CCH
a Wolters Kluwer business

Tax Notes

January 2010
Number 564

The Trouble with Trusts

In recent months, there has been a flurry of developments focusing on the proper "execution" of tax planning arrangements involving trusts.

Of course, at ground zero are the *Garron*[1] and *Antle*[2] cases. In case you've been out of the country, *Garron* involved the imposition of the central management and control test to trust residency. *Antle* involved an attack on technicalities of the establishment of a trust, including defective settlement and lack of intention to create a trust. While both cases involved aggressive tax structures and offshore trusts, many practitioners probably experienced some private angst over whether this sort of trust-busting approach might "spread inland", putting more conventional structures at risk. Actually, the aforementioned angst precedes these cases. Readers will remember the CRA questionnaire sent to prominent Alberta trustees last March, questioning the residence of Alberta trusts based on a central management and control concept – that turned out to be downright propitious.[3]

A few weeks after the *Garron* and *Antle* cases were released, a Toronto law firm issued a "news flash" about CRA audits of domestic trusts in a number of suburban and outlying tax offices in the Golden Horseshoe area. The warning, which is repeated in the December issue of *Canadian Tax Highlights*,[4] pertains to possible CRA review of distributions paid with promissory notes that may be unenforceable under limitation rules, diversion of cash for the trustees' own use,[5] the absence of proper accounting records or trustees' minutes, inability to locate the original settlement property,[6] as well as the monitoring of compliance with the 21-year rule.[7]

Inside

Royal Assent of Bill C-51 4

Release of Draft Legislation and Regulations Regarding Foreign Affiliates 4

Mandatory Internet Filing for Business 5

Prescribed Interest Rates – First Quarter of 2010 5

Tax-Free Savings Account – Applicability of Attribution Rules 6

By the way, while many readers may think that tax cases attacking trusts are new developments, old timers (like me) will remember a number of cases in the 70s involving attacks on the validity of trust formation, including *Leon*,[8] *Atinco Paper Products*,[9] and one of my all time favourites, *Kingsdale Securities*,[10] which involved an ultimately unsuccessful attempt to create a trust at a Bar Mitzvah in Regina. (The most amazing point of the case: they actually have Bar Mitzvahs in Regina!). In the 90s, the proper execution of transactions relating to trusts was called into question in *Langer*[11] and *Romkey*.[12]

Now What?

OK, so what do we do now – i.e., when it comes to the successful execution of conventional income splitting, freeze structures and the like, involving *inter vivos* trusts?

Know the ground rules.[13] For starters, there should be an awareness of the technical ground rules pertaining to *inter vivos* trusts. Dividends from a private corporation allocated to an individual who has not turned 18 in the year will trigger the kiddie tax (although dividends from public corporations will not). Even if the trust has allocated all of the income, filing a T3 return is advisable. If the trust controls a corporation, an appointment of a trustee might trigger the acquisition of control rules, including a deemed year-end, the loss streaming rules, and so on. Consideration should be given to the impact of the association rules, especially for estate freezes. The general rule is that transfers of assets into trusts trigger deferred tax exposure. Distributions of property from a trust require professional assistance; in particular, distributions of trust assets to non-resident beneficiaries may trigger capital gains or other tax exposure, as well as compliance requirements under ITA section 116. The 21st anniversary of the trust should not be forgotten, lest there be a deemed disposition of trust assets at that time (including the year of formation in the name of the trust provides a good reminder). A substantial change in the terms of a trust – made either by a court order to vary the trust or pursuant to an amending provision (if one exists) – may result in the disposition of a beneficiary's interest or, if the change is fundamental, a resettlement of the trust itself (including a deemed disposition of the trust's assets).[14] For further discussion of trusts, including applicable tax rules, see chapters 2 and 3 of *Tax and Family Business Succession Planning*, 3rd edition.[15]

Who's on first? Especially in view of the *Antle* case, it is important that the participants in a trust be aware of the significance of their roles, including the settlor, the person entitled to appoint and/or remove trustees,[16] and most important, the trustees themselves. The trustees should be given at least a basic understanding of the trust (if not a clause-by-clause review) and should be apprised of the significance of their fiduciary duties to beneficiaries. Documentation of the foregoing is helpful.[17]

Allocations and distributions. In many cases, a trust will simply hold growth shares in a freeze structure. If so, the income of the trust will be limited or non-existent; often the growth shares will not even pay dividends. An income-splitting trust, on the other hand, requires annual allocations of income, investment decisions, and so on. In these cases in particular, trustees must be prepared to keep records and do some paperwork. If this is sloughed off, a CRA review could mean trouble. Particularly in view of this possibility, it should be certain that allocations to beneficiaries are paid or payable by December 31st of each year. The best way to do this is to make the distributions in cash – preferably, by a payment from the trust bank account to the beneficiary's bank account prior to the end of the year (there should be a separate bank account for each beneficiary). Allocations not paid in cash should be evidenced by promissory notes (dated no later than year-end). In Ontario at least, under current rules, the limitation period on a demand note will not begin to run until demand is made; nevertheless, it is probably prudent to repay the notes fairly promptly.

One of the most dangerous practices in an income-splitting trust could be where taxable allocations/distributions are made to children as beneficiaries and the parents simply scoop the proceeds for their own use. In many cases, the parents get into a habit of doing this, perhaps intending to replenish the child's bank account sometime in the future. This is a bad habit which could end up being fatal to the tax plan. Distributions to beneficiaries should be for their use. If they are not invested on behalf of

TAX NOTES

Published monthly by CCH Canadian Limited. For subscription information, see your CCH Account Manager or call 1-800-268-4522 or (416) 224-2248 (Toronto).

For CCH Canadian Limited

ROBERT SPENCELEY, Editor
(416) 224-2224, ext. 6279
e-mail: Robert.Spenceley@wolterskluwer.com

ROBIN MACKIE, Director of Editorial
Tax, Accounting and Financial Planning
(416) 228-6135
e-mail: Robin.Mackie@wolterskluwer.com

TR ISLAM, Marketing Manager
(416) 228-6166
e-mail: TR Islam@wolterskluwer.com

PUBLICATIONS MAIL AGREEMENT NO. 40064546
RETURN UNDELIVERABLE CANADIAN ADDRESSES TO
CIRCULATION DEPT.
330–123 MAIN ST
TORONTO ON M5W 1A1
email circdept@publisher.com

© 2010, CCH Canadian Limited
90 Sheppard Ave. East, Suite 300
Toronto, Ontario M2N 6X1

the beneficiary, then it is advisable to ensure that distributions are spent for items benefiting the particular child.[18]

Trustees' procedures. If at all possible, the trustees should meet at least annually and prepare minutes or at least notes of their meetings.[19] If income is to be distributed, resolutions making irrevocable allocations to the beneficiaries should be prepared and equivalent funds should be distributed to the beneficiaries to be used for their exclusive benefit.[20]

Because of the possibility of the reversionary trust rules applying, payments made by beneficiaries on behalf of the trust, e.g., for professional fees, etc., are best avoided; otherwise, they should be accounted for as a loan to the trust rather than a capital contribution (and documented as such if at all possible). Better still, such expenditures should be funded by dividends or other income received by the trust.

Now we get to the 64 dollar question. What if the only asset of the trust is non- or limited-voting common shares which do not pay dividends? The rights of the trustees to information may be limited, and the intent of the settlor may well be for the trust to simply hold on to the shares until its 21st anniversary.[21]

What should the trustees do? The representative of a leading trust company has informally suggested that the trustees would nonetheless have an obligation to turn their minds to this kind of investment on a regular basis.[22] It was also suggested that the trustees could review financial statements [even though they often provide limited information] and the portions of corporate books and records that are available under corporate law.[23] Generally, questions might be asked as to concerns of the settlor and primary beneficiaries.

Certainly, doing this sort of thing and keeping minutes to evidence this can't hurt; whether the CRA will ever press the matter in a "passive freeze structure" remains to be seen. Hopefully, it would not use lack of paperwork as an excuse to disrupt a garden-variety freeze, especially if the activities of the trustees would have amounted to an exercise in navel gazing.

One possibility is to prepare "standardized minutes". But there could be great danger here if it can be established that the minutes were false: Mr. Louis did not meet in Toronto on December 26th – he was at a Bar Mitzvah in Regina.

Don't Forget about Estates!

Although the focus of both the tax cases and other developments has been on *inter vivos* trusts, there are also restrictions on dealings with a testamentary trust. Testamentary trust status will be disallowed if property has been contributed to the trust otherwise than by an individual on or after the individual's death, and as a consequence thereof. There has been a long stream of CRA pronouncements as to which transactions are kosher. For example, where a trust has elected to pay tax on an amount payable to a beneficiary,[24] the payment to or on behalf of a testamentary trust by a beneficiary in respect of the trust's tax liability will not result in a loss of testamentary trust status.[25] The CRA has also indicated that where a beneficiary uses property owned by a testamentary trust and pays operating expenses as a condition of using the property, the payment of such expenses may be viewed as the equivalent of rent rather than a contribution to the trust which would cause it to lose its testamentary status. However, capital expenditures made on behalf of the trust would undermine testamentary status,[26] as would a reimbursement of medical expenses paid by a testamentary trust.[27] In general, therefore, caution should be exercised when making payments to or on behalf of a testamentary trust.

Loss of testamentary trust status will mean that the trust will lose the benefit of graduated income tax rates. In addition, the tainting of a testamentary trust triggers a year-end. This may well result in the missing of tax filing and other deadlines; this appears to include transactions that would trigger a subsection 164(6) "carry back", since this must arise in the first taxation year of an estate. For further discussion, see ¶814 of *Tax and Family Business Succession Planning*.[28]

– David Louis, J.D., C.A., Minden Gross, Toronto, a member of MERITAS law firms worldwide. Thanks to Bill Cooper of Boughton, Vancouver and Ray Hupfer of McLennan Ross, Edmonton, also members of MERITAS.

Notes:

[1] *Garron et al v. The Queen*, 2009 DTC 1287 (TCC).

[2] *Antle v. The Queen*, 2009 DTC 1305 (TCC).

[3] Not long afterward, an article on discretionary trusts caught my eye: "Discretionary family trust – A user's guide", Frank Baldry, in *Wealth and Tax Matters*, Spring 2009, PricewaterhouseCoopers. Among other things, it contained a warning in respect of the possible application of the so-called "reversionary trust rules" to everyday transactions with a trust by beneficiaries and others. Examples cited include the deposit of funds to clear an overdraft or the payment of trust expenses (other than if funded by a documented loan with normal commercial terms), as well as the purchase and sale of trust assets by beneficiaries or trustees, even if at fair market value. The article goes on to discuss a number of other points pertaining to the ongoing "care and maintenance" of trusts (some of which will be discussed later in this article).

[4] "CRA Audits Domestic Trusts", Jack Bernstein, Vol. 17, No. 12.

[5] The release indicates that in such cases, the CRA may challenge the trust's deduction for the distribution or it may assess a benefit to the parents.

[6] We affix $5 bills to trusts as evidence of settlement, so that they don't get lost. Recently I received a copy of a trust from a large law firm, with a $50 bill affixed. I guess that's the difference between a large firm and a medium-size firm.

[7] A similar warning was issued in Deloitte's "Weekly Tax Highlights", December 9, 2009 and at least one other firm publication.

[8] *Ablan Leon v. M.N.R.*, 76 DTC 6280 (FCA).

[9] *Atinco Paper Products Limited v. The Queen*, 78 DTC 6387 (FCA).

[10] *Kingsdale Securities Co. Limited v. M.N.R.*, 74 DTC 6674 (FCA).

[11] *The Howard Langer Family Trust v. M.N.R.*, 92 DTC 1055 (TCC).

[12] *Barry Romkey and Brian Romkey v. The Queen*, 2000 DTC 6047 (FCA).

[13] This article does not deal with Quebec civil law.

[14] For further discussion, see (for example) "Enigma Variations", Sian Matthews (*Estates, Trusts & Pensions Journal*, Vol. 28, 2009, p. 355). Changing beneficiaries may be particularly problematic.

[15] David Louis, Samantha Prasad and Michael Goldberg (2009, CCH Canadian Limited).

[16] A.k.a. the "Protector".

[17] In addition, it has been suggested that one of the first fiduciary duties involves making the beneficiaries aware of their status as such.

[18] See *Income Tax Technical News* No. 11, September 30, 1997. The CRA's position is that a taxable benefit under subsection 105(1) will not arise to the parent as a consequence of the trust paying (in accordance with the terms of the trust indenture or will) expenditures for the support, maintenance, care, education, enjoyment and advancement of the child, including the child's necessaries of life, including those that the parent would otherwise have been legally obligated to incur for the support, maintenance, etc., of the child pursuant to applicable provincial and/or federal statutes. For further discussion (including payments to third parties), see "Tax Planning with Trusts – Current Issues", Elena Hoffstein, 2007 OC p.13A:30. My personal view is that it is better to make third-party expenditures from a bank account for the beneficiary rather than directly from the trust's bank account. Obviously, the particular expenditure should be evidenced.

[19] There should be documentation of investment decisions, or supervision and review of agents appointed for this role, where applicable.

[20] Per the Baldry article, mentioned earlier.

[21] This may be underscored by an anti-diversification clause and/or letter of wishes.

[22] Perhaps annually in this type of case, unless they become aware of circumstances that merit more frequent attention.

[23] Access to corporate books and records are provided for under sections 145 and 146 of the OBCA. A shareholder may examine and make extracts of: the Articles and by-laws of the corporation; any unanimous shareholders' agreements; minutes and meetings of shareholders; the directors' register; the securities register showing shareholders, debt holders and warrant holders. Pursuant to section 154 of the OBCA, directors must provide shareholders at least once a year at the annual general meeting with information on the financial position of the corporation, such information as is required by the charter and by-laws, as well as financial statements of the particular corporation. Shareholders' rights in regard to a subsidiary are greatly reduced. (Note: The foregoing is based on a recent STEP presentation by Arlene O'Neill.)

[24] I.e., pursuant to subsections 104(13.1) and (13.2).

[25] See Interpretation Bulletin IT-381R3, paragraph 19. See also Doc. No. 2003-0046171E5, December 1, 2004.

[26] Doc. No. 2002-0154435, April 17, 2003.

[27] Doc. No. 5-972549, October 30, 1997.

[28] In addition to tainting testamentary trust status, such transactions might trigger the application of the reversionary trust rules.

Royal Assent of Bill C-51

The House of Commons has adjourned until January 25, 2010 and the Senate has adjourned until January 26, 2010.

On December 15, 2009, Bill C-51, *Economic Recovery Act (stimulus)*, received Royal Assent and is now law as S.C. 2009, c. 31. This Bill (CCH SPECIAL REPORT No. 045H, dated September 14, 2009) contains certain measures proposed in the 2009 federal Budget including the Home Renovation Tax Credit, the First-Time Home Buyers' Tax Credit, and enhancements to the Working Income Tax Benefit, which had not been included in the first Budget Bill (Bill C-10, S.C. 2009, c. 2 (Royal Assent March 12, 2009)). As well, it includes the proposals to extend the tax deferral on the disposal of breeding livestock in designated drought regions to also apply in designated areas of flooding or excessive moisture. According the Department of Finance News Release No. 2009-116, dated December 16, 2009, which announced the Royal Assent, Bill C-51 in addition, "enhances Canada Pension Plan (CPP) benefits by removing the work cessation test starting 2012, enhancing the general drop-out provision, extending participation to working beneficiaries and improving fairness in the pension adjustments for early and late CPP take-up". Also on December 15, 2009, Bill C-56, the *Fairness for the Self-Employed Act*, which amends the *Employment Insurance Act* and Bill C-62, the *Provincial Choice Tax Framework Act*, which amends the *Excise Tax Act* with respect to HST for Ontario and British Columbia received Royal Assent.

Release of Draft Legislation and Regulations Regarding Foreign Affiliates

On December 18, 2009, the Department of Finance released draft legislation and regulations regarding foreign affiliates, including draft regulations relating to the foreign affiliate amendments to the *Income Tax Act* (such as the elections) that were contained in Bill C-28 (S.C. 2007, c. 35). News Release No. 2009-120, dated December 18, 2009, announcing this package of draft amendments is reproduced below. Subscribers to the CANADA INCOME TAX GUIDE print, DVD and online will receive CCH Special Report No. 047H containing the draft legislation, regulations and explanatory notes. Additional copies of the Special Report may be ordered by calling the CCH Customer Satisfaction Hotline at (416) 224-2248. Outside the Greater Toronto Area, call toll-free at 1-800-268-4522.

> The Honourable Jim Flaherty, Minister of Finance, today released for consultation a package of draft Income Tax Regulations, as well as other draft legislation, relating to the taxation of Canadian multinational corporations with foreign affiliates. Among other things, the package includes the Income Tax Regulations that are consequential to the Budget 2007 foreign affiliate changes to the *Income Tax Act*.
>
> "Our government is committed to enhancing the fairness and competitiveness of Canada's international tax rules," said Minister Flaherty. "The proposals I am announcing today will improve the tax system and assist Canadian businesses in complying with the tax law."

Bill C-28, the second Budget 2007 implementation bill, provided substantial tax relief for Canadian businesses, including the historic corporate income tax rate reductions announced in the 2007 Economic Statement. In addition, the bill, which received Royal Assent on December 14, 2007, implemented a number of amendments to the *Income Tax Act* relating to foreign affiliates.

Included in Bill C-28 were provisions allowing taxpayers to elect retroactive application of some of its foreign affiliate amendments. In response to concerns that the deadline for filing those elections was too early, the Government announced in June 2008 an 18-month extension of that deadline – the new deadline for a corporation having a taxation year coinciding with the calendar year is December 31, 2009. The package being released today contains all of the proposed changes to the Income Tax Regulations that are relevant in determining whether or not to make any of the retroactive elections provided for in Bill C-28. Furthermore, all seven of these retroactive elections are being made revocable. Thus, for example, calendar year corporations will have until June 30, 2011 to decide whether or not to cancel any such election.

The attached Annex outlines all of the measures being proposed in this package. Explanatory notes providing additional details are also being released.

References to "announcement date" in the draft legislation and explanatory notes released today should be read as referring to today's date.

Minister Flaherty indicated that the Government will be accepting comments from stakeholders until February 15, 2010 and will proceed with legislation at an early opportunity to implement the proposed amendments, taking into account any comments received.

Annex

The following provides the highlights of the income tax proposals relating to foreign affiliates that were announced by the Honourable Jim Flaherty, Minister of Finance, on December 18, 2009.

- Minor amendments to the *Income Tax Act* (Act) that are necessary to provide authority to enact certain aspects of the Income Tax Regulations (Regulations) noted below.
- Amendments to 2007 Bill C-28 to:
  - implement the 18-month extension of the foreign affiliate election deadlines, and
  - extend the ability to revoke one of the foreign affiliate elections in Bill C-28 to the other six foreign affiliate elections in that Bill.
- Amendments to the Regulations to:
  - implement consequential changes to the Regulations that flow from the amendments to the foreign affiliate provisions of the Act contained in Bill C-28 and, to a lesser extent, *Budget Implementation Act, 2009*;
  - implement measures first announced in March 2001 relating to
    - foreign accrual property losses, and
    - partnerships;
  - implement measures first announced in December 2002 relating to
    - foreign oil and gas levies,
    - exempt surplus reductions following certain winding-up transactions, and
    - foreign tax consolidation; and
  - implement a rule to replace a component of the outstanding February 2004 foreign affiliate proposals relating to surplus consolidation.

Mandatory Internet Filing for Business

On December 18, 2009, the CRA released a Fact Sheet concerning the mandatory Internet filing requirement for certain corporations with annual gross revenues of more that $1 million. Starting with the 2010 taxation year, such corporations, except for insurance corporations, non-resident corporations, corporations reporting in functional currency, and corporations exempt from tax under section 149 of the *Income Tax Act* must file the T2 corporate tax return through the Internet, using CRA-approved T2 software. Penalties for failing to file through the Internet will not be imposed until 2011 taxation years. Similarly, starting in January 2010, filers of information returns who submit more that 50 information slips, such as T3s, T4s, and T5s are required to file such slips via the Internet. As with corporate tax returns, failure to file via the Internet will not be subject to fines until 2011.

Prescribed Interest Rates – First Quarter of 2010

The prescribed interest rates for the first quarter of 2010 are unchanged from the fourth quarter of 2009 and are noted below:

- 1% to calculate a deemed interest taxable benefit on subsidized employee and shareholder loans;
- 3% on refunds of income tax overpayments; and
- 5% on payments of overdue income taxes, insufficient income tax instalments, unremitted employee source deductions, CPP contributions or EI premiums, and unpaid penalties.

These rates will be in effect from January 1, 2010 to March 31, 2010.

A listing of the prescribed interest rates for each quarter, dating back to 1994, is reproduced in Volume 1 at ¶12,745, and under "Quick Links" in the CANADA INCOME TAX GUIDE on DVD and online.

Tax-Free Savings Account – Applicability of Attribution Rules

The issue reviewed by the CRA involved two Canadian residents, A and B, who had reached the age of majority and were married to each other. B would enter into a "qualifying arrangement" within the meaning of this expression in subsection 146.2(1) of the Act, which would also be a "tax-free savings account (TFSA)" under subsection 146.2(5). This arrangement would be an arrangement in trust, as described in subparagraph (*b*)(i) of the definition of "qualifying arrangement" under subsection 146.2(1) of the Act. B would be the "holder" of the arrangement within the meaning of this expression in subsection 146.2(1) of the Act. During 2009, A would make the sole $5,000 contribution to B's TFSA. The $5,000 would be used to purchase a "qualified investment" within the meaning of this term in subsection 207.01(1) of the Act. Under the first scenario, at some point in 2011, B would withdraw all the funds worth $10,000 contained in the TFSA and use them to buy a property producing investment income. Under the second scenario, B would withdraw, at some point in 2011, $5,000 (i.e., half of all the funds of $10,000 included in the TFSA) and use the $5,000 to buy a property producing investment income. The CRA was asked the following questions: (1) Would section 74.1 of the Act apply to the investment income earned by B from the property acquired under the first scenario? (2) If the answer is yes, would the attribution rule apply to all the investment income or only to the 50 per cent portion of the income attributable to the $5,000 original TFSA contribution? (3) Would section 74.1 of the Act be applicable to the investment income earned by B from the property acquired under the second scenario? (4) If the answer is yes, what proportion of the investment income would be subject to the application of the attribution rule?

The CRA confirmed that the above arrangement would not qualify as a TFSA because it would allow the contribution by a person other than the holder (i.e., A) to B's TFSA in contravention of paragraph 146.2(2)(*c*) of the Act. Because the arrangement would cease to be administered in accordance with subsection 146.2(2) of the Act, it would cease to be a TFSA by virtue of paragraph 146.2(5)(*c*). Although there is an exception to the applicability of the attribution rule in respect of TFSA accounts used by spouses and common-law partners, the CRA indicated clearly that this exception would not be applicable in the above scenarios. The attribution rule under subsection 74.1(1) could therefore apply in the above situations, but the CRA did not have enough information to determine in respect of what amounts the rule would be applicable.

Document No. 2009-0309861E5, October 23, 2009

Notice: *Readers are urged to consult their professional advisors prior to acting on the basis of material in this newsletter.*

CCH™ a Wolters Kluwer business

CCH Canadian Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
416 224 2248 • 1 800 268 4522 tel
416 224 2243 • 1 800 461 4131 fax
www.cch.ca