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Workshop B

A Comprehensive Review of Trusts Fundamentals

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Overview

- What's new?
- The basics
- Tax planning with trusts
- Design and implementation
- Administrative issues
- Problem areas
- Dealing with the 21 year rule
- Alter Ego & Joint Partner trusts

What’s New

- July 18, 2017 Proposals/TOSI
- 55(2)
- Principal residence exemption

Legal Basics

- Trust: legal relationship under the rules of equity
- ITA ss. 108(1); 104(1) – inclusive definitions
- Related device: the power of appointment
- How is a trust created?
- What are the requirements?

Tax Basics for Trusts

- Taxation of Trusts
- Disposition of Property to a Trust
- Reversionary Trust Rules
- Attribution Rules
- Distribution of Property from a Trust
- 21 Year Rule
- Affiliation Rules
- Testamentary Trusts

TAXATION OF TRUSTS

- Not a separate legal entity, but taxed as one
- Taxed as individual (without personal credits)
  - Inter vivos – top marginal rate (54% for NS), calendar year
  - Testamentary – formerly graduated rates (until 2016), now top marginal rate with few exceptions.
  - Deemed disposition of capital property every 21 years

TAXATION OF TRUSTS

- Taxable income of trust equal to:
  - Income received by trust
  - Less: expenses incurred by the trust to earn income
  - Less: income allocated to beneficiaries
  - Less: amounts for payments for upkeep of property used by beneficiaries
  - Less: losses carried forward and applied
- Trust is taxed on remaining balance
- Note: net capital losses and non-capital losses cannot be allocated to beneficiaries

TAXATION OF TRUST BENEFICIARIES

- Beneficiaries include income paid or payable to beneficiary in their income
  - Meaning of "paid or payable"
  - Payments made to third parties on behalf of beneficiary
- Allocations of income restricted to income beneficiaries

TAXATION OF TRUST BENEFICIARIES

- Most income can retain its character when allocated to beneficiary:
  - i.e. dividends, capital gains and foreign income
- If trustees elect, can tax in the trust income or capital gains actually allocated to beneficiaries from the trust <u>to extent of trust's losses</u> to make trust income zero
- Part XIII Tax on allocations to non-residents
- Trust may be subject to Part XII.2 tax if trust earned "designated income" and there are non-resident beneficiaries

TAXATION OF TRUST BENEFICIARIES

Caution: High-rate tax on split income ("TOSI")

- Current state
  - Dividends (and certain capital gains) from private company shares allocated to minors (i.e. < age 18)
- July 18, 2017 proposals
  - Expanding the application – no longer just minors
  - Introduction of reasonableness test
  - Broadening of the types of income
    - Income from debt instruments, capital gains on properties subject to TOSI, income on income

TAXATION OF TRUST BENEFICIARIES

TOSI Reasonableness Test

- Three-prong test
  - Labour/efforts (caution – N/A for "passive" companies)
  - Capital contributed
  - Risk assumed
- But must also consider previous amounts paid/payable

DISPOSITION OF PROPERTY TO A TRUST

- Disposition to a trust occurs at FMV unless exceptions met
- Qualifying transfers of capital property at cost under subsection 73(1.01) by individual to a:
  - Spousal trust
  - Alter-ego/Joint-spousal
  - Self benefit trusts
- Transferor deemed to receive proceeds equal to cost
- Trust deemed to acquire property at cost
  - Can elect for FMV treatment if desired

REVERSIONARY TRUST RULES

- Subsection 75(2) applies when property (or substituted property) is held by a trust on the condition that it:
  - May revert to the contributor of the property
  - May pass to persons determined by the contributor
  - Not be disposed of without the consent of the contributor
- Not applicable to persons transferring property at FMV
- Impacts:
  - Any income, capital gains (loss, capital losses) earned on the property (or substituted property) attributes to contributor (if alive and resident)
  - Trust cannot "rollout" <u>any</u> property to capital beneficiaries if subsection 75(2) applied at <u>any</u> time

ATTRIBUTION RULES

- Not applicable to GRE’s or testamentary trusts
- Purpose: restrict income splitting
- Income and capital gains attributed to person who transferred property
- Designated person
  - Spouse
  - Non-arm's length individuals under 18 (children)
  - Nieces/nephews
- Exception if valid loan bears interest at prescribed rate
- Corporate attribution

DISTRIBUTION OF PROPERTY FROM A TRUST

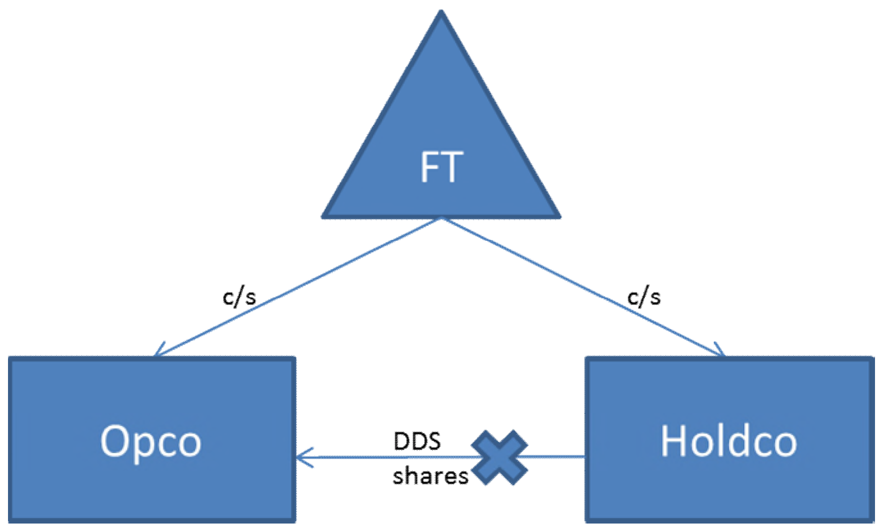
- "Rollout" under subsection 107(2)
  - Must be a disposition as defined in 248(1)
  - Trust disposes of property at cost, beneficiary acquires property at cost
- Not available if:
  - Subsection 75(2) ever applied to the trust (unless to contributor)
  - Beneficiary is non-resident
  - Trustees elect out of rollout
- If no rollout, disposition is at FMV
  - Trust disposes of property at FMV, beneficiary acquires property at FMV

21 YEAR RULE

- Deemed disposition of all capital property, every 21 years
  - Applies to all trusts (except life interest trusts)
- Options
  - Do nothing, pay tax
  - Distribute property to capital beneficiaries (including corporate)
    - at cost under ss. 107(2)
    - at FMV if elect under 107(2.001)
  - Freeze with a holding company and distribute shares

55(2)

- Expanded anti-avoidance rule in s. 55(2) may capture certain inter-corporate dividends (such as dividends paid from opco to holdco) that were previously tax-free
- Existing corporate structures may need to be modified, particularly if structured with dividend streaming shares
- Can use existing family trust to avoid s. 55(2), so long as the trust permits a corporate beneficiary
- If not, may need to restructure and implement a new trust that does


FT
c/s
c/s
Opco
DDS
shares
Holdco

TESTAMENTARY TRUSTS

- Arise as a consequence of the death of an individual
  - ➢Will can create several separate trusts
- No graduated tax rates (after 2016)
- No off-calendar year end (after 2016)
- Exception to both for GRE’s for 36 months
- Spousal testamentary trust
  - ➢Rollover at deceased's cost base to trust, may elect out
  - ➢Tax on deemed dispositions on death of individual is deferred
  - ➢Only spouse can receive income or capital during their lifetime
  - ➢Vest indefeasibly within 36 months

GRADUATED RATE ESTATES

- New as of Jan 1, 2016
- Graduated rate estate (**"GRE"**) – three part test

  (i) an estate that arose on and as a consequence of an individual's death
  (ii) that is a testamentary trust and
  (iii) only for 36 months from date of death
- Must be designated as a GRE by the executors in the estate's first tax return
- Only one GRE per taxpayer
- Is the estate itself – not a trust arising from the will

GRE RULES

- GRE can have an off-calendar year end BUT loses this status 36 months post date of death (Note – possible to have 4 Y/E's within one GRE although 2 will be short years)
- Deemed year end on loss of status and thereafter December 31 year end going forward
- Only a GRE eligible for 164(6) loss carry back and 112 (3.2) loss restriction
- Only a GRE can make estate donations under the new rules
- No installment obligations for a GRE
- Graduated tax rates apply

PRINCIPAL RESIDENCE EXEMPTION

- Previously covered all "personal" trusts in the ITA
- Trust designates on Form T1079 with the T3 return
- Trust notes the specified beneficiaries
- Effective after 2016, trust must be an "eligible trust" to qualify AND must have a "specified beneficiary" AND for property acquired after October 2, 2016 trust terms must provide the specified beneficiary with a right to use and enjoyment of the property as a residence throughout the period trust owns the property

PRE (Cont'd)

- Do you need a specific clause or is a right to use and enjoyment of the trust property generally by a specified beneficiary enough?
- Eligible trusts:
  - alter ego, joint partner, spousal and self-benefit trusts (specified beneficiary is settlor or spouse/common-law partner of settlor)
  - qualified disability trusts (specified beneficiary is the "electing beneficiary")
  - trust for minors where parents not alive and one or both parents settled the trust

PRE (Cont'd)

- Non-eligible trust (i.e. a classic residence/house trust) still qualifies to shelter gains up to December 31, 2016
- Consider:
  - rolling out property to beneficiaries (now or later – beneficiary can still use the PR exemption for years up to the end of 2016 when owned by the trust) (See s.107(2) and s. 40(7) of the ITA)
  - sale by trust to trigger gain now and shelter with exemption

AFFILIATION RULES

- Affiliation rules apply to post-mortem planning involving trusts
- Important definitions:
  - Majority interest beneficiary
  - Contributor
- Capital losses realized by trust on redemption of shares may be denied under subsection 40(3.6) if trust and corporation are affiliated *after* redemption
- Note 40(3.61) exception for GRE where 164(6) applies

Tax Planning with Family Trusts

- Planning Tips
- Planning Traps
- When does a trust make sense?
- When doesn’t a trust make sense?

Planning tips for family trusts

- Ensure the beneficiaries allow for a corporation and/or another trust for distributions purposes as well as future planning.
- Do not shortcut mechanics
  - Share subscriptions
    - Try uncalled basis if no funds available
  - Interest rate on loans
- Planning early
  - When might values or a plan to sell signify a family trust structure is useful?
  - When will children, parents or grandparents require funds?
    - When children are teenagers. Trust date may depend on desired value that needs to be accrued.
  - Be on the lookout for current or potential association or attribution issues with beneficiaries

Planning traps for family trusts

- 21 year rule - be prepared
- Named spouse as beneficiary?
- Beware of Trust's effect on Part IV tax in corporate group
- Beware of ITA 74.4 – Corporate attribution
  - Things to consider
    - SBC status
    - Stock dividends
    - Restrictions on income or capital (AKA 74.4(4) trusts)
    - Paying the dividends or interest (avoid phantom income)
    - Wasting freeze

More traps

- Acquisition of control on change of trustees
- Corporate beneficiaries – connected corporation status
- Tension in structuring to deal with the two issue above

When does a trust make sense?

- Tax-related Reasons:
  - Income splitting – caution TOSI
  - Multiplication of capital gains exemption
  - Avoid probate fees
  - Tax minimization on death
- Non-Tax Reasons:
  - Asset protection
  - Control of assets
  - Business succession
  - Care for disabled persons (e.g. *Henson* trusts)
  - Protection of privacy
  - Family marital issues
  - Commercial uses

When doesn't a trust make sense?

- When there is no immediate or future need
  - No children, spouse, or family members where income or wealth splitting is possible or TOSI would apply
- Low values
  - If company is planning to be sold, but does not exceed capital gains exemption
  - Tax and Probate savings less than cost to implement and operate
  - Business with no growth potential – i.e. medical professional corporation
  - Companies with share ownership restrictions – i.e. some professional corporations
- Other
  - Association, attribution etc.
  - Spouse to income split with, but no children
  - No wish to share growth with the family, but want to income split

Design and Implementation - Overview

- Settlor
- Trustees
- Beneficiaries
- Corporate beneficiaries
- Trust beneficiaries
- Integration with the freezor’s will
- Rule against perpetuities

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Settlor

- 75(2) concerns
- Proper trust formation concerns
- Freezor as transferor/”settlor” - *Sommerer*

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Trustees

- How many?
- Power of appointment for freezor
- 56(2) concerns? – 2012-0462891C6

Beneficiaries

- Trust law requirement of certainty
- Requirements for a power of appointment
- Concerns with adding beneficiaries later
  - Sham
  - Varies existing beneficiaries’ interests – therefore a disposition by the beneficiaries
  - Resettlement of the trust – disposition by the trust
  - See Elie Roth – STEP Inside article – October 2013
- Adding beneficiaries by reference to the freezor’s will

Corporate Beneficiaries

- 75(2) concerns (circularity)
- Part IV tax concerns
- Certainty of beneficiaries concerns

Trusts as Beneficiaries

- 75(2) issues
- Trust to trust transfers

Integration with the Freezor's Will

- Different approaches
- Tie to the will by power of appointment

Rule Against Perpetuities

- The rule
  - No trust interest is valid unless it must vest, if at all, not later than twenty-one years after the death of some life in being at the creation of the interest.
- NS – abolished the rule in 2015
- PEI – modified the rule by statute (LIB + 60 years)
- NF – still has the rule
- NB – still has the rule, but considering changes

Administrative issues

- Filing requirements
- Filing deadlines & penalties
- Reporting and distributing certain types of income
- Connected corporations status – corporate beneficiaries
- Change of arm's length trustees and change of control issues

Filing requirements

A return must be filed if any one of the following conditions applies, the trust:

- the trust has tax payable;
- is requested to file;
- is resident in Canada and has either disposed of, or is deemed to have disposed of, a capital property or has a taxable capital gain;
- is a non-resident throughout the year, and has a taxable capital gain or has disposed of taxable Canadian property;
- is a deemed resident trust;
- holds property that is subject to subsection 75(2) of the Act;
- has provided a benefit of more than $100 to a beneficiary for upkeep, maintenance, or taxes for property maintained for the beneficiary's use or
- receives from the trust property any income, gain, or profit that is allocated to one or more beneficiaries, and the trust has:
  – total income from all sources of more than $500;
  – income of more than $100 allocated to any single beneficiary;
  – made a distribution of capital to one or more beneficiaries; or
  – allocated any portion of the income to a non-resident beneficiary.

Filing Deadlines & Penalties

- Filing deadlines
  - Return required 90 days after trust year end
  - Tax payment required 90 days after trust year end
- Penalties
  - Late filing: If no return filed, 5% on unpaid tax + 1% on unpaid tax for each full month late (max of 12 months)
    - Will be higher if demand to file the return was issued (10% and 2%, max of 20 months)
  - Late T3 slips
    - $25/day for each slip, minimum $100, maximum of $2,500
  - If convicted of not filing a return or slip
    - May be a fine of $1,000-$25,000 or imprisonment for up to 12 months
  - Filer penalties
    - Culpable conduct, prepares returns or slips on behalf of another person with false statements or omissions
    - Greater of $1,000 or 50% of tax avoided

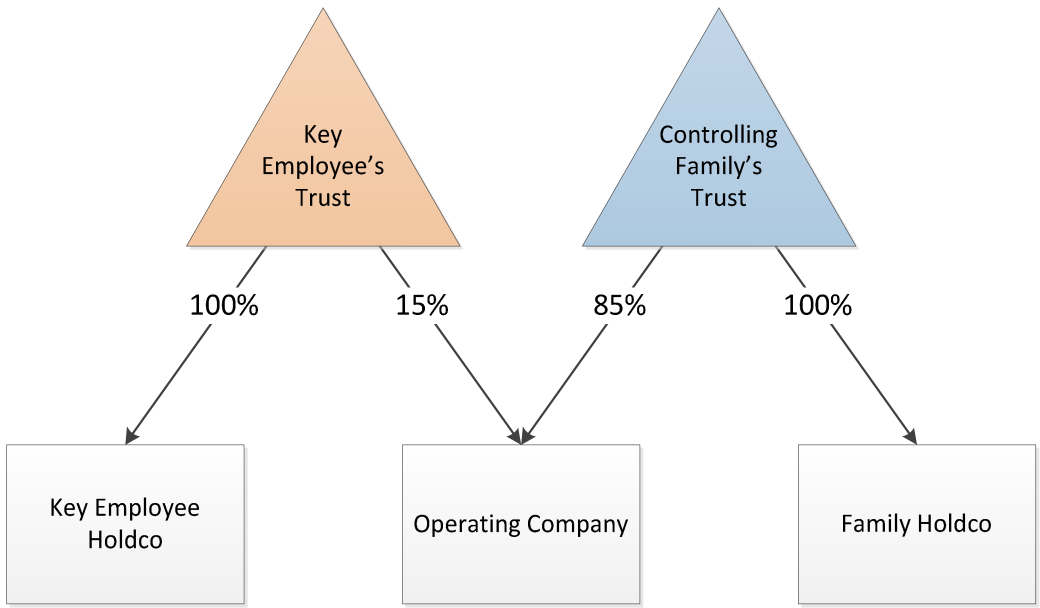
Reporting and distributing income

- Most types are dollar for dollar
  - Dividend income, interest income, etc.
- Common topic; capital gains
  - Only required to distribute taxable capital gains to a beneficiary
  - Remainder is trust capital, can be distributed to another beneficiary
  - Example
    - Trust sold shares of a CCPC for $1,600,000. Cost base nil.
    - Taxable capital gain of $800,000
      - Allocates $400,000 to two different beneficiaries in accordance with ITA 104(21) and 104(21.2)
      - Cash of $400,000 paid to those beneficiaries. Remaining $1,200,000 can be allocated to other beneficiaries.
- CDA dividend trapped in trust when not paid out in the same year – 2012-0469591E5

Part IV Tax – Connected Corporations

- Two methods to be connected – 186(2); 186(4)
- Single family corporate structures – usually able to have connected status for corporate beneficiary
- Arm's length shareholders – can be problematic to have connected status

Connected Corporations - Example



Change of Arm’s Length Trustees

- CRA position: results in acquisition of control
- Deeming provisions
  - 256(7)(i) – non-discretionary trust – no AOC when trustees change
  - 256(7)(h) – “loss restriction event” (251.2) = AOC
  - 251.1/251.2 – “majority interest beneficiary”

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Problem Areas

- Inadvertent Association of Companies
- Inadvertent Change of Control
- Non-Resident Trustees and beneficiaries
- US Citizen issues
- Family law issues
- Client’s impending death – no integration of the trust and will

Inadvertent Association of Companies

- Beneficiaries are deemed to own shares of held by a trust
  - ITA 256(1.2)(f)(ii)
  - Discretionary trust – deemed ownership is 100% to each beneficiary.
  - Common shares and non-specified class of shares cause association issues.
  - Voting shares to another shareholder does not help
- Where ss. 75(2) applies – shares deemed to be held by contributor of property
- Understand the beneficiaries (do they own or plan to own a company?)
- Limit the beneficiaries – Pros and cons
- Boot or penalty box clauses – Who likes them?
  - Careful drafting is needed

Inadvertent Change of Control

- ITA 256(7)(a) does not apply to Alter Ego or Joint Partner Trusts
- Recent CRA views confirms acquisition of control could apply:
  - Sole trustee resigns and is replaced by unrelated party
  - Two trustees, one resigns and is replaced -> results in new group
  - Three trustees; trust requires either unanimous decision making or majority decision making. One trust resigns and is replaced
    - In CRA view 2011-0401931C6, CRA states they have taken concerns to Department of Finance.

Non-Resident Trustees

- Central management and control (Garron case)
- Trust becomes non-resident
- Exit tax concerns
- S. 94 issues

Non-Resident Beneficiaries

- Part XIII withholding on distributions – 212(1)(c)
- Distributions deemed to be income – 212(11)
- No roll-out on capital distributions (except real estate) – 107(2)
- Part XII.2 tax
  - Paid by trust
  - If non-resident beneficiaries + "designated income"
    - = Canadian business income or gains from TCP
  - Credit for Canadian beneficiaries

US Citizens

- Concerns if US citizen is the freezor – i.e. US gift tax, etc.
- Also concerns if US citizen is the beneficiary
  - Sub-Part F income (interest, dividends and other investment/property income) in any of the companies under the trust
  - Including dividends out of active business income of a lower tier corporation that is not controlled by the parent
  - <u>If</u> the income is not flowed out of the structure each year (i.e. that is retained in one of the companies).
- Consider:
  - Excluding US citizens from the trust – or a "boot" clause if they become citizens
  - Default rule to stream Sub-Part F income to non-US citizen
  - Language in trust to clarify intent re, Sub-Part F income

Family Law

- Are family trust assets matrimonial property?
- Pros and cons of including the freezor’s spouse as a beneficiary
- Pros and cons of including the spouses of children as beneficiaries

No Integration with the Will

- Proper design of the dispositive provisions of the trust
- Boot clauses for beneficiaries?
- Power of appointment exercisable by will
- Standing trustee resolutions
- Revocable allocations/appointments

21 Year Planning

- The problem: 104(4)
- Potential solutions
  - Do nothing – manage double tax in underlying corps
  - Rollout – manage complications regarding control and non-resident beneficiaries
  - Reduce the value of the underlying shares
  - Freeze the trust
- The rollout – 107(2)
  - Non-resident complications
  - Maintaining control – voting shares
  - Shareholders' agreement

Alter Ego and Joint Partner Trusts

- The advantages
- The problems
  - Cost
  - Integration with the client's will
  - Charitable donation problems
  - Capital gains exemption problems
  - Post-mortem planning challenges
  - Canada-US issues

Charitable Donation Issues

- Applicable for 2016 and subsequent taxation years for a death that occurred after 2015 (revisions to 118.1)
- Donations made in a will, and those made by designation under a RRIF, RRSP, TFSA or life insurance policy, are no longer deemed to be made by the individual immediately before the individual's death
- Now deemed to have been made by the individual's estate at the time the property is transferred to a qualified donee, provided the transfer occurs within 60 months after death (provided was a GRE for 36 months)

Donations (Cont'd)

- Executor/trustee has flexibility to allocate the available donation credit among:
  - the taxation year of the estate in which the donation is made (75% limit)
  - an earlier taxation year of the estate (75% limit) **or**
  - the terminal and/or immediately preceding taxation year of the individual (100% limit)
- If estate not a GRE credit only available against the estate's income in year donation made plus 5 year carry forward

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Donations (Cont'd)

- Property being gifted must be "property that was acquired by the estate on and as a consequence of the death" or "property that was substituted for that property"
- Valuation of donation credit is value on date property transferred to charity – if not cash, could be different than at date of death

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Charitable Donations (Cont’d)

- Compare with gifts made by alter ego trust:
  - deemed disposition in trust (104(4)) – want the donation credit there to match
  - Non-discretionary gift – no donation credit !!!
  - Need trustees’ discretion to make the gift – to match with income inclusion
  - Letter of wishes?
  - No carryback to prior year
  - Must make the gift in the calendar year in which the death occurs plus 90 days (118.1(1))

Capital Gains Exemption

- The problem:
  - Exemption cannot be claimed by an alter ego trust on the death of the settlor, and gains arising on death of the settlor cannot be allocated to the settlor
- The solution:
  - Elect out of the rollover on the transfer in to the trust

Post-Mortem Planning

- Problems:
  - Loss carrybacks (164(6) not applicable)
  - 88(1)(d) bump:
    - Getting 88(1)(d.3) to apply – AOC “as a consequence of death”

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Questions???

Thank You!!!