EFFECTIVE USES OF TRUSTS

FOR BUSINESS OWNERS FOR TAX PLANNING PURPOSES

EFFECTIVE USES OF TRUSTS FOR BUSINESS OWNERS FOR TAX PLANNING PURPOSES

I. INTRODUCTION

This paper reviews the reasons behind, technical requirements of, and strategies for using trusts in the context of estate planning or implementing an "estate freeze" transaction. The tax impediments to transferring property to trusts, joint spousal and common-law partner trusts (hereinafter referred to as "joint spousal trusts") and *alter ego* trusts, as well as the various tax issues that arise when using these trusts for estate planning purposes, are discussed below. This paper also discusses the rationale behind undertaking an "estate freeze" transaction, the situations in which such a transaction would be appropriate, and the tax consequences to effecting an estate freeze.

This paper does not intend to provide an exhaustive summary of all matters relating to the use of trusts in the context of estate planning or implementing an estate freeze. Many excellent articles have previously done so.[1] Rather, the goal of this paper is to provide practitioners with guidance on how to use trusts effectively in two situations that frequently arise.[2]

This paper is structured in three general sections. The first covers general estate planning issues with trusts, looking in greater detail at trusts that are used as will substitutes, such as joint spousal and alter ego trusts. The second examines the concept of the estate freeze, and the third the structuring considerations of an inter vivos trust used for income splitting and capital gains tax deferral as part of an estate freeze.

II. USE OF TRUSTS IN ESTATE PLANNING

There are numerous non-tax reasons why trusts are used in estate planning. Some of those reasons include:

---

1 For example, see David Christian, *Estate Freezes: Basic and Advanced Strategies*, Pacific Law and Business Institute, February 28, 2007.

2 All statutory references herein are to the *Income Tax Act* (Canada) (the "Act"), unless otherwise specified.

Non-Tax Reasons for Using a Trust

- Asset Management
- Isolating Share Ownership
- Asset Protection
- Providing for the Disabled
- Avoiding Compulsory Succession Schemes
- Avoiding Probate Fees
- Avoiding Probate

A. ASSET MANAGEMENT

Perhaps the greatest advantage of using discretionary trusts in estate planning is the ability to delegate decisions to the trustees rather than making important decisions once and for all. Using a trust permits the trustees to make decisions over time as events unfold and circumstances change. Children may be incapable, legally and otherwise, of dealing with assets. See *Edell v. Sitzer*, (2001) 55 OR (3d) 198 (OSCJ) as an example of using discretionary trusts to effectively control a family corporation and in particular to cut out a problem child.

B. ISOLATING SHARE OWNERSHIP

The three primary grounds of complaint available to a shareholder are:

- the affairs of the company are being conducted in a manner that is oppressive to the shareholder;
- there has been an act that is unfairly prejudicial to the shareholder; and
- it would be just and equitable to wind up the company.

Certain shareholder rights are status rights that simply depend on ownership of shares; how a shareholder acquired a share is not relevant to exercising these rights: see John J. Chapman, *"Sharper than a Serpent's Tooth: Estate Freezes Thirty Years*

Later", (1996) 16 E. & T. J. 47. Therefore, holding shares through a trust may be preferable to issuing shares directly to family members.

C. ASSET PROTECTION

Subject to concerns about fraudulent conveyances, property might be transferred to a trust as a means of creditor proofing. It is often difficult to attack a debtor's interest in a discretionary trust because the value of that interest depends upon decisions made by the trustees. The trust may even provide that an individual ceases to be a beneficiary if the individual becomes insolvent or the trust may be created in a jurisdiction with asset protection trust legislation which precludes the trust from being sued or challenged.

In the family law context, the efficacy of a trust as an effective asset protection mechanism is much less certain: see for example *Francis v. Francis*, 53 BCLR (3d) 50 (BCSC). Specifically note 84(1), 84(2)(f), 85(f), and 93 of the *Family Law Act* (British Columbia).

The *Family Law Act* has brought great change to the division of property on the breakdown of a marriage or a common-law partnership. In addition to extending the rules relating to the division of property to common-law relationships, the new act introduces an excluded property regime which reduces the uncertainty with respect to what assets are subject to division.

D. PROVIDING FOR THE DISABLED

Trusts are often used to provide for the disabled. Trusts can be set up in a manner that will not disentitle a disabled beneficiary from receiving provincial disability benefits: www.mhr.gov.bc.ca./PUBLICAT/db/Trusts.htm.

In the decision of *Crowe v. Bollong*, 1998 CanLII 5607 (B.C.S.C.) a British Columbia notary public was found to be professionally negligent due to the preparation of a testamentary trust for a disabled beneficiary which resulted in the disabled beneficiary needlessly losing persons with disability assistance under the

under the *Employment and Assistance for Persons with Disabilities Act*. The standard of care that the notary public breached was that of a reasonably prudent notary public.

E. AVOIDING COMPULSORY SUCCESSION SCHEMES

The *Wills Variation Act* (British Columbia) gives disgruntled children, spouses and common-law partners standing to challenge a will on the basis that adequate provision has not been made for their maintenance and support. The Supreme Court of Canada decision in *Tataryn* v. *Tataryn Estate*, (1994), 93 B.C.L.R. (2nd) 145, is authority for the proposition that "adequate provision" is not a narrow test concerning a minimum financial need but rather a more expansive test which imposes greater moral obligations on the testator. The Supreme Court of Canada further noted:

> The language of the Act confers a broad discretion to the Court. The generosity of the language suggests that the legislature was attempting to craft a formula which would permit the Courts to make orders which are just in the specific circumstances and in light of contemporary standards…Courts are not necessarily bound by the views and awards made in earlier times. The search is for contemporary justice.

The *Wills Variation Act* has resulted in a significant loss of testamentary freedom and to deal with that loss British Columbia residents have used *inter vivos* trusts as will substitutes in an attempt to have their testamentary wishes honoured.

An action under the *Wills Variation Act* must be brought within six months of the date of grant of probate.

An attempt to prevent the plaintiff from bringing an action under the *Wills Variation Act* is ineffective; however, the fact that the plaintiff agreed not to bring the action may be a relevant factor in determining the adequacy of the provision made for the plaintiff: *Allchorne v. Allchorne Estate*, 2005 BCSC 104.

An important issue is whether property transferred by an individual into an *inter vivos* trust (or by way of gift or transfer to a joint tenancy) as a means of avoiding

the *Wills Variation Act* can be attacked by a disgruntled child, spouse or common-law spouse. This is such an important, and evolving, issue that it is discussed separately at the end of this paper.

F. AVOIDING PROBATE AND PROBATE TAX

In British Columbia, the probate process is time consuming, involves public disclosure and it can be very expensive. While the probate process adds considerable certainty that a testator's wishes will be carried out, some wealthy families avoid probate simply to avoid public disclosure. The problem may even be worse where assets are in multiple jurisdictions as foreign personal representatives may be required.

Furthermore, in 1997 the British Columbia government changed the probate fee regime into a probate tax regime and set the probate tax rate at $14 per $1,000 of *gross value* of assets in excess of $50,000 situated in British Columbia. Previously probate fees were taxed at a rate of $6 per $1,000 of gross value. Probate tax is payable on the gross value of the real and tangible personal property situated in British Columbia of a deceased regardless of the ordinary residence of the deceased. Probate fees only apply in respect of property situated in British Columbia that passes under a will that is probated. Intangible property is now deemed to be situated in British Columbia for probate tax purposes if the deceased was ordinarily resident in British Columbia. Probate tax does not apply to assets passing on the death of an individual pursuant to the terms of an inter *vivos* trust, right of survivorship by virtue of joint tenancy or by virtue of a designation in a life insurance policy, an RRSP or an RRIF.

Probate tax could be completely eliminated if a will was administered without probate. In order for that to happen:

- there must be complete certainty that the will in question is in fact the last will;
- there must be complete certainty that the last will was validly executed;

- each person with standing under the *Wills Variation Act* (British Columbia) (a spouse, common-law partner, or child) must confirm that they will not challenge the provision made for them in the will under the *Wills Variation Act*;

- each person obtaining a benefit under the will must provide an indemnity to the executors in connection with administering the will without probate;

- legal title to any real estate registered in the deceased's name may have be dealt with while the deceased is alive as discussed below; and

- any other property which a third-party would otherwise require probate, must be dealt with in some fashion which would likely require the heirs to give indemnities to the third parties.

The greatest challenge to administering a will without probate would be dealing with third parties. Typically, dealing with third parties involves creating legal, but not beneficial, joint tenancies.

Under a legal, but not beneficial, joint tenancy the deceased would be considered to be the owner of the property while other co-tenants, who would only be legal owners, would have no beneficial entitlement to the property. For instance, a bank account could be jointly in the name of a surviving parent and one or more of his or her children. Each child would sign a declaration saying that he or she has no beneficial interest in the bank account. On the parent's death, the bank would deal with the children, by their legal right of survivorship, without being concerned that it was a legal but not beneficial joint tenancy. The beneficial interest in the bank account would still pass under the parent's will.

The biggest problem in dealing with third parties is in respect of real estate because of property transfer tax. The land title system would require that a deceased's will be probated in order to deal with real estate registered in the deceased**'s** name at the time of his or her death.

For many years, property transfer tax and probate tax could be avoided on real estate by:

- transferring a beneficial interest in real estate to a corporation or an *alter ego* trust or a joint spousal trust;
- on the death of the transferor, the transferor's executor would report the ownership of legal title only for the purposes of paying probate tax and properly ascribe no value to that interest;
- legal title to the real estate would pass on a property-transfer-tax-free basis to the estate; and
- the estate would simply continue to hold legal title to the property as a nominee of the beneficial owner.

In a surprising decision, in *Graham v. Smith*, 2009 BCCA 192, the British Columbia Court of Appeal concluded that in these circumstances that the Registrar of Land Titles could refuse to register the transfer of legal title from the deceased to the estate under section 260 of the *Land Title Act* (British Columbia) because the deceased did not have "good, safe holding and marketable title" to the real estate.

Transferring legal title to real estate prior to the owner's death can reduce or eliminate probate tax. However in the case of taxable transfers, property transfer tax applies at a rate of 1% on the first $200,000 of fair market value and 2% thereafter. Accordingly, it may not make sense to pay property transfer tax at these rates to avoid probate tax at a tax rate of 1.4%. Sometimes legal but not beneficial joint tenancies are created as that permits the payment of property transfer tax on one half or one third of the value of real estate which permits both probate tax and property transfer tax to be avoided on the owner's death. The use of a corporate joint tenancy is attractive because that avoids having to make any decision about who the successor title holder should be.

It is also important to note that there are limited exemptions from property transfer tax and it is possible, for instance, to transfer an interest in a principal residence from parent to child even though the child takes title as the trustee of an *alter ego* or joint spousal trust. True to the trust law concept of a trust, the provincial government recognizes that a trust is not a legal entity but merely a relationship. Accordingly, for the purposes of the property transfer tax exemptions, the fact that trust exists is generally ignored in determining whether an exemption applies.

Generally speaking, this means that an interest in the family home can be transferred without paying property transfer tax to a trust provided that an appropriate family member is a trustee of the trust.

It is important to note that for property transfer tax purposes an individual is not related to him or herself. Therefore the property transfer tax exemption in respect of principal residence would not be available if legal title was transferred from mother to *alter ego* trust if the trustee of the trust was or included mother. It is however possible to do a two-step transfer. Going back to the example, if mother really wanted to be a trustee of the *alter ego* trust, then mother could transfer legal title to the principal residence to son (as an example) as trustee of the *alter ego* trust and subsequently mother could replace son as a trustee of the trust.

Trying to avoid probate tax by not obtaining a grant of probate is an all or nothing proposition; if one property requires probate then everything must be declared including beneficially owned property.

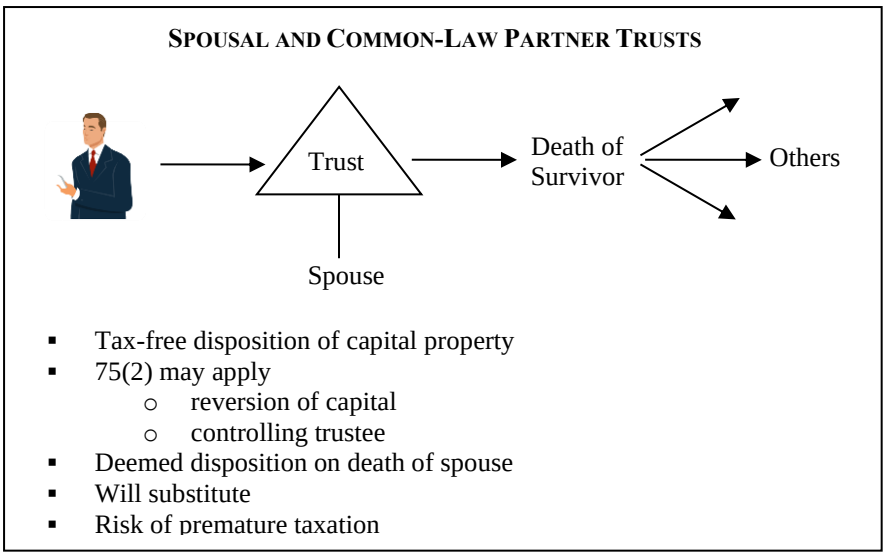
III. COMMON TYPES OF TRUSTS USED IN ESTATE PLANNING

A. SPOUSAL OR COMMON-LAW PARTNER TRUST

A spousal or common-law partner trust is a trust created for the exclusive benefit of the taxpayer's spouse or common-law partner (hereafter referred to as "spouses"). While the spouse is alive the spouse must be entitled to all the income of the trust and no one else may be entitled to any capital of the trust. Capital property can generally be contributed tax-free to these trusts. However, there are two significant drawbacks to using a spousal trust:

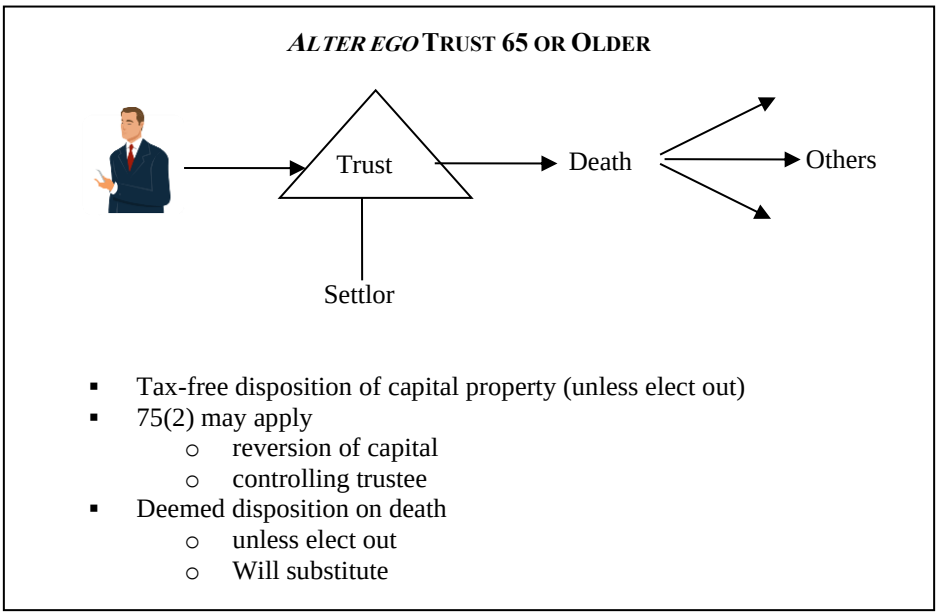
- a spousal trust is deemed to have disposed of certain of its property for fair market value on the date of the spouse's death and accordingly if the spouse/beneficiary predeceases the transferor spouse there could be a premature realization of a capital gain and recaptured depreciation because normally on the death of the first spouse such property will not be subject to tax if it is transferred to the surviving spouse or a testamentary spousal trust; and

- the transferor spouse is required to give up his or her interest in the asset transferred to the spousal trust unconditionally (this can be mitigated if he or she sells property to the spousal trust).



B. *ALTER EGO* TRUSTS

Alter ego trusts are specifically defined in subsection 248(1).[3] They are trusts created by individuals who have attained the age of 65 and want to set up an *inter vivos* trust for their primary benefit. Capital property can generally be contributed tax-free to these trusts provided that the trust does not make an election under subparagraph 104(4)(a)(ii.1) to be subject to the normal 21 year rule. Income from property and capital gains realized by an *alter ego* trust is normally, but not always, attributable to the settlor while the settlor is a resident of Canada.

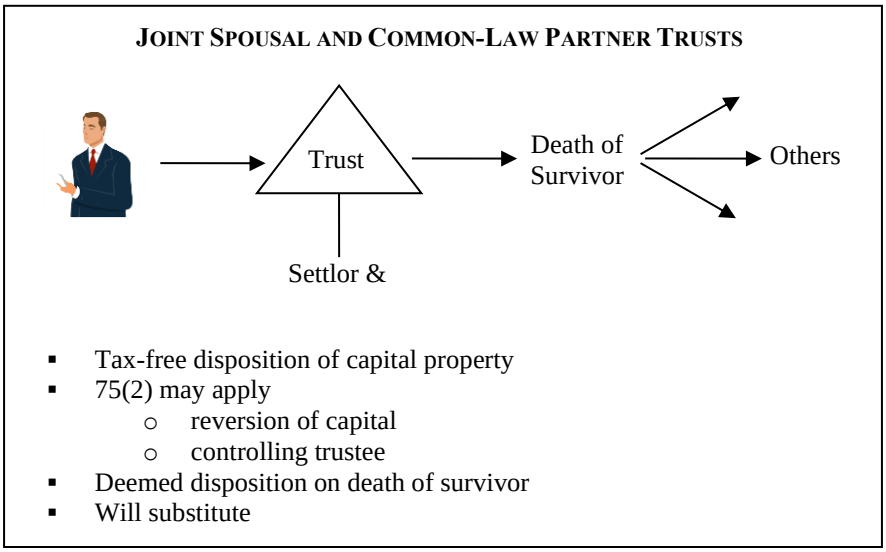


C. JOINT SPOUSAL AND COMMON-LAW PARTNER TRUSTS

Joint spousal and common-law partner trusts are specifically defined in subsection 248(1). For simplicity, I have called these trusts "joint spousal trusts". Joint spousal trusts are trusts created by individuals who have attained the age of 65 and want to set up an *inter vivos* trust for the primary benefit of the settlor and the settlor's spouse. Capital

[3] All following statutory references are to the *Income Tax Act* R.S.C. 1985 (5th. Supp) c. 1 (the "Act"), unless otherwise specified

property can generally be contributed tax-free to these trusts. All of these trusts can serve as will substitutes.



IV. COMMON ELEMENTS OF SPOUSAL TRUSTS, *ALTER EGO* TRUSTS, *AND* JOINT SPOUSAL TRUSTS

Common elements relating to transferring property to spousal trusts, joint spousal trusts and *alter ego* trusts on a tax deferred basis are:

A. SETTLOR 65 OR OLDER

The person who creates an alter ego trust or joint spousal trust must be 65 or older at the time that the trust is created.

The Department of Finance's idea behind the age 65 restriction is to limit the ability to defer tax; someone 65 years old is not likely to survive much beyond 86 years old and therefore, it is unlikely that the 21 year deemed disposition date will be extended by using a joint spousal trust. The technical notes that accompanied the legislation use as an example a 66 year old parent who arranges for common shares of a private corporation to be issued to his or her 27 year old child with the understanding that those common shares would be transferred by the child to a trust

effectively controlled by the parent and which provides for the beneficiaries after the child's death.

This restriction is unwarranted and misguided. The example of the "undesirable" result given by Finance is regularly achieved by using vote-only shares in order to give parents control of corporations frozen for their children. Further, why should the age restriction apply to joint spousal and alter ego trusts but not spousal trusts?

B. ONLY CAPITAL PROPERTY

The tax-deferred transfer of assets only applies to capital property (e.g. not goodwill, inventory or resource properties). "Capital property" is defined in section 54 to mean depreciable property and other property that would give rise to a capital gain (loss) on disposition.

The Canada Revenue Agency usually takes the position that undeveloped land that is not used in a business activity (such as farming) is land inventory rather than capital property because the only reason for acquiring such land is to sell it at a profit. Sometimes real estate that was initially held as capital property can be converted into land inventory by virtue of development activities undertaken by the owner and this can be problematic.[4]

C. AUTOMATIC ROLLOVER

The transfer will automatically occur on a tax-deferred basis unless the transferor elects otherwise.

D. ELECTION TO TRANSFER AT FMV

When a transferor elects for a transfer to occur on a fully-taxable basis, then subsection 69(1) will apply which deems the transferor to have received fair market value proceeds of disposition. Therefore, the transfer of property to an alter ego or

[4] This issue is discussed in Interpretation Bulletin IT-218R. Given the relevant jurisprudence, the Canada Revenue Agency's comments upon when a change of use occurs should not be accepted at face value.

joint spousal trust will occur either on a fully-taxable basis or a fully tax-deferred basis.

However, in the case of identical properties (such as shares), it is possible for some of the properties to be transferred on a fully taxable basis and some property to be transferred on a fully tax-deferred basis, in effect giving the transferor the ability to elect the amount of gain to be created.

In the case of a single property (such as real estate located on a single legal title), a two-stage transfer can give rise to a similar result. For instance, a 50% interest in the real estate could be transferred on a tax-deferred basis while the other 50% interest in the real estate could be transferred on a taxable basis as part of a separate transfer.

A partially taxable transfer may be desirable in order to use non-capital losses, capital losses or one of the lifetime capital gain exemptions.

E. RESIDENCY REQUIREMENT

Both the transferee and the transferor must be resident in Canada. The residency of the trust is determined without reference to subsection 94(1).

F. DEEMED DISPOSITION

A taxpayer is deemed to have disposed of his or her capital property immediately before death. However, when property is transferred to a spousal trust, alter ego trust or joint spousal trust, a deemed disposition generally arises in the trust as follows:

Type of Trust	**First Deemed Disposition**
spousal trust	death of spouse
alter ego trust	death of settlor/beneficiary
joint spousal trust	death of surviving spouse

The disposition is deemed to have occurred at the end of the day the relevant person died.

G. TIME OF DEEMED DISPOSITION

As it is the trust, not the individual, who is deemed to have disposed of property at the end of the day that the relevant person dies, any recapture or capital gains will be taxed in the jurisdiction where the trust, not the individual, is resident because subsection 75(2) cannot apply if the settlor is dead. On the other hand, if the deceased had losses while the trust had gains, or vice versa, the losses and the gains could not be offset.

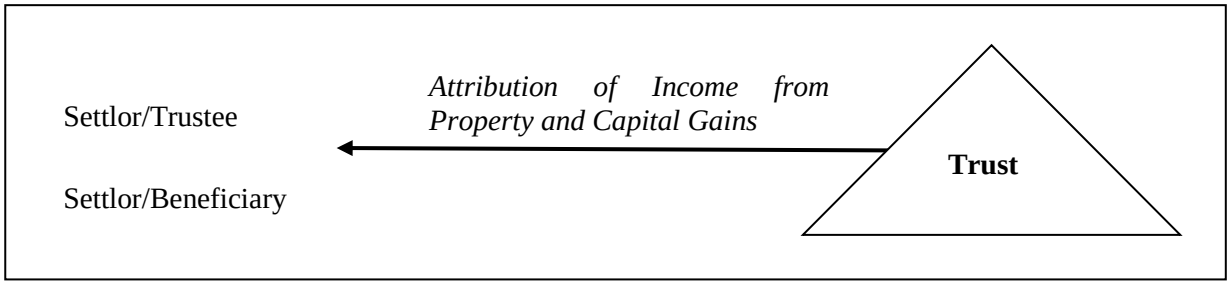
H. DEPARTURE TAX

If property, that would otherwise be subject to departure tax on the emigration of the transferor from Canada, is transferred to a spousal, joint spousal or alter ego trust in anticipation of the transferor leaving Canada, then there will be a deemed disposition of trust assets when the transferor leaves Canada.

V. MISCELLANEOUS MATTERS REGARDING SPOUSE TRUSTS, *ALTER EGO* TRUSTS AND JOINT SPOUSAL TRUSTS

A. SUBSECTION 75(2)

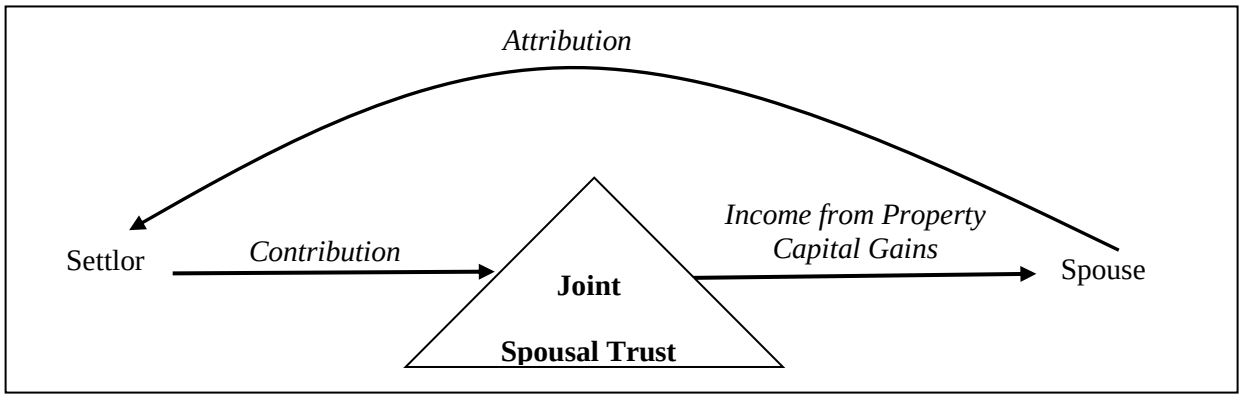
If the settlor of a trust is a capital beneficiary of the trust or a controlling trustee (which will always be the case unless there are more than two trustees and a majority rule clause), then all income and losses from property (not business), capital gains and capital losses will be attributed to the settlor while he or she is resident in Canada pursuant to subsection 75(2).



Subsection 75(2) will not necessarily apply to *alter ego* and joint spousal trusts. Either type of trust could be established without meeting any of the requirements of subsection 75(2), i.e., the settlor of the trust need not be the controlling trustee of the trust and, as a beneficiary, the settlor need not have any entitlement to the trust capital. Therefore, if the settlor is willing to part with his or her property, but not the income from it, subsection 75(2) need not apply to the property settled on the trust. This opens up the possibility of shifting that income to a low tax rate province. Note that the Canada Revenue Agency is now starting to look more closely at the residence of domestic trusts to combat interprovincial tax avoidance.

B. SPOUSAL ATTRIBUTION RULES

Generally, property contributed by a spouse to a trust that gives rise to income or losses from property (not business) and capital gains or capital losses that are allocated to the contributor's spouse as a beneficiary of the trust, are attributed back to the contributor under subsections 74.1(1) and 74.2(1) by virtue of subsection 74.3(1). Accordingly the spousal attribution rules can attribute back to the contributor income and losses from property, capital gains and capital losses realized by a spousal trust or joint spousal trust and allocated to the spouse beneficiary.



Attribution can be avoided by:

- retaining capital gains in the spousal or joint spousal trust as they do not need to be paid to the spouse if the trust is properly drafted;

- selling property to the trust pursuant to the commercial sale exception in subsection 74.5(1) which requires a taxable sale;

- lending property to the trust pursuant to the commercial loan exception in subsection 74.5(2) which requires the timely payment of interest; or

- by making designations under subsections 104(13.1) or (13.2).

The subsection 104(13.1) or (13.2) designations cause income or capital gains paid to a beneficiary to be taxed in the trust and if such income is taxed in the trust no attribution will apply (the income will be taxed in the trust at the top tax rate). In the case of a joint spousal trust there will be no spousal attribution if the trust is a reversionary one caught by subsection 75(2). If the trust is not a reversionary one because the spouse/settlor had no entitlement to capital and was not a controlling trustee of the trust, then the spousal attribution rules could apply to attribute income to the spouse/settlor in the same fashion as in a spousal trust.

C. $750,000 LIFETIME CAPITAL GAINS EXEMPTION[5]

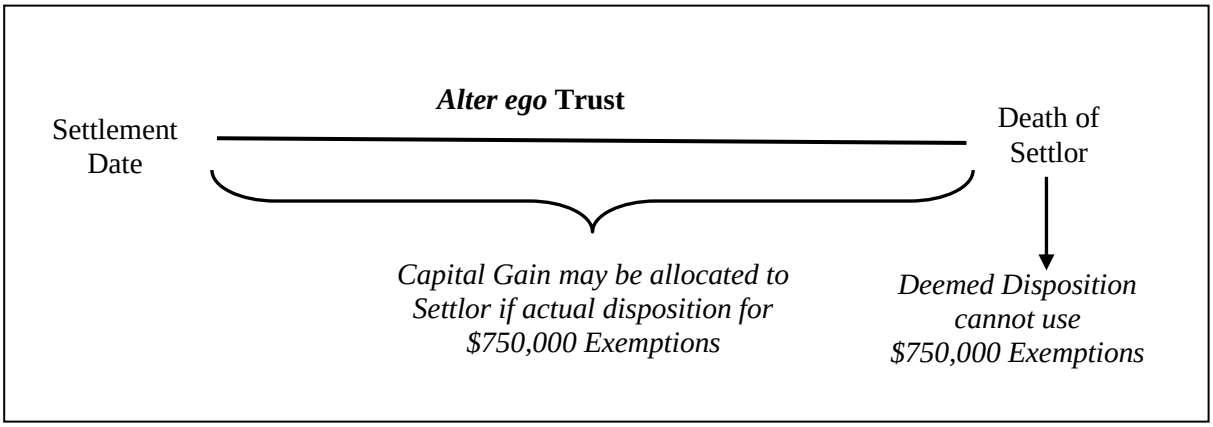
Spousal trusts have access to the capital gains exemption by virtue of subsection 110.6(12) but for some reason, alter ego trusts and joint spousal trusts do not. Subsection 110.6(12) permits the spousal trust to utilize any part of the $750,000 exemption that the deceased spouse was entitled to use but did not use. Subsection 110.6(12) was amended so that the capital gains exemption will not apply with respect to gains on property arising on the date of death of:

- the settlor's death in the case of an alter ego trust; and

- the surviving spouse in the case of a joint spousal trust.

[5] To be raised to $800,000 in 2014 and indexed for inflation for years after 2014.

It does not help matters if subsection 75(2) applies to an alter ego or joint spousal trust unless the gain arises before death. Although income and capital gains may be attributed to the settlor under that rule, the attribution is only during the lifetime of the settlor. The deemed disposition on death occurs at the end of the day of death so that subsection 75(2) does not apply to any resulting capital gains. The situation is different for a capital gain realized by an alter ego trust or a joint spousal trust during the lifetime of the settlor if subsection 75(2) applies to attribute the gain to the settlor. In this case, the settlor may be able to claim the capital gains exemption with respect to the gain by virtue of subsection 74.2(2).



D. POST-MORTEM TAX PLANNING

Where an alter ego trust or joint spousal trust holds shares that are deemed to be disposed of on the death of the individual, the strategy of redeeming shares or winding up the corporation to avoid double taxation may be available if the trust continues to exist after such death. However, this will not be because of subsection 164(6).[6] In the case of an alter ego trust or a joint spousal trust the ordinary loss carry-back rules will apply provided the trust is not wound up on the deemed disposition date. Therefore a trust has between three to four years to wind up the corporation and create a capital loss. This can be extremely important because every dollar of specified investment business income earned by a Canadian-

[6] Subsection 164(6) has no application. It is only applicable where an estate realizes a capital loss in the year following the death of the deceased. Subsection 164(6) is necessary in the case of an estate because a capital gain and a capital loss are realized by different taxpayers.

controlled private corporation during this period can eliminate 17¢ of tax arising from the deemed disposition of shares. If the trust requires the immediate distribution of property to residual beneficiaries following the death of the settlor, or the settlor's spouse, as the case may be, then there will be no opportunity to offset the gain because it will not be possible for the trust to realize a loss. Subsection 40(3.61) makes post mortem planning easier for estates, but not spousal trusts, joint spousal trusts and alter ego trusts. Various submissions have been made to the Minister of Finance to extend the application of subsection 40(3.61) to such trusts.

E. PARAGRAPH 88(1)(d) BUMP

By virtue of paragraph 88(1)(d.3), an 88(1)(d) bump can be used to remove capital property that has appreciated in value from a corporation following the death of the controlling shareholder thereby avoiding double taxation. This can avoid or greatly reduce the problem associated with inheriting high cost base, low paid-up capital shares. As capital gains are now taxed at a lower rate than dividends, the 88(1)(d) bump now produces a better tax result than winding-up the corporation by redeeming its shares to create a loss that can be carried back to reduce the gain arising on death by making an election under subsection 164(6). If there is a change of control as a consequence of death, then:

- shares of the corporation held at the time of death can be transferred to a new corporation for a promissory note subject to subsection 84.1(1);
- the existing corporation can be wound up in to the new corporation under subsection 88(1);
- the ACB of the non-depreciable capital assets of the existing corporation can be bumped to their fair market value at the time of the death of the controlling shareholder; and
- these assets can be used to pay down the promissory note.

The overall objective is to have the gain on the shares at the time of death taxed as a capital gain rather than as a dividend. This strategy is not available with respect to preferred shares transferred to an alter ego trust, a joint spousal trust or a spousal trust unless there is an acquisition of control occasioned by the death of the settlor or the settlor's spouse, as the case may be: see Technical Interpretation 2000-0039395 or Ruling 2004-0060271R3.

F. DEPARTURE TAX

There is an anti-avoidance rule in paragraph 104(4)(a.3) that applies if it is reasonable to conclude that property is transferred on a rollover basis to a trust in anticipation of leaving Canada. In this case, there is a deemed disposition of property when the taxpayer ceases to reside in Canada. This has brought an end to rolling property into spouse trusts and avoiding departure tax in anticipation of emigrating from Canada. On the other hand, departure tax does not apply to an interest in a personal trust resident in Canada if the interest was not acquired for consideration or by a qualified disposition. Therefore the use of trusts may serendipitously avoid departure tax.

G. SHAMS

There is a risk that alter ego trusts might be challenged on the basis that they are shams. Although the decision of *Rahaman v. Chase Bank (C.I.) Trust Co. Ltd*. (1991), JLR 103 is often referred to in this regard, there is a far better analysis in *Abacus (CI) Limited, Trustee of the Esteem Settlement v. Grupo Torras SA*, [2003] JRC 092. This case shows the difficulty in arguing a sham.

H. LOSS OF GRADUATED TAX RATES

Testamentary trusts are entitled to graduated tax rates which can give rise to significant tax savings over time. "Testamentary trust" means:

- a trust or estate that arises on and as a consequence of the death of an individual; and

- all property that is contributed to the trust by the individual on or after the individual's death and as a consequence thereof.

The Canada Revenue Agency has taken the position that subtrusts created by an alter ego following the settlor's death do not qualify as testamentary trusts for the purposes of the Act because:

- the subtrusts are created by the alter ego trust and not by the deceased, and
- the property is contributed by the trust (an individual under the Act) and not the deceased.

Subtrusts might be made executory (i.e. inchoate or unconstituted) trusts, by using a power of appointment, so that they are created by the settlor and not by the trustee of the alter ego trust so that graduated tax rates apply.

I. TESTAMENTARY INSTRUMENTS

Alter ego and joint spousal trusts may be challenged as being testamentary documents that are either void for failure to comply with the formal requirements of the Wills Act or if those requirements were met, subject to the *Wills Variation Act*. The test for determining whether an instrument is a testamentary one is described in *Cock v. Cooke* (1866), L.R. 1 P. 241, 36 L.J.P. 5:

"It is undoubted law that whatever may be the form of a duly executed instrument, if the person executing it intends that it shall not take effect until after his death, and it is dependent upon his death for its vigour and effect, it is testamentary."

The test was explained by Frank Ford, J.A. in C*orlet v. Isle of Man Bank Limited et al.*, [1937] 2 W.W.R. 209 (Alta. S.C. A.D.), at p. 211:

"The fallacy in the argument based upon the "oft quoted words" of Sir J.P. Wilde in Cock v. Cooke (1866) L.R. 1 P. 241, 36 L.J.P. 5, lies in a misunderstanding of what the words "vigour and effect" are applicable to. They are clearly applicable not to the result to be obtained by, or to the performance of, the terms of the instrument,

but to the instrument itself. The question is whether the instrument has vigour to effect, and does effect, or is "consummate on execution" to effect, a gift or to create a trust. If the document is "consummate" to create a trust in praesenti, though to be performed after the death of donor, it is not dependent upon his death for its vigour and effect."

Although an alter ego trust purports to be irrevocable, if the settlor is the trustee and retains full control over the trust property and has the right to all of the income and to encroach on the capital, he can effectively revoke the trust by paying out all of the capital to himself as beneficiary. Thus it may be argued that the trust instrument does not have "the vigour and effect" of vesting a future interest in the contingent beneficiaries. If this is a concern, the trust terms should be changed to bolster the argument that the trust has immediate vigour and effect. This could be accomplished by naming someone other than the settlor as trustee (thus removing the settlor's ability to control the property) and/or by restricting the settlor's right, in whole or in part, to encroach on the capital (thus vesting that capital in the contingent beneficiaries).

J. AVOIDANCE OF DOUBLE TAXATION ON DEATH

On the death of the settlor of an alter ego trust, the spouse beneficiary of a spousal trust or the last spouse to die who is a beneficiary of a joint spousal trust:

- the trust will be deemed to have disposed of its assets; and
- the deceased will be deemed to have disposed of his or her assets including his or her capital interest on the trust.

This could result in double taxation but for the definition of "cost amount" in 108(1)(a.i) which increases the individual's cost amount of the capital interest in the trust to account for the deemed disposition of the trust's property thereby avoiding double taxation.

K. DONATIONS

Spousal trusts, joint spousal trusts and alter ego trusts can be problematic when a charitable gift is to be made on the death of the spouse, last spouse or settlor as the case may be.

When trust assets are transferred to a charity the first problem is whether the transfer to a charity is a donation to a charity or a distribution to a charity:

- if the transfer is a donation the trust is entitled to a tax credit;
- if the transfer is a distribution to a charity as a beneficiary then no tax credit is available.

This problem can be dealt with by drafting a provision in the trust indenture which permits, but does not obligate, the trustee of the trust to make a charitable donation to a charity. The charity should not be described as a beneficiary. See Ruling 2001-0076753.

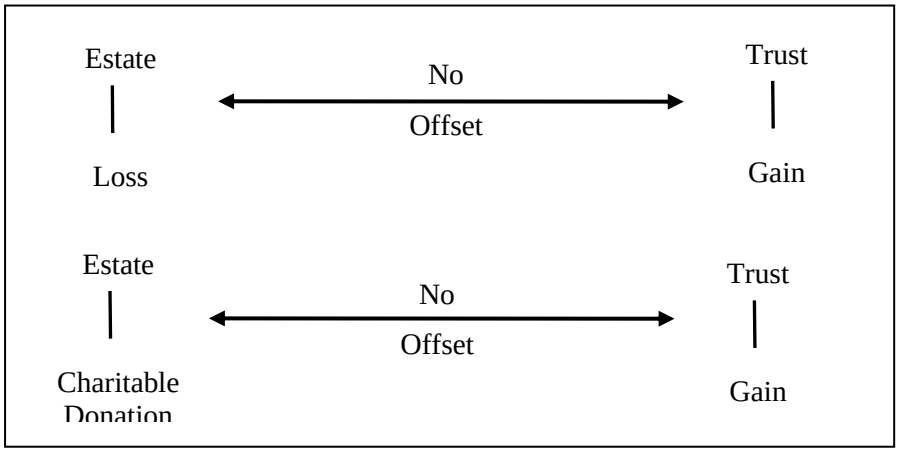
The second problem associated with an alter ego or joint spousal trust making a donation is that the donation will be subject to the normal 75% of income restriction that applies to *inter vivos* donations rather than the more liberal rules that apply to donations made by wills.

The third problem is if the donation occurs after the year in which a deemed disposition occurs, then the donation tax credit cannot reduce tax in respect of the deemed disposition. Subsection 118.1(5) which deems a gift made by a will to be a gift made by the individual immediately before the individual's death. However it has no application to gifts made by alter ego or joint spousal trusts.

L. MISMATCH OF INCOME AND LOSSES OR DONATIONS

Using an alter ego trust, joint spousal trust or *inter vivos* spousal trust means that on death there will be another totally separate pool of assets and tax liabilities. What if

on death the deceased had a large capital loss while his or her alter ego trust had a large capital gain; the loss could not offset the gain.



With the appropriate planning this problem could be avoided. The trust could distribute property to the settlor on a tax-deferred basis who might then contributed back to the trust on a taxable basis by electing out of the subsection 73(1) rollover. This would create a gain to offset the loss.

M. PRINCIPAL RESIDENCE

Since 1991 the definition of "principal residence" in section 54 has permitted certain personal trusts, which would generally include spousal, joint spousal and alter ego trusts, to claim the principal residence deduction.

N. PROPERTY TRANSFER TAX

Legal title to real property generally cannot be transferred to a trust without paying property transfer tax.

In the case of taxable transfers, property transfer tax applies at a rate of 1% on the first $200,000 of fair market value and 2% thereafter. Accordingly, it may not make sense to pay property transfer tax at these rates to avoid probate tax at a tax rate of 1.4%.

Sometimes legal but not beneficial joint tenancies are created as that permits the payment of property transfer tax on one half or one third of the value of real estate

which permits both probate tax and property transfer tax to be avoided on the owner's death. The use of a corporate joint tenancy is attractive because that avoids having to make any decision about who the successor title holder should be.

It is also important to note that there are limited exemptions from property transfer tax and it is possible, for instance, to transfer an interest in a principal residence from parent to child even though the child takes title as the trustee of an alter ego or joint spousal trust. True to the trust law concept of a trust, the provincial government recognizes that a trust is not a legal entity but merely a relationship. Accordingly, for the purposes of the property transfer tax exemptions, the fact that trust exists is generally ignored in determining whether an exemption applies.

Generally speaking, this means that an interest in the family home can be transferred without paying property transfer tax to a trust provided that an appropriate family member is a trustee of the trust.

Bear in mind that for property transfer tax purposes an individual is not related to him or herself. Therefore the property transfer tax exemption in respect of principal residence would not be available if legal title was transferred from mother to alter ego trust if the trustee of the trust was or included mother. It is however possible to do a two-step transfer. Going back to the example if mother really wanted to be a trustee of the alter ego trust, then mother could transfer legal title to the principal residence to say son as trustee of the alter ego trust and subsequently mother could replace son as a trustee of the trust.

O. TAX RETURNS

The Canadian Revenue Agency recently changed its administrative policy that formerly exempted most alter ego and joint spousal trusts from filing T3 tax returns; trusts subject to subsection 75(2) must now file T3 tax returns in accordance with the administrative policy set out annually in the T3 Guide.

P. FILING DEADLINES

A terminal tax return must be filed on or before April 30 or June 15 for an individual who dies in the first 10 months of a year and on or before six months after the date of death for an individual who dies in the last two months of a year. As alter ego trusts and joint spousal trusts are inter vivos trusts they must file their tax returns within 90 days from the end of a calendar year; consequently the filing deadlines are shorter for these trusts.

Q. PAYMENT OF TAX

Pursuant to subsection 159(5) an estate can pay tax arising from the deemed disposition of assets on a taxpayer's death over a ten year period provided that a T2075 election is filed and acceptable security is provided to the Minister of Nation Revenue. Alter ego trusts and joint spousal trusts can also defer the payment of a tax in this fashion pursuant to subsection 159(6.1). However, given the Canada Revenue Agency's restrictive view of what constitutes "acceptable security", the fact that interest accrues on unpaid tax at prime plus 4% compounded daily, and that interest is not deductible, I cannot imagine why an estate or a trust would ever utilize subsection 159(5) or 159(6.1).

R. GOODS AND SERVICES TAX

Non-refundable GST could apply in connection with the transfer of certain property to a trust. A trust may need to become a registrant before property can be transferred to it.

VI. INTRODUCTION TO "ESTATE FREEZES"

"Estate freeze" is a generic term that is applied to transactions that seek to shift the growth in the value of property to other – generally younger - family members in order to reduce capital gains tax at death. An estate freeze is one of the fundamental techniques of family property and business succession. However, it is important to remember that succession planning is a process, not an event: once an estate freeze has been undertaken there may be extremely valuable

opportunities to avoid tax by effectively administering the affairs of the corporation used to freeze the property.[7]

Estate freezes are aimed at reducing the tax liability that arises on the death of a freezor by reducing the value of a freezor's estate. Growth in value is directed to the freezor's lineal descendants. Therefore, an estate freeze only creates the potential to defer some of the tax that would otherwise be payable on a freezor's death until the death of the freezor's lineal descendants.[8] If the freeze shares or the property that is being frozen will be disposed of immediately after the freezor's death, then no tax will be deferred.[9]

VII. TRUSTS IN ESTATE FREEZES

Unlike transfers to corporations or partnerships which can be undertaken on a tax-free basis, property is generally contributed to a trust on a taxable basis.[10] This makes trusts problematic vehicles to use for estate freezing except when the assets are tax-paid. Of course, if the asset is tax-paid, there is often no reason to freeze the value of the asset.

Although capital property can be transferred on a tax-deferred basis to a spousal or common-law partner trust, alter ego trust, qualified disposition trust, joint spousal or joint common-law partner trust, by virtue of the terms of these trusts as required by the Act, they are not suitable for estate freezes because there will be a deemed disposition of the trust assets on the death of either the spouse, common-law partner, settlor respectively or in the case of a qualified disposition trust the assets will fall back into the settlor's estate.

---

7 A very good paper discussing post-freeze transactions is David Thompson, *Rules of Thumb for Post-Freeze Planning*, Pacific Business and Law Institute, January 26, 2005.

8 A cornerstone of estate planning involves maximizing the use of the tax deferral associated with the transfer of assets on death from the deceased to the deceased's spouse or common-law partner, or a testamentary trust for such persons. In order to simplify the analysis I have assumed throughout this part of the paper that tax will be payable on the freezor's death.

9 There may be an income splitting advantage and/or opportunities to multiply the use of the $750,000 lifetime capital gains exemption in respect of gains on qualified small business corporation shares where immediately after the death of the freezor the shares of the company are sold or the company's assets are sold and cash distributed.

10 See paragraph "c" of the definition of "disposition" in subsection 248(1) of the Act.

Even though trusts are not suitable vehicles to receive the freezor's property, trusts are frequently used as the recipient of "growth" shares: common shares issued by a corporation after a freezor has transferred property to the corporation and received fixed-value shares in exchange (the process by which an estate freeze is undertaken is discussed in greater detail below). The interposition of a trust between the corporation and the freezor's lineal descendants allows the trust to split the income it receives (e.g., in the form of dividends), or capital gains it realizes (e.g., on the subsequent disposition of the growth shares), amongst its beneficiaries.

VIII. TESTAMENTARY TRUSTS

The principal benefit of testamentary trusts is that income of such trusts is taxed at graduated marginal tax rates, unlike the income of most inter vivos trusts, which is taxed at the top marginal tax rate on all income. However, it appears the Department of Finance has become concerned about the potential for erosion of the tax base through the proliferation of testamentary trusts, and has proposed to revise the taxation scheme for testamentary trusts. The first notification of such a plan came in the 2013 federal budget. On June 3, 2013 the Department of Finance released a description of tax measures for testamentary trust that it was considering, and invited comments. The essence of the proposals is to restrict the incidence of graduated tax rates to the first three years an estate exists, other than a testamentary trust for a disabled beneficiary. After the three year period expires, the trust/estate would be liable for flat, top-rate taxation. A number of relieving rules that apply to testamentary trusts would be eliminated. This is the text of the Department's release.

> Introduction
>
> A trust, in general terms, is a type of legal arrangement under which one person (the trustee) holds property for the benefit of another person (the beneficiary). An estate (including a civil law succession) arises on the death of an individual and involves a legal representative administering the final affairs and property of the individual.
>
> The federal income tax system treats both trusts and estates as taxpayers. Trusts and estates are, therefore, required to pay tax on their taxable income.
>
> Most trusts (including estates) are entitled to deduct in computing their income each year for tax purposes the portion of that income, otherwise determined, that is made payable in that year to their beneficiaries. This deduction eliminates tax at the trust level on that income. A trust's beneficiaries are then required to include in computing their income for tax purposes the portion of the trust's income that is made payable to them. The beneficiaries pay tax on any resulting taxable

income at their marginal rate of taxation, which in the case of ordinary individuals is determined according to graduated tax rates.

Graduated rate taxation is provided under the federal tax rules that apply to individuals and certain trusts and estates. The rules contain four brackets for which different rates of tax apply depending on the level of taxable income. For 2013, the rates are 15% on the first $43,561 of taxable income, 22% on the next $43,562 of taxable income (on the portion of taxable income over $43,561 up to $87,123), 26% on the next $47,931 of taxable income (on the portion of taxable income over $87,123 up to $135,054), and 29% on taxable income over $135,054.

If, instead of making payable its income to its beneficiaries, a trust recognizes the income in the trust for income tax purposes, the trust (and not its beneficiaries) must generally pay tax on the resulting taxable income. The tax rate imposed on the trust in these circumstances depends upon whether the trust is a testamentary trust or a grandfathered inter vivos trust, as distinguished from an ordinary inter vivos trust.

A testamentary trust arises on and as a consequence of the death of an individual and the only contributions it receives must be as a consequence of an individual's death. There are two categories of testamentary trust. The first consists of estates. The second consists of trusts created by will, including certain trusts created by court order in relation to a deceased individual's estate.

Grandfathered inter vivos trusts are Canadian resident inter vivos trusts1 that were created before June 18, 1971 and that satisfy certain restrictions regarding their activities. This grandfathering exemption was provided as part of the 1972 tax reform. That reform introduced high flat-rate taxation for inter vivos trusts. Prior to that reform trusts generally had full access to the graduated rates applicable to ordinary individuals.

Testamentary trusts and grandfathered inter vivos trusts compute federal tax using the graduated tax rates available to individuals. Other trusts (ordinary inter vivos trusts) pay tax at the top federal marginal tax rate applicable to individuals, which is currently 29%.2

The flat top-rate taxation of ordinary inter vivos trusts, together with a number of anti-avoidance regimes applicable to trusts and their beneficiaries, constrain the use of these trusts for tax planning purposes. This promotes fairness and neutrality in the tax system, and protects the Government's revenue base.

The taxation of testamentary trusts and grandfathered inter vivos trusts at graduated rates effectively allows the beneficiaries of those trusts to access more than one set of graduated rates. This tax treatment raises questions of both tax fairness and neutrality in comparison to the treatment of beneficiaries of ordinary inter vivos trusts and taxpayers receiving equivalent income directly.

Tax planning opportunities associated with the availability of trust-level graduated rates include the use of multiple testamentary trusts, tax-motivated delays in completing the administration of estates, and avoidance of the Old Age Security Recovery Tax. The tax benefits arising from tax planning of this nature raise questions of fairness, and negatively affect government tax revenues. In addition, the extent of tax planning in this area heightens these concerns.

Economic Action Plan 2013 announced the Government's intention to consult on possible measures to eliminate the tax benefits that arise from taxing at graduated rates grandfathered inter vivos trusts, trusts created by will, and estates (after a reasonable period of estate administration).

This consultation paper is being released to provide stakeholders with an opportunity to comment on the proposed measures.

Proposed Measures

Graduated rates

The Government proposes measures to amend the income tax rules to apply flat top-rate taxation to grandfathered inter vivos trusts and trusts created by will. In addition, flat top-rate taxation is proposed to apply to estates ("flat top-rate estates") after a reasonable period of administration. Specifically, a deceased individual's estate would be considered a flat top-rate estate starting immediately after the 36-month period that follows the individual's death.3 Estates of deceased individuals would therefore be eligible to retain, as testamentary trusts, access to graduated rates for up to the first 36 months of the estate's administration. These measures would apply to existing and new arrangements for the 2016 and later taxation years.

Trusts for the disabled and for minor children

The income tax provisions contain special rules (i.e., the preferred beneficiary election rules and the rules for trusts for minor children) that suspend or lessen the effects of high flat-rate taxation on income accumulating in a trust for certain disabled persons or minor children. These special rules allow (subject to certain anti-avoidance rules) income to be recognized for tax purposes in the beneficiary's hands (i.e., taxed at the beneficiary's marginal rates) even though the income actually accumulates in the trust. The proposed measures on graduated rates would not change the preferred beneficiary election rules or the rules that apply to trusts for minor children.

Spousal trusts and common-law partner trusts

Upon the death of an individual, the individual's capital property is generally subject to a deemed disposition, with the result that accrued gains on capital property are recognized in computing the individual's income in their final tax return. Where the individual's property is on death transferred to the individual's spouse or common-law partner, the deemed disposition on death is suspended, and instead the property is transferred to the spouse or common-law partner on a tax-deferred (i.e., rollover) basis. The rollover is also available to eligible trusts, commonly referred to as spousal trusts and common-law partner trusts. The proposed measures on graduated rates would not change the rollover rules that apply on the death of a spouse or common-law partner.

Related income tax rules

Consistent with the proposed measures for the elimination of graduated rates for trusts and flat top-rate estates, the Government is also consulting on possible measures to amend a number of related tax rules that are available to testamentary trusts and grandfathered inter vivos trusts. The proposed measures, described in greater detail below, would generally limit the application of the related rules to estates other than flat top-rate estates. Affected trusts and estates would, as a result, be subject to the same treatment as ordinary inter vivos trusts.

Income tax instalments - The income tax rules contain an instalment system that imposes a requirement on affected taxpayers to pay a portion of their estimated tax liability for a taxation year in instalments over the course of the year. The rules for individuals require, when they apply, that instalment payments be made on a quarterly basis. Testamentary trusts are exempt from the tax instalment rules and therefore are required to pay any tax owing only within 90 days after the end of the taxation year. The proposed measures would extend the instalment rules to trusts created by will and flat top-rate estates.

Alternative minimum tax - Individuals, including trusts, are subject to the alternative minimum tax ("AMT"). In computing AMT, a $40,000 basic exemption is available to testamentary trusts and grandfathered inter vivos trusts. The proposed measures would deny the basic exemption to grandfathered inter vivos trusts, trusts created by will, and flat top-rate estates.

Taxation year and fiscal period - The taxation year of a trust is generally the calendar year, and, similarly, any fiscal period of a trust is required to end in the calendar year in which it began. Testamentary trusts are exempt from these rules, being allowed off-calendar year taxation years and fiscal periods. The proposed measures would require trusts created by will and flat-top rate estates to use a calendar year taxation year and require that their fiscal periods end in the calendar year in which the periods began.

Part XII.2 tax - Part XII.2 of the Act imposes a trust-level distribution tax on trusts that make payable certain Canadian source income to non-residents and, in certain circumstances involving dealings in beneficial interests in the trust, to certain Canadian tax-exempts. These beneficiaries are referred to in Part XII.2 as "designated beneficiaries". Testamentary trusts are exempt from Part XII.2 and, in certain cases, from treatment as designated beneficiaries. The proposed measures would deny this preferential treatment under Part XII.2 to trusts created by will and flat top-rate estates.

Personal trust status – Personal trusts enjoy certain tax benefits, including the ability to distribute property to beneficiaries on a tax-deferred basis. A trust generally qualifies as a personal trust only if beneficial interests in the trust have not been acquired for consideration payable to the trust or to a contributor of property to the trust. Testamentary trusts automatically qualify as personal trusts, without regard to the circumstances in which beneficial interests in the trust are acquired. The proposed measures would subject trusts created by will and flat top-rate estates to the same conditions that apply to ordinary inter vivos trusts in determining eligibility as a personal trust.

Investment tax credits - Taxpayers, including trusts, are permitted to claim investment tax credits (ITCs) in respect of certain expenditures. Inter vivos trusts are generally required to recognize ITCs in the trust. Testamentary trusts, on the other hand, can make ITCs available to their beneficiaries for use by the beneficiaries in computing their own income tax liability. The proposed measures would require that the ITCs of trusts created by will and flat top-rate estates be recognized in the trust or estate.

Tax administration rules - A number of tax administration rules apply only to ordinary individuals, and not to trusts. An exception is provided, however, for testamentary trusts, which have access to these special rules. These rules extend the period:

(i) during which the Canada Revenue Agency (CRA) may refund an overpayment of tax,

(ii) for objecting to a tax assessment,

(iii) for filing an agreement to transfer forgiven amounts under the debt forgiveness rules, and

(iv) during which, at the trust's request, the CRA may reassess or make determinations in respect of certain income tax liabilities.

The proposed measures would limit the category of trusts that would qualify for relief under the rules to testamentary trusts that are estates. Specifically, the rules would apply in respect of taxation years for which an estate that is a testamentary trust is not a flat top-rate estate.

1 Inter vivos generally refers to a transfer between living persons. An inter vivos trust includes, for income tax purposes, any trust that is not a testamentary trust.

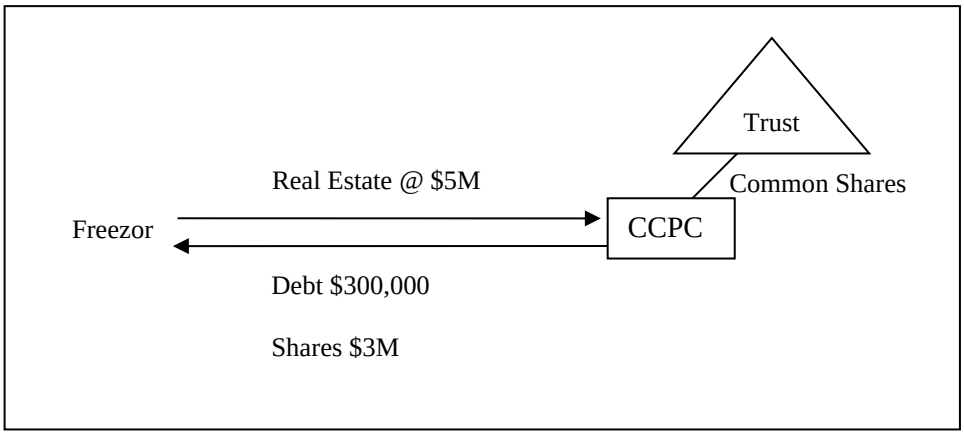
2 Provinces with a Tax Collection Agreement (TCA) (all except Quebec for personal tax) are required to mirror federal changes to the common tax base. The TCA definition of common tax base includes rules regarding the tax rate applied to trusts contained in section 122 of the federal Income Tax Act. As a result, the proposed measures would also result in similar changes to the provincial rates of taxation of trusts.

3 Upon expiry of that period, the estate would be subject to a deemed taxation year-end.

IX. ESTATE FREEZE EXAMPLE: ASSET FREEZE

By way of example assume:

- the freezor transfers, pursuant to subsection 85(1) of the Act, $5 million of real estate (an apartment building) with a mortgage of $1.7 million and a cost amount of $2 million to a Canadian controlled private corporation ("CCPC") in exchange for:
    - $3 million of preferred shares which will have an adjusted cost base and paid-up capital of nil;
    - assumption of the $1.7 million mortgage; and
    - a $300,000 promissory note;
- common shares of the CCPC are issued to a trust for the benefit of the freezor's lineal descendants.



- the apartment building earns taxable income of $100,000 in the initial year it is owned by the CCPC and that income increases at a rate of 5% per annum;
- to avoid paying tax at the top corporate tax rate of 44.66%, the freezor follows advice received from his advisor to reduce corporate tax to nil by taking salary from the CCPC equal to the amount of income that the CCPC would otherwise have ($100,000 in the initial year); and

- 20 years later the survivor of the freezor and the freezor's spouse[11] dies and, immediately before that, the value of the shares of the CCPC is $13 million.

The result is that until such time as the CCPC sells the apartment or the taxpayer's lineal descendants dispose, or are deemed to dispose of , their shares of the CCPC, tax of $2,185,000 on the $10 million of growth that arose after the freeze will be deferred by virtue of the estate freeze. There is still tax of $655,500 on the $3 million of preferred shares received by the freezor as a part of the estate freeze and deemed to be disposed of immediately before the death of the survivor. Note that by transferring real estate that includes depreciable property, the potential for recaptured depreciation taxed at 43.7% has been replaced with the potential for a capital gain taxed at 21.85%.

Note that the result could be improved by undertaking a wasting freeze, meaning that rather than paying salary to the freezer the CCPC would pay tax on the investment income and use the after-tax proceeds to redeem the preferred shares owned by the freezer.

X. ESTATE FREEZE – CORPORATE FREEZE WITH SECTION 86

The reorganization of a corporation to "freeze" a shareholder's interest in the corporation is usually undertaken using section 86 of the Act. The result of the application of s. 86 is that the recognition of the capital gain or loss that would otherwise be realized on the disposition of shares of a corporation in the course of a reorganization of its capital is deferred. Normally, under a subsection 86(1) rollover, a taxpayer will exchange one class of shares in the capital stock of a corporation for the issuance of shares of another class. The "cost base" of the new shares received by the taxpayer will be equal to the cost base of the exchanged shares less the fair market value of any non-share consideration received by the taxpayer. If no non-share consideration is received, the cost base of the exchanged shares will simply be attached to the new shares that are issued. Any taxable gain, which would otherwise arise upon the disposition of the exchanged shares, will be deferred until the new shares are sold.

---

[11] I have assumed that the freezor's shares will pass to the freezor's spouse if the freezor predeceases the spouse. The same result would obtain if the preferred shares were transferred into a joint common-law partner and spousal trust and the freezor's spouse dies last.

The requirements for application of section 86 are:

A. DISPOSITION

A taxpayer must "dispose" of his or her shares to trigger the operation of section 86. In certain cases a corporation may modify the rights and restrictions attaching to the shares without triggering a disposition of those shares, in which event section 86 will not apply. However, if no disposition occurs, the alteration of the share rights will not be a taxable event.

B. CAPITAL PROPERTY

The shares disposed of by the taxpayer must be capital property to the taxpayer at the time of disposition. Thus, subsection 86(1) will not apply in respect of shares disposed of by a trader or dealer in securities in the course of a reorganization of the capital stock of a corporation.

C. ALL SHARES OF CLASS OWNED BY TRANSFEROR

Subsection 86(1) will only apply when there has been a disposition of all the shares of any particular class owned by the taxpayer. It is not sufficient that the taxpayer dispose of only some of the taxpayer's shares of such class.

D. REORGANIZATION OF CAPITAL

Subsection 86(1) will apply only when the taxpayer is disposing of shares in the course of a reorganization of the capital of a corporation. The term "reorganization" is not defined for purposes of the Act. A reorganization for purposes of section 86 is likely to refer to a "fundamental change" or an "arrangement" as contemplated by modern corporate statutes.

E. CONSIDERATION

Subsection 86(1) only applies if the taxpayer receives from the corporation consideration that includes other shares of the capital stock of the corporation.

F. INAPPLICABILITY OF 85(1) OR 85(2)

The final restriction on subsection 86(1) is that it will not be applicable in any case where the rollover provisions under subsections 85(1) and (2) are applicable.

G. INDIRECT GIFT

Subsection 86(2) is a provision similar in concept to paragraph 85(1)(e.2). In order for it to apply, three conditions must be met:

(i) shares must have been disposed of under circumstances described in subsection 86(1);

(ii) the fair market value of the exchanged shares immediately before their disposition must exceed the cost to the taxpayer of all non-share consideration and the fair market value of the new shares received by the taxpayer for the exchanged shares; and

(iii) it must be reasonable to regard any portion of such excess as a benefit that the taxpayer desired to have conferred on a person to whom he or she is related.

As a result of these requirements, subsection 86(2) should not apply in arm's length situations or when the taxpayer has no intention of conferring a benefit on another person.

When subsection 86(2) does apply, the amount of the gift portion reduces the adjusted cost base to the taxpayer of the new shares he or she has received, thus effectively becoming a deferred capital gain. If the amount of the gift exceeds the adjusted cost base to the taxpayer of the exchanged shares, the excess is deemed to be a capital gain of the taxpayer at the time of the exchange. Section 86(2) also operates in a punitive manner, since the shareholders to whom the gift is intended will not receive a corresponding increase in the adjusted cost base of their shares of the company.

Consider using a price adjustment clause in the exchange agreement or the rights and restrictions of the shares issued in exchange for the convertible property to avoid the possible application of subsection 86(2).

H. PAID-UP CAPITAL

Subsection 86(2.1) is similar to subsection 85(2.1). It is a relieving provision that permits the paid-up capital of the old shares to flow through to the new shares if the paid-up capital is increased during the course of reorganization. For example, if the paid-up capital of the old shares is $100 and that paid-up capital is increased to $1,000 in the course of the reorganization, a deemed dividend of $900 will normally result. Subsection 86(2.1) will reduce the paid-up capital of the new shares to $100, to avoid the deemed dividend.

I. ALTERNATIVES TO SECTION 86

In addition to section 86, two other sections of the Act may be used in order to implement an estate freeze: section 86 and section 51. These sections may be the preferred choice for effecting an estate freeze in certain circumstances.

It should also be noted that a stock dividend freeze is a further possible alternative to the use of section 86. Such freezes are accomplished by issuing high redemption amount, low paid-up capital preferred shares to the freezor as a means of reducing the value of common shares to a nominal amount.[12]

That said, the issuance of growth shares to a trust is largely unaffected by the section pursuant to which the estate freeze is undertaken. Accordingly, an analysis of these alternatives to the use of section 86 would be superfluous in this paper.

---

[12] The definition of "amount" in subsection 248(1) determines the amount of a stock dividend generally as the amount a corporate issuer's paid-up capital increases by virtue of issuing the stock dividend. Therefore the freezor will be subject to a nominal deemed dividend if the stock dividend shares have a nominal par value. It is essential that the payment of a stock dividend does not shift value among classes of shares because the fair market value of the stock dividend could be brought into the freezor's income under subsection 15(1.1). Note also that the ability of a corporation to pay a high redemption value but low paid-up capital stock dividend depends upon the applicable corporate law.

XI. STUCTURING A TRUST

As mentioned above, trusts are commonly used in conjunction with estate freezes as vehicles to hold the growth shares issued to the younger generation. Due to the difficulty in varying the terms of a trust it is important to design a trust properly at the outset. Certain errors in trust design, such as making the settlor a beneficiary or trustee, may be irreversible.

A. SELECTION OF SETTLOR

There is more choice now in choosing a settlor because of the effective repeal of the preferred beneficiary election (which requires the beneficiary to be a spouse, child, grandchild or great-grandchild of the settlor) and the repeal of the 21 year deemed disposition election. Further, if the trust's income is "split income" that would be subject to kiddie tax if allocated to minor beneficiaries, then the attribution rules would not apply in respect of that income regardless of the identity of the settlor. It is important that the settlor be someone who would logically take interest in the beneficiaries, settle property on the trust without expectation of any compensation, and take the time to understand the basics of the trust.

The settlor cannot be a beneficiary or sole trustee of the trust otherwise the reversionary trust rule in subsection 75(2) may apply.[13]

If the settlor is related to the beneficiaries, is an aunt or uncle of the beneficiaries or does not deal at arm's length with the beneficiaries as a matter of fact, then there is a potential for the application of the attribution rules in respect of income that is not subject to kiddie tax unless the trust is settled with a non-income producing property.

Concerns with respect to attribution can also be avoided by using a non-resident settlor.[14] However one problem with using non-resident settlors is that this may create a foreign tax problem for the settlor. A Canadian settlor of a non-resident

---

[13] If it is really important that the settlor be a trustee this can be accomplished without the reversionary trust rule applying by using multiple trustees and ensuring that the trust indenture provides that trustee decisions are made by majority.

[14] Note that the attribution rules will once again become an issue if the settlor subsequently becomes a resident of Canada.

trust established for non-resident grandchildren could be subject to attribution of income for Canadian tax purposes; could a non-resident settlor of a Canadian trust for Canadian resident grandchildren be caught by a similar rule in the foreign jurisdiction?

More commonly, the attribution rules have been avoided by settling trusts with property that does not produce income such as silver ingots or gold coins. If a trust is being created to acquire the shares of a private corporation then there may be no attribution concerns; because the dividend income will be subject to kiddie tax if it is allocated to minors the attribution rules will not apply.[15]

B. CHOICE OF TRUSTEE(S)

In view of the wide discretion often afforded trustees, the choice of trustee is extremely important.

Sometimes more than one trustee is chosen. In that case, unless the trust indenture provides otherwise, all trustee decisions must be unanimous. While some practitioners prefer to use more than one trustee (being of the view that this adds more substance to the trust), this strategy may backfire unless all trustees are actually involved in administering trust assets.

The trustee of a trust may be considered to control the company that has issued shares to the trust. Multiple trustees are sometimes used to avoid having a particular trustee controlling a company by virtue of being the sole trustee of a trust.[16]

While subsection 75(2) generally prevents the settlor from being a trustee or a capital beneficiary, a trustee can be a beneficiary. Although this gives rise to a conflict of interest whenever the trustee appoints property to him or herself as a

---

[15] Subsection 74.5(13)

[16] See *MNR v. Consolidated Holding Company Limited*, 72 DTC 6007 (SCC), [1972] CTC 18; *Lusita Holdings Limited v. The Queen*, 84 DTC 6346 (FCA), [1984] CTC 335; *Rostal Sales Agency Ltd. v. The Queen*, 83 DTC 5036 (FCTD), [1983] CTC 5; and *Robson Leather Co. Ltd. v. MNR*, 77 DTC 5016 (FCA), [1977] CTC 132.

beneficiary, there is no trust or income tax rule that expressly prevents this. Concern with a trustee being a beneficiary is that the trustee may begin treating trust property as if it were his or her own, calling into question the validity of the trust,[17] resulting in a court questioning decisions made by the trustee,[18] or triggering the application of subsection 56(2) resulting in the attribution of all income to the trustee on the basis the trust was a sham.

Where a beneficiary is also a trustee these problems are often addressed by appointing multiple trustees.

C. SELECTION OF THE BENEFICIARIES

The beneficiaries must be determined with certainty. Children and grandchildren are often defined as beneficiaries in a generic manner so that if there is subsequent issue they will automatically be beneficiaries of the trust. Spouses are sometimes defined in a generic manner so that in the event of a divorce the former spouse will automatically cease to be a beneficiary (which may help preserve the preferred beneficiary election but generally has limited relevance in the case of a marital breakup).

Subject to concerns about the association rules,[19] beneficiaries should be widely defined because it gives the trustees additional flexibility, it assists in addressing creditor proofing concerns and it bolsters the argument that each beneficiary's interest in the trust has nominal value for the purposes of any deemed disposition on death.

If the trust intends to own a principal residence and claim the principal residence deduction then it cannot have any beneficiaries that are corporations (other than

---

17 See *Rahaman v. Chase Bank (C.I.) Trust Co. Ltd.*, (1991), JLR 103.

18 See *Fox v. Fox Estate*, (1996) 10 ETR (2d) 229.

19 Paragraph 256(1.2)(f) deems the beneficiaries of a trust to own certain shares of a company that the trust is a shareholder of for the purposes of the association rules.

charities) or partnerships[20] nor any beneficiary (and certain connected persons) who is claiming the deduction.

Trust indentures sometimes distinguish between income and capital beneficiaries. With the elimination of the preferred beneficiary election it is less important to distinguish between income and capital beneficiaries in discretionary trusts. An advantage of having a single class of beneficiaries is that the trustees do not need to be as concerned about the rule of even-handedness which complicates decisions when the interests of income and capital beneficiaries have to be considered separately.

Trust indentures sometimes give trustees, or more commonly third parties, the power to appoint additional beneficiaries. It is generally preferable to give such a power to a third party and to specifically provide that that power can be exercised by the third party as a personal power. As a trustee owes a fiduciary duty to the existing beneficiaries, it is difficult for a trustee to exercise a power to add a beneficiary.

The CRA has stated that the addition of a beneficiary to a discretionary trust pursuant to a power of amendment requiring the agreement of the settlor and all the trustees:

(i) did not result in a disposition of a property of the trust (ruling given);

(ii) did not result in the application of subsections 56(2) or 105(1) (ruling given);

(iii) resulted in a disposition of a portion of each beneficiaries' interest in the trust at the time of the variation (opinion expressed); and

[20] See paragraph (c.1) of the definition of "principal residence" in section 54.

(iv) the value of each beneficiary's interest in the trust would be proportionate based on the "even-handed principle" i.e., the value of each beneficiary's interest was approximately equal.[21]

Most practitioners have a considerable amount of skepticism with respect to these last two points. A technical interpretation from 2008 repeats the proposition that the addition of a beneficiary would result in the disposition of a portion of each existing's beneficiary's interest, but said that only the proceeds realized by trustee/beneficiary who appointed the new beneficiary would be taxable. The author of this document also sidestepped the question of valuation of the proceeds, suggesting the field officer raising the question contact the valuation division.[22] The proposition that an amendment of a trust gives rise to a disposition of the interests of the beneficiaries in the trust is contrary to older rulings given by Revenue Canada.[23] The argument that the even-handed principle means that the beneficiaries of a discretionary trust must be treated equally is wrong; while the trustees of a discretionary trust must act in a bona fide manner vis-à-vis the beneficiaries, that does not mean that the beneficiaries must be treated equally. Indeed, requiring equal treatment may be contrary to the intentions underlying a discretionary trust. [24]

It is noteworthy that in the first ruling the CRA was not considering the addition of a beneficiary of a trust pursuant to an express power to add beneficiaries but rather amending the terms of the trust to add a beneficiary. In the 2008 document the CRA was considering the addition of a beneficiary of a trust pursuant to an express power to add beneficiaries.

---

21 CRA Document No. 2001-0111303.

22 CRA Document No. 2008-028141117.

23 Examples of these rulings are discussed in *Russ v. British Columbia (Public Trustee)* (1994), 89 B.C.L.R. (2d) 35 (CA) and *Hunter Estate v. Houlton* (1992), 46 E.T.R. 178 (Ont. Ct. (Gen. Div.)).

24 However, some family law decisions concerning the value of interests in discretionary family trusts also may support the CRA's views.

D. PROTECTOR

Trust indentures often include a provision for the appointment of a protector. The concept of protector is a relatively recent phenomena for domestic trusts. Initially the protector's function was usually limited to consulting with the trustee in particular situations as well as appointing and dismissing trustees in accordance with the terms of the indenture. This function has been significantly increased in the case of offshore trusts where there is a need to balance the power of non-resident trustees with some element of control by resident beneficiaries. In these situations protectors of family trusts are often granted the power to control the dissemination of information, approve investments and receive prior notice of any major decision of the trustees. If a protector's authority over the trustees is extensive then there would be a risk that the CRA could fairly characterize the protector as the *de facto* trustee and the trust's residence as Canada.

It can be particularly important to provide for a protector where a commercial trustee is employed; this will greatly change the dynamics of any dispute relating to trustee fees.

There is some doubt as to the status of a protector under trust law. Notwithstanding contrary provisions contained in a trust indenture, the courts have generally considered protectors to be fiduciaries and have imposed fiduciary obligations on their actions as protectors.[25]

In *Re the Freiburg Trust*, 6 ITELR, 1078 (Royal Court of Jersey), the Court concluded that it has inherent jurisdiction to remove the protector of a trust from office for due cause. In this case, the protector had appropriated money from the trust, was imprisoned and, upon release, disappeared. The basis for the exercise the Court's discretion was that the protector was the fiduciary and the jurisdiction arose from the necessary incidence of the Court's duty to supervise the interests of the beneficiaries.

---

[25] See *In the Matter of the Star I (Revised) and Star II Trusts*, and *In the Matter of the Trustee Act, 1975*; *von Knieriem v. Bermuda Trust & Grosvenor Trust,* Eq Nos 154 and 162 of 1994 and *Steel v. Paz,* (1993-5) MLR 102.

E. SETTLEMENT OF THE TRUST

A trust indenture should refer to the trust property given to and accepted by the trustee. To avoid the application of subsection 75(2) to a Canadian resident settlor on income or gains from the property used to settle the trust, or property substituted therefor, it should be made clear that the trust is an irrevocable trust and that under the provisions of the trust under no circumstance can the settlement property (or substituted property) revert to or be controlled by the settlor. As mentioned, in view of the need to settle trusts by the delivery of property by the settlor to the trustee, consideration should be given to settling a trust with a preliminary piece of property that is easy to deliver where the primary property to be settled on the trust is not easily delivered to the trust at a specific time.

F. FAILURE AND IRREVOCABILITY OF THE TRUST

If a trust fails for want of beneficiaries or impossibility of purpose, then the trust property must be returned to the settlor. Trust indentures often provide for a failsafe alternative scheme of distribution, which precludes trust property from reverting to the settlor. This addresses the concern that the income or capital of the trust could be taxed in the hands of the settlor pursuant to subsection 75(2) because the property could revert to the settlor. However, the CRA's view is that if the reversion occurs by operation of law, and not by operation of the terms of the trust, subsection 75(2) will not apply.[26]

G. PURPOSES OF THE TRUST

The purpose for which a trust is established should be clearly set out. Purposes can vary significantly. In a purely discretionary trust the trustee, in his or her absolute and unfettered discretion, can subsequently distribute the trust income and capital to

---

[26] *The Tax Window*, (January 1994) Report No. 31 (North York, Ont.: CCH Canadian Limited), paragraph 2528 summarizes a technical interpretation which states that subsection 75(2) does not apply to a settlor when property can revert by operation of law due to the complete failure of the trust for lack of beneficiaries or impossibility of purpose.

any particular beneficiary. In a non-discretionary trust assets go to specific beneficiaries leaving little or no discretion to the trustees.

H. REGULATION OF THE TRUSTEES

Trust indentures typically provide for rules that govern the replacement, remuneration and deliberations of the trustees. Although trustees may be appointed and removed in accordance with the applicable provincial statute[27] or through the inherent jurisdiction of the court, it is prudent and more convenient to simply provide for a method of appointment and removal of trustees in the trust indenture. The replacement of trustees is often accomplished by the protector being given the power.[28]

Normally remuneration for a trustee is provided for in the relevant provincial legislation.[29] Any variation from this amount of remuneration should be set out in the indenture.

I. INDEMNIFICATION OF THE TRUSTEES

Trust indentures usually provide for the indemnification of trustees for any actions taken by them which are within the scope of the duties specified in the trust indenture. However, it should be noted that a limitation on a trustee's liability in the trust indenture alone may not limit the trustee's liability to a third party. Accordingly, the trustee should ensure that the limitation of liability is also provided for in the documents relating to any transaction undertaken by the trustee in his or her capacity as trustee. Such a limitation should include an express disclaimer of liability in excess of the value of the trust assets.

---

[27] In British Columbia, sections 27 to 31 of the *Trustee Act* (British Columbia), RSBC 1996, c. 464. In Ontario, sections 2-8 of the *Trustee Act* (Ontario), RSO 1990, c. T.23 as amended.

[28] It has been held that the power to appoint additional trustees is a fiduciary power that must be exercised in the best interests of the beneficiaries: *Re Osiris Trustees and Goodways*, (2000) 2 ITELR 404 (High Court of Justice of the Isle of Man, Chancery Division).

[29] In British Columbia, section 86 of the *Trustee Act* (British Columbia).

Generally speaking, the fiduciary duties associated with being a trustee are so onerous that it would be difficult to recruit trustees if these duties were not limited in the trust indenture. As a result, trust indentures typically have a series of provisions aimed at reducing the high standards that trustees must otherwise meet so that trustees will only be liable in the event of willful default. While there is little Canadian case law dealing with the efficacy of exculpatory clauses, decisions from other jurisdictions suggest they will not be effective in respect of acts of gross negligence, willful default or fraud.[30] The relevant provincial statutes give courts a statutory power to excuse any trustee who has acted honestly and reasonably, and fairly ought to be excused for the breach and for failing to seek the court's direction.[31] In view of the specific statutory relief, Canadian courts have not looked upon exculpation clauses favorably. This is particularly so in the case of professional trustees. While the efficacy of these clauses is not certain, few indentures omit them.

Professionals acting as trustees must consider whether their professional liability coverage would extend to services rendered as a trustee.

J. TRUSTEES' POWERS

Trustees are under a general duty to make proper investments. Unless a trust indenture provides otherwise the powers vested in a trustee to make proper investments are those set out in the applicable provincial statute.[32] Typically provincial legislation either:

(i) contains a list of very conservative investments that trust can make; or

(ii) permits a trustee to invest as a prudent investor would.

---

[30] Exculpatory clauses are discussed in detail by David A. Steele in "Exculpatory Clauses in Trust Indentures" (1994) 14 E. & T.J. 216.

[31] In British Columbia, section 94 of the *Trustee Act* (British Columbia), in Ontario section 35 of the *Trustee Act* (Ontario).

[32] In British Columbia sections 15 to 23 of the *Trustee Act* (British Columbia), in Ontario sections 26 and 27 of the *Trustee Act* (Ontario).

In jurisdictions where trust investments are limited to a statutory list of investments, it is prudent for the trust indenture to enlarge upon these investment powers. The powers of investment are also regularly enlarged where the prudent investor rule applies because that rule requires trustee investment decisions to be made by reference to a reasonable assessment of risk and return that a prudent investor would make.

In addition the prudent investor rules permit trustees to:

(i) seek investment advice and delegate authority in accordance with ordinary business practice; and

(ii) pool trust assets for investment purposes.

Further liability for breach of trust is restricted to net losses unless the trustee has acted dishonestly, in which case losses cannot be offset by gains.

K. TIME OF DIVISION

The Act contains certain rules which are intended to prevent the indefinite postponement of capital gains taxes through the use of long term trusts. Subsection 104(4) generally provides for a deemed disposition of non-capital trust property every 21 years. Many trusts that are “personal trusts” (as defined in subsection 248(1)) contain a time of division clause designed to automatically distribute all of the trust property equally to the beneficiaries on a tax-deferred basis under subsection 107(2) immediately before the application of the 21 year deemed disposition rule in subsection 104(4). The rationale behind this type of provision is that it is assumed that the automatic wind-up of the trust will occur on a tax-free basis if the trustee forgets to distribute property on a different basis before the trust's 21st anniversary. This is generally a valid assumption when all the beneficiaries are Canadian residents.

L. LAW GOVERNING TRUST

Trust indentures generally include a provision which sets out the jurisdiction of the law governing the trust.[33] Such provisions normally choose both the law to be applied with respect to a trust's affairs and the jurisdiction in which litigation must be conducted.

Green and another v. *Jernigan and others*, 2003 BCSC 1097 shows the importance of the choice of the law governing the trust. In that case, the island Nevis was chosen as the forum for the administration of the trust and the governing law of the trust. When the plaintiff alleged that the trustees had misused trust funds, he tried to bring an action in British Columbia arguing that notwithstanding the selection of the law and the courts of Nevis in the trust indenture, the connections between the Nevis courts, businesses and political authorities, the small size of the Nevis bar and the deficiencies in discovery process would prejudice the plaintiff in bringing an action there. Notwithstanding these concerns, the court gave effect to the choice of law clause in the trust indenture holding that the concerns raised by the plaintiff were not sufficient to depart from the choice of venue and forum clauses. That would require a "strong cause" and one did not exist in that case.

M. DEEDS OF APPOINTMENT

Trustees often exercise powers of appointment (powers to distribute or hold property for a particular beneficiary) by executing a deed of appointment. Deeds of appointment may be revocable or irrevocable.

N. POWERS OF APPOINTMENT

An individual can be given a power of appointment under the terms of a trust which entitles that person to determine how trust property is to be distributed to the beneficiaries. The CRA has indicated that a power of appointment is not, in itself,

---

[33] Many provinces have enacted legislation giving effect to the International Convention on the Law Applicable to Trusts and their Recognition which entitles a settlor to choose the law by which the trust is to be governed.

property and thus not subject to a deemed disposition pursuant to subsection 70(5).[34] However, the CRA noted that such a power could affect the value of an interest in the trust for the purposes of subsection 70(5).

O. LETTER OF WISHES

A non-binding declaration of the settlor's wishes often accompanies discretionary trust indentures as a means of suggesting, in a non-binding manner, how the trustees should administer the trust. A trustee's duty is in respect of the beneficiaries and therefore it is improper for a trustee to administer a trust in accordance with a letter of wishes without considering the beneficiaries' interests.

P. TRUST MINUTE BOOKS

While not required by law, consideration should be given to preparing trust minute books which contain:

(i) the trust indenture;

(ii) evidence of the trust property being delivered by the settlor to the trustee;

(iii)the trust property if it is a silver ingot or gold coin;

(iv)a register of trustees; and

(v) trust minutes.

Some trust advisors say that the trustees should not keep written minutes of their decisions, based on the *Hastings-Bass*[35] jurisprudence whereby decisions of trustees can be set aside by the courts if the trustees have failed to take into account considerations that they should have and *vice versa*. It has been suggested that the unspoken reason for not keeping trust minutes is that such reasoning can be

---

[34] CRA Document No. 2000-0013235.

[35] *Re Hastings-Bass (Decd), Hastings* v. *IRC*, [1975] Ch 25 (CA)

improved with hindsight should the decision ever be challenged. A far better practice is to record decisions appropriately made at the outset.

XII. ATTRIBUTION RULES

A. CONCEPTUAL OUTLINE OF THE RULES

The attribution rules are always a concern in an estate freeze. The purpose of the attribution rules is to foil income splitting; generally on of the main purposes of an estate freeze is to split income. It is therefore critical to ensure that planning proceeds within the framework permitted by the attribution rules.

There are two particular places where the attribution rules are likely to apply: when spouses or minor children purchase shares of a corporation in the course of an estate freeze; and when property is transferred to a corporation that has as a shareholder a spouse or minor child or grandchild (either directly or as a beneficiary of a trust).

B. LOANS OR TRANSFERS TO SPOUSES OR MINORS

Section 74.1 requires that any income derived from property that is lent or transferred by an individual (the "transferor") to his or her spouse, or to certain individuals under the age of 18, will be attributed back to the transferor for tax purposes. The Act restricts the attribution of income earned from a property lent or transferred to a minor to situations where the minor does not deal at arm's length with the transferor or, alternatively, is the transferor's niece or nephew.

When a loan or transfer of property has been made in favour of the transferor's spouse, attribution of any income derived from the property that is lent or transferred will only apply during the period in the year throughout which the recipient of the property is his or her spouse (s. 74.1(1)). In the case of property transferred or lent to designated minors, attribution will only apply in respect of income derived during years in which the designated minor did not attain the age of 18. In addition, attribution of income will only apply to the period in a particular

year throughout which the transferor is resident in Canada (see subsections 74.1(1) and (2)).

The attribution rules are not limited in their application to the particular property originally transferred or lent by the transferor to his or her spouse or a designated minor. Any property substituted for or acquired with the proceeds of disposition of the particular property will be subject to the same rules. In addition, if the property lent or transferred is used by the transferee to repay, in whole or in part, amounts borrowed to acquire some other property, or alternatively, to reduce the outstanding balance owing in respect of that other property, then the attribution rules will apply to attribute back to the transferor a pro rata portion of income derived from that other property. Under the Act, the allocation of income realized from the other property between the transferor and his or her spouse or the designated minor will be based on the proportion of the cost of the other property that is represented by the value of the property that was originally lent or transferred by the transferor and ultimately used by the spouse or designated minor to satisfy their outstanding obligations in respect of the other property (s. 74.1(3)).

C. LOANS AND TRANSFERS TO TRUSTS

The attribution rules also apply in situations where a transferor lends or transfers property to a trust for the benefit of his or her spouse or a designated minor.

The rules in paragraph 74.3(1)(a) determine the amount of the trust income derived from the property lent or transferred to the trust by a transferor that is allocable to a particular designated person. Any amount of the trust income so allocable will be attributed to the transferor under section 74.1 if the amount relates to a period in the year throughout which the transferor is resident in Canada and the designated person is either his or her spouse or a designated minor.

Note that the exemptions described above for loans made on a commercial basis in respect of which interest is paid within 30 days after year end and for transfers of property made for fair market value consideration are also available for loans and

transfers of property made by a transferor to a trust for the benefit of one or more designated persons.

D. EXEMPTIONS

There are several important exemptions to the general rules described above. Firstly, property lent by an individual to or for the benefit of a spouse or a designated minor will be exempt from the attribution rules when the following conditions are satisfied:

(i) the loan bears a rate of interest equal to or greater than the lesser of

- the prescribed rate applicable under Part XLIII of the Regulations at the time the loan is made; or

- that rate of interest that would have been charged by an arm's length party in similar circumstances (s. 74.5(2)(a)); and

(ii) the interest payable in respect of the loan for a particular year is actually paid within 30 days following the end of that year (s. 74.5(2)(b)).

Note that a loan that becomes tainted for the purposes of the attribution rules because interest is not paid within 30 days of the end of a particular year cannot be restored to the status of an exempt loan by subsequent payment of that interest even if in every year following interest is paid within the prescribed time frame (see paragraph 74.5(2)(c)).

Secondly, transfers of property made by a transferor to or for the benefit of his or her spouse or a designated minor will also be exempt from the attribution rules if, at the time of the transfer, the transferor receives property having a fair market value which is not less than that of the property transferred (paragraph 74.5(1)(a)). When the consideration received by a transferor includes some form of indebtedness, he or she will be treated as having received fair market value consideration only if the indebtedness bears a commercial rate of interest (that is, the lesser of the prescribed rate and the rate that would be charged by an arm's length party under similar

circumstances) and such interest is in fact paid within 30 days after the end of each year (see paragraph 74.5(1)(b)).

E. CORPORATE ATTRIBUTION RULE

The corporate attribution rule in section 74.4 is the most complex,[36] least understood[37] and potentially most damaging of all of the attribution rules. When the rule applies it results in double taxation: the taxpayer is taxed at a penal rate on income he or she never receives. Further, the rule applies when the opportunity to income split has been created regardless of whether income splitting has occurred.

The rule is designed to prevent income splitting of passive income through the use of a corporation. Prior to October 28, 1986 the attribution rules could be avoided by transferring or loaning property to a corporation whose shareholders were a taxpayer's spouse and children instead of transferring or loaning the property directly to family members. The corporate attribution rule catches such transfers unless the corporation remains a "small business corporation".[38] The underlying policy is that it is permissible to income split through a corporation if the income being split is active business income. However, the restrictive definition of small business corporation can lead to attribution even where all the corporation's income is from an active business - for example, an active business carried on outside Canada.

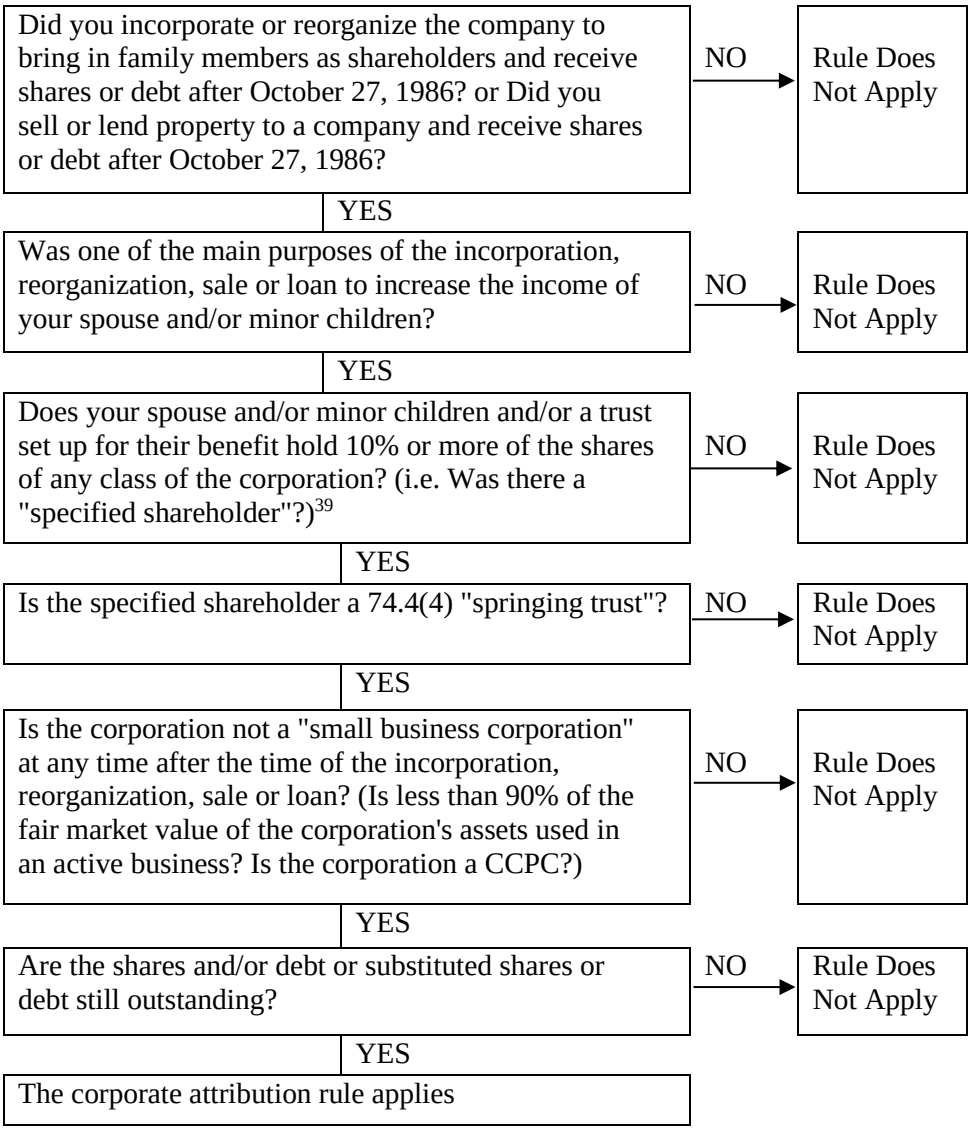
---

[36] The predecessor to the corporate attribution rule was introduced on November 21, 1985 but was repealed because it was too complex!

[37] In *Gehres v. The* Queen, 2003 DTC 913, [2003] 4 CTC 2752 (TCC), the Minister unsuccessfully tried to reassess the taxpayer under 74.1(2) even though the taxpayer was clearly caught by section 74.4.

[38] Subsection 248(1) defines a small business corporation to be a Canadian-controlled private corporation (also defined in subsection 248(1) by reference to a definition in subsection 125(7)) all or substantially all (90% in the CRA's view) of the assets of which are used in an active business carried on primarily (50%+) in Canada, shares or debt of "connected" (defined in subsection 186(4)) small business corporations or combinations thereof.

This is a simplified analysis to determine if the rule applies:



The requisite income splitting purpose for the corporate attribution rule to apply is generally easy to find. All that is required is that income splitting be reasonably considered to be one of the main purposes, i.e. all the CRA needs to reassess is a reasonable argument. Subsection 74.4(4) deems the requisite purpose not to exist if

---

[39] Prior to 1992 a beneficiary of a discretionary trust could not be a specified shareholder of a corporation. By virtue of the addition of paragraph "e" to the definition of specified shareholder in subsection 248(1) beneficiaries of discretionary trusts can be specified shareholders since 1992.

the trust is a springing trust described in that provision.[40] A springing trust's beneficiaries cannot include any designated persons. This is an extremely important exception that facilitates using a springing trust for long-term estate freezes.

The rule could arguably apply where a taxpayer simply guarantees corporate debt because the taxpayer will be considered to have lent the funds to the corporation by virtue of subsection 74.5(7). However, the CRA has stated that in these circumstances it is unlikely that the main purpose of the loan would be to benefit a "specified person" in respect of the guarantor.[41] This would no doubt be the case if the corporation services the debt on a timely basis so that the guarantee is not called upon.

The corporate attribution rule deems a taxpayer to have received a yearly deemed interest benefit determined as follows:

Yearly deemed interest benefit	=	Prescribed interest rate from time to time	X	Redemption amount of outstanding preferred shares or amount of outstanding debt	X	No. of Days corporation not a small business corporation 365 days	–	5/4 dividends received on shares and/or interest received on debt in the year and/or 5/4 dividends subject to kiddie tax

Assume a taxpayer is subject to the corporate attribution rule because as part of a reorganization introducing a trust (whose beneficiaries include the taxpayer's spouse and minor children), the taxpayer received preferred shares worth $1,000,000 in exchange for common shares, and that throughout the year following the reorganization the corporation was not a small business corporation, the prescribed rate under regulation 4301(c) to the Act was 6% and no dividends were paid on the preferred shares. The deemed interest benefit would be:

6% X $1,000,000 X 365/365 C 0 = $60,000

At a 50% tax rate the tax cost of the deemed interest benefit would be in the order of $30,000 to a high rate taxpayer. If a dividend had been paid on the shares of $48,000 the taxpayer would have paid approximately $16,800 of tax, assuming a 35% tax rate, on $48,000 of dividend income actually received but would have no imputed income.

This example clearly shows that if there is a significant corporate attribution problem, dividends (or interest) should be paid on the offending shares (or debt) to the taxpayer so that he or she pays tax at a lower rate on income actually received rather than tax on the deemed interest benefit.

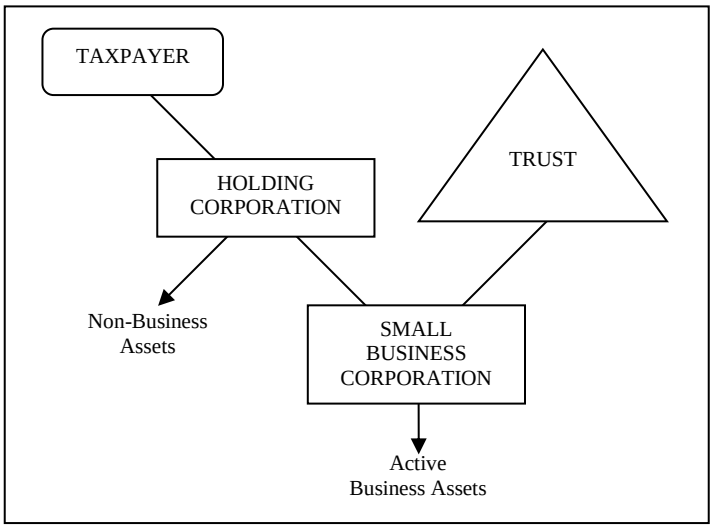
Redeeming the offending shares or repaying offending debt generally, but not always, removes the corporate attribution problem. Subparagraph 74.4(3)(a)(ii) prevents the corporate attribution rule from being avoided by substituting shares or debt that are subject to the rule with other shares or debt.

A deemed dividend arising on the repurchase or redemption of the particular shares will not reduce the amount of a deemed interest benefit.[42]

The corporate attribution problem can be avoided by keeping the company in question a small business corporation by regularly removing surplus (i.e., assets not used in the company's active business) to a holding company using the following structure:

---

[42] Paragraph 74.4(2)(f).



Rather than purifying a corporation by transferring non-business assets to a new parent corporation in advance of introducing a trust as a shareholder, consideration should be given to transferring business assets to a new subsidiary. As there would be no transfer of property to a corporation by an individual the corporate attribution rule may not apply. [43]

By virtue of paragraphs 74.5(6)(a) and (c) the corporate attribution rule could apply in these circumstances if the property transferred from one corporation to another was property, or property substituted therefore, that an individual originally transferred to the transferor corporation. In these circumstances the individual is deemed to have transferred the property directly to the transferee corporation and there is no ability to reduce the deemed interest benefit by paying dividends on shares or interest on debt given by the transferee corporation to the transferor corporation because the dividends or the interest would not be considered to be received by the individual. Substituted property is defined in subsection 248(5) to include a stock dividend paid on a share but otherwise substituted property is created only when the original property is disposed of or exchanged. Therefore, the

43

corporate attribution rule could not apply where a corporation transferred property to a second corporation that was acquired with retained earnings earned with property transferred to the transferor corporation by an individual.

TABLE OF CONTENTS