Family Trust Update

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Recently, there has been an increased focus on trusts by the Canada Revenue Agency (the "CRA"), both in the international and domestic context. This focus probably originated as far back as 2005, but more recently, the CRA seems to be concerned with the residency of trusts, the proper establishment of a trust, and the ongoing maintenance of a trust. While CRA attacks on trusts are nothing new (the case law goes as far back as the 1970s), a current review of all existing trust structures is recommended in order to ensure compliance with Canadian income tax and trust legislation.

Residence of a Trust

Historically, it had been "conventional wisdom" of many Canadian tax practitioners that a trust is resident in the jurisdiction in which a majority of its trustees resided. In March 2009, however, a questionnaire was sent by the CRA to several prominent Alberta trustees focusing on a determination of a trust's residence based on the "central management and control" of the trust (the test ordinarily utilized to determine a corporation's residence). The questionnaire contained queries aimed at determining who has the real authority to make trust decisions, including those related to the trustees' qualifications, expertise and experience; the trustees' duties and responsibilities; and how decisions are made in relation to the trust property (including whether to distribute income to beneficiaries and where to have income taxed).

Just a few months later, the Tax Court of Canada (the "TCC") released its decision in Garron, where the TCC applied the "central management and control" test to deem a trust to be resident in Canada that would have otherwise been resident in the Barbados based on the trustee's residence. Like the Alberta questionnaire, Garron raises the issue of who really controls the trust, specifically with respect to where real decision-making power lies and the ability of individuals to indirectly control the trust through the power to remove and/or replace the trustees. While Garron was decided within the context of international trusts, the CRA recently confirmed that its principles would be extended to domestic trusts.

Depending on the circumstances, the two distinct tests regarding a trust's residence could lead to different results and potentially significant tax implications. Where an uncertainty exists with respect to the residence of a trust, an advisor should be consulted. Besides offshore trusts, clients with Alberta trusts should be concerned with adverse CRA proceedings.

Proper Establishment and Ongoing Maintenance of a Trust

A little over a week after the Garron decision was released, the TCC issued its judgment in Antle, a case which involved the purported formation of a Barbados trust as part of a series of transactions. The timing of the facts was crucial to the TCC's decision, specifically with respect to the supposed establishment of the trust. Of relevance, the Barbados trustee had signed the trust deed a month and a half before it was dated and Antle, one of the trustees, did not sign the trust deed until 10 days after its purported settlement. Trustee resolutions relating to other steps in the transaction were also not signed until after the steps purportedly happened. The TCC concluded that the Trust was never validly construed, primarily as a result of defective settlement and a lack of intention to create the trust. Accordingly, the TCC concluded that the Barbados trust never came into existence.

While Antle may be considered to be a technical attack on an aggressive tax planning structure, the case also highlights that sloppy trust procedures may leave trust structures vulnerable to CRA attack. In fact, shortly after the release of Antle, tax advisors became aware of the CRA's "Horseshoe Initiative", an audit project commenced in the golden horseshoe area (Mississauga, Hamilton, Kitchener, London and Windsor) focusing on a number of issues regarding domestic trusts. While the majority of the items for which the audit is focused relate to the ongoing maintenance of a trust (discussed further below), one of the initiative's focuses is the absence of original settlement property used to establish the trust. While there is no rule as a matter of trust law that the settlement property must be retained at all times, the settlement property (together with the signed trust deed) provide strong evidence of the establishment of a trust, should its existence ever be challenged.

With regards to the ongoing maintenance of a trust, the "Horseshoe Initiative" audits are apparently focused on a number of items, including the use of promissory notes for payments to beneficiaries that have become unenforceable due to the Ontario Limitations Act; determining whether the trustees were withdrawing funds from the trust for their own use even though these funds were purportedly being paid to the beneficiaries; an absence of proper accounting records or trustee minutes for the trust; and compliance with the 21-year rule. It was recently confirmed that this initiative will be expanded both with respect to what the CRA is looking for and the regions in which it is looking.

We believe that some items which may be vulnerable to attack include "homemade amendments" to trusts (e.g., adding or deleting beneficiaries invalidly), questionable share structures (e.g., where a trust acquires shares of a corporation for inadequate consideration), and "resetting" interest rates (e.g., by amending a promissory note to take advantage of the recently low "prescribed rate of interest", which does not appear to be effective). Further, we have also identified a number of factors that may lead to the CRA's attempted application of one of the most dangerous traps in the estate planning field whereby a trust is precluded from distributing its assets on a tax-deferred basis to anyone other than the person from whom the property was received or his or her spouse (e.g., the contributor of the property is a beneficiary of the trust; a beneficiary buys or sells property from or to the trust even if at fair market value; a beneficiary contributes funds to a trust to pay its expenses). These are not comprehensive lists of potential initiatives or factors, and an advisor should be consulted with respect to any uncertainties relating to past or future trust transactions.

Minden Gross Letter

In light of the recent developments, a letter to Minden Gross clients is forthcoming regarding a full "check-up" for client trust structures. Especially for income-splitting structures, we are recommending that our clients review their existing trust structures, and, if trustee decisions made over the years have not been properly documented (e.g., with respect to the allocations and payments of income to beneficiaries), we are recommending that trustee minutes or resolutions be prepared in order to confirm the validity of prior acts. Further, we are recommending that annual resolutions and minutes of trustee meetings (where appropriate) be prepared going forward in order to ensure that trustee decisions are properly documented. Upon receipt of the letter, or prior thereto, please contact one of the members of Minden Gross' tax group or other contact at the Firm.

For further discussion of recent developments in the taxation of trusts, see "The Trouble with Trusts" and "Is a Family Trust Vulnerable to the CRA? Some Warning Signs" (a two-part article), on the Minden Gross website. A webinar – Family Trusts and What Every Tax Professional Needs to Know - conducted by the author, as well as Joan Jung and David Louis of Minden Gross, will be presented by CCH Canadian Limited in coming weeks.