The Estate Planner

March 2015
Number 242

Descarries et al. v. The Queen 3

Deceased Left Everything to Wife and Children, Nothing to Common-Law Spouse 4

Wolters Kluwer

THE EFFECTIVE USE OF TRUSTS IN CONNECTION WITH INCOME SPLITTING (PART I OF IV)

— Michael Goldberg, Tax Partner, Minden Gross LLP, MERITAS law firms worldwide and founder of "Tax Talk with Michael Goldberg", a quarterly conference call about current, relevant and real life tax situations for professional advisors who serve high net worth clients.

Special thanks to Ryan Chua of Minden Gross LLP for his comments on earlier drafts of this series of articles. All errors and omissions are the author's.

Based on a host of recently enacted legislation attacking the use of offshore trusts by Canadians,[1] eliminating immigration trusts, severely restricting testamentary trust tax benefits, generally attempting to eliminate inter-provincial testamentary tax planning opportunities,[2] and so on, it seems safe to say that the Federal government views the use of trusts in Canada dimly these days. And yet, even following all of this legislative upheaval and even if one assumes that more changes may still be coming, it is likely that trusts will continue to be highly used estate planning and succession planning vehicles in Canada.

The main reasons for the endurance of trusts for these purposes is that they are incredibly useful tools that permit individuals to maintain varying amounts of control over assets that they dispose of as part of their estate and succession planning, whether such dispositions occur while they are alive or after they are dead, and due to the flexibility that can be built into trusts to accommodate all manners of changes in family situations. Another significant reason that trusts will continue to be used is that, even with all of the legislative changes and the general chilly tax climate impacting trusts, they continue to provide a host of opportunities for shifting income from high rate taxpayers to low rate taxpayers, which is generally referred to as income splitting.

In the first instalment of this series of articles, some of the basic tax requirements for using trusts to split income will be reviewed. The second instalment of the series will delve into a number of common income splitting opportunities that are accessible through the use of trusts, namely:

- planning to allow additional family members to access their capital gains exemption (sometimes called capital gains exemption (or CGE) multiplication);
- preferred beneficiary and age 40 trust planning;
- prescribed rate loan planning; and
- Ontario surtax planning.

The third instalment of the series will provide a historical overview of income splitting using testamentary trusts, and will touch on the upheaval to trusts, wills, and estates practices caused by the enactment of Bill C-43. Finally, in the last instalment of the series we'll review some of the benefits and risks of planning with Alberta trusts and with trusts deemed to be resident under subsection 94(1) of the *Income Tax Act* (Canada) (the "Act").[3]

Income Splitting Basics

Income and Capital Encroachment

The ability to use a trust to income-split with family members is dependent on the actual terms of the instrument under which any particular trust is formed.[4] For example, discretionary family trust deeds will generally contain broadly drafted powers to permit trustees to make discretionary allocations of income and capital among the beneficiaries of a trust. In addition, a properly drafted trust deed should define "income" as including income for all purposes of the Act.

Unfortunately, many older trust deeds will not include a definition of income that dovetails with the Act. For example, I've seen some trusts where income has been defined as income for GAAP purposes. In other situations, I've seen trust deeds where there is no definition of income at all, in which case the income of those trusts is left to be determined under the law of trusts.

In both of these cases the terms of the trust deed will likely not permit the allocation of capital gains or "phantom income"[5] to beneficiaries. However, so long as the trust deed contains a broad capital encroachment power, it may still be possible to structure capital distributions that permit the trust to allocate its actual realized taxable capital gains income to capital beneficiaries and, under certain circumstances, it may even be possible to allocate taxable income from deemed capital gains to capital beneficiaries.[6]

Taxable Allocation of Income and Losses

Assuming that it is possible to allocate income from a trust for trust and tax law purposes, then it should be possible to use a trust for income splitting because, pursuant to subsection 104(13), amounts allocated and made "payable" to a beneficiary in a particular year will be taxable in the beneficiary's hands instead of in the trust.[7] For purposes of this and a number of other provisions in section 104, subsection 104(24) deems amounts not to have become payable unless the amounts have either been actually paid to a particular beneficiary in the taxation year or unless that beneficiary has a legally enforceable right against the trust for payment of such amounts in that taxation year.

Although it is possible to allocate income to beneficiaries, losses realized in a trust cannot be allocated from a trust to its beneficiaries.[8]

Character of Income

Generally, income earned by a trust loses its character once it is distributed to beneficiaries,[9] so maintaining the character of allocated taxable income in the hands of beneficiaries is very important. Fortunately, section 104 contains specific rules to ensure that certain types of income retain their character.[10]

For example, subsection 104(19) ensures allocated taxable dividends will be treated as taxable dividends in the hands of trust beneficiaries, and subsection 104(20) ensures that the tax status of capital dividends is maintained. In addition, provided that a trust has been drafted appropriately, it should be possible for the trust to allocate realized capital gains to its beneficiaries under subsection 104(21) and, provided that the trust contains a broad definition of income that captures deemed capital gains, it should be possible for these types of capital gains to be allocated as well. In both cases, if the capital gains would otherwise be eligible for CGE treatment, then through the joint operation of subsections 104(21) and (21.2), the trust's beneficiaries will be able to claim their personal CGEs, assuming the beneficiaries are otherwise eligible to do so.

As was mentioned previously, even without broad income definitions in the trust deed, so long as the trust deed contains broad capital encroachment powers and provided that capital distributions are made in the year that those gains are realized, it may still be possible to allocate the trust's capital gains and exempt capital gains (CGEs) to capital beneficiaries.[11]

Complying with the Terms of the Trust

In order to enjoy the benefits of income splitting and CGE multiplication, allocations of trust income and distributions of trust property must be made in accordance with the terms of each particular trust deed to beneficiaries of a particular trust or, if the terms of the trust permit, for the benefit of those beneficiaries.

If the trustees of a trust purport to make allocations or distributions to non-beneficiaries of the trust, such trustee actions will be made in breach of the terms of the trust deed and, in addition to any trust law consequences of such breaches, the income that was intended to be allocated will, for purposes of the Act, remain taxable in the trust. In addition, a tax-deferred rollout of appreciated property of the trust pursuant to subsection 107(2) to persons who are not beneficiaries of the trust will not be possible. As a result, if distributions of trust property are made to non-beneficiaries, the trust will be fully taxable on any unrealized gains in respect of such distributions.[12] This latter issue can be particularly problematic for trusts reaching their 21st anniversary. If these results aren't bad enough on their own, the recipient of such allocations and distributions will likely be considered to have received a benefit from the trust which would subject that person to tax on the value of the benefit under subsection 105(1).

Notes:

[1] See Bill C-48, *Technical Tax Amendments Act, 2012*, which received royal assent on June 26, 2013.

[2] All of these items were dealt with in Bill C-43, *Economic Action Plan 2014 Act, No. 2* ("Bill C-43"), which was enacted on December 16, 2014.

[3] Unless otherwise noted, all statutory references are to the Act.

[4] Among other terms for this instrument, it is sometimes called a trust deed or a trust settlement.

[5] For example, deemed dividends on redemptions or deemed capital gains, such as those that occur on the 21st anniversary of a trust.

[6] For examples of how this might be accomplished, see CRA document number 9531165 dated March 13, 1997, and CRA document number 9428005 dated February 24, 1995.

[7] To avoid double taxation, the Act will generally permit a trust to claim a deduction for amounts that become payable in the hands of its beneficiaries pursuant to the terms of subsections 104(6) or 104(12).

[8] However, pursuant to subsection 75(2), where this provision applies to a transferor of property to the trust, all income and capital losses from such property (or substituted property) will attribute back to the transferor. Losses of a trust from an active business will not attribute back to the transferor (see CRA document number 2013-0476871E5 dated October 3, 2014).

[9] Pursuant to subsection 108(5)(*a*) income received by a beneficiary from a trust is generally characterized as income from property.

[10] One example of where taxable income allocations will lose their character is if they are made to non-residents. In such cases the rules in subsection 212(1) will need to be consulted, as modified by tax treaty, if any.

[11] *Supra*, footnote 5.

[12] See, for instance, CRA document number 9637535 dated January 9, 1997.

DESCARRIES ET AL. V. THE QUEEN 2014 TCC 75

— *Jack Bernstein, Aird & Berlis LLP, Toronto*

The case in question involves tax planning to convert a deemed dividend into a capital gain by first triggering a capital gain and bumping the adjusted cost base and paid up capital ("PUC") of shares received from a holding company. The subsequent redemption of shares generated a capital loss to offset the capital gain.

The taxpayer wished to have a company, OKA Inc., sell its assets and liquidate. This would have resulted in a deemed dividend of $592,366 and a capital loss which could not be applied against the dividend. The tax plan involved triggering a capital gain of $255,808 on the shares of OKA with an internal section 85 of the *Income Tax Act* (the "Act") reorganization (no capital gains exemption) and then transferring the shares to a new holding company, 9149-732 Quebec Inc. ("9149"), for high PUC, high adjusted cost basis ("ACB") Class A shares ($347,848) and NIL PUC, high ACB ($269,618) Class B shares. No tax arose on the redemption of the Class A shares. Section 84.1 of the Act applied to limit the PUC of the shares received from 9149. The Class B shares were subsequently redeemed creating a deemed dividend of $196,505 and a capital loss of $196,505, significantly reducing the capital gain (of $255,808). On the redemption of the balance of the Class B shares, a deemed dividend of $69,000 arose, and a $73,112 capital loss was triggered.

The CRA challenged the transaction as either being an indirect winding up of OKA's business under subsection 84(2) of the Act resulting in a deemed dividend or as a series of transactions designed to improperly convert dividends to capital gains contrary to the general anti-avoidance rule ("GAAR").

Subsection 84(2) refers to funds being distributed or appropriated in any manner whatever to or for the benefit of the shareholders. The court referred to *Canada v. MacDonald*, 2013 FCA 110, for the elements necessary for subsection 84(2) as well as guidance on determining the textual, contextual, and purposive analysis of subsection 84(2). The provision requires: (i) a Canadian resident corporation; (ii) a winding up, discontinuance or reorganization; (iii) a distribution in any manner whatever; (iv) to or for the benefit of its shareholders. The court should examine: (i) who initiated the winding up, discontinuation, or reorganization; (ii) who received the funds at the end; and (iii) the circumstances in which the purported distribution took place.

The Court reviewed *MNR v. Meritt* [1941]Ex. Cr. 175 (Exch Ct) for guidance on indirect distributions. At the time of redemption, OKA still held assets. The term distribution requires both a gain for the shareholders and a loss for the company. In *McDonald v. The Queen*, 2012 TCC 123, the company's assets were reduced by the amount appropriated to the shareholder. In *McNichol v. Canada* [1997] TCJ No. 5 (QL) subsection 84(2) didn't apply because company's assets remained unchanged at time of the alleged distribution. There was no distribution when OKA's funds were loaned to 9149. There was no stripping of assets when there was a merger and OKA still owned lots when shares were redeemed.

The second test, which is that the distribution must be concurrent with a winding up, was also not met (i.e., as the business of OKA still continues). There was only one distribution, and therefore subsections 84(2) and 84(3), which apply to redemptions, cannot apply.

The final argument was that GAAR applied. It was necessary to conclude that the avoidance transaction giving rise to the transaction was abusive.

Although not raised by the CRA, Mr. Justice Hogan brought up whether the transactions abused the deemed dividend rule in section 84.1 of the Act. He gave both the CRA and the taxpayer the opportunity to make submissions.

Section 84.1 deems a dividend to occur if shares are transferred on a non-arm's length basis to a corporation resident in Canada for non-share consideration that exceeds the greater of the PUC and the ACB of the transferred shares. If share consideration is received the PUC is deemed to be the PUC of the transferred shares. By doing an internal rollover and triggering a capital gain, it was possible to increase the PUC of the Class A shares received. The ACB of the Class B shares was higher than the PUC ensuring that the redemption of these shares generated a capital loss sufficient to eliminate the capital gain on the transfer of the OKA shares to 9149. The result of the transaction is that part of OKA's surplus was distributed on a tax-free basis in a manner contrary to the object and spirit of section 84.1. Section 84.1 was applied in an abusive fashion, and GAAR applied. Applying section 84.1 resulted in a deemed dividend of $525,422 (compared to $592,362, which the Minister had assessed).

DECEASED LEFT EVERYTHING TO HIS WIFE AND CHILDREN, NOTHING TO HIS COMMON-LAW SPOUSE

The deceased and the Appellant, Ms. Quinn, lived in a common-law relationship for 8.5 years, until the deceased died in 2008 of a heart attack at age 57. The deceased left net estate assets of about $2.4 million. He left the bulk of his estate to his wife, Ms. Carrigan, from whom he had been separated but not divorced for 12 years. He also left something to each of his daughters, both of whom were independent adults at the time of his death. He left nothing to Ms. Quinn.

It was agreed that Ms. Quinn and Ms. Carrigan were the deceased's only dependants. The trial judge awarded Ms. Quinn dependants support of $350,000. On Appeal, the Divisional Court noted that "$350,000 is a lot of money". However, after deducting support already paid to her, and adverse costs awards at trial, Ms. Quinn was left with a debt to the Respondents of over $85,000. Moreover, she had health problems, had lost her job, and had no assets of her own.

The deceased and Ms. Quinn lived in a condominium that he bought at the outset of their living together. He took title to the condominium jointly — with Ms. Carrigan. The deceased also made the latter the beneficiary of his pension and life insurance.

The deceased did consider making some arrangement for Ms. Quinn. In 2006, he sought legal advice about leaving Ms. Quinn the condominium, plus the proceeds of a $100,000 life insurance policy. He discussed this arrangement with Ms. Carrigan and his daughters, and they were content with it. However, his lawyers advised him that this arrangement would not prevent Ms. Quinn from seeking more unless she agreed to it in a domestic contract. And, for that contract to be valid, she would have to obtain independent legal advice, and he would have to make financial disclosure of his income, assets and overall financial affairs. The deceased would not disclose his finances to Ms. Quinn. And so his proposed arrangements for Ms. Quinn went no further.

The Divisional Court was determined to address the discrepancy between the difficult situation of Ms. Quinn and the very comfortable one of Ms. Carrigan. To rectify things, it awarded Ms. Quinn dependants support of $750,000 — about as much as the spousal support guidelines provided for in the circumstances. The Court surmised that "in the fullness of time" the deceased may have made some arrangement for Ms. Quinn. Of course, when it comes to estate planning, leaving things to "the fullness of time" can be risky.

— *Quinn v. Carrigan*, 2014 ONSC 5682

ESTATE PLANNER

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

For Wolters Kluwer Limited

Tara Isard, Senior Manager, Content
Tax & Accounting Canada
(416) 224-2224 ext. 6408
email: Tara.Isard@wolterskluwer.com

Natasha Menon, Senior Research Product Manager
Tax & Accounting Canada
(416) 224-2224 ext. 6360
email: Natasha.Menon@wolterskluwer.com

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

Wolters Kluwer Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
416 224 2248 · 1 800 268 4522 tel
416 224 2243 · 1 800 461 4131 fax
www.wolterskluwer.ca

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