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ESTATE PLANNING AND THE TAXATION OF TRUSTS

by

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A. INTRODUCTION

The term "estate planning" invariably evokes thoughts of complex tax-planned structures designed and implemented for the largest of estates. Notwithstanding the foregoing perception, estate planning encompasses such diverse activities as the preparation of the simplest will to the implementation of more complicated tax-planned structures involving corporations and trusts. Thus, the topic of estate planning and the taxation of trusts is obviously of the broadest possible scope. Of necessity, the focus of this paper shall be limited to a number of tax-related issues, which are of fundamental concern and importance in any estate plan.

The choice of an appropriate estate planning vehicle is dependent upon a number of factors, including the stage of life of the individual, his or her own financial needs and expectations as well as the nature and extent of the individual's assets. Although the point may seem moot, it is necessary for an estate planner to appreciate the wishes and intentions of the client as well as his or her circumstances in order to provide the proper advice concerning an appropriate course of action. For example, if the client wishes to plan for business succession and/or has a desire to split income among family members during his or her lifetime, the use of an *inter vivos* trust may be advisable, whereas if the individual does not have significant business interests and simply wishes to provide for the orderly disposition of his or her estate following death, a will incorporating the necessary testamentary distributions might prove sufficient. It is therefore important to first gain an understanding of the individual's circumstances and the extent to which an orderly succession plan is required. Often, where a business succession plan is required, an estate freeze is involved, the idea being to give an interest in the business to the children so that the future growth accrues to them rather than being taxed in the hands of the parent while still permitting the parent (freezor) to retain control. A discretionary *inter vivos* family trust offers income-splitting possibilities as well as flexibility and control. A will would generally also be crafted to round out the estate plan by dealing with any shares taken back on the freeze as well as other assets of the freezor.

My paper today will focus on one aspect of estate planning, namely, the use of trusts and some of the tax issues pertaining to the taxation of trusts in the context of *inter vivos* and testamentory estate planning. While recent legislative changes have eliminated some of the tax benefits to using trusts to achieve income splitting benefits, they have not eliminated entirely the ability to achieve various tax and non-tax planning strategies.

My discussion will focus on the following:

(a) general overview, including a brief discussion of the nature of a trust and duties of trustees;

(b) review of some of the technical rules relating to trust transactions. In this section I propose to deal with the taxation of trusts and their beneficiaries in the context

of an estate freeze and to explore some of the new types of trusts, which were introduced a few years ago into the *Income Tax Act*[1].

B. TRUSTS – GENERAL OVERVIEW

1. Nature of A Trust

It is important to remember that a trust is not a legal entity. It is a relationship which arises whenever a person called the trustee holds property, whether real or personal, for the benefit of some persons who are called *cestui que trust* or beneficiaries (of whom the trustee can be one) or for the benefit of some object permitted by law (e.g., trusts for charitable purposes) in such a way that the benefit accrues to the beneficiaries or objects of the trust and not to the trustee.

A trust therefore is unlike a corporation in that it cannot enter into contracts, own property or incur liabilities. Such acts must be effected by the trustees in their capacity as trustees and subject to the terms of the trust instrument. It is therefore not correct to describe the trust as owner of shares. Rather, the shares should be in the names of the individual trustees in their capacity as such. Similarly, if a trust is a party to a contract, it is not correct to describe the trust party as "the XYZ Trust". Rather, the trust party to a transaction should be the trustees in their capacity as such.

Since the trustees conduct business in their own name, they should be careful to expressly limit their personal exposure to the unadministered assets of the trust from time to time and make it clear that they are executing documents not in their personal capacity but in their capacity as trustees. Liability insurance should also be considered especially in business trusts.

It is also important to distinguish between the trust relationship and other relationships. For example, trustees act as principals and, except in the case of a bare trust where the trustee has no independent powers, are not agents of the beneficiaries. At the same time they are accountable to the beneficiaries and must exercise their powers in a manner which is within the terms of the trust instrument and in the best interests of the beneficiaries. This dichotomy is reflected in the sections of the Act, which deal with the taxation of trusts and their beneficiaries. In some cases the trustees are fixed with primary obligations such as the obligation to file tax returns and pay taxes. In other sections, the trust is treated as a conduit in respect of income or capital payable to the beneficiaries or assets distributed to beneficiaries.

The trust relationship has also been contrasted to the relationship created by contract. A contract is a vehicle for the creation of reciprocal rights and obligations between the parties to the agreement. If one of the parties to a contract breaches his obligations, the other party or parties can seek to enforce that obligation or seek damages for breach.

In contrast, a trust instrument, while it may set out the powers, duties and obligations of the trustees, does not create contractual obligations between the settlor (the person who establishes the trust) and the trustees nor between the trustees and the beneficiaries.

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[1] *Income Tax Act* R.S.C. 1985 (5th Supp.) c. 1 as amended (the "*Income Tax Act*" or the "Act").

While at common law it is not necessary to have a document in writing to constitute a trust in respect of certain property, generally, in the estate planning context there is a trust indenture, which clearly expresses the intention of the settlor and identifies the property and the beneficiaries either specifically or by description. If problems arise, they arise because insufficient attention is paid to observing the formalities or because of drafting deficiencies. For example, the mere description of the trust property will not be sufficient to constitute the trust. Property must actually be transferred to the trustees, and the trust will not be constituted until the property has been transferred. The decision of *Milroy v. Lord*[2] stands for the proposition that for a voluntary settlement to be effective everything must have been done to transfer the property. A promise to donate property is not enough to create a trust relationship. In this regard, it is important to note that property which is not yet in existence cannot be used to settle a trust.

In addition, when describing the trust objects it is important to be sufficiently precise so that the trustees and, if necessary, the court can determine whether a particular person is intended to be in the class of beneficiaries. When establishing a trust one must remember that, in order for a trust to come into existence, it must have three essential characteristics, commonly referred to as the three certainties.[3] In addition, careful drafting may be necessitated by certain provisions

[2] (1862) 4 Deg. F. & J 264.

[3] The importance of ensuring the three certainties are present is demonstrated in the recent case of Paul Antle v. MNR (2009) T.C.C) The case involved a capital property step up strategy and a shifting of capital property with an accumulated gain from a Canadian resident husband a Barbados spousal trust. The strategy involved having the spousal trust sell the property to the wife for a promissory note. The wife would then sell the property to a third party and use the proceeds to pay off the promissory note to the trust. The Trust would then distribute the funds to the wife as beneficiary and the trust would then dissolve. The tax strategy was as follows: a transfer to an offshore spousal trust would occur on a roll over basis. This would be so because, although the trustees are resident in Barbados, the trust would be deemed to be resident in Canada (94(1)(c). Therefore there would be no capital gain taxable in Canada. The sale of shares to the wife at fair market value for a promissory note, and sale by the wife to the third party would occur on a tax free basis because any gain on the sale to the third party would be treaty-protected in Barbados.

The Minister of National Revenue argued as follows:

1. The trust was not validly constituted and the gain on the sale to the third party is taxable to the husband (MNR won)
2. The trust was a sham (MNR lost…there was no deception)
3. The capital gains were taxable in Canada on the basis that the trust was resident in Canada 94(1)(c) (MNR lost)
4. SS. 73(1) was 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).

Additional Facts were as follows:

- 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
- 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

of the Act such as those found in the attribution rules, which will be explored in more detail below.

It is also important to beware of drafting errors which could defeat the intentions of the settlor. For example, it is important to draft the trust so as to avoid the application of the rule in *Saunders v. Vautier* which permits early termination of a trust if all of the beneficiaries are *sui juris*. The rule against perpetuities should also be kept in mind. Trust property must vest within the time period of twenty-one years from the death of the last relevant life in being.

2. Duties of Trustees

An individual assumes certain fiduciary duties in taking on the responsibility of a trustee. The primary duties imposed on trustees by the common law include the following:

(a) ***duty of care*** – The standard is that of a reasonable and prudent business person who is administering another person's assets;

(b) ***duty to act personally*** – Generally a trustee is not entitled to delegate his or her decision-making powers. The rationale is that if a person has accepted the responsibility to manage property for others, she has no right to shift that responsibility to others. The strict rule is relaxed in certain cases when administrative as opposed to decision-making functions are involved;

- 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 Court reviewed the facts and concluded as follows:

A. Validity of the 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

B. 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

C 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

(c) ***duty to act in beneficiaries' best interests*** – Trustees must avoid conflicts between their own interests and those of beneficiaries. They must not profit from their position. If there is a breach of trust, a trustee can be compelled to hand over any improper gain to the beneficiaries;

(d) ***maintain even hand*** – Trustees are required to act impartially in dealing with trust assets for the benefit of successive beneficiaries. This obligation arises when investments are made that favour income beneficiaries over capital beneficiaries or vice versa and also when considering exercising power to make distributions to beneficiaries.

An important question arises as to what extent these duties may be modified by the terms of the trust indenture. The duty of loyalty can be modified by specific or implied consent to permit conflicts of interest in some circumstances or the trustees can be authorized to deal with the trust on the purchase or sale of trust assets. Otherwise the authority must be sought from the court. The standard of care can be eroded by the terms of the trust although one might wonder why the settlor would want to do that. Providing for the ability to engage professional advisors or imposing a portfolio perspective on investment performance rather than an asset specific performance perspective may make some sense. However, reducing the duty of care or providing the trustees with the ability to delegate should be considered carefully. The even hand rule is often ousted and deliberately so, for example, when trustees are given broad powers to encroach to favour needs of particular beneficiaries.

It is also important for trustees to consider the manner in which powers given to them (such as discretionary powers to distribute income or capital or to select beneficiaries) are to be exercised. When exercising powers, trustees must consider the purpose of the power. This is one of the issues to be addressed, for example, when considering the distribution of trust assets to beneficiaries to avoid the application of the 21-year rule. While the courts have expressed reluctance to interfere with powers given to the trustees they have interfered to prevent trustees from exercising their powers for an improper purpose or a purpose outside of the scope of the power. In order to do so, however, the court must find that the improper purpose forms part of the trustee's decision. An example of the court's use of this ground to strike down a trustee's exercise of discretion is found in the recent case of *Fox v. Fox Estate*[4]. The testator gave his wife, who was also a trustee, a life interest as to 75% of the income of the residue of his estate and to his son a life interest as to the remaining 25%. There was a power to encroach on capital for the benefit of the son during his mother's lifetime and the son would inherit the estate on the death of his mother. In addition the testator provided that the trustee had the right to encroach on the capital for the benefit of the issue of the son or any one or more of the issue of the son.

Following the death of the testator, the son decided to marry his secretary who was a gentile. The Fox family was Jewish. The news of the impending marriage became a source of tension and the mother disinherited her son from her will and made a series of encroachments on the capital from the estate of her husband in favour of the son's children. She effectively encroached all the assets comprising the residue of the estate to her two grandchildren.

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[4] (1996) 28 O.R. (3d) 496; (1996), 88 O.A.C. 201; 1996 CanLII 779 (ON C.A.).

The court considered the reasons of the executrix for exercising the power of encroachment and whether the exercise of the power was a proper one. The court, agreeing with the trial judge, found that the executrix had used her power to encroach in order to deprive her son of his interest in the bulk of the residue of the estate because he had married a gentile. The trial judge had also found that this motive was perhaps coupled with a concern for the welfare of her grandchildren but the prime motivation for the encroachment was her dislike of her son's marriage.

With respect to the legal issue of whether the exercise of the power was a proper one, the trial judge had determined because there was no finding of *mala fides* the exercise of discretion had been a proper one. The Court of Appeal determined that, while previous law had articulated the principle that so long as there is no *mala fides* on the part of a trustee the exercise and absolute discretion is to be without any check or control by the courts, he determined that a court may interfere if a trustee's discretion is influenced by extraneous matters and concluded that the intention to marry a gentile was completely extraneous to the duty which the will obviously imposed on the executrix, which was to be concerned about the welfare of her grandchildren. He concluded that this extraneous consideration was sufficient *mala fides* to bring her conduct within any reasonable interpretation of that term. One of the other judges on the Court of Appeal reached the same conclusion but the analysis focused more on determining the purpose of the will and whether the encroachments were made within that purpose. The judge concluded that the intention of the testator was to insure that the son had a life income from the estate and a remainder interest following the death of his mother. It was not a proper exercise of discretionary power for the trustee to encroach entirely in favour of one beneficiary so as to wipe out the life interest and income and remainder interest of the capital of another beneficiary.

C. GENERAL OVERVIEW OF TAXATION OF TRUSTS AND BENEFICIARIES

1. Trust as a Taxpayer

In structuring an estate plan involving the use of a trust, it is important to be aware of the tax rules applicable to trusts. These rules are important in that they will have an impact on decisions as to the selection of trustees, the choice of beneficiaries and the nature interest which such beneficiaries will have (for example, income and/or capital; discretionary and/or fixed), the powers to be given to trustees and other provisions of the trust.

The word "trust" is not defined in the Act. Nevertheless, a trust or estate is generally treated as a separate taxpayer for tax purposes. Sections 104 to 108 of the Act address the taxation of trusts and their beneficiaries. Subsection 104(2) deems a trust to be an individual subject to tax and a separate tax-paying entity distinct from the trustee or executor who has legal title to the property. Subsection 104(1) states that a reference to a trust or estate is to be read as a reference to the trustee, executor, administrator or other legal representative having ownership or control of the trust property. The legal title holder is therefore the nominal taxpayer and as such is responsible for filing tax returns and paying tax owing out of the trust property. Subsection 159(3) fixes personal liability on a trustee for unpaid tax if he or she distributes trust property without a clearance certificate[5]

[5] And see ss. 210.2(6) re liability for Part XII.2.

2. Residence of a Trust

The Act does not provide any rules for determining the residence of a trust for tax purposes. The residence of a trust or an estate is a question of fact. For years the case of Thibodeau Family Trust v. The Queen (Thibodeau)[6] has been cited as the judicial authority for the residence of a trust being determined by the residence of a majority of the trustees. The court in *Thibodeau* apparently rejected the central management and control test for determining residence of trusts when it stated:

> The judicial formula for this respecting a corporation, in my view, cannot apply to trustees because trustees cannot delegate any of their authority to co-trustees. A trustee cannot adopt a "policy of masterly inactivity" as commented upon in Underhill on the Law of Trusts and Trustees, 12th Edition, page 284; and on the evidence, none of the trustees did adopt such a policy. Therefore, it is not possible for a trust to have a dual residence for income tax purposes, and therefore it is not possible to find that part of the paramount of "superior and directing authority" of a Trust is and was in two places. In any event, a finding of dual residence of this Trust is not made in this case

. Interpretation Bulletin IT-447 entitled "Residence of a Trust or Estate" also provides in part, that a trust is generally considered resident where the trustee who manages the trust or controls the trust resides.

The question of the residence of a trust has recently been considered in the case of Garron Family Trust v. Her Majesty the Queen ("Garron")[7].

At issue was the residence of two trusts created during the reorganization of a Canadian resident corporation whereby the common shares of a 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 two trusts settled by a resident of St. Vincent Islands. The 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 who were Canadian residents. When the trusts disposed of the majority of their shares in the holding companies there were realized capital gains of over $450,000,000.00.

Amounts were withheld and remitted to the CRA pursuant to section 116 of the ITA and the trusts sought a return of the amounts on the basis of an exemption from Canadian tax liability under Article XIV(4) the Canada-Barbados Tax Treaty. 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.

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[6] [1978] D.T.C. 6376

[7] 2009 DTC1297(TCC)

The Minister of National Revenue 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.

Justice Woods ruled that the correct test to be applied in determining the residence of a trust for Canadian income tax purposes was where central management and control actually abides. Adoption of this test to the question of trust residence promotes consistency and fairness. Justice Woods 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. According to the Garron decision, this assumption is inappropriate because it assumes that trustees always comply with their fiduciary obligations.

In a trust context, management and control of a trust resides with the person who makes the "key decisions" for the trust. Justice Woods found that the management and control of the trusts resided with the Canadian beneficiaries and not the Bermuda trustee because:

(a) The trustee was selected to provide administrative services.

(b) There was no evidence to suggest the trustee was expected to have decision making responsibility.

(c) The evidence suggested the trustee had limited role.

(d) The limited role of the trustee was enforceable through protector provisions – i.e., the protector could replace the trustee and the Canadian beneficiaries could replace the protector.

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 also concluded that the transactions did not constitute an abuse or misuse of the Treaty and the GAAR did not apply.

The 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.

It should be noted that a trust's residence may change if a trustee is replaced or a trustee changes his or her personal residence status. A change of trustee's residence status for Canadian tax purposes could cause a deemed disposition of trust property.

If a trust is a resident of Canada, such a trust is taxable in respect of its worldwide income. A trust is also a conduit and may pay income out to the beneficiaries to be taxed in their hands. The general rule for the taxation of personal trusts is that the income of the trust is not

taxed in the trust's hands to the extent that it has paid or made payable to a beneficiary in the year. Subsection 104(13) provides that any amount paid or payable to a beneficiary from a trust is to be included in the beneficiary's income. The trust in turn receives a deduction for such amount. Until recently, the Act also provided for deductions when income accumulates in a trust but is included in the income of a preferred beneficiary in accordance with a special election to be made pursuant to the provisions of subsection 104(14). While the rule remains, it is now limited to circumstances where there is a beneficiary under disability.

3. Personal Trusts and Tax Rates

In very basic terms, a personal trust is a trust for which no consideration was paid to the trust or to a contributor to the trust to acquire a beneficial interest. Generally family trusts will qualify as personal trusts[8]. Personal trusts are further broken down into testamentary trusts and *inter vivos* trusts. Testamentary trusts arise on and as a consequence of the death of an individual and include both testate and intestate estates[9]. These are taxed separately from the deceased taxpayer and can have a fiscal period other than the calendar year. A testamentary trust can also be created by court order pursuant to dependent relief legislation in the various provinces. An *inter vivos* trust is a trust other than a testamentary trust. Its fiscal period is the calendar year.

A testamentary trust is taxed using the graduated rates of tax specified in subsection 117(2). An *inter vivos* trust will be subject to the highest marginal rate of tax on all of its income retained in the trust and not paid or made payable to a beneficiary or subject to a preferred beneficiary election. Subsection 122(2) provides an exception to this rule when an *inter vivos* trust:

(a) was established before June 18, 1971;

(b) was resident in Canada on June 18, 1971 and without interruption thereafter until the end of the year;

(c) did not carry on any active business in the year;

(d) has not received any property by way of gifts since June 18, 1971; and

(e) has not, after June 18, 1971, incurred any debt or any other obligation to or, guaranteed by, any person with whom a beneficiary is not dealing at arm's length.

4. Trusts as Conduits

As noted earlier in this paper, while the Act treats a trust as a taxable individual, it also recognizes the concept of a trust as a conduit. The general rule with respect to the classification of income from the perspective of a beneficiary is provided in subsection 108(5). This subsection provides that amounts included in the beneficiary's income are considered to be

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[8] See ss. 248(1) and 108(7).

[9] While Canada Revenue Agency had expressed the view that a trust which arises following the death of a life tenant pursuant to the terms of a will will not be considered to be a testamentary trust, they have since confirmed that such a trust would be considered testamentary.

income from a property (the property being an interest in a trust) and not from any other source, unless otherwise provided for in the Act. Some specific provisions do exist to permit the flow-through from the trust to the beneficiaries of the source of income so that the beneficiary is in the same position as if the income were directly earned by that beneficiary. Some of the items of income dealt with by the flow-through provisions include taxable dividends[10], capital dividends[11], and capital gains[12].

D. SPECIFIC TAX CONSIDERATIONS

To put the following discussion in context, consider the following fact situation:

Sylvia, a successful entrepreneur, has built up a business which is now worth about $30,000,000. She is happily married to Bob and they have 2 children neither of whom seem to be interested in the business. One is married with 2 young children. Sylvia is at a stage in her life where she wants to consider retiring from the business in the next 10 years and devoting herself to her favourite activity – golf. She wants to explore possible tax costs on her death and further reduce such costs. She has heard of probate tax and understands that given the value of her estate that probate tax would be in the range of $450,000. She would like to assist her children and grandchildren financially during her lifetime but wants to retain control as neither child is likely to be self sufficient. In addition to minimizing tax wherever possible and through income splitting and other means, she also wants to ensure that, following her death, her husband is looked after but in such a way that her estate does not fall into the hands of an unscrupulous fortune hunter but rather devolves to her children following the death of her husband.

Whether a person's wealth has been built up through a business as Sylvia's has or through shrewd prudent investment, these objectives are not unusual.

You have heard about the deemed disposition on death rules which may give rise to significant tax costs on death. Much of the estate planning which is carried out *inter vivos* is to attempt to reduce or eliminate these tax costs and ensure that there is enough liquidity often

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[10] Subsection 104(19) provides that trusts that earn taxable dividends from Canadian corporations may designate that a certain amount of such dividends are to be allocated to one or more beneficiaries and the dividend that is deemed to be received by the beneficiary will be considered dividend income, not trust income, in the hands of the beneficiary.

[11] Subsection 104(20) allows for designation of capital dividends received by the trust in respect of its beneficiaries.

[12] Subsection 104(21) provides that a Canadian resident trust may allocate all or a part of its net taxable capital gains to one or more beneficiaries resident in Canada throughout the taxation year of the trust. Net capital gains of the trust are the aggregate of its taxable capital gains for the year in excess of its allowable capital offset for the year in any amount deducted under paragraph 111(1)(b) (see subsection 104(21.3)). If a trust makes a designation pursuant to subsection 104(21), the beneficiary is deemed to realize a taxable capital gain from the disposition of property by him for the purposes of sections 3 and 111 and the beneficiary is thereby able to utilize any allowable capital offset realized in the year over from another taxation year to offset against such capital gain. This designation can be made in favour of a beneficiary only to the extent that it is reasonable to consider that the taxable capital gain realized by the trust was part of the income included in the income of the beneficiary. As a result, in the absence of trust terms to the contrary, since a taxable capital gain is capital for trust purposes, the designation cannot be made in favour of the beneficiary who is entitled only to income and not to capital of the trust.

through the purchase of life insurance to pay this tax. An estate freeze with a discretionary family trust to take the new common shares is a common technique to reduce and crystallize the tax costs on death in addition to considering an estate freeze . Sylvia will likely also want to consider the use of a spousal trust in her will to hold her freeze shares following her death to achieve the desired result of providing for benefits for her husband for life while preserving the capital for her children and other issue. To avoid probate tax, she will want to consider the use of double wills with the intention that one will deal with the shares of her company and will not be probated. In order to maximize the low tax rates available to testamentory trusts she will want to consider setting up separate trusts for the children and grandchildren[13].

The extent to which she can achieve all of her objectives and what limitations, constraints and other considerations will affect these objectives will be explored below.

1. The Attribution Rules

It is necessary to be aware of the various attribution rules contained in the Act when establishing and administering an *inter vivos* trust as these rules will impact on the decision of who should be the Settlor, and who should be the Trustees, will affect the powers of the Settlor and Trustees, and influence the selection of the income and capital beneficiaries, the scope of their respective interests and the manner in which the trust will be funded. The attribution rules include the corporate attribution rule in subsection 74.4 of the Act as well as the personal attribution rules contained in subsections 74.1(1) and (2) and section 74.2 of the Act, the hidden traps of the special attribution rule found in section 75(2), the deemed interest rule contained in subsection 56(4.1) of the Act and subsection 56(2).

1.1 Income/Capital Gain Attribution – General

Subsection 74.1(1) of the Act provides that where an individual has transferred or loaned property to or for the benefit of his or her spouse, any income or loss of the spouse from the property, or from property substituted therefor, is deemed to be the income or loss of the individual. A similar rule is found in subsection 74.1(2) where an individual transfers property to another individual who is under 18 years of age and who does not deal at arm’s length with the transferor or who is the niece or nephew of the transferor. The attribution of income or loss from the property applies if the property was transferred to the spouse or minor either directly or indirectly by means of a trust or by any other means whatever but only applies to the income or loss that relates to the period in any particular year throughout which the transferor was resident in Canada.

With respect to transfers of property for the benefit of a spouse or minor, subsection 74.5(9) provides that where a taxpayer has loaned or transferred property to a trust in which another taxpayer is beneficially interested, the taxpayer shall, for purposes of the attribution rules, be deemed to have loaned or transferred the property to or for the benefit of the other taxpayer. The phrase “beneficially interested” is defined in subsection 248(25) of the Act and provides that a person is beneficially interested in a trust if the person has any right as a beneficiary under the trust to receive any of the income or capital of the trust either directly from

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[13] See Appendix A

the particular trust or indirectly through one or more other trusts. The right of the beneficiary can either be immediate or future, absolute or contingent or conditional on or subject to the exercise of any discretionary power by any person or persons. By virtue of these provisions, a transfer of property to the trust is deemed to be a transfer of the property to a beneficiary of the trust for purposes of the attribution rules. This subsection appears to codify previous case law in which it was held that a transfer of property to a trust was a transfer of property to the beneficiaries of the trust for purposes of the attribution rules[14] There was, however, a suggestion in the *Sachs* case that the result may have been different if the beneficiaries' interest in the trust had been merely a discretionary contingent interest. Subsections 74.5(9) and 248(25) would appear to now preclude any argument that a transfer of property to a trust does not constitute a transfer of property to a discretionary contingent beneficiary of the trust for purposes of the attribution rules.

The term "property" is defined in section 248 of the Act in very broad terms. It means "property of any kind whatever whether real or personal or corporeal or incorporeal", and it includes "a right of any kind whatever and a share or a chose in action". The very broad scope of the term "property" as it applies in the context of the attribution rules is illustrated by the jurisprudence[15].

The personal attribution rules also apply to attribute income from property substituted for the property transferred or loaned. Subsection 248(5) of the Act provides that where a person has disposed of or exchanged a particular property and acquired other property in substitution therefor and subsequently, by one or more further transactions, has affected one or more further

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[14] See *Sachs v. The Queen*, 80 DTC 6291 (FCA).

[15] In the case of *Murphy v.The Queen*, 80 DTC 6314 (FCTD), the taxpayer was one of the executors of his father's estate. The original will provided a yearly sum for the taxpayer's mother with the remaining income split equally between the taxpayer and his two sisters. The will was subsequently varied by a court order to provide, among other things, that the taxpayer's wife was to be added as a beneficiary and that income payments could be made to one or more of the beneficiaries in the absolute discretion of the executors. The court decided that what the taxpayer held prior to the variation was the vested right to one-half the income of his father's estate and clearly that was not transferred by him to his wife. However, the taxpayer gave up that right in exchange for being included along with his spouse in the class of discretionary beneficiaries. Accordingly, the property transferred to the taxpayer's spouse was a contingent right to receive trust income, if and when the trustees exercised their discretion to pay her any trust income that would have been paid to the taxpayer if the trust had not been varied. The court held that by that chain of events the taxpayer had transferred property to his wife by means of a trust with the result that the attribution rules applied.

In the case of *The Queen v. Kieboom*, 92 DTC 6382 (FCA), the taxpayer owned ninety percent of the shares of a corporation and his wife owned the other ten percent. By special resolution, the corporation was authorized to issue a special class of shares which ranked equally with the common shares in terms of equity. The shares were issued to both the taxpayer and his wife such that the taxpayer's equity in the corporation decreased from ninety percent to fifty percent and the taxpayer's spouse's equity increased from ten percent to fifty percent. Although there had not been an actual transfer of shares from the taxpayer to his spouse, the Federal Court of Appeal held that there had been a transfer of property for purposes of the attribution rules. After referring to the very broad definition of property contained in subsection 248(1) of the Act, the Court stated that the taxpayer had transferred to his wife a portion of his ownership of the equity in his corporation. The forty percent capital interest in the corporation which the taxpayer gave to his wife was, in the Court's view, clearly property. The fact that this transfer of property was accomplished through causing the corporation to issue shares made no difference to the Court since the attribution rules clearly covered transfers that are made "directly or indirectly" and, "by any other means whatever".

substitutions, the property acquired by any such transaction is deemed to have been substituted for the particular property.

Accordingly, if the transferee of property to which the attribution rules apply sells the property and reinvests the proceeds of sale, the attribution rules continue to apply to the new investment. Income from the new investments or capital gains from their disposition (in the case of transfers to a spouse) will be attributed in the same way as if the investments were the original subjects of the transfer or loan.

However, if the recipient of property to which the attribution rules apply invests the income yielded by the transferred property, the income yielded by the investments acquired using income from the property originally transferred or loaned is not attributed. The reason for this is that income from the property originally loaned or transferred does not constitute part of the property that was loaned or transferred nor is it property substituted for such property. This result is specifically approved by Canada Revenue Agency ("CRA") in paragraph 6 of Interpretation Bulletin IT-511R and paragraph 4 of Interpretation Bulletin IT-510.

CRA takes a different position, however, with respect to capital gains realized on the disposition of property that was originally loaned or transferred. For example, suppose that an individual transfers $1,000 to his spouse who uses the $1,000 to acquire shares of a public corporation, then sells the shares of the public corporation for $1,500 and invests the proceeds in a guaranteed investment certificate. CRA's position is that all of the income earned by the spouse from the guaranteed investment certificate will be attributed to the taxpayer on the basis that the guaranteed investment certificate represents property substituted for the $1,000 originally transferred by the taxpayer to the spouse[16].

The attribution rules will also apply if the property loaned or transferred is used by the transferee to repay a loan or indebtedness that was incurred to acquire other property. In these circumstances, subsection 74.1(3) of the Act provides that for purposes of the attribution rules, there shall be included in computing the income from the loaned or transferred property that is used to repa6y the prior borrowing that proportion of the income or loss from the other property that the fair market value of the loaned or transferred property is of the cost to the other person of the other property. For example, if a spouse borrows $100 to acquire shares in a public corporation and then borrows $60 from his or her spouse to repay all or a portion of the original loan, sixty percent of the income or loss from the shares of the public corporation will be treated as income from the money borrowed from the spouse for purposes of the attribution rules. It has been suggested, however, that the rule may not apply if the prior borrowing is repaid directly by the spouse[17].

It is generally accepted that the income attribution rules do not apply to income from business[18]. This conclusion is based in part on the fact that section 74.1 speaks of income from "the property or property substituted therefor" and not income from a business. Support for this

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[16] See paragraph 27 of Interpretation Bulletin IT-511R.

[17] See Edwin G. Kroft, "Splitting and Shifting Tax Benefits: A Guide for the Perplexed Practitioner", 1988 C.R. 32:1 at 32:85.

[18] See R. Couzin, "Business and Property Income", 1981 Corporate Management Tax Conference 41 at 70.

proposition is also found in the case of *Robins v. M.N.R.*, 63 DTC 1013 (Ex.Ct.), in which the court refused to attribute to a taxpayer income from property transferred to his spouse which was used by the spouse to realize a gain which was treated as an income gain. It should be noted, however, that where property loaned or transferred is used to acquire an interest in a partnership, any income from the partnership will be deemed to be income from property for purposes of the attribution rules if the transferee is a limited partner of the partnership or is not actively engaged in the business activities of the partnership on a regular and continuous basis[19].

Notwithstanding this provision, there is still scope to take advantage of this exception from the attribution rules where loaned or transferred property is used by the transferee to earn income from a business. In this context, the decision in *Canada Trustco Mortgage Company v. M.N.R.*[20] is relevant. In this case, it was held that income from substantial investment in mortgages was active business income for purposes of the foreign accrual property income rules contained in the Act. This exception from the attribution rules should also be available in respect of property transferred to a trust. While paragraph 108(5)(a) of the Act provides that any amount included in the beneficiary's income in respect of income earned from a trust is deemed to be income of the beneficiary for the year from a property that is an interest in the trust, the provision specifically states that it is not applicable for purposes of the attribution rules. Accordingly, for purposes of the attribution rules, business income earned by a trust should retain its character when distributed to beneficiaries.

The income attribution rules also apply to attribute capital gains and losses of a transferee of property in certain circumstances. Section 74.2 provides that where a taxpayer loans or transfers property to his or her spouse, any capital gain or capital loss realized by the spouse is deemed to be a capital gain or capital loss realized by the taxpayer. Subsection 74.2(2) provides that where a capital gain or capital loss has been attributed to a taxpayer, for purposes of the capital gains exemption, the property is deemed to have been disposed of by the taxpayer. This subsection ensures that the taxpayer is entitled to claim the capital gains exemption in respect of capital gains realized by another person that are attributed to the taxpayer. There is, however, no attribution of capital gains and losses in respect of property transferred to minors.

1.2 Attribution Through a Trust

Where property is transferred to a trust, it is not the income of the trust but rather the income of a beneficiary of the trust which may be attributed to the transferor in certain circumstances. The Act provides rules for determining the amount of the income of a beneficiary of a trust which is to be attributed to the transferor of property to the trust.

1.3 Personal Attribution Rules

Subsection 74.3(1) of the Act provides that where an individual has *transferred* or *loaned* property to a trust in which another individual who is at any time a designated person in respect of the individual, is beneficially interested at any time, then any income or loss from the property (or property substituted therefor) or (in the case of a designated person who is a spouse of the

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[19] See subsection 96(1.8) of the Act.

[20] 91 DTC 1312 (TCC).

transferor or lender) any capital gains realized from a disposition of the property (or property substituted therefor) which would be included in computing the income of the beneficiary, as a result of a distribution from the trust to the beneficiary, is attributed to the individual who has transferred or loaned the property to the trust.

"Designated person" in respect of an individual means the individual's spouse, his or her minor nieces and nephews, and any minor (under 18 years of age) who does not deal at arm's length with the individual (*i.e.* persons who are related to each other are not considered to deal at arm's length).[21]

As a result of these rules it is preferable that the trust not receive property by transfer or loan from a person in respect of whom the beneficiaries are designated persons. However, it is likely that certain of the beneficiaries will include designated persons in respect of the Settler[22]. Thus, it is important that the settled amount consist of an asset such as a coin, which will not generate income or capital and that the settled amount not be liquidated or used to subscribe for income producing assets such as common shares on an estate freeze.

As noted above, subsection 74.3(1) applies to loans to a trust when there are designated persons in respect of the lender who are beneficiaries of the trust. Another attribution rule, subsection 56(4.1), may apply, if an individual loans property to a trust and a beneficiary of the trust is an individual who is 18 years of age or older who does not deal at arm's length with the lender such as the lender's child if it may reasonably be considered that one of the main reasons for the making of the loan was to reduce or avoid tax by causing the income from the loaned property (or from property substituted for such loaned property or from property that the loan enabled or assisted the trust to acquire) to be included in the income of the beneficiary. In such a

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[21] An important exception to the personal attribution rules applies in the case of property loaned or transferred in exchange for fair market value consideration.

Subsection 74.5(1) provides that the attribution rules does not apply in respect of the transfer of property if at the time of the transfer the fair market value of the transferred property did not exceed the fair market value of the property received by the transferor as consideration for such property. If the consideration received by the transferor includes indebtedness, interest must be charged on the indebtedness at a rate equal to the lesser of the prescribed rate or the rate that would, having regard to all the circumstances, have been agreed upon at the time the indebtedness was incurred between parties dealing with each other at arm's length. In addition, the amount of the interest that was payable in respect of a particular year must be paid not later than thirty days after the end of the year. If this condition with respect to the payment of interest is not satisfied in any particular year, then the attribution rules will commence to apply in respect of the transferred property in that year and in every subsequent taxation year even if interest is payable in those subsequent taxation years.

If the property was transferred to or for the benefit of the transferor's spouse, the exception will not apply unless the transferor elects in his or her tax return for the year in which the property was transferred not to have the rollover provisions of subsection 73(1) of the Act apply to the transfer. In other words, the exception to the attribution rules will only apply if the transferor transfers property to his or her spouse or a trust for his or her spouse on a taxable basis.

[22] The Settlor is the person who establishes the trust by expressing the intention to settle the trust, determines the terms of the trust. For the importance of the 3 certainties including the certainty of intention on the part of the Settlor to settle the trust see *Kingsdale Securities Co. v MNR* [1974] 2 F.L. 760, [1975] CTC 10, 74 DTC 6674 (CA).

case any income from the loaned property that would otherwise be included in the income of the beneficiary will be attributed to the lender.[23]

Both the rule in subsection 74.3(1) and in subsection 56(4.1) can, however, be avoided if the lender is an arm's length lender (such as a financial institution) or if the terms of the loan meet certain arm's length requirements. Specifically: (i) interest was charged on the loan equal to the prescribed rate in effect at the time of the loan; (ii) the interest in respect of a particular year was paid not later than 30 days after the end of the particular year; and (iii) the amount of interest that was payable in each preceding taxation year was paid not later than 30 days after the end of each such taxation year.[24]

In the context of loans to a trust, subsection 74.5(7) of the Act is a further attribution rule which requires consideration. It is designed to prevent a taxpayer from avoiding the application of the attribution rules indirectly. Subsection 74.5(7) essentially treats a guarantee as a transfer of property. It provides that if an individual guarantees repayment of a loan made by a third party to a specified person with respect to an individual, as that term is defined in the Act, the loan by the third party is deemed to have been made by the individual. For these purposes, a specified person with respect to an individual is a "designated person", as defined above. It is for this reason that any loan made by an arm's length person to a trust should not be guaranteed by any individual in respect of whom a beneficiary is a specified person to the guarantor.[25]

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[23] The rules in subsection 56(4.1) may apply in the following situations involving loans made by or to a trust:

1) if a particular individual is beneficially interested in a trust which receives a loan from or otherwise becomes indebted to another individual (referred to as the creditor) if the creditor and the particular individual do not deal at arm's length;
2) if a particular individual receives a loan from or becomes indebted to a trust (referred to as the creditor trust) to which another individual (referred to as the original transferor) has transferred property if the particular individual does not deal at arm's length with the original transferor and the original transferor is resident in Canada at any time in the period during which the loan or indebtedness is outstanding; and
3) the particular individual is beneficially interested in a trust which receives a loan from or becomes indebted to another trust (referred to as a creditor trust) to which another individual (referred to as the original transferor) has transferred property if the particular individual and the original transfer do not deal at arm's length and the original transferor is resident in Canada at any time in the period during which the loan or indebtedness is outstanding.

[24] If in any year such interest is not paid then the attribution rule will apply in that year and in every subsequent year in which the transferee continues to earn income from the property originally loaned or from property acquired with the proceeds of the original loan. Because of the rules in subsection 56(4.3) (which are similar to the rules in subsection 74.1(3), discussed above), it is not possible to cure the attribution problem by refinancing the original non-exempt loan with an exempt loan.

Where the creditor is an individual and not a trust, the rule attributes to the creditor any income of the particular individual from the property which arises during the period that the creditor is resident in Canada. However, the rule in subsection 56(4.1) will not apply to the extent the attribution rules in subsections 74.1 or 75(2) apply. Where the creditor is a trust the income of the particular individual from the property loaned or acquired with the indebtedness will be attributed to the creditor trust except to the extent the attribution rules in that section 74.1 applies. In these circumstances if subsection 75(2) applies to any property of the trust the rules in 56(4.1) apply before 75(2) apply.

[25] Loans made by third parties to certain specified persons may also give rise to attribution. Pursuant to subsection 74.5(6), when an individual has loaned or transferred property to a third party and that property or property substituted therefor is loaned or transferred by any person to or for the benefit of a specified person with respect to the individual, for purposes of the attribution rules, the property loaned or transferred by the third party is

1.4 Subsection 75(2) Attribution

An important attribution rule which requires consideration in the context of the selection of the Settlor is the rule in subsection 75(2) of the Act. Subsection 75(2) is an attribution rule which applies in circumstances where a person exercises a certain measure of control over the property transferred to a trust.

Subsection 75(2) provides as follows:

> (2) Where, by a trust created in any manner whatever since 1934, property is held on condition
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> (a) that it or property substituted therefor may
>
> > (i) revert to the person from whom the property or property for which it was substituted was directly or indirectly received (in this subsection referred to as "the person"), or
> >
> > (ii) pass to persons to be determined by the person at a time subsequent to the creation of the trust, or
>
> (b) that, during the lifetime of the person, the property shall not be disposed of except with the person's consent or in accordance with the person's direction,
>
> any income or loss from the property or from property substituted therefor, any taxable capital gain or allowable capital loss from the disposition of the property or of property substituted therefor, shall, during the lifetime of the person while the person is resident in Canada be deemed to be income or a loss, as the case may be, or a taxable capital gain or allowable capital loss, as the case may be, of the person.

Thus, subsection 75(2) will apply where property of a trust is held on any of the following conditions: (i) that the property may revert to the person from whom the property was received or (ii) pass to persons to be determined by such person at a time subsequent to the creation of the trust, or (iii) that, during the lifetime of such person, the property shall not be disposed of except with the consent of that person. It would appear that this section applies even if property is transferred to the trust at fair market value.[26]

If the section applies, then any income or loss, capital gains or losses from the property will be attributed to the person from whom the property or substituted property was received

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deemed to be property loaned or transferred by the individual. The same result follows if an individual loans or transfers property to a third party on condition that such property be loaned or transferred by any person to a specified person in respect of the individual.

Finally, subsection 74.5(11) provides that the attribution rules will not apply to any transfer or loan of property where it may reasonably be concluded that one of the main reasons for the transfer or loan was to reduce the amount of tax that would be payable under the Act on income and gains derived from the property but for the application of the attribution rules.

[26] Tax Window File #9332575, January 27, 1994.

while such person is resident in Canada. It should be noted that while the literature on this section refers to these powers in relation to the settlor, the section applies to any transfer of property to a trust by any person.[27]

The terms of subsection 75(2) are not precise and the limits of the provision are far from certain. There has been little, if any, jurisprudence which would assist in interpreting the provisions of the section. The most often asked questions with respect to ss. 75(2) relate to: (i) what is a "condition" that creates a reversion, and (ii) what constitutes a "determination", "consent" or "direction" by the settlor or transferor.

(a) Reversion

With respect to what constitutes a reversion of property for purposes of subsection 75(2), the provision will presumably cover revocable trusts notwithstanding "that the term "revert" is normally used to refer to a property interest rather than to a revocation under a reserved power".[28]

Where the trust indenture contains a provision that would allow the settlor or other person who contributed property to a trust to reacquire the property, (as for example if the Settlor was a potential capital beneficiary), even if the ability to reacquire the property were remote, subsection 75(2) would apply. Where, however, the contributor could reacquire the property by operation of law, such as the total failure of the trust for lack of beneficiaries, subsection 75(2) would not apply.[29] Accordingly, a contributor of property to the trust, whether as settlor or otherwise, should not be a capital beneficiary. If a settlor/contributor is an income beneficiary, subsection 75(2) does not appear to have application.(APFF 2004 Conference Round Table Question 26)

It is clear, therefore, that if it is desirable to avoid the application of subsection 75(2), the trust should be irrevocable and under no circumstances should it be possible for the property to revert to the Settlor other than by operation of law on the failure of the trust.

It appears that subsection 75(2) will not apply where property is loaned to a trust since, in these circumstances, the transfer of property back to the person from whom it was received would not be a reversion of the property pursuant to the terms of the trust.[30] CRA has indicated,

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[27] See recent article by Brenda Crockett, CTJ(2005) Vol 53 #3 p 806. It should be noted that, unlike other attribution sections, there is no exception to subsection 75(2) for fair market sales of property to a trust CRA document #9332575 January 27, 1994 subsection 75(2) will not necessarily apply, however, if the vendor is neither a beneficiary nor a controlling trustee.

Also, the section speaks of a "person" contributing to the trust. It should be noted that person includes not only an individual (or another trust) but also a corporation (ss 248(1))

[28] Cullity & Brown, Taxation & Estate Planning 3d edition, p. 664

[29] Tax Window File #9332575, January, 1994; Tax Window File #9304585, May 19, 1993.

[30] Annual Conference of the Canadian Tax Foundation, Toronto, November, 1991, Question 7, *Access to Canadian Income Tax*, para. C56-124. See also Question 46 at the 1986 Annual Conference where it was stated that the making or repayment of a loan does not constitute a reversion within the meaning of subsection 75(2) of the Act; and see IT-369R.

however, that the loan must be a genuine loan made to a trust outside and independent of the terms of the trusts.[31]

(b) "Determination", "Consent", "Direction"

At first it was considered that an individual who may have contributed property in a personal capacity took on a different role as a trustee. To be on the safe side it was suggested that there be more than one trustee, although initially there did not appear to be a technical reason to do so. Clarification by CRA over the past few years has confirmed that a contributor of property to a trust should not act as a trustee who has sole or veto power as a trustee. In a number of technical interpretations, CRA has clarified that subsection 75(2) will apply on a contribution of property to a trust in the following circumstances:

(a) if the contributor is the sole trustee;[32]

(b) if the contributor is one of two trustees;[33]

(c) even if the contributor is one of three or more trustees

  (i) if the trust indenture provides for the unanimous consent of the trustees to make decisions;[34]

  (ii) and even if the trust provides for decision-making by majority vote, if the contributor must form part of the majority or if in fact at any time there are only two trustees.[35]

One concession that has been made is found in Tax Window File #9213965, dated August 11, 1992 which provides as follows:

> "When the person from whom the property was received by the trust cannot determine the identity of the beneficiaries but can only determine the quantum of the trust property to be distributed to the beneficiaries which have already been identified by the trust documents, we are of the opinion that subparagraph 75(2)(a)(ii) and paragraph 75(2)(b) of the Act may not be applicable.
>
> However, if the possibility to determine the quantum of the trust property is such that it results in the possibility to determine the beneficiaries to whom the

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[31] CRA has expressed its view on what it considers to be a genuine loan in paragraph 8 of Interpretation Bulletin IT-258R2 dealing with "Transfers of Property to a Spouse" and paragraph 3 of IT-260R entitled "Transfers of Property to a Minor". Generally speaking, CRA will accept a loan as "genuine" where there has been a written and signed acknowledgment of the loan by the borrower and an agreement to repay it within a reasonable time. Consequently, a promissory note or other such document should be executed by the trustees of the trust evidencing the indebtedness.

[32] Tax Window File #9317655, February 27, 1992; 2001-0110425 June 10, 2002.

[33] Tax Window File #9213965, August 11, 1992; Tax Window File #9407905, June 6, 1994.

[34] Tax Window File #9317655, December 17, 1993.

[35] Tax Window File #9407905, June 6, 1994. See also Tax Window File #9514275, August 21, 1995 for comments about the interplay between ss. 75(2) and 107(4.1); Tax Window File #9717815, November 19, 1997.

property will pass, it is our view that subparagraph 75(2)(a)(I) and paragraph 75(2)(b) of the Act could apply. This situation may occur, among others, if the settlor retains the possibility to identify which property can be distributed to a beneficiary or if he retains the possibility to fix the quantum (for example, in allocating nothing to a beneficiary) so that he has retained the possibility to identify the beneficiary."

In two *Technical Interpretations:*[36] CRA considered the application of subsection 75(2) to an irrevocable discretionary trust that originally had three trustees, one of whom was the settlor. The terms of each of the trusts provided that, among other things, each of the settlor's children were to be the beneficiaries of their respective trusts and that the decisions of the trustees were to be made unanimously[37].

Document No. 2001-0067955 provides in part as follows:

"Where the beneficiaries under a trust are named in the trust indenture and cannot be modified (i.e., the person from whom the property was received by the trust cannot select additional beneficiaries after the creation of the trust), subparagraph 75(2)(a)(ii) is generally not considered applicable. This is true even though the person from whom the property was transferred to the trust may be able to determine the amount of the trust property that is to be distributed to beneficiaries already identified in the trust documents. However, subparagraph 75(2)(a)(ii) is worded broadly and there could be exceptions to this general position depending on the situation.

With respect to paragraph 75(2)(b), it is our view that the condition in paragraph 75(2)(b) might not be met in respect of property which is contributed to the trust by a person who is one of two or more co-trustees acting in a fiduciary capacity in administering the trust property where the property is subject to standard terms ordinarily found in trust indentures and there are no specific terms outlining how the trust property is to be dealt with. However, a determination of whether this condition is met in respect of any particular property can only be made on a case by case basis following a review of all the facts and circumstances surrounding a particular situation."[38]

In informal discussions with CRA, it was noted that in a situation involving a single trustee, CRA would likely continue to apply subsection 75(2). In addition, in another *Technical Interpretation*[39] which dealt with subsection 75(2) in the context of "common disaster" or "fall back" clauses, the CRA was asked to comment on the application of subsection 75(2) in four scenarios: two which contemplated that in the event of there being no identifiable beneficiaries

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[36] Document #2000-0042505, April 30, 2001; and Document #2001-0067955, January 3, 2002.

[37] cf Estate Freeze from Hell, update 2002.

[38] And see 2003 - 0050671E5, April 5, 2004. Note that the comment does not appear to differentiate between co-trustees of a trust governed by unanimous trustees' decisions and co-trustees of a trust governed by majority vote.

And see CRA document 2004-0086921C6, October 8, 2004 (Round Table question 29) where CRA was not able to clarify what it meant by "standard terms found in trust indentures"

[39] Document #2002-0116535, February 19, 2002.

of a trust the trust assets were to be distributed in accordance with the terms of the settlor's spouse's will; and the other two which contemplated that in the event of there being no identifiable beneficiaries of a trust the trust assets were to be distributed in accordance with the settlor's will. The CRA applied section 75(2) in all four scenarios on the basis that the property could revert back to the settlor (with respect to distributions in accordance with the terms of the settlor's spouse's will). With respect to distributions made in accordance with the terms of the settlor's will, the CRA indicated that it would apply subparagraph 75(2)(a)(ii) on the basis that by retaining this power the settlor had effectively retained a general power to determine to whom the property would pass after the creation of the trust. However, in a later commentary, #2002-0139205 (July 22, 2002), in commenting again on scenarios 1 and 2, CRA noted that it had reconsidered its position and indicated that ss. 75(2) would not apply because if the property devolved back to the transferor spouse it would do so as a result of the terms of a will and not the terms of the trust as required by ss. 75(2).

In order to avoid the application of subsection 75(2), if the Settlor or other contributor to the trust is to be a trustee, he or she should be capable of being outvoted on every issue relating to the determination of which beneficiary will benefit and to what extent. The easiest way to ensure that this happens is to require a minimum of three trustees at all times with decision-making by majority. The trust indenture should not provide that the settlor/contributor must form part of the majority and should provide that, if at any time there are two trustees of whom the contributor/settlor is one, the trustees are constrained from making decisions concerning distribution to beneficiaries until a third trustee is appointed. Similarly, the settlor or transferor should not be given any right to veto distributions to beneficiaries.[40]

An even more disconcerting administrative position was advanced by CRA with respect to appointment and removal of trustees[41]. In the Minister's opinion, where "the settlor/trustee has the power to appoint, remove or replace any trustee", "it is a question of fact whether the property held by the trust could only be disposed of with the consent of the settlor/trustee". Thus, where a settlor/contributor also desires to be a trustee, one must compare the risk of subsection 75(2) applying against the benefit of conferring such a power on the settlor.

CRA has expressed the view that signed letters of wishes can be considered part of the trust document.[42] This is relevant in considering the possible application of subsection 75(2). It should be noted that unwitnessed letters of wishes would appear not to have this effect.

It should also be noted that subsection 75(2) differs from the personal and corporate attribution rules contained in section 74.1 in that it is any income or loss from the property or property substituted therefor, or capital gains or capital losses realized from dispositions of the property or property substituted therefor, that are attributed to the transferor. In the case of the other attribution rules, it is only the income, loss, capital gains or capital losses allocated to (i.e., paid or made payable to) the beneficiaries of the trust that are attributed to the transferor. In addition, CRA takes the position that if a trust has a capital gain on property that is subject to

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[40] Tax Window File #9514275, August 21, 1995; Tax Window Files #9213965, August 11, 1992; #9514275, August 21, 1995; #9717815, November 19, 1997.

[41] Tax Window File #9407905, June 6, 1994.

[42] 2000-0023997, November 3, 2000.

subsection 75(2) attribution, the attributed capital gain is not eligible for the capital gains exemption. This is because subsection 75(2) contains no provision similar to subsection 74.2(2) to deem the person to have disposed of the property for purposes of the exemption. The application of subsection 75(2) to any of the property held by a trust at any time will also restrict the ability of the trust to distribute property on a rollover basis to any persons other than the person from whom the trust received the property or the spouse of such person (see subsection 107(4.1)).

The CRA has also indicated that while it is possible to avoid the application of subsection 75(2) by transferring property from a trust to which subsection 75(2) applied to a new “clean” trust, subsection 107(4.1) will apply to the new trust.[43]

1.5 Subsection 107(4.1)

In many cases, it may be considered that subsection 75(2) will not have application as the only property, which is contributed to the trust is the settled amount, which will not generate income. For example, an *inter vivos* trust is often used in an estate freeze where common shares are acquired by the trust. In order to avoid the application of other attribution rules, the trust will acquire the common shares with funds borrowed from an arm’s length third party, usually a financial institution. Even though the application of subsection 75(2) in such a situation is not significant, as the settled amount is generally of little value, the greater concern is the possible application of section 107(4.1).

Generally, a distribution of capital out of a trust to a capital beneficiary in satisfaction of that beneficiary’s capital interest is effected on a tax-deferred rollover basis. Subsection 107(2) of the Act provides that where any property of a personal trust has been distributed by the trust to a beneficiary in satisfaction or all or any part of the beneficiary’s capital interest in the trust, the trust will be deemed to have disposed of the property for proceeds of disposition equal to the cost amount of the property to the trust. As a result, the trust will not realize any income or capital gain on the distribution of the property. A personal trust is defined in subsection 248(1) to mean a testamentary or an *inter vivos* trust in which no beneficial interest in the trust was acquired for consideration payable to the trust or to any person who has made a contribution of property to the trust.

There are several important situations in which property cannot be distributed by a personal trust to a beneficiary in satisfaction of the beneficiary’s capital interest in the trust on a rollover basis.

(I) Subsection 107(4)

One such situation is the distribution of property which is capital property, resource property or land inventory by a spousal trust to a beneficiary other than the spouse while the spouse is alive.

(II) Subsection 107(5)

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[43] Document #2001-0067955, January 3, 2002.

Another situation in which a trust cannot distribute property on a tax-deferred basis to a beneficiary is found in subsection 107(5) of the Act. Pursuant to this subsection, where a trust distributes property other than Canadian real property, Canadian resource property, timber resource property, property used in a business carried on in Canada through a permanent establishment, including rights and shares of a non-resident investment corporation, to a non-resident beneficiary, the trust is deemed to have disposed of the property for proceeds of disposition equal to its fair market value at that time. The beneficiary will be deemed to have acquired the property at a cost equal to its fair market value and generally to have disposed of his or her interest in the trust for proceeds of disposition equal to the adjusted cost basis of that interest.

By far the harshest exception, however, is found in section 107(4.1).

(III) Subsection 75(2) and Subsection 107(4.1)

Subsection 107(4.1) provides that where subsection 75(2) applies at any time to any particular property of a trust, then the trust will not be able to distribute any property of the trust on a tax-deferred basis to any beneficiary other than the person from whom the property or property substituted therefor was received (or the spouse or former spouse of that person) during the lifetime of that person. Instead, the trust will be deemed to have disposed of the property and received proceeds of disposition equal to the fair market value of such property and the beneficiary will be deemed to have acquired the property at a cost equal to its fair market value. Generally the beneficiary will not realize any capital gain in respect of the disposition of his or her capital interest in the trust.[44] Subsection 107(4.1) appears to apply in respect of the distribution of any property of a trust and is not limited to the property over which a person has the control described in subsection 75(2). Accordingly, the section could lead to very harsh results. For example, if a settlor contributed $100 to a trust and reserved one or more of the powers described in subsection 75(2) or subsection 75(2) otherwise applied because the settlor was a trustee in circumstances described above, even if the balance of the assets of the trust were contributed by others or acquired with borrowed funds, section 107(4.1) would potentially apply to the distribution of every asset of the trust.

This point was further illustrated in a recent CRA *Comfort Letter*.[45] However, in the letter, the CRA determined that subsection 107(4.1) is inappropriately broad in its effect on distributions from a trust, specifically when the trust was created before the introduction of subsection 107(4.1) into the Act. In the letter, concern was expressed regarding the application of subsection 107(4.1) to an *inter vivos* trust settled in 1986 through the gift of a gold coin (with nominal value). The terms of the trust stated that decisions of the trust were to be determined by a majority of the trustees, including the settlor of the trust. Due to the fact that subsection 75(2) therefore applied to attribute any income earned on the gold coin to the settlor, subsection 107(4.1) also applied to distributions of property from the trust. However, due to its terms, subsection 107(4.1) applied not only to the gold coin (as is the case with subsection 75(2)), but to all of the properties of the trust distributed to beneficiaries. Given that the trust was established prior to 1989 (the year in which distributions of the trust were first subject to subsection

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[44] Sections 107(4.1) and 107(2.1).

[45] Comfort Letter—"Subsection 107(4.1)—Trust Distribution", October 19, 2007.

107(4.1)) the CRA indicated that it was prepared to recommend to the Minister of Finance that subparagraph 107(4.1)(b)(ii) be amended so as not to apply in determining whether subsectuon 107(2.1) applies in respect of a trust distribution which occurs after 2001 and before 2009 where:

(a) the distribution is of property to which subsection 75(2) had not applied at any time while the property was held by any of the trusts referred to in subparagraph 107(4.1)(b)(ii);

(b) one of the trusts referred to in subparagraph 107(4.1)(b)(ii),

 (i) was created before 1989, and

 (ii) held, at a time before 1989, particular property that was, at that time, subject to subsection 75(2); and

(c) none of the trusts referred to in subparagraph 107(4.1)(b)(ii) held any property (other than the particular property) that was subject to subsection 75(2).

The interplay between subsections 75(2) and 107(4.1) makes it imperative that these sections be considered when establishing a trust, and in particular, when determining the identity of the trustees and the manner in which decisions are to be made by the trustees.

It is also important to consider the possible application of these sections whenever a decision is made to effect an *in specie* distribution of assets to a beneficiary in satisfaction of the beneficiary's capital interest such as, for example, where an in specie distribution is being considered to avoid the application of the 21-year deemed disposition rule. In all cases where an in specie distribution is contemplated, it will be imperative to review the history of the trust, the identity of the trustees vis a vis the beneficiaries and the property contributed to the trust and the terms of the trust with respect to how trustees make decisions to satisfy oneself that subsection 75(2) never applied.

1.6 Attribution In Respect Of Property Transferred To A Corporation

Any time a taxpayer transfers or loans property to a corporation, there is a potential that the attribution rule in subsection 74.4(2) may apply and require the taxpayer to include in income, as interest, an amount equal to an annual percentage of the value of the property so loaned or transferred. This subsection applies to loans and transfers made by an individual to a corporation if one of the main purposes of the loan or transfer may reasonably be considered to reduce the income of the individual and to benefit, either directly or indirectly, a designated person. "Designated person" means the spouse of the transferor or a minor who does not deal at arm's length with the transferor or a minor who is the niece or nephew of the transferor. It is not necessary that the designated person actually receive income from the corporation as long as the purpose test is satisfied. The provision will only apply, however, in a taxation year that includes a period after the loan or transfer and throughout which the following conditions are satisfied:

(a) the transferor is resident in Canada;

(b) the corporation is not a small business corporation; and

(c) the designated person is a specified shareholder of the corporation.

A small business corporation is any Canadian-controlled private corporation all or substantially all of the fair market value of the assets of which are attributable to assets that are either assets used principally in an active business carried on primarily in Canada by the corporation or a corporation related to it or shares or debt instruments of other "connected" small business corporations. For the purposes of the corporate attribution rules, a specified shareholder of a corporation is, generally, a person who holds at least ten percent of the shares of any class of the corporation or a related corporation (other than a small business corporation). Where the person is a beneficiary of a trust, the person is deemed to own that proportion of the shares of the corporation owned by the trust that the fair market value of the person's interest in the trust is of the total fair market value of all interests in the trust. Where a beneficiary's share of the income or capital of the trust is dependent upon the exercise of a discretionary power, the beneficiary is deemed to own each share of the corporation which is owned by the trust. Accordingly, any time shares of a corporation which is not a small business corporation are owned or acquired by a trust, care must be exercised in order to ensure that the corporate attribution rules do not apply to attribute income to any person who has transferred property to the corporation.

This rule must be considered any time an estate freeze is contemplated whether by way of s.85, s.86, or s.51 as in each case there is a transfer of property to a corporation. For example, if an individual exchanges shares of a corporation on a tax-deferred basis under section 86 of the Act and a trust for the individual's spouse or minor children acquires more than 10% of the issued and outstanding shares of any class of the corporation, the corporate attribution rules in subsection 74.4(2) may apply. This follows from subsection 84(9) which provides that where a shareholder disposes of a share of the corporation as a result of the redemption, acquisition or cancellation of the share by the corporation, the shareholder is deemed, for the purposes of the Act, to have disposed of the share to the corporation. As a result, an exchange of shares pursuant to section 86 is considered to be a transfer of property to the corporation which may lead to the application of subsection 74.4(2). A similar result will follow if shares of one corporation are transferred to another corporation on a section 85 basis in exchange for shares of the second corporation and a trust for the transferor's spouse or minor children subscribes for shares of the second corporation.

If the conditions of subsection 74.4(2) are satisfied, the individual transferor is deemed to have received an amount of interest in the taxation year computed at the prescribed rate on the "outstanding amount" of the loaned or transferred property. In the case of a transfer of property, the outstanding amount is equal to the fair market value of the property at the time of the transfer less the fair market value of the consideration received from the corporation by the transferor other than consideration that is "excluded consideration". If subsequent to the transfer the transferor receives consideration (other than excluded consideration) in exchange for any excluded consideration received on the original transfer, the outstanding amount is reduced by the value of such consideration.

In the case of a loan of money or property, the outstanding amount is the principal amount of the loan of money or the fair market value of the loaned property. If the loan is subsequently repaid, the fair market value of the repayment (other than the repayment that is excluded consideration) reduces the outstanding amount.

For these purposes, “excluded consideration” includes indebtedness, shares or a right to receive indebtedness or shares.

To the extent that the transferor actually earns income in respect of the loan or transfer, such income reduces the amount of the deemed interest received. Specifically, in any taxation year, the amount of the interest to be included in the income of the transferor is reduced by the amount of any interest received in the year by the individual in respect of the transfer or loan and five-quarters of all taxable dividends (other than deemed dividends) received by the individual in the year on shares that were received from the corporation as consideration for the original transfer of property or as repayment for the original loan. This reduction of deemed interest income is understandable since, to the extent that the transferor earns actual interest and/or dividend income from the transferee corporation, the benefit to designated persons from the transfer is thereby reduced.

It should be noted that the requirements for the application of subsection 74.4(2) must be satisfied on an annual basis. As a result, the rules will cease to apply if and when the original transferor ceases to be a resident of Canada. In addition, although the provision does not apply where the corporation is a small business corporation, it is not sufficient for the corporation to be a small business corporation at the time of the loan or transfer of property. If at any time subsequent to the original loan or transfer the corporation fails to meet the requirements of a small business corporation, the rules in subsection 74.4(2) may apply to deem the individual transferor to receive an amount of interest computed in accordance with the rules in that subsection.

There is an important exception to the corporate attribution rules where the only interest of the designated person in the corporation is a beneficial interest in a trust which owns shares of the corporation, and additional conditions are met[46]. In order for the exception to apply, the terms of the trust must provide that the designated person may not receive or otherwise obtain the use of any of the income or capital of the trust while he or she is a designated person in respect of the transferor, and the exception only applies if the designated person has not received or otherwise obtained the use of any of the income or capital of the trust. In addition, the trust must not make any deduction in respect of any income that has been paid to such designated person or in respect of any preferred beneficiary election made jointly with such designated person. Thus, if the freezor holds shares of a corporation which does not at the time of the freeze or may not in the future than qualify as a small business corporation in order to invoke the “safe harbour” provisions of 74.4(4), it will be necessary in drafting any trust which will acquire the common shares on the freeze, to restrict the rights of any beneficiary while he/she a “designated person” in relation to the freezor. It should be noted that it would appear that these restrictions would still have to apply even if the freezor became non-resident.

2. Income Splitting, subsection 56(2) and the “Kiddy” Tax

The new tax on “split income”, nicknamed the “Kiddy tax” was introduced in the Federal Budget of February 16, 1999. This legislation was introduced in response to a series of cases involving income-splitting arrangements, which were objectionable to the Department of

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[46] Subsection 74.4(4)

Finance. These included dividend sprinkling arrangements and management and technical services structures.

Dividend sprinkling involves the shares of a business being issued to family members directly or through a trust or holding company, often as part of a partial or complete estate freeze. The share capital provisions permit the directors to declare dividends to some family members (presumably those in lower income brackets) and not others. The quantum of the dividends could be determined by the directors as well. Thus, discretionary dividends could be sprinkled among family members in a tax advantageous manner.

Management services arrangements were typically utilized where an individual was a sole proprietor or a member of a professional partnership. In these cases, a management services corporation was incorporated by family members or a trust in favour of them to provide secretarial, administrative and/or technical services to the professional partnership. The corporation could also own the real estate leased to the professional partnership.

Aspects of this type of planning were approved of by the Supreme Court of Canada in the case of *Neuman* v. *The Queen*[47] and by the Federal Court of Appeal in *Ferrell* v. *The Queen* [48].

In *Neuman* the Supreme Court of Canada held that the payment of discretionary dividends to non-active shareholders of family owned corporations is not subject to income attribution pursuant to subsection 56(2) of the Act.

For subsection 56(2) to apply to a taxpayer, the following four conditions must exist:

(a) There must be a payment or transfer of property to another person other than the taxpayer.

(b) The payment or transfer must be made pursuant to the direction of, or with the concurrence of, the taxpayer.

(c) The payment or transfer must be for the benefit of the taxpayer, or was a benefit that the taxpayer desired to confer on the other person.

(d) The payment or transfer would have been included in the taxpayer's income if it had been made to the taxpayer.

In 1991, the Supreme Court of Canada, in *R. v. McClurg*[49]' held that as a general rule subsection 56(2) does not apply to the payment of dividends. As a result, it was generally believed that income splitting through the payment of discretionary dividends was permissible. However, the Court stated that if a distinction is to be made, subsection 56(2) may be applicable in non-arm's length transactions where the non-arm's length recipient shareholder has made no contribution (whether work or financial) to the company. Though this comment was obiter and not part of the reasons for the judgment, the Federal Court of Appeal in the *Neuman* case appears

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[47] [1998] DTC 6297 (SCC).

[48] [1999] 2 CTC 101 (FCA).

[49] [1990] 3 SCR 1020.

to have seized on it and found that in the *Neuman* case, the taxpayer's spouse made no active or financial contribution to the corporation. Attribution would therefore apply under subsection 56(2) if the four conditions were present, which the court found to be the case. At the Federal Court of Appeal level, therefore, the dividends received by the spouse were included in the taxpayer's income.

The Supreme Court however disagreed and took the position that this approach ignores the fundamental nature of a dividend, that is to say, a payment which is related by way of entitlement to one's capital or share interest in the corporation, and not to any other consideration, such as the shareholder's level of contribution to the corporation, or the existence of a non-arm's length transaction. Accordingly, unless a re-assessed taxpayer had a pre-existing entitlement to the dividend income, subsection 56(2) cannot operate to attribute the dividend income to him/her for tax purposes. For all of these reasons, the dividend paid to Mrs. Neuman in the *Neuman* case was not required to be included in the taxpayer's income and the Minister was ordered to reassess accordingly. It should also be noted that in Technical News No. 16, CRA has concluded that GAAR does not apply to income splitting arrangements of the type described in the *Neuman* case.

In the case of *Her Majesty The Queen* v. *Ferrell*,[50] the taxpayer was settlor and sole trustee of a family trust. He also held voting, non-participating shares of a family holding company and the trust held the equity shares. In the year in question, the company accrued management fees in respect of services provided by the taxpayer and paid them up to the trust which in turn allocated them to the taxpayer's minor children under preferred beneficiary elections. The funds did not directly or indirectly find themselves into the hands of the taxpayer or his wife. The Minister included the accrued fees in the income of the taxpayer relying on the indirect payment provisions of 56(2) and (4) of the Act. The Tax Court disagreed and refused to apply subsection 56(2) and allowed the taxpayer's appeal.[51] The Federal Court, Trial Division agreed, applying *Neuman* v. *The Queen*. It affirmed that taxpayers can arrange their affairs so as to reduce taxes so long as there was no specific legislation to preclude such action and this included the ability to use not only corporations but other structures such as trusts to save tax so long as the transactions were properly documented.

The *Ferrell* case represents the high water mark of success for taxpayers and the government's response was swift, at least with respect to income splitting with minors.

The measures introduced in the Federal Budget of February 16, 1999 eliminated the tax benefits of structures such as *Neuman* type structures by applying for the 2000 and subsequent taxation years a special tax at the top marginal rates on certain income of individuals aged 17 or under[52]. The types of income ("split income") which are taxed under this new measure are

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[50] 99 DTC 5111.

[51] 97 DTC 1565.

[52] Subsection 120.4(2) defines a "specified individual" as one who (a) has not attained the age of 17 years before the year; (b) at no time in the year was a non-resident; and (c) has a parent who is resident in Canada at any time in the year.

(a) taxable dividends and other shareholder benefits on unlisted shares of Canadian and foreign companies received directly or indirectly through a trust or partnership.

(b) Income from a partnership or trust where the income is derived by the partnership or trust from the business of providing goods or services to a business carried on by a relative of the child or in which the relative participates.[53]

Thus, almost all dividend income from private corporations received by minors would be subject to the Kiddy tax.

Income that is subject to this tax will not be eligible for any deductions or credits other than the dividend tax credit and foreign tax credit.[54] Thus the basic personal credit is not available.

To avoid double tax, income that is subject to this new income splitting tax will be deductible in computing the minor's taxable income under Part I of the Act.[55] In addition, income subject to the income splitting tax will not be subject to the attribution rules[56] and it would appear that there is no surtax charged (assuming the individual's tax liability does not reach the surtax threshold). An amendment to subsection 127.5 provides that alternative minimum tax ("AMT") payable will not be less than the tax on split income (and see also subsection 120.2(1) which provides that the tax on split income will be excluded from the calculation of tax payable from which AMT carryover amount may be claimed).

To ensure that the tax is collectible, parents are made jointly liable for the tax of their children.[57] This joint liability applies not only if the parent was active in the business from which the income that is subject to the new tax was derived but also applies to parents who are passive shareholders.[58] Exemptions from this new tax are as follows (applicable to certain types of individuals and certain types of income):

(a) income not received as "private" dividend income, partnership income or trust income, for example: income from employment or personal services by the minor, dividends and shareholder benefits received on any listed shares;

(b) income from property inherited by the minor from his or her parent (but not, it would appear, if inherited from grandparents, aunts and uncles, etc.;

(c) income on other inherited property in any year during which the minor is in full-time attendance at a post-secondary educational institution or is eligible to claim the disability tax credit;

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53 Subsection 120.4(2) and see also 120(3) and (4).

54 126(1), (2.1), (3).

55 Subsection 20(1)(ww).

56 Subsection 56(5) and 74.5(13)) in relation to 74.1, 74.4, 74.8, 75(2).

57 Subsection 160(1.2).

58 See 160(1.2)(b-(e).

(d) minors who have no parent resident in Canada at any time in the year.

It would appear that the objective of the legislation in targeting the income sprinkling and management services structures described earlier has been successful insofar as it relates to income splitting with minors. The split income tax apply to all arrangements that existed at the time the Kiddy Tax provision were introduced as there was no provision for grandfathering and they apply regardless of whether or not it was intended to engage in income-splitting (*i.e.* there is no purpose test). Many taxpayers concluded that existing structures should be wound-up. However, it should be noted that there might still be reasons to retain existing structures.[59]

The following should be considered before winding up existing structures.

(a) The tax does not apply to many income sources such as dividends from shares listed on a prescribed stock exchange, taxable capital gains, income from property and interest income.

(b) Income splitting can continue to be achieved through the payment of reasonable salaries to family members active in the business;

(c) The split income tax does not apply to spouses and adult children. It may be advantageous to continue to retain existing structures even if children are minors, as once they become adult and pursue post secondary studies, income would be available to pay these expenses and would not be subject to the split income tax.

(d) The traditional estate freeze is still useful as a mechanism for deferring tax on death and for multiplying the enhanced capital gains exemption with respect to shares of a qualifying small business corporation.

3. Application of the Attribution Rules and the Kiddy Tax to Fact Situation

To return to our fact situation, how do the attribution rules and the kiddy tax impact on any trust which may be established to acquire the new common shares on the estate freeze. Assuming that the beneficiaries will include one or more of Sheila’s spouse, children and other issue, the following conclusions can be drawn:

(a) The trust should be settled with a coin.

(b) The settlor should not be a trustee or a beneficiary (eg. a grandparent may be suitable).

(c) If no such settlor can be found then if the settlor is to be a beneficiary he or she should only be an income beneficiary not a capital beneficiary.

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[59] For a more comprehensive discussion, see Heather Evans, The Impact of the Proposed “Kiddy Tax” on income splitting arrangements 1999 Conference Reports 31.1 and David Stevens, Income Splitting – Planning in the New Regime 2000 Ontario Tax Conference).

(d) If the settlor is to be a trustee, he or she should be one of 3 or more trustees and the trust should provide that the trustees act by way of majority, that at any time there are fewer than 3 trustees and the settlor is one of them, then no decisions can be taken until the number of trustees is up to at least 3. There should not be any provision that requires the settlor to form part of the majority.

(e) The trust should borrow funds from a non-related third party such as a bank to obtain the funds to subscribe for the common shares.

(f) The freezor and any other person in relation to whom a beneficiary is a specified person should not guarantee the borrowing.

(g) To avoid the possible application of the corporate attribution rule in 74.4(2) and benefit from the safe harbour provisions on ss. 74.4(4), the terms of the trust restrict the rights of any beneficiary while he or she is a designated person in relation to the freezor.

(h) Care should be taken to avoid the application of the kiddy tax.

4. OTHER PROVISIONS AFFECTING TRUSTS

Since a trust or estate is deemed by the Act to be an individual for tax purposes, it follows that it will complete its income under Division B of the Act and will be allowed a deduction for all expenses incurred for the purpose of gaining or producing income from business or property. Where a trust is resident in Canada it will be taxed on its income from all sources both within and outside Canada except to the extent that:

(a) its income for the taxation year is actually paid to its beneficiaries;

(b) its income is payable (although) not actually paid to its beneficiaries;

(c) preferred beneficiaries elect to assume the tax liability for their share of the trust's income event though that income remains in the trust;

(d) a benefit (other than a distribution payment of capital) is conferred by the trust on its beneficiaries (ex. the trust or estate pays for the upkeep, maintenance or taxes on property used by the beneficiary).

These amounts are treated as deductions from the income of the trust and included in the income of the beneficiaries concerned.

4.1 Preferred Beneficiary Election

The concept of the preferred beneficiary election (PBE) was introduced in the 1971 tax reform legislation which brought in capital gains taxation. Prior to tax reform, income of a trust could only be taxed in the hands of a beneficiary if it was paid or payable to that beneficiary in a taxation year. Tax reform legislation added the concept that income which was the subject of election by preferred beneficiaries would also be deductible.

The preferred beneficiary election is a mechanism which allows the accumulating[60] income of a trust to be taxed in the hands of the beneficiaries without the income being distributed to the beneficiary[61]. The use of the preferred beneficiary election has the advantage of being able to have the income taxed in the hands of beneficiaries who are generally in lower

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[60] Accumulating income is defined in section 108 of the Act. Essentially it is the undistributed income of the trust computed under tax rules without reference to any deductions under the preferred beneficiary election. Any gains on the deemed disposition of property of a spousal trust is not included in the accumulating income of the trust.

The definition of accumulating income was amended for trust taxation years ending after July 19, 1995 to the effect that the accumulating income of the trust will be calculated as if the greatest amount allowable under subsection 104(6) was deducted. The purpose of this new provision appears to be to prevent a trust from making distributions to other income beneficiaries (who may pay tax at high rates), not deducting those distributions from the trust's income under subsection 104(6), making an election to have the income taxed in the trust under subsection 104(13.1) and adding the income to the trust.

One other amendment relating to the definition of "accumulating income" provides that where a trust is a post-71 spousal trust any capital gains realized by the trust both from actual dispositions in the year of the trust in which the spouse-beneficiary died or from the deemed disposition on the spouse's death are excluded from any part of the accumulating income of the trust.

At the time of the changes to the PBE, changes were also made to subsection 104(15). This section drops the concept of a preferred beneficiary's share in the accumulating income in favour of the new concept of a beneficiary's "allocable amount". Prior to the amendments, subsection 104(14) stated that if the trust and the preferred beneficiary had jointly elected, that part of the accumulating income of a trust that was designated in the election would be included in computing the income of the preferred beneficiary in the year, and a series of rules was set out to determine the share of each preferred beneficiary of the trust's accumulating income for tax purposes. Subsection 104(15) provided that the preferred beneficiary's share was as follows:

(a) for pre-1972 spousal trusts and post-1971 spousal trusts all of the accumulating income if the beneficiary was a spouse and nil if the preferred beneficiary was anyone other than the spouse;

(b) in the case of trusts where beneficiaries had an entitlement to trust income which was fixed then that portion that may reasonably be regarded as having been earned for the benefit of the beneficiaries of that class divided by the number of beneficiaries in that class in existence in the year;

(c) in respect of discretionary trusts, the proportion set out in Regulation 2800; and

(d) for all other trusts, nil.

As noted above, these provisions have been revised by eliminating the concept of the preferred beneficiary's share and replacing it with a concept of allocable amount for a preferred beneficiary. This does not affect spousal trusts as the spouse beneficiary is still allocated all of the accumulating income of the trust.

The rules with respect to fixed interest trusts and discretionary trusts now provide that where the beneficiary has a right of any type to any portion of the accumulating income, the beneficiary's interest in the trust is not solely contingent on the death of another beneficiary who has a capital interest in the trust and who does not have an income interest in the trust, the allocable amount for the preferred beneficiary will be the trust's accumulating income for the year. In any other case, the allocable amount will be nil.

The amendments also deal with the possibility that there may be more than one preferred beneficiary under a trust and in such a case, the total allocable amount may well exceed the accumulating income of the trust. In that regard, subsection 104(12) ensures that the amount that may be deducted in computing the trust's income from a taxation year does not exceed its accumulating income for the year. However, the new rules allow one or more beneficiaries to elect on more than what would have been their pro rata share of the accumulating income of the trust. Proposed subsection 104(12) permits the trust to deduct the lesser of all amounts designated under subsection 104(14) by the trust in respect of the year and the accumulating income of the trust for the year. These amendments apply to trust taxation years that begin after 1995.

[61] Statutory authority found in subsection 104(14). The definition of preferred beneficiary and accumulating income is found in subsection 108(1).

tax brackets[62], while permitting the trustees to retain control over the income. Additional flexibility is achieved as the tax paid income, which remains in the trust is added to capital and, in the case of a discretionary trust, can be distributed among capital beneficiaries not necessarily those who participate in the election[63]. While the preferred beneficiary election is available to both *inter vivos* and testamentary trusts, it is more attractive for *inter vivos* trusts since income accumulating in such trusts would be taxed at the top marginal rates (as opposed to the graduated rates of tax which are applicable to testamentary trusts).

The February, 1995 Budget severely restricted the use of the election and it is now only available to trusts with preferred beneficiary who suffers from significant disabilities, i.e., those who qualify for the tax credit under subsection 118.3(1)[64]. It will be recalled that a preferred beneficiary as defined in subsection 108(1), must be an individual resident in Canada who is a beneficiary and who is the settlor, the spouse or former spouse of the settlor, a child, grandchild or great grandchild of the settlor or a spouse of any such person. The new rules clarify that, with respect to residence in Canada, the preferred beneficiary must be resident in Canada at the end of the taxation year.

4.2 Paid or payable

Because of the virtual elimination of the preferred beneficiary election except in the restricted circumstances noted above, for both *inter vivos* and testamentary trusts, in order to avoid having income taxed in the trust, it will have to be paid or become payable in the year to the beneficiary[65]. The meaning of the terms “paid or payable” is therefore very important.

Before moving to a discussion of what constitutes “payable”, however, it should be noted that tax savings may also be achieved in certain circumstances if income is taxed in the trust. Thus, consideration should be given to whether tax savings might be achieved by having trust income taxed in the trust. This is achieved either because the income was not paid or did not

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62 As noted earlier, income taxable in the hands of beneficiaries will generally retain its character, for example, capital dividends, taxable dividends, taxable capital gains (including capital gains eligible for the capital gains exemption of a beneficiary).

63 The case *Sachs v. The Queen* (1980) C.T.C. 358, 80 D.T.C. 6291,8 E.T.R. 39, 33 N.R. 40 (Federal Court of Appeal) seems to suggest that the making of a preferred beneficiary election gives the beneficiaries a vested interest in the amount elected on. Many discretionary trusts give the trustees power to make income and capital distribution among the beneficiaries in proportions that they determine and also provide that even if an election is made, the beneficiary participating in the election does not have a vested right to receive the income.

64 Section 118.3 allows a tax credit for mental or physical impairment. In order to qualify for a disability tax credit, an individual must be

(a) an individual [who] has a severe and prolonged mental or physical impairment,

(a.1) the effects of the impairment are such that the individual’s ability to perform a basic activity of daily living is markedly restricted,

(a.2) a medical doctor, or where the impairment is an impairment of sight, a medical doctor or an optometrist, has certified in prescribed form that the individual has a severe and prolonged mental or physical impairment the effects of which are such that the individual’s ability to perform a basic activity of daily living is markedly restricted,

(b) the individual has filed for a taxation year with the Minister the certificate described in paragraph (a.2), and

(c) no amount in respect of remuneration for an attendant or care in a nursing home, in respect of the individual, is included in calculating a deduction under section 118.2 (otherwise than because of paragraph 118.2(2)(b.1)) for me year by the individual or by any other person.

Some of the qualifications a taxpayer must meet in order to qualify for the disability tax credit are more fully set out in section 118.4. In essence, the concept of disability relates to basic activities of daily living and criteria of how the ability to perform such activities would be markedly restricted. The criteria under section 118.4 are exhaustive. If an activity of daily living is not one of those specified in this section, it is not an activity in which impairment thereof permits a deduction or disability tax credit.

65 104(6)(b)

become payable in the year to beneficiaries or because, though such income was paid or payable by the terms of the trust, it was taxed in the trust by virtue of the 104(13.1) election.

In the case of *inter vivos* trusts, accumulating income would be taxed at the top marginal rates. However, in the case of testamentary trusts, that income is taxed at the marginal rates applicable to individuals. In the case of a single-family trust where all of the children are beneficiaries, there would be limited access to the marginal tax rate of the trust. One planning technique to increase the access to the increasing marginal rates therefore could be to create separate testamentary trusts for each child. Each trust would be a separate taxpayer as would the child beneficiary.

As a cautionary note, subsection 104(2) permits the Minister to consolidate trusts for the purposes of the Act if substantially all of the property of the trusts has been received from one person and if the trusts are "conditioned so that the income thereof accrues or will ultimately accrue to the same beneficiary or group or classes of beneficiaries". Where these conditions are met, the Minister may treat the trusts as if they were one trust. Thus, the income of all of the trusts would be treated as the income of one trust. The case of *Mitchell v. MNR*[66] is the only case which has judicially considered subsection 104(2) and it held that subsection 104(2) did not apply to four trusts each of which had been set up for a different child of the settlor. Technical Interpretation 9812985 dated January 14, 1999 identified factors which will be considered in making a determination. These include:

(a) whether there was a clear intent by the testator as evidenced by the terms of the will to create separate trusts;

(b) whether the trusts have common beneficiaries;

(c) whether the assets of each trust are segregated and accounted for separately – separate bank accounts, no undivided interests in property, separate accounting records for income received and capital and/or income disbursements;

(d) the conduct and powers of the trustees.

Subsection 104(24) provides that for an amount to be payable, it must be paid in the year to the beneficiary or the beneficiary must be entitled in the year to enforce payment of the amount. In such a case, the beneficiary must include in his/her income the income of the trust which is payable even if the amount is not actually paid in the year. When the amount is paid in a subsequent year, it would not be included in the income of the beneficiary. A beneficiary is generally considered to be entitled to enforce payment of the amount in the year if all decisions, steps and authorities with respect to the payment of the amount to the beneficiary have been taken in the year. For example, if the right of a beneficiary to demand a payment of income is subject to the approval of a third party, no amount is payable until a demand for payment of income has been approved by that third party. Similarly, in the case of a discretionary trust, the trustees must exercise their discretionary power on or before the end of the trust's year in order to make an amount payable in that year.

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[66] (1956) 16 Tax ABC 99, 56 DTC 521 (TAB)

Clearly, actual payment or distribution from a trust would comply with the provisions of subsection 104(6). However, in many cases, there will be a reluctance to distribute cash either because beneficiaries are infants or, even if the beneficiaries are adults, if the amounts involved are large.

Concerns over payments of large amounts to beneficiaries may range from concerns about loss of control to estate planning issues such distributions may cause for beneficiaries, such as exposure of such distributed property to claims of creditors, possible exposure to claims of spouses under applicable matrimonial laws, probate fee issues and estate tax issues in such jurisdictions as the United States. Some of these concerns may be alleviated by a loan-back of the funds by the child-beneficiary structured as a long-term debt. Where this may put the funds back in the control of the trustees, it does not alleviate all of the concerns noted above. In addition, if such an arrangement were made with respect to a beneficiary who is a minor, there would be concern that the child could void the arrangement upon attaining majority.

An alternative to actual payment is for trustees to ensure that a beneficiary is entitled to receive payment before the end of the year even if funds are not distributed. In the case of a discretionary trust, this can be accomplished by a resolution by the trustees prior to the end of the year resolving to distribute an amount of trust income to a beneficiary and issue of a promissory note to the beneficiary as evidence of the obligation to pay. The note should be payable on demand to satisfy the requirements of the Act[67]. The beneficiary should be informed of the existence of the promissory note[68].

The importance of documenting trustee decisions and ensuring that income becomes vested in the beneficiaries in order to make it deductible to the trust is illustrated in the case of *Jeremy Cole Trust and Seth Lawson Cole Trust v. MNR*[69]. In that case, the trustees (parents of the beneficiaries) determined to make trust income payable to the beneficiary and agreed it was to be paid to the infant beneficiary when requested by the parents. No income was in fact paid in the year. The trust claimed a deduction on its T-3 return and reported the income as that of the beneficiary and the beneficiary reported the income in his tax return. It was held that the income was properly taxable in the trust. The trustees did not pay the income, it was not made payable and the amount did not vest in the beneficiary. The court noted that to make an amount payable to the beneficiary, the trustees must take some action to ensure that the beneficiary cannot be deprived of the amount and the payment cannot be conditional on the happening of an event. The funds must be irrevocably earmarked as belonging to the beneficiary.

One problem with respect to making capital gains payable to beneficiaries relates to mutual funds. Mutual funds generally do not report capital gains realized within the funds in the year to holders of units until February or March of the following year. Thus, it will be impossible for trustees to know the exact amount of the capital gains in respect of such investments by December 31 in the year. In such a case, the trustees should document their

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[67] Technical View 342(1992)

[68] John Saunders, *inter vivos* Discretionary Family Trusts: A Potpourri of Issues and Traps, 1993 Conference Reports 37 at p.50

[69] [1980] CTC 3027, 81 DTC 8

intention and promise to pay and describe the type of payment (similar to the approach where "bonus" resolutions are passed)[70].

4.3 Payments to Third Parties

In some cases where deductions with respect to minors are involved, trustees make payments out of the trust directly to third parties. These payments can include private school fees, camp fees, expenses related to sports, travel costs and other similar expenditures. Third party payments would appear to have been approved informally by CRA, notwithstanding that technically 104(24) provides that to be deductible by the trust, income payments must be made directly to a beneficiary[71] and notwithstanding comments in the case of *Howard Langer Family Trust v. The Queen*[72].

In that case, the court disallowed approximately $400,000 of payments made by the trustees directly to reimburse the parents of the infant beneficiaries for their expenses in respect of the well-being, upkeep and maintenance of the children. No records were kept by the parents of payments made on behalf of the children and the court did not accept the oral evidence of the trustees as to the use of the trust funds. Rather than make payments directly to the beneficiaries, the trustees made the payments to Dr. Langer presumably to reimburse him for having paid all of the children's living expenses. No consent of the beneficiaries to make such payments was obtained. The comments made in that case cast some doubt on whether payments made to the parents on behalf of a beneficiary are deductible by the trust because they are not made directly to the beneficiaries. On the other hand, it is arguable that the case turned on the fact that there were no records and other proof of payments to the parents.

In the recent case of *Ken and Jessie Degrace Family Trust v. The Queen*[73] CRA disallowed amounts payable to beneficiaries for household expenses. In that case, Mrs. Degrace as trustee paid herself $46,000 and treated the amount as deductible from the trust and an expenditure on behalf of her children who were beneficiaries of the trust. The money was used to pay for shelter costs (mortgage payments on a house owned by the parents and decorating expenses, painting bedrooms, etc.), grocery expenses for the family's food, medicines for the family, clothing, diapers and the costs of cremating a family pet and the costs of replacing the pet with another pet. The court held that these expenses were ordinary household expenses and were not made for a purpose which is unequivocally for the benefit of the beneficiaries.

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[70] John Budd, Income Splitting Trusts and The Impact of the Elimination of the Preferred Beneficiary Election, 1995 Ontario Tax Conference. The issue of whether trusts have the ability and authority to invest in mutual funds has been the subject of some controversy. A number of cases (*Haslam v. Haslam* (1994), 114 D.L.R. (4th) 562 (Gen. Div.), *Central Guaranty Trust Co. v. Eric Sin-Sara*, April 3, 1995 (Ont.Ct. (Gen. Div.)) (unreported), and *Canada Trust Co. v. Rutherford*, O.J. 277 (Gen. Div.)) have discussed this issue. While the issue is in part whether investment in mutual funds is an authorized investment, the major issue is whether such investments constitute an improper delegation of authority. This has now been dealt with in Ontario with the enactment of changes to the *Trustee Act* that permit delegation of investment decisions within the parameters set up in the *Trustee Act*.

[71] View #9233505, 1993 (Feb. 15)

[72] 92 DTC 1055, [1992] 1 CTC 2119

[73] 99 DTC 453

While it is recognized that CRA is not bound by its previous assessing practices, some comfort can be taken from the position stated in its technical interpretations that it will accept certain third party payments as payments made directly to a beneficiary and hence deductible[74].

If one wishes to ensure that third party payments are deductible, care must be taken to keep proper records and documentation and to consider the nature of the payment. With respect to proper records, CRA has expressed the view[75] that the following steps must be taken to ensure that third party payments are deductible for the income of the trust and included in the income of the beneficiary.

(a) the payments must be made pursuant to the beneficiary's direction or concurrence

(i) when the beneficiary is an adult he/she can request and direct the trustees in advance of the trustees making the payments;

(ii) the trustees should consider exercising their discretion and if they do so exercise their discretion to make income payable to the beneficiary, they must notify the beneficiary to that effect either before or after they exercise their discretion and make the payment;

(iii) if the trustees initiate the steps to make the payment, they should notify the beneficiary and obtain his/her concurrence;

(iv) in the case of a minor beneficiary, he/she will not be able to initiate a request for a third party payment or concur in such a payment made by the trustees. In such a case concurrence should be sought from the person who is the legal guardian of the property of the child, generally a parent. It should be noted that in Ontario, a parent of a minor is not the legal guardian of his/her child's property simply by virtue of being a parent. However the concurrence of the parent should be sought in any event and should be sufficient.

In all cases the Trustee decisions should be evidenced by a resolution in writing and the beneficiary's (or parent's) actions should be similarly documented. Records should be kept by the Trustees including receipts issued by the third parties for the expenditures.

It is also important to consider whether the payments reimbursed are in fact deductible and do not result in taxable benefits being conferred on the parents. In that regard there was some concern that because parents have an obligation to provide the necessities of life (food, shelter, clothing) to their children, to the extent the trust bears these expenses, a section 105 benefit may have been conferred on the parents. However, CRA has expressed the view[76] that expenses with respect to "support, maintenance, care, education, enjoyment and advancement of life, including the child's necessaries of life" can be paid out of a trust's annual income and

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[74] David Christian and Bruce McCarley, Family Trusts/the Future of Tax Shelters, 1995 B.C. conference

[75] Technical News No. 11, Sept 30, 1997; Aug. 26, 1997 document #9722465.

[76] Ibid

included in the income of the child. CRA has gone on to explain that these expenses would include "those that [a] parent would otherwise have been legally obligated to incur". This represents a significant expansion on what was formerly allowed and allays concerns about 105(2) benefits[77].

4.4 Vesting of Rights within the Trust

The amended section will effectively eliminate the application of subsection 104(18) to discretionary trusts. The amendment provides that Subsection 104(18) provides that an amount will be deemed to be "payable" to an individual in a taxation year where

- the individual is less than 21 years of age at the end of the year;
- the individual's right to the income is vested by the end of the year;
- the individual's right to that income did not become vested because of the exercise or the non-exercise of a discretionary power; and
- the individual's right is not subject to any future condition (other than a condition that the individual survive to an age not exceeding 40 years).

This provision overrode the provision of subsection 104(24) and allowed the trust to deduct income of the trust allocated under subsection 104(6) and 104(12).

This provision could provide a useful tool to permit income and capital gains to be taxed in the hands of a beneficiary while continuing to retain that income or gain in the trust and under the control of the trustees, possibly until the beneficiary attains age forty. It should be noted that in order for the subsection to apply, the right to the income must be vested in the beneficiary and that vested right not be subject to the exercise (or failure to exercise) discretion. The subsection also contemplates that the distribution of the vested amount can be deferred until a later age. The question arises, however, as to how to avoid the possible application of *Saunders v. Vautier* without running afoul of the requirement that the right be vested.

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[77] Examples of the types of payments that may be satisfied out of the income of the trust include the following:

a) payments to nannies (parents and trustees should consider being the co-employer. This way the parents can still deduct child care expenses);
b) camp expenses;
c) private school fees (but not the religion component);
d) vacations (air fare, hotels) to the extent they can be allocated to the child;
e) post secondary tuition fees and other post secondary expenditures;
f) clothing;
g) sports equipment;
h) music, dancing, skating, etc. lessons;
i) computer for the child.

4.5 Payment in Kind – Stock Dividends

As noted earlier, while it may be desirable to ensure that income be deductible to the trust and taxable in the hands of beneficiaries for tax reasons, there are potentially adverse non-tax consequences of income becoming paid or payable to beneficiaries. For example, the income which now "belongs" to the beneficiary may become exposed to the claims of creditors of the beneficiary and may become subject to marital property disputes with the beneficiary's spouse. The loss of control over potentially large amounts and high value assets also raises concerns.

It may be possible for the beneficiary to reduce the risks of attachment by creditors in certain circumstances by disposing of the assets by gift or transfer. However, consideration must be given to possible adverse tax consequences of such a transfer, possible contravention of creditor protection legislation and applicable marital statutes.

One possible strategy which may allow some measure of control is to make a payment in kind to the beneficiary. Generally this type of planning is restricted to the situation where a family trust is a shareholder of a closely held corporation[78]. This would involve the creation of a class of preferred shares of a company which would be used to pay stock dividends to the trust. These shares could in turn be distributed by the trust to the beneficiaries. The preferred shares would be non-voting and redeemable by the company (but not retractable by the owner) so that the timing of their conversion to cash would be left to the discretion of the corporation; the stated capital of the shares (and paid-up capital) would be equal to their redemption amount.

A stock dividend is defined in section 248 to include "any dividend ... paid by a corporation to the extent that it is paid by the issuance of shares of any class of the capital stock of the corporation".

Subsection 82(1) of the Act provides that the recipient of a dividend must include in income the "amount" of the dividend plus the 25% gross-up (in the case of an individual). "Amount" is defined in the Act. Provided that the stock dividend is not subject to the anti-avoidance rules[79], then the amount of a stock dividend is the amount by which the paid-up capital is increased by the payment of the dividend.

Thus if a share with a paid-up capital of $10 is paid as a stock dividend to the trust, the paid-up capital of the corporation would be increased by $10. This will be the amount of the income inclusion under section 82. The trustees can then effect the distribution and make a subsection 104(19) designation of the distribution as a dividend and the beneficiary will include it as his income. The cost of the share, its redemption amount and its paid-up capital will be $10. Thus the beneficiary would have no additional income and tax when the share is redeemed. Some control is maintained as the share cannot be liquidated at the will of the shareholder-beneficiary. This presumably would make this asset of less interest to a creditor, although in the marital situation the value as of the stock dividend could be taken into account in ascertaining the rights of spouses.

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[78] Lisa M. Collins, Family Trusts: An Update, 1995 Prairie Provinces Tax Conference at pp. 13-16

[79] In 112(2.1), (2.2), (2.4); 187.2, 187.3, 258(3) or (5) 191.1 (the latter for Part VI.1 purposes only). Generally these do not apply to closely-held private corporation situations.

4.6 The 21-Year Deemed Disposition Rule

(a) Historical Review

The 21-year deemed disposition rule has seen a number of changes in the past few years and the tinkering continues. The rules were first introduced as part of tax reform in 1971, for the purpose of preventing the use of trusts to defer indefinitely the recognition for tax purposes of gains accruing on capital properties, resource properties and land investors.

Subsection 104(4) of the Act provides for a deemed disposition and reacquisition of capital property (other than depreciable property) and land inventory owned by a trust (including a testamentary trust) other than spousal trusts (and certain other new types of trusts introduced by the March NWMM and described further below) for fair market value proceeds on the day which is twenty-one years after the later of January 1, 1972, and the day on which the trust was created. Subsequent deemed dispositions occur on each successive twenty-first anniversary thereafter.

Spousal trusts are treated differently. A pre-1972 spousal trust[80] is subject to the deemed disposition rule on the date which is the later of the date of death of the spouse and January 1, 1993. A post-1971 spousal trust on the other hand is subject to the deemed disposition rule on the death of the spouse. In addition, different deemed disposition rules apply to certain new trusts recently introduced into the Act which will be discussed in more detail below.

New rules were introduced in 1991 to permit a trust to defer the deemed disposition until the death of the last "exempt beneficiary". Essentially, an exempt beneficiary is a family member who is not more than one generation removed from the family member chosen as the designated contributor. A designated contributor is a person who has a significant role in the establishment of the trust (the test includes a financial component and factors relating to control of a corporation whose shares may be held by the trust). In the case of pre-72 spousal trusts (a concept introduced in 1991), the first deemed realization date would be the later of January 1, 1993 and the death of the spouse. These rules have now been repealed and it is not possible to elect to defer the 21-year deemed realization after 1998. Briefly, the effects of these changes are as follows:

(a) Those trusts created in 1978 or later (other than spousal trusts) will be deemed to have disposed of their assets 21 years after the date the trust was established and every 21 years thereafter.

(b) Trusts which had filed an election to defer the deemed realization at any time before January 1, 1999 were deemed to dispose of their assets at fair market value on January 1, 1999[81].

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[80] A pre-1972 spousal trust is defined in ss. 108(1) as a trust created by the will of a taxpayer who died before 1972 or was created *inter vivos* before June 18, 1971 and that from the date of creation to the earliest of January 1, 1993, the spouse's death and the particular time was a trust under which the spouse of the taxpayer was entitled to receive all of the income of the trust that arose before the spouse's death unless a person other than the spouse received or otherwise obtained the use of any of the income or capital of the trust before the end of that period.

[81] The following transactional rules are noted for historical purposes

It is important to consider the possible impact of the 21-year rule when drafting the trust to ensure that there is sufficient power to the trustees to encroach on the capital in the event that it is determined to distribute the amounts of the trust to the beneficiaries prior to the 21st anniversary of the trust. In the case of a trust, which has been in existence and is faced with a 21 year deemed disposition in the near future, a number of factors should be considered.

(a) It is not possible to transfer amounts from one trust to another trust whose 21st anniversary will not occur for some time, as in such trust to trust transfers the transferee trust will be deemed to have the same deemed disposition date as the transferor trust.

(b) The trustees may decide to permit the deemed realization to occur on the 21st anniversary of the trust and ensure that the trust continues to exist to fulfill its purpose after that date. In the meantime, action can be taken to reduce the anticipated gains by effecting an estate freeze or reducing the value of corporate shares by making distributions from the company.

(c) If there are assets in the trust with significant accrued gains, it may be advisable to consider a distribution of such assets to the beneficiaries on a tax-deferred basis pursuant to the provisions of subsection 107(2) of the Act. Because of the possible application of subsection 107(4.1) which denies rollover treatment if ss. 75(2) ever applied to the trust it is necessary to conduct an historical review of the creation of the trust, any transfer to the trust during its existence and to review the terms of the trust and in particular the number of trustees and the manner in which such trustees effect decisions, the identity and interests of the beneficiaries and their relation to the settlor, any other contribution to the trust and the trustees, to satisfy oneself that ss. 75(2) is not and has never been applicable to the trust. As noted above, except to the extent that a roll-over is not available, the rollover would apply in respect of distributions to beneficiaries. While this ensures that these assets will not be trapped in the trust on "DD"-day, this proposed solution has a number of drawbacks.

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(1) Trusts which were reaching their 21st anniversary and had not yet made their election could still make the election at any time before January 1, 1999 and in that case, the deemed realization would be deferred until the earlier of January 1, 1999 and the first day on which there was no longer an exempt beneficiary. Essentially, this rule applied to trusts established in 1975, 1976 and 1977. If these trusts made an election, they would not be able to distribute assets out of the trust on a tax-deferred basis except to exempt beneficiaries.

(2) paragraph 104 (5.3)(b.l) was introduced to ensure that trusts which had elected would not be penalized by having made the election under 104(5.3). This allowed trusts which elected prior to the 1995 Budget to make tax-deferred distributions to non-exempt beneficiaries;

(3) 104(5.31) was introduced to allow trust which had elected prior to July 1995 to apply before 1997 to the Minister to revoke the election. If the revocation was permitted, the trust was treated as if it had never made the election. 104(5.31)(b) provides that a trust is not liable to any penalty to the extent of the liability that it incurred because of the revocation of the election. At first blush one would ask why any trust would want to consider revoking the election when it is no longer in a position to consider alternatives to the deemed realization rules. However, a revocation was attractive where it appeared likely that the last exempt beneficiary may die before 1998 and the accrued gains since the filing of the election had increased significantly in amount and it was not feasible to distribute the trust assets prior to that time.

(i) Firstly, it is important to consider the terms of the trust agreement to determine whether there is an ability to encroach on the capital and whether any limitations are imposed on capital encroachments. If there is no power to encroach on the capital or the power is limited, then it may be necessary to seek to vary the terms of the trust. Court applications to vary trusts are time-consuming, and if this will be necessary, then consideration should be given to commencing the process in the near future. Generally, the Children's Lawyer and possibly the Public Guardian and Trustee will have to become involved. An application will not be granted if the court is not satisfied that the arrangement provides sufficient benefit for the interests which the Children's Lawyer represents[82].

(ii) In the case of *Re Schumacher; Fennell v. Canada Trust Co. et al.*[83], the court came to the conclusion that while the variation of trust would have resulted in significant tax advantages for the trust and its beneficiaries, there was not enough benefit for infant, unborn and unascertained beneficiaries, and the arrangement was not approved.

(iii) In addition, it should be noted that a trust variation may involve dispositions for tax purposes, and thus the tax implications both for the trust and its beneficiaries should be considered before embarking on a variation application[84].

(iv) The tax benefits of a distribution of assets to beneficiaries should be weighed against the advisability of distributions which may benefit some beneficiaries to the exclusion of others and the loss of control over the assets. In addition, such distributions create issues for the beneficiaries receiving such assets, (for example, creditor issues, marital law concerns and possible probate fee concerns).

(v) While the distribution of trust assets may be the tax-efficient way of proceeding, such distributions may thwart the wishes of the settlors, who would prefer to have the trustees retain some control over the assets. The trustees could consider a reorganization of the corporation prior to the transfer of shares to the beneficiaries. Following the reorganization, the trust would hold both voting non-participating shares, and non-voting participating shares. The voting shares could be retained by the trust as no gain would arise on the deemed realization date, and the participating shares could be distributed to the beneficiaries. Alternatively, the common shares of a corporation could be frozen and a new trust formed to acquire the common shares and voting non-participating shares. The

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[82] Willson A. McTavish and Ronald R. Anger, "Variations of Trust: The Official Guardian's View", Vol. 9 1988-89 ETJ 132; Strachan Heighington, Q.C., "Variations of Trust and Tax Avoidance", Vol. 10,1990-91 ETJ 30

[83] 37 ETR 170 (Ont. C.A.)

[84] See Wm. Innes and Joel Cuperfain, "Variations of Trusts: An Analysis of the Effects of Variation of Trusts under the Provisions of the Income Tax Act (1995)", Vol. 43, no. 1, CTJ 16

frozen shares would then be rolled out of the first trust to the beneficiaries. The trust could also enter into a shareholder agreement before distributing the preference (frozen) shares which would be binding on the beneficiaries to prevent the retraction of the shares without the consent of all of the beneficiaries. If the shares involved are shares of a qualifying small business corporation, the $500,000 capital gain exemption can be crystallized as part of this process.

E. NEW TYPES OF TRUSTS[85]

A client may wish to transfer assets to a trust for a number of non-tax reasons. These include:

(a) to set a mechanism in place to manage one's property in the event of disability or incapacity;

(b) to protect property from the claims of creditors;

(c) to provide for disabled beneficiaries without jeopardizing their government benefits;

(d) to provide for a person who is not able to look after his or her property by reason of minority, mental incapacity or lack of business experience;

(e) to give a beneficiary the benefits of property ownership without giving up control over the property;

(f) to provide for successive interests;

(g) to create income splitting opportunities;

(h) to avoid the application of probate tax.

We have earlier considered some of the impediments to income splitting which are found for the most part in the attribution rules. Often difficulties in achieving some of the above objectives relate to the rules which govern transfers to trusts. These rules have undergone extensive changes in the past few years ranging from a codification of administrative provisions to substantive changes and new initiatives. It is not proposed to deal exhaustively with these recent changes but rather to focus on the new definition of "disposition" and the new types of trusts which are of interest to the estate planner.

As a general rule, a transfer of property to a trust constitutes a disposition. Paragraph 69(1)(b) will generally deem the proceeds of disposition to be the fair market value of the

[85] A comprehensive discussion of the new rules can be found in a paper by Cindy Rajan and Catherine Brown, Personal Trusts 2000: Taxation and Planning in the New Millenium, CTF September, 2000.

property transferred whether the disposition is by way of *inter vivos* gift, or by way of transfer for no proceeds or for proceeds less than fair market value.[86]

The definition of "disposition" is contained in subsection 248(1) of the Act. The definition expands the previous definition of disposition for tax purposes and it is important to review these provisions when considering any disposition which affects the transfer of assets to trusts, the transfer of assets by trusts, dealing with trust assets by a trust and dealing with the interests of the beneficiaries. Paragraphs (a) to (d) of the definition create broad categories of transfers that will qualify as dispositions while the rest of the definition carve out specific exceptions to dispositions. A number of these exceptions are relevant to trusts in situations where a transfer of property does not result in any change in beneficial ownership.

The definition of disposition in subsection 248(1) states that most transfers to trusts will qualify as disposition. For example, subparagraph (b)(v) of the definition sates that any transaction by which a trust that can reasonably be considered to act as agent for the beneficiaries ceases to acts as agent will be a disposition. Subparagraph (c) states that any transfer of property to a trust or any transfer of property of a trust to a beneficiary is also a disposition, unless excepted by paragraphs (f), (g), or (k). This provision essentially includes most transfers to or from trusts as dispositions. Subparagraph (d) makes any payment from a trust to a beneficiary on account of the beneficiary's capital interest in the trust a disposition.

The definition of disposition also includes examples of certain transfers that will not be dispositions. Thus, paragraph (e) states that a transfer of property that does not result in any change in beneficial ownership is not a disposition but for a few exceptions. The exceptions apply to a transfer of property from a person or partnership to a trust for the benefit of the transferor, and to a transfer from a trust to a beneficiary under the trust. Similarly, despite a lack of change in beneficial ownership a transfer of property from one trust to another with both trusts having the same beneficiaries is a disposition. Paragraph (f) of the definition confirms that transfers of property that do not change beneficial ownership are not dispositions where the transferor and transferee are trusts, the transfer is not by a Canadian resident trust to a non-resident trust, the transferee does not receive the property in satisfaction of a beneficial interest, the transferee held no property before the transfer, the transferee does not elect out of the provisions of paragraph (f), and the transfer results in the transferor ceasing to exist.

Paragraph (h) carves out a special exception from the definition of disposition for transfers from unit trusts. According to this provision, a payment after 1999 in respect of the capital interest of a unit trust is not a disposition where the number of units owned by a taxpayer in the trust are not reduced by the payment. Similarly, paragraph (i) states that payments after 1999 in respect of the capital interest of a taxpayer in a trust are not dispositions where the payment is out of income or capital gains of the trust for a particular year and the payment was made in the year or the right to payment was acquired in the year. Moreover, any capital dividend received by a trust in a year that is designated in favour of a beneficiary in the same

[86] Para. 17, IT-419 provides that CRA considers the relationship between trust and its settlor to be non-arm's length; it should also be noted that 251(1)(b) once amended will provide that a beneficiary of a trust will be deemed not to deal at arm's length with the trust. For a definition of who constitutes a beneficiary see 248(25)(a) and (b) and also see 104(1.1) for a description of persons who will be considered <u>not</u> to be a beneficiary.

year under subsection 104(20) is not a disposition if the payment is in respect of the taxpayer's capital interest in the trust.

Paragraph (k) of the definition states that there shall be no disposition for transfers of property to a trust with no change in beneficial ownership where the transfer is made to effect payment under a debt or loan or to provide assurance that an absolute or contingent obligation of the transferor will be satisfied. The same applies when the transfer is made to facilitate the provision of compensation or the enforcement of a penalty in the event of non-satisfaction of an obligation of the taxpayer.

These exceptions to the definition of disposition for transfers to and from trusts serve as the main provisions preventing the tax consequences of a disposition. However, certain special kinds of trusts and transfers discussed below may also be able to avoid the tax consequences inherent in a disposition through the rollover provisions in the Act. One major exception to the deemed disposition on the transfer of assets to a trust has been the provisions where permitted tax free transfers to a spousal trust both *inter vivos* and testamentary.

The new rules have introduced further exceptions in the form of a variety of new trusts which are of interest in the estate planning context. These changes have expanded the tax-free rollovers available on transfer to spouses and spousal trusts. The new types of trust include the following:

(a) bare trust;

(b) revocable trust;

(c) protective trust;

(d) alter ego trust;

(e) trusts under subsection 107.4(1);

(f) spousal trust/joint partner trust.

1. Bare Trust

There has in the past been some discussion of whether bare trusts are trusts at all[87]. In 1996, CRA set out its administrative position that in some circumstances a bare trust could be ignored for tax purposes with the result that for tax purposes the beneficial owner would be considered to be the owner of the property for all purposes[88].

Since a simple bare trust is not a trust for purposes of the Act, a transfer of property to it is not a disposition[89].

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[87] Raphael, Canadian Income Taxation of Trust, (2d) (1982) p. 7 calls them a fiscal illusion.

[88] 1998 Corporate Management Tax Conference.

[89] See 104(1) and paragraph 248(1)(c).

The term "bare trust" is not defined in the Act but is described in 104(1) as "arrangement under which the trust can reasonably be considered to act as agent". CRA has set out guidelines as to the required elements for a bare trust to exist.

(a) the trustee has no significant powers or responsibilities and can take no action without instructions from the settlor;

(b) the only function of the trustee is to hold legal title to the property;

(c) the settlor is the sole beneficiary and can cause the property to revert to him or her at any time[90].

2. Revocable Living Trusts

These trusts are generally considered in planning to avoid the impact of provincial probate tax. CRA takes the position[91] that a revocable living trust should be fully recognized as a trust for tax purposes. In an early position CRA had taken the position that a transfer of property to such a trust was a disposition of the remainder interest only. CRA reversed that position and now considers that a transfer of property to such a trust involves a change in beneficial ownership of the property and is thus a disposition of the entirety at fair market value. In addition, ss. 75(2) will be applicable during the lifetime of the settlor while he or she is resident in Canada[92].

A revocable living trust is described as one where the settlor

(a) is the sole beneficiary of the income and the capital,

(b) is the trustee,

(c) retains the power to revoke, alter or amend the terms of the trust and

(d) essentially has the ability to deal with trust assets at all times during his or her lifetime.

A revocable living trust also usually provides for how property will devolve on the death of the settlor unless the trust is revoked during the settlor's lifetime.

3. Protective Trusts

The concept of a protective trust was addressed in 1996 where CRA pronounced that a protective trust was a trust, which provides that[93]:

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[90] 1995 Canadian Tax Foundation and see also Technical News No. 7 February 21, 1996 ("Technical News No. 7"); and see also David Simmonds, Future Planning with *Inter vivos* Trusts LSUC Special Lectures 1996, p. 115-117. These views are also repeated in the Technical Notes to the December 1998 Draft Legislation.

[91] Technical News No. 7 February 21, 1996

[92] See 248(1)(c), (f) and (g) of the new definition of disposition and new paragraph 107.4(a).

[93] Technical News No. 7; see also Technical Interpretation 9830103 February 26, 1999 on Blind Trusts

(a) the settlor is the sole beneficiary;

(b) the settlor is entitled to as much of the annual income and realized capital gains of the trust as he or she requests, or in the absence of request, as the trustees in their absolute discretion deem advisable,

(c) if the trust is terminated prior to the death of the settlor, it reverts to the settlor and

(d) the trust will terminate on the death of the settlor unless it is terminated at an earlier date.

When the settlor dies any property held by the trust will devolve in accordance with the terms of the settlor's will or in accordance with the laws of intestacy that are relevant to the estate.

CRA recognized that a trust exists in such circumstances and that a transfer to such a trust would not give rise to a taxable disposition during the lifetime of the settlor. The subsection 75(2) attribution rule would apply to such a trust.

The concept of a protective trust was not carried over in its original form to the current legislation. However, a number of different trusts have been introduced which bear some resemblance to the protective trust. These include the alter ego trust and joint partner trusts.

4. Alter Ego Trusts

An alter ego trust is defined in subsection 248(1) as a trust to which paragraph 104(4)(a) applies. This is a provision which deems periodic dispositions of trust assets with respect to spousal trusts and which has been expanded to apply similar rules to alter ego trusts and joint partner trusts. An alter ego trust is an inter vivos trust created after 1999 by an individual who has attained the age of 65, the terms of which provide that the individual is entitled to receive all of the income of the trust that arises before the individual's death and no person except the individual may, before the individual's death, receive or otherwise obtain the use of any of the income or capital of the trust and has not elected out of these provisions[94]

Where the alter ego trust provision may not be available because the transferor is not yet 65 years of age, there is another provision in new subsection 73(1.01) which contemplates a non-taxable transfer of property to a trust for the benefit of the person creating the trust.

In order to qualify for this rollover the following requirements must be met[95]:

(a) the transfer must be by an individual to a trust;

(b) the trust is an inter vivos trust;

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[94] First introduced in the 1999 December draft legislation; and see Technical Interpretation 1999-0013105 (May 15, 2000). The relevant sections are 248(1), 73(1.01), 73(1.02) and clause 104(4)(a)(1.1) and (ii.i) (iv).

[95] Subsection 73(1.02) and subsection 73(1.01)(c)(ii)

(c) the trust was created after 1999;

(d) the individual is entitled to receive all of the income of the trust that arises before the individual's death and no person except the individual may before the individual's death receive or otherwise obtain the use of any of the income or capital of the trust;

(e) the terms of the trust provide that no one but the individual shall until the individual's death have an absolute or contingent right as a beneficiary under the trust[96].

In addition the other requirements of subsection 73(1) must apply – the property must be capital property of the individual, the individual must not be a trust and both the transferor and transferee must be resident in Canada and the individual must not elect out of the rollover. The attribution rules in subsection 75(2) will apply to the transferor.

Alter ego trusts and trusts under subsection 73(1.01) are treated identically for the purpose of the deemed disposition rules in subsections 104(4) to 104(5.2). Since an alter ego trust is considered to be a trust for the purpose of subsection 104(4), the deemed disposition rules apply to it. An alter ego trust has its first disposition on the death of the individual who created the trust. Proceeds of the deemed disposition will be determined under subsections 104(4) to 104(5.2). However, the contributor does not have the ability to choose proceeds of disposition other than the fair market value or tax cost of property transferred.

A transfer of assets to an alter ego trust will ensure that the assets transferred are removed from the deceased's assets for the purposes of the deemed disposition on death rules under subsection 70(5). However, the trust will be deemed to have disposed of the assets at the highest marginal tax rate. This provides options for careful estate planning depending on a taxpayer's situation at the time of settlement of the trust. For example, taxpayers in low marginal tax brackets or with unused losses should ideally not plan to transfer assets into an alter ego trust. Alternatively, assets with potential losses can be transferred into an alter ego trust to shelter gains resulting from the deemed disposition under subsection 104(4).

An alter ego trust is an effective planning vehicle for the protection of a taxpayer's assets in the event of incapacity or diminished capacity, and for protection against non-traditional creditors like caregivers and second spouses. The terms of an alter ego trust may be tailored to the exact needs of a client by providing for specific powers and restrictions. Moreover, there is greater certainty with respect to the standard of care when a trust is used. These reasons support the use of an alter ego trust as protective devices in planning for asset protection over powers of attorneys.

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[96] Subsection 73(1.02)(b)(ii).

5. Trusts Under Subsection 107.4(1)

Transfers to trusts that are "qualifying dispositions" under subsection 107.4(1) are eligible for a rollover on the transfer. A transfer of property to a trust will qualify for a rollover on the transfer of property if the following conditions are met:

(a) there is no change in beneficial ownership on the transfer although the legal title may change (paragraph 107.4(2)(a) provides a deeming rule for determining when there is a change in beneficial ownership for these purposes);

(b) the disposition is not by a person resident in Canada to a non-resident trust;

(c) no person other than the transferor of property holds any contingent or absolute interest in the trust immediately after the transfer;

(d) the proceeds of the transfer are not determined under any other provision of the Act;

(e) subsection 73(1) does not apply to the transfer and would not apply even under certain conditions.

The rollover is also prevented if the transfer is part of a series of transactions beginning after December 17, 1999, and includes either the disposition of interest in a personal trust or the subsequent acquisition of any interest in the trust for consideration paid to the trust. Moreover, the transferor cannot receive any consideration for the transfer other than an interest in the trust or the assumption of a debt by the trust for which the assets can reasonably be considered to be security.

If the transferor meets the definition of a "qualifying disposition", subsection 107.4(3) is used to determine the transferor's proceeds of disposition, the cost base of the transferred assets and the cost bases of the transferor's capital and income interests. Generally, the transferor and transferee's proceeds of disposition are deemed to be the cost amount of the property, subject to enumerated exceptions. A subsequent disposition of the capital interest in the trust will generally be at fair market value under subsection 107.4(4). However, the rollover on the transfer of property to a trust pursuant to subsection 107.4(1) only applies when the transferor is an individual or another trust. Coupled with subsection 73(1), subsection 107.4(1) should allow for the transfer of virtually any asset of a taxpayer on a rollover basis.

6. Spousal/Joint Partner Trusts

The concept of spousal trust is a familiar one and is used both in *inter vivos* and testamentary estate planning. Capital property can be transferred to a spousal trust (*inter vivos* or testamentary)[97] on a rollover basis if the following consideration are met:

(a) both transferor and spouse are resident in Canada at time of transfer;

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[97] 73(1) and 70(6)

(b) the spouse is entitled to all of the income during his or her lifetime;

(c) no one other than the spouse is entitled to the use of the income or capital during his or her lifetime;

(d) there was no election out of the rollover;

(e) in the case of the testamentary trust the property vested in the trust within 36 months.

The scope of these provisions has now been expanded to include joint partner trusts[98].

As with an alter ego trust a joint partner trust must be an *inter vivos* trust created after 1999 by an individual who has attained the age of 65 years, under the terms of which the individual or the individual's spouse or common law partner is, in combination with the other, entitled to receive all of the income of the trust, and no person may receive or otherwise obtain the use of any of the income or capital of the trust until the later of the death of the individual and his or her spouse or common law partner[99]. The trust must also be an inter vivos trust created after 1999.

In both the alter ego trust and joint partner trust cases it is contemplated that the trust will have contingent beneficiaries who will receive the income and/or the capital of the trust after the death of the individual or the individual and his/her spouse in the case of the joint spousal trust.

Joint partner trusts are treated virtually identically with alter ego trusts with respect to deemed disposition rules of the Act. Generally speaking, when there is a transfer of legal ownership of property to a trust (other than to a trust where there is a transfer of legal title but not beneficial ownership, or to a qualifying spousal trust) there is a disposition at fair market value. In contrast, a transfer of property from an individual to an alter ego trust or a joint spousal trust will not constitute a taxable event (unless the transferor elects that the disposition takes place at fair market value). These transfers are classified as "qualifying transfers" under subsections 73(1), (1.01), (1.02), and (1.1). However, on the death of the individual (or the individual and his/her spouse in the case of the joint spousal trust) there will be a deemed disposition of the trust property at its then fair market value. In addition, the 21-year rule will not start to run until the death of the individual (or the individual and his/her spouse in the case of the joint partner trust).

These trusts serve as useful in estate planning tools. For example, in the past few years, a major past-time of individuals engaged in will planning is how to avoid or minimize the high cost of the estate administration tax ("EAT") (formerly known as the probate fee) on death. Solutions have ranged from the simple solutions of joint ownership of property and beneficiary designations to more complex arrangements involving dual wills. The alter ego trust and the joint partner trust offer new opportunities to maintain control over the use and enjoyment of one's assets during one's lifetime while avoiding or minimizing the payment of EAT which

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[98] Defined in 248(1) by reference to 104(1)(a)

[99] It should be noted that the definition of spouse will be expanded to include common law partner (both same-sex and opposite sex common law partner) after 2000. See Federal Bill C-23 Royal Asset June 29, 2000, Modernization of Benefits and Obligations Act, S.C. 2000, c. 12.

would otherwise be exigible on death, in respect of the property so transferred. Joint partner trusts in particular, are useful in planning for situations when the younger spouse is significantly younger than the older spouse, thereby allowing for an extended tax deferral through these trusts.

In addition to the financial benefits, there are other benefits to avoiding the probate process such as the ability to maintain confidentiality (the probate process is a matter of public record), the ability to permit funds to be available shortly after the death without the delays occasioned by the probate process, and the ability to permit easier dealing with assets in foreign jurisdictions, to name a few.

Such trusts may also be considered as an alternative to the power of attorney to provide for the management of property in the event of incapacity. This assures greater certainty of management after the death of the incapable, person and ensures a higher degree of accountability from trustees of such trusts as opposed to persons acting under power of attorney. As with the use of a trust as a will substitute, the use of a trust to deal with incapacity will make it easier to deal with assets in foreign jurisdictions to avoid the need for multiple powers of attorney or multiple mental incapacity proceedings.

There are a number of tax issues that need to be addressed in considering the use of such trusts. These include the loss of the executor's year and the loss of charity credits. With respect to the loss of the executor's year, where corporate shares are held by the alter ego trust, if it is desired to permit loss carrybacks arising on the redemption of shares on windup of the corporation, consideration should be given to extending the lifetime of the alter ego trust for a number of years after the death of the settlor. Also note that, pursuant to subsection 40(3.6) of the *Act*, to avoid the denial of the loss the trust cannot be affiliated with the corporation following the redemption. Another significant tax issue is the loss of the graduated rates of tax enjoyed by testamentary trusts. It will be recalled that *inter vivos* trusts are subject to the top marginal rates of tax while testamentary trusts enjoy the graduated rates of tax. If it is desired to retain the access to the graduated rates of tax by using multiple testamentary trusts under a will for children and other issues, the use of an alter ego trust or joint partner trust will not achieve this result.[100]

F. NEW RULES RELATING TO LOSSES, TRUSTS AND AFFILIATED PERSONS

On March 23, 2004, a Notice of Ways and Means Motion to amend the *Income Tax Act* (Canada) (the *Act*) was tabled which proposed additions to the affiliated person rules in section 251.1 of the *Act*. Bill C-33, which contained these amendments, received Royal Assent on May 13, 2005. These new rules affect the tax treatment of losses, not only on transfers of property to or from trusts, but also transfers to and from corporations and transfers to and from partnerships where trusts are involved.

Paragraphs 251.1(1)(g) and (h), in conjunction with the definitions for the terms "beneficiary," "contributor," "majority-interest beneficiary" and "majority-interest group of beneficiaries" to subsection 251.1(3) and the interpretive rules contained in paragraphs 251.1(4)(c) and (d) of the

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[100] This has been confirmed by CRA in a number of technical interpretations December 2000-0005135 Mar 23, 2001; December #2001-0075375 Mar. 23, 2001; and December #2000-0059755 Mar. 23, 2001.

Act, are intended to address perceived problems associated with the application of the stop-loss rules, to trusts. The stop loss rules are intended to defer recognition of losses realized on transfers of property to affiliated persons, or transfers of property to persons who are affiliated with the transferor immediately following the transfers.

Prior to the implementation of the amendments, it was perceived that the operation of the affiliated person and stop loss rules contained in the *Act* sometimes yielded inappropriate and inconsistent results with respect to the realization of losses on dispositions of property to and by trusts. Specifically, prior to the amendments, the affiliated persons provisions contained in section 251.1 of the *Act* did not specifically address when a trust was affiliated with another person, though the provisions addressed affiliation in the context of individuals, corporations and partnerships. In the absence of affiliated person rules for trusts, such as 251.1(1)(g) and (h), subsection 104(1) of the *Act* was relied upon. This subsection, of course, states that a reference to a trust or estate "…shall, unless the context otherwise requires, be read to include a reference to the trustee, executor, liquidator of a succession, heir or other legal representative having ownership or control of the trust property…." The application of subsection 104(1) led to an examination of whether or not a beneficiary and trustee were affiliated. In the case of commercial trust companies, in particular, this was problematic since it could result in the trust companies, "…as sole trustees…being affiliated with every trust they managed."[101] Moreover, the trusts, which such trust companies managed could also all be affiliated.

The amendments addressed this issue by focussing on the identities of the beneficiaries rather than the Trustees in determining whether a trust (including an estate) is affiliated with any other persons. First, paragraphs 251.1(1)(g) and (h) were added to the definition of "affiliated persons." Paragraph 251.1(1)(g) states that a person and a trust are affiliated if the person is a majority-interest beneficiary of the trust, or is affiliated with a majority-interest beneficiary of the trust otherwise than by reason of the paragraph.

As an adjunct to these rules, the new definitions of "beneficiaries", "contributor", majority interest beneficiary" and "majority interest group beneficiaries" must also be considered. Majority interest beneficiaries is defined to mean a person who has a greater than 50% beneficial interest in the income or capital of a trust above or in conjunction with one or more affiliated beneficiaries.

The Technical Notes to the amendments state some of the effects of paragraph 251.1(1)(g):

(a) A sole beneficiary of a trust is, by virtue of being a majority beneficiary of the trust, affiliated with the trust.

(b) Two trusts are affiliated where a corporation that is a majority-interest beneficiary of one trust is controlled by the other trust or, where both the contributors and the beneficiaries of both trusts are affiliated.

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[101] For a comprehensive review of the new rules, see Professor Catherine Brown, "Trusts, Losses and Affiliated Persons: The 2004 Legislation: What The Prudent Trust or Estate Practitioner Should Know," (Estates and Trusts Forum, November, 2004) at LSUC

(c) Two trusts are not affiliated under paragraph 251.1(1)(g) simply because they share a majority-interest beneficiary.

Meanwhile, paragraph 251.1(1)(h) states that two trusts are affiliated if a contributor to one of the trusts is affiliated with a contributor to the other trust and:

(a) a majority-interest beneficiary of one of the trusts is affiliated with a majority-interest beneficiary of the other trust,

(b) a majority-interest beneficiary of one of the trusts is affiliated with each member of a majority-interest group of beneficiaries of the other trust, or

(c) each member of a majority-interest group of beneficiaries of each of the trusts is affiliated with at least one member of a majority-interest group of beneficiaries of the other trust.

With respect to the previous practice of looking to the trustee regarding the affiliated persons analysis, paragraph 251.1(4)(c) overrides subsection 104(1), providing that, for the purposes of the affiliated persons rules, a reference to a trust does not include a reference to the trustee or other persons who own or control the trust property.

Moreover, paragraph 251.1(4)(d) provides four interpretive rules for the purposes of determining whether or not a person is affiliated with a trust.

(a) Subparagraph 251.1(4)(d)(i) provides a rule, the effect of which is to maximize, for the purposes of determining whether a person is affiliated with a trust, the amount of income or capital of the trust which the person can receive as a result of a discretionary power contained in the trust. If the amount of income or capital, which a beneficiary can receive depends on the exercise or non-exercise of a discretionary power, subparagraph 251.1(4)(d)(i) deems the power to have been exercised or not exercised as the case may be. It has been noted that this rule may be problematic in circumstances in which a trust is fully discretionary with respect to income or capital because the trust's beneficiaries will be deemed to be majority-interest beneficiaries of the trust.

(b) Subparagraph 251.1(4)(d)(ii) permits a beneficiary to transfer funds or property to a trust for fair market value consideration without being considered in all cases a contributor to the trust. Thus, for the purposes of determining whether a person who is a beneficiary of a trust is affiliated with the trust, the person will not be considered to be non-arms' length to the trust simply because the person is a beneficiary of the trust.

(c) Subparagraph 251.1(4)(d)(iii) provides that a trust is not considered to be a majority-interest beneficiary of another trust unless the first trust has an interest as a beneficiary in the income or capital of the second trust. Thus, if a trust has no income or capital interest in another trust it may not be a majority-interest beneficiary of the other trust even in circumstances in which the first trust is

affiliated with one or more persons who together have majority interests in the income or capital of the second trust.

(d) Finally, for the purposes of determining whether a contributor to one trust is affiliated with a contributor to another trust, subparagraph 251.1(4)(d)(iv) expands the categories of individuals considered to be affiliated with each other. Under the subparagraph, individuals connected by blood relationship, common-law partnership or adoption will be considered to be affiliated for the purposes of the affiliated persons rules.

Again, the Technical Notes to the amendments point out the effects of paragraph 251.1(4)(c) (d):

(a) A person is not affiliated with a trust simply because that person is affiliated with the trustee of the trust.

(b) The spouse of the sole beneficiary of a trust is affiliated with the trust even if the spouse is not affiliated with the trustee of the trust.

CONCLUSION

As will be clear from the foregoing discussion the area of taxation of trusts their beneficiaries is becoming increasingly complex and codified. While some of the recent changes are welcome in that they clarify many administrative positions and create new opportunities through the introduction of new types of trusts, there is also an element of confusion and uncertainty, which has been introduced. Only time will tell to what extent these new developments create planning opportunities or unforeseen tax traps.