E.g., interest accrual, deemed capital gain
- How can phantom income be distributed to a beneficiary?
  - See CRA Document No. 9425345

Adopting ITA concept of Income

"Net Income" when used in this Agreement shall mean income, including income determined in accordance with the ITA or an equivalent provincial statute at the particular time and, for greater certainty, shall include any amounts deemed to be income under the ITA or equivalent provincial statute whether or not such amount would have been income or capital but for this paragraph"

Inter Vivos Estate Freeze

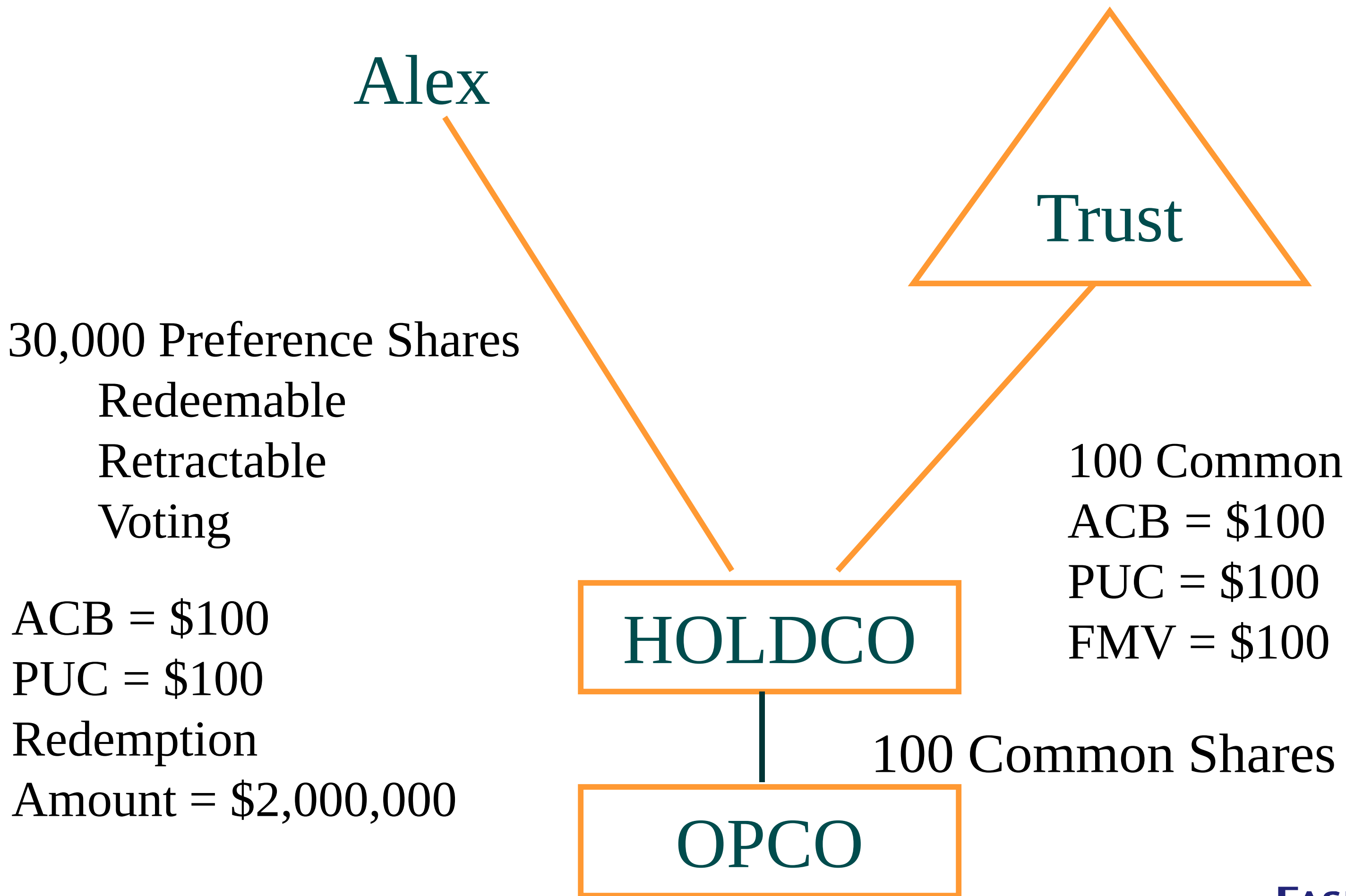
Alex

100 Common shares

ACB = $100
PUC = $100
FMV = $2,000,000

OPCO - Labcorp

Inter Vivos Estate Freeze



Personal Attribution Rules

- Transfer/ Loan of property to a trust and distribution by trust to beneficiary
  a) To spouse → Attribution of income & capital gains
  b) To non-arm's length minor
  c) To minor niece, nephew of transferor / Lender
- 74.5(7) guarantee
- 56(4.1) attribution
  - Loan to trust
  - Beneficiary 18 or older
  - Purpose test

(b), (c), 74.5(7) guarantee → Income (but not capital gains)

Exceptions to Personal Attribution Rules

1. Income on income
2. Income from business
3. Transfers at FMV
4. Loans at FMV
   - Interest at or greater than prescribed rate at time loan made
   - Interest must be paid no later than 30 days after year end each year loan outstanding

Corporate Attribution Test

- Income attribution in respect of property transferred to a corporation (s. 74.4(2))
  - Applies where property loaned or transferred to a corporation
- Main purpose is to reduce income of transferor, and benefit designated person who is a specified shareholder of the corporation

Corporate Attribution Test

- Designated person of a transferor
  - Spouse
  - Non-arm’s length minor
  - Minor Niece, Nephew

Corporate Attribution Test

- Specified shareholder
  - Person who holds at least 10% of the shares of any class of the corporation
  - If specified shareholder is beneficiary of a trust & has a fixed interest, deemed to own proportionate share of the shares owned by the trust
  - If specified shareholder is beneficiary of a discretionary trust, deemed to own each share the trust owns

Corporate Attribution Test

- APPLICATION: anytime shares are transferred to a corporation must consider application of this rule
- Applies to s.85 transfers
- Applies to s.86 reorganizations
  - s.84(9) – where a shareholder disposes of a share as a result of the redemption, cancellation, acquisition of the shares by the corporation, shareholder is deemed to have disposed of the share to the corporation
  - Therefore, exchange of shares considered to be a transfer for purposes of s. 74.4(2)

Corporate Attribution Test

- If 74.4(2) applies, transferor deemed to have received income inclusion
  - Income attributed equals prescribed percentage of “outstanding amount” of property transferred whether or not income earned by designated persons

Corporate Attribution Test

- In case of transfer of property - outstanding amount equals fair market value of property at time of transfer less fair market value of consideration received other than excluded consideration (debt, shares, right to receive debt or shares)
- actual income received will reduce amount of deemed income

Exceptions to S. 74.4(2)

- When transferor ceases to be resident of Canada
- Exception if transferred shares are shares of small business corporation (caveat: test is annual test)
- "Safe harbour" – 74.4(4)
  - Designated person's only interest in corporation is as beneficiary of trust with certain terms

Terms of Trust

- Designated person may not receive or otherwise obtain use of income or capital of trust while he or she is designated person in respect of transferor and has not received or otherwise obtained use of the income of capital of the trust
- Trust cannot make deduction in computing its income in respect of amounts paid or payable to
  or included in income of a designated person
  via preferred beneficiary election

Sample s.74.4(4)(b), ITA Clause

"Notwithstanding any other provision contained herein, during the of XXX , the Trustees shall not:

(a) allow any Beneficiary to receive or otherwise obtain the use of any income or capital (within the meaning of subsection 74.4(4) of the Income Tax Act (Canada)) of the Trust; or

(b) join with any Beneficiary in making a preferred beneficiary election,

while such Beneficiary is a "designated person" as defined by subsection 74.5(5) of the Income Tax Act (Canada) in respect of XXX ."

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Controlled Trusts and Attribution (s.75(2))

- If property is held in a trust on condition that the property
  - May revert to person from whom property received (transferor)
  - May pass to persons determined by the transferor
  - May not be disposed of without the consent or direction of the transferor
- Then income, loss, capital gains, capital losses from property of the trust will be attributed to the transferor while alive and resident in Canada

Controlled Trusts and Attribution (s.75(2))

- “Condition” Creating a Reversion
  - revocable trust
  - If settlor or transferor has ability to reacquire the property (e.g. If he/she is capital beneficiary)
  - Repayment of loan ≠ reversion
  - Reversion by operation of law – OK

Controlled Trusts and Attribution (s.75(2))

- "Determination", "consent", "direction" by/of Settlor or Transferor
  - If sole trustee
  - If one of two trustees
  - If has ability to select beneficiaries and veto distributions and investment decisions
  - If more than two trustees but unanimity required for decision or majority decisions but must form part of majority

Consequences of Application of Subsection 75(2)

- Attribution of the income, losses, capital gains, <u>of the trust</u> not of the beneficiaries
- Trust to trust transfer – avoid s.75(2) but not s.107(4.1)
- s.107(4.1) will apply – trust will not be able to distribute any property on a tax deferred basis to any beneficiary other than the person from whom the property or substituted property was received or the spouse of that person during the lifetime of that person
- Harsh result – but see 2007 comfort letter re potential relief for pre-1989 trusts

Other Considerations

- 21 year rule
  - flexibility to make capital distributions prior to 21st anniversary of settlement
  - if no such flexibility – variation of trust?
- Income splitting "kiddy" tax

Thank You

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