

Tax Law for Lawyers

Estate Planning and The Taxation of Trusts

The Canadian Bar Association
The Continuing Legal Education Committee and
The National Taxation Law Section
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Introduction: Legal Principles & Tax Concepts

The Trust

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

Trusts v Other Relationships

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

The Three Certainties - Antle

Summary

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

The Three Certainties - Antle

Additional Facts

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

The Three Certainties - Antle

MNR Arguments

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

The Three Certainties - Antle

Trust Settlement (Additional Facts)

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

The Three Certainties - Antle

Validity of Trust: Certainty of Intention

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

The Three Certainties - Antle

Validity of Trust: Certainty of Subject Matter

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

The Three Certainties - Antle

Validity of Trust: No Actual Transfer

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

Uses of Trusts

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

Uses of Trusts (cont'd)

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

Types of Trusts

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

Residence of a Trust

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

Residence of a Trust - Garron

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

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

Residence of a Trust - Garron

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

Residence of a Trust - Garron

- 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

Residence of a Trust - Garron

Arguments

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

Residence of a Trust - Garron

Decision

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

Residence of a Trust - Garron

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

Residence of a Trust - Garron

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

Residence of a Trust - Garron

- Decision 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

Residence of a Trust - Caveat

- Caveat
 - Change of Trustees → Change of Residence

Inter Vivos Estate Freeze

Sheila

10,000

Common
shares

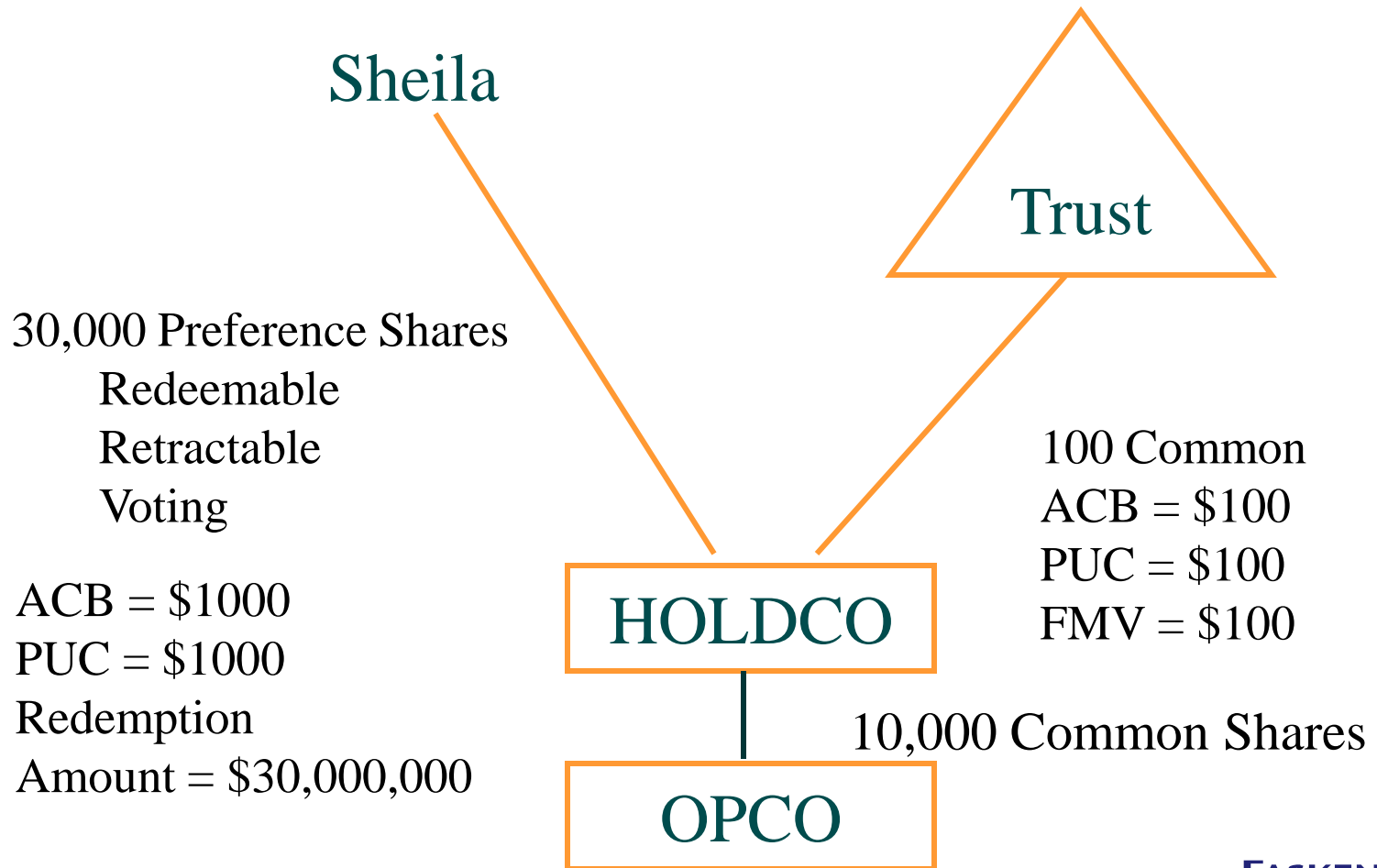
ACB = \$1000

PUC = \$1000

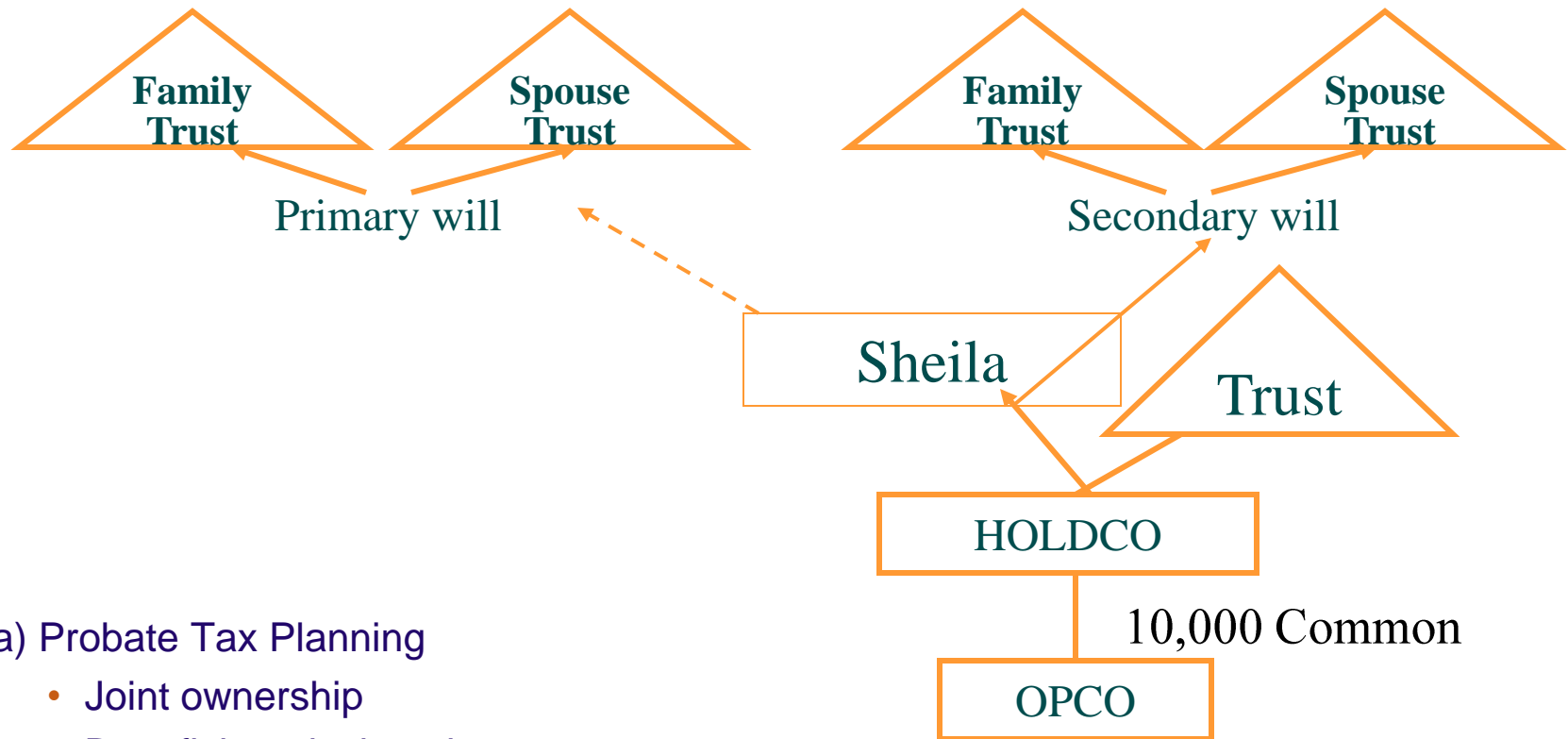
FMV = \$30,000,000

OPCO

Inter Vivos Estate Freeze



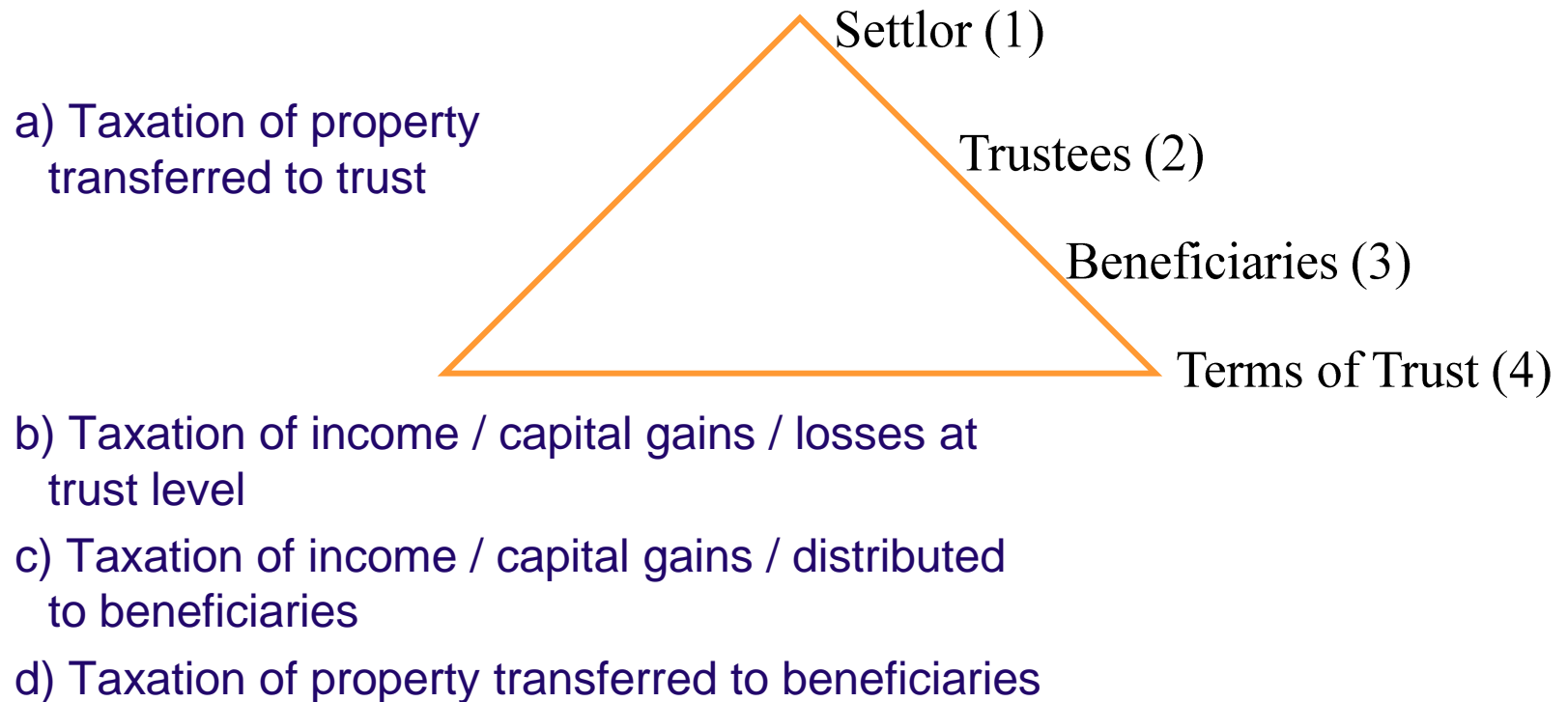
Testamentary Estate Planning





a) Probate Tax Planning

- Joint ownership
- Beneficiary designations
- Multiple wills
- Alter ego trust / Joint spouse or common law partner trust

Taxation of Trusts



Components of a Trust

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

Components of a Trust

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

Components of a Trust

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

Components of a Trust

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

Taxation of Trusts, Beneficiaries

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

Taxation of Trusts, Beneficiaries

- Trust – Taxable entity
 - Inter vivos
 - Testamentary
 - Amounts paid/payable to beneficiaries
- A trust is also a conduit (limited)
 - Interest
 - Capital gains
 - Dividends

Taxation of Trust, Beneficiaries

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

Attribution Rules

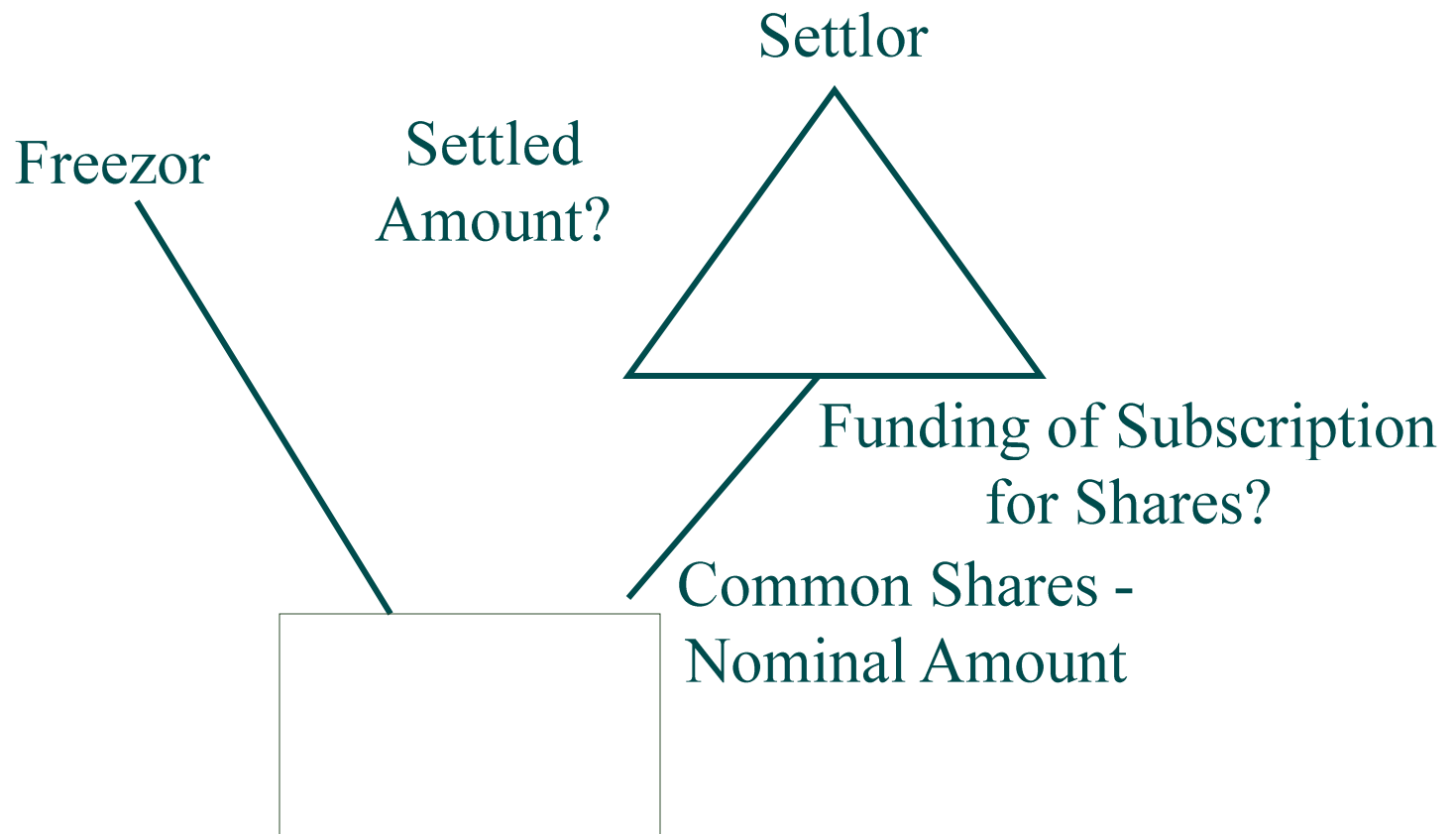
- Personal attribution rules
- Corporate attribution rule
- 75(2)
- 56(4.1)

Personal Attribution Rules

- Transfer/
Loan of property
 - Spouse → Attribution of income & capital gains
 - Non-arm's length minor → Income & capital gains
 - Minor niece, nephew of transferor / Lender → Income (but not capital gains)
- 74.5(7) guarantee
- 56(4.1) attribution
 - Loan to trust
 - Beneficiary 18 or older
 - Purpose test

Exceptions to Personal Attribution Rules

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



Controlled Trusts and Attribution (75(2))

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

Controlled Trusts and Attribution (75(2))

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

Controlled Trusts and Attribution (75(2))

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

Consequences of Application of Subsection 75(2)

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

Corporate Attribution Test

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

Corporate Attribution Test

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

Corporate Attribution Test

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

Corporate Attribution Test

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

Corporate Attribution Test

- If 74.4(2) applies, transferor deemed to have received income inclusion
 - Income attributed equals prescribed percentage of “outstanding amount” of property transferred whether or not income earned by designated persons
 - In case of transfer of property - outstanding amount equals fair market value of property at time of transfer less fair market value of consideration received other than excluded consideration (debt, shares, right to receive debt or shares)
 - actual income received will reduce amount of deemed income

Exceptions to S. 74.4(2)

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

Terms of Trust

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

Other Considerations

- 21 year rule
 - flexibility to make capital distributions
 - if no such flexibility – variation of trust
- Income splitting “kiddy” tax

Kiddy Tax

- Response to Neuman, Ferrell
- Special tax at top marginal rates on certain income of persons under 18 applicable after 1999
- Will apply to
 - a) Canadian resident minor children with at least one parent alive in Canada
 - b) Taxable dividends and other shareholder benefits in respect of unlisted shares of Canadian and foreign companies received directly or indirectly through a trust or partnership
 - c) Income from partnership or trust where income derived by partnership or trust from business of providing goods / services to or in support of business carried on by related person

Kiddy Tax

- No deduction or credits other than dividend tax credit and foreign tax credit
- Added as a separate component of Part I tax
- Attribution rules will not apply
- Parents jointly liable for the tax if parent active in the business or passive shareholders

Exceptions to Kiddy Tax

- Does not Apply:
 - to spouse, adult children
 - Income from publicly traded shares
 - Income from property if property inherited from parent (but not other relatives)
 - If minor in full time attendance at a post-secondary educational institution or handicapped
 - If minor has no parent resident in Canada in the year

When is Income of Trust Deductible?

- Paid
- Payable
- PBE
- Payments in respect of property for use of a beneficiary or life tenant

PBE and Relationship to Settlor

- Defined in 108(1)
- Deceased / Person who created trust
- May lose settlor if someone else contributes property of greater value
- Limited application
 - Settlor, spouse or former spouse of settlor
 - Child, grandchild, great grandchild of settlor or spouse (but not former spouse) of same
 - Mental or physical impairment

Payable

- Entitled to enforce payment
 - By terms of trust
 - By exercise of discretion
- Payments to third parties

Other Types of Trusts

- Bare Trust
- Alter Ego Trust
- Joint Spousal or Common Law Partner Trust
- Self Benefit Trust
- Qualifying Disposition Trust

Bare Trust

- Arrangements under which the trust can reasonably be considered to act as agent
 - trustee has no significant powers
 - only function is to hold bare legal title
 - settler is sole beneficiary and can cause property to revert to him/her

Alter Ego Trust / Joint Spousal or Common Law Partner Trust

Alter Ego Trust

- I.V. trust
- Individual at least 65
- Trust created after 1999
- Individual entitled to all income
- No person other than individual entitled to or to use of income or capital
- Rollover (if don't elect out)

Subsection 73(1.01) “Self Benefit” Trusts

- IV trust created after 1999
- Individual must be entitled to receive all of the income of the trust and no person except the individual can receive or otherwise obtain the use of any of the income or capital of the trust; and
- No person (other than the individual) or partnership has any absolute or contingent right as a beneficiary under the trust (determined with reference to subsection 104(1.1)).

Subsection 107.4(1) “Q.D.” Trusts

- Subsection 107.4(1) introduces the concept of a rollover on a qualifying disposition. In the context of a trust for an individual, these new rollover provisions will apply on a transfer of property to a trust if the following conditions are met:
 - there is a change in legal title but no change in beneficial ownership;
 - the disposition is not by a person resident in Canada to a non-resident trust;

Subsection 107.4(1) “Q.D.” Trusts (Cont’d)

- Conditions (Cont’d)
 - immediately after the transfer no person other than the contributor holds an absolute or contingent interest of any kind in the trust (determined without reference to subsection 104(1.1)).
 - the proceeds of the transfer are not determined under any other provision of the Act.
- No rollover if transfer part of series of transactions that includes disposition of interest in personal trust or subsequent acquisition of interest in trust for consideration.

STOP-LOSS RULES, TRUSTS, AFFILIATED PERSONS

- Relevance of stop-loss rules
- Who is affiliated
 - individual
 - corporation
 - partnerships
- Trusts – no specific mention
 - generally look to identity of trustees

NEW RULES

- Ignore trustees
 - look to beneficiaries
 - trust affiliated with majority interest beneficiary
 - two trusts affiliated if both contributors and beneficiaries of the two trusts are affiliated
- Majority interest beneficiary
 - person who has more than 50% interest in income or capital of trust alone or in conjunction with one or more affiliated beneficiaries

RELEVANCE

- Transfers by individuals to trusts
- Transactions with trusts
 - to and from corporation
 - to and from partnerships
 - inter-trust transfers



Thank You

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