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Is a Family Trust Vulnerable to the CRA? Some Warning Signs

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It is not unusual for accountants or financial planners to have a bit of reluctance towards getting down and dirty with family trust structures. My guess is that this often stems from the convoluted legalese involved, be it the seemingly interminable provisions of the trust itself, or the often-picayune details of the financial structure of the trust arrangement. Trouble is, in recent months, structures involving trusts have received an unprecedented amount of attention, both from the CRA and our courts (see "The Trouble with Trusts", Tax Notes, January #564).

Once a structure has been implemented, and the lawyers have gone their (un)merry way, it is often the accountant or financial planner that stands in the line of fire between the client and a possible CRA challenge. In view of this scrutiny, it is more important than ever that a tax or estate plan involving a family trust should not be left on auto pilot - all the more so because family circumstances, as well as tax laws and policies may change over the years.

It is often unreasonable for accountants or financial planners to be expected to roll up their sleeves and understand the arcane trust and tax law underpinnings of a structure involving a trust. However, experience shows that there are a number of warning signs that may mean it is time to take a more careful look at the structure.

In this article, I will talk about a number of these warning signs in respect of common estate freeze and income-splitting structures. Some of these stem from the ongoing operation of the trust structure; others may derive from the structuring of the trust arrangement itself.

Here are some signals that the structure could be vulnerable to CRA scrutiny.

- **"Homemade Amendments" to Trusts**. In common law provinces, the general rule is that trusts must be amended by a court-ordered variation, unless the trust itself allows amendments to be made. From time to time, I have seen situations where terms of the trust are changed, e.g., by adding or deleting a beneficiary. Because these amendments are not valid, allocations and distributions of income or capital to the beneficiary are likewise invalid and could be challenged. Moreover, this could be a sign that those involved in these amendments may not be well versed in trust law, so that a review of the structure for other defects may be advisable. In some situations, it might be argued that the "amendments" are really clarification of the settlor's intention and are therefore part of the original trust; however, whether this argument is tenable may depend on the fact situation.

- **Questionable Share Structures**. Where shares of a corporation are held by a family trust, sometimes deficiencies in the share structure itself may be a sign that the design itself is flawed. Perhaps the most telltale situation arises where the trust acquires valuable shares of the corporation for nominal or no consideration. As a simple example, a pre-existing shareholder may hold, say, one hundred common shares of a valuable corporation, but wishes to split dividends with other family members or perhaps multiply the capital gains exemption. So the trust subscribes to, say, 50 additional common shares for a nominal amount. Assuming that the corporation has at least some value, the result of this is that the trust has received a financial benefit. The CRA may assert that there has been a transfer (taxable disposition) of one-third of the shares to the family trust, based on their fair market value, so that a sizable capital gain will result. Alternatively, the CRA may tax the trust as a shareholder benefit (under subsection 15(1)) based on the value of the shares. But besides these issues, this could be a warning sign that the structure may have other warts.[1]

A similar warning sign relates to so-called exclusionary dividend structures. These are structures which involve more than one class of common-type shares, typically with shares of one class containing sufficient voting rights to control the corporation going to the founder of the business. The various classes of shares have so-called "exclusionary dividend" features – that is, dividends can be paid on one class to the exclusion of the others. I have mentioned these types of share structures on a number of occasions in recent months. These structures may be implemented in order to provide dividend or capital gain splitting. But the trouble with these structures is that it might be asserted that there is a significant "control premium" attaching to the voting shares, so that the non-voting (or limited voting) shares have a lower value[2]. This may undermine an estate freeze or the multiplication of the capital gains exemption[3]. In this context, if an exclusionary dividend structure has overlooked these issues, it could also be another warning sign that further review of the structure is in order – are there other deficiencies?

"Operational" Defects

In some cases, the structure itself may be fine, but the ongoing operation may be flawed or sloppy.

- **Parents Scoop the Cash**. One of the most common situations arises where income is T3'd to children or other low-bracket family members, but the cash ends up in the hands of the parents – they simply "scoop the cash". This can be very problematic, and in fact is one of the deficiencies that the CRA is looking for in its review of trusts that it is currently undertaking. We generally recommend that, where income is to be allocated and distributed to a particular beneficiary, the cash payments should be paid from the trust's account to a separate bank account for that beneficiary. Payments out of the bank account should be for the benefit of the particular beneficiary, either for investments or personal expenditures for his or her benefit. In the former case, it should be clear that the investment is for the particular beneficiary, e.g., if the beneficiary is a child who is a minor, one alternative is for the account to be opened by the parent, "in trust" for the particular child. Receipts of personal expenditures for the particular beneficiary should be retained.

If payments are made directly from the trust for the benefit of the particular child, experience shows that, unless there is scrupulous record keeping, this can become quite messy; accordingly, the CRA might attack the arrangement as invalid.[4] It is not sufficient to be able to show that the expenses were incurred for children in general, as opposed to the particular beneficiary[5].

- **Interest Rate is "Reset"**. In most cases, income splitting arrangements with a spouse or minor children will depend on the "prescribed rate loan" exception: the attribution rules will not apply to income earned on loans that bear the CRA's prescribed rate of interest. (The attribution rules will not apply to capital gains or losses of a minor, even if the investment is not funded by a prescribed rate loan.) In recent years, the prescribed rate has dropped, so that, at time of writing, the rate matches an all time low of 1%. In some cases, taxpayers may try to take advantage of this by lowering the rate on a loan to a family trust or low-bracket family members to match the prescribed rate. For example, the promissory note might be amended to lower the interest rate from, say, an original prescribed rate of 3%, to 1%. It is extremely doubtful that this manoeuvre works. In order to take advantage of the exception to the attribution rules, the interest rate must be based on the prescribed rate in effect when the loan was originally made. Accordingly, lowering the interest rate to below this amount would mean that the exceptions to the attribution rules no longer apply, so that the income from the proceeds of the income-splitting loan would be attributed back to the lender in the year in which the interest rate was lowered and subsequent years. The safest way to take advantage of the lower prescribed rates is to make a new loan, which typically involves selling the investment funded by the proceeds of the original loan (although this may of course involve capital gains or losses on the sold investment).[6] When the recession was in full swing, this could be problematic because the sale might leave a shortfall; however, this is less of an issue than it would have been, say, a year ago.

Finally, a reminder: interest payable in respect of a particular year on a prescribed-rate income splitting loan must be paid no later than 30 days after year-end, or the attribution rules will apply for the year and future years. Hopefully, our high-tech diaries will help us not to lose sight of this requirement.

- **No Paper?** In my January article, I talked about deficiencies in trust documentation in the light of the CRA spotlight on trust structures (particularly, where income splitting is involved). Here is a reminder of some of the items:

  - If income is not actually paid to or on behalf of beneficiaries by year end there should be evidence that the income was legally payable by that time, e.g., trustees' resolutions and/or promissory notes.

  - There should be minutes or other evidence that trustees met and that they made decisions relating to the trust, including allocations to beneficiaries, investment management and/or delegation, and so on.

  - The CRA is concerned that there be proper accounting records; the original settlement instrument can be located; promissory notes should not have "stale-dated" (i.e., due to applicable limitation periods)[7].

In next month's article, I will continue my discussion of warning signs for family trust structures, focusing on one of the most dangerous traps in the Income Tax Act: the so-called "reversionary trust rules" in subsection 75(2), and a related provision, subsection 107(4.1), which can be even more damaging – jeopardizing the tax-free rollout of shares and other trust assets to beneficiaries.

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[1] Presumably these results would occur at the time of the restructuring. If the situation is discovered years later, it would hopefully be statute barred. However, there may be a growing trend that the normal assessment limitation period can be breached as a result of "technical mistakes". See "Neglect is Not Just Unreported Income", Joan Jung, *Tax for the Owner-Manager*, Vol. 10, April 2010.

[2] At the 2009 Canadian Tax Foundation CRA Round Table, significant comfort was provided for so-called "skinny voting shares". However, it is questionable whether this would apply in the context of exclusionary dividend structures.

[3] Unlike the previous example, the adverse tax results would occur at the time of the disposition (or deemed disposition, e.g., when freezor passes away) of the shares.

[4] See, for example, *Howard Langer Family Trust* v. *The Queen*, 92 DTC 1055, in which the Tax Court of Canada disallowed deductions for payments made by the trustees to reimburse the parents of the minor beneficiaries for their personal expenses. No records were kept by the parents of payments made on behalf of the children. The court did not accept the evidence of the trustees as to the use of the trust funds. See also *Ken* *and Jessie Degrace Family Trust* v. *The Queen*, 99 DTC 453, in which the CRA successfully attacked an arrangement where payments were made to the mother of beneficiaries, the Tax Court of Canada holding that the expenses in question were ordinary household expenses, not made unequivocally for the benefit of the beneficiaries. For further discussion of payments to third parties by trusts, see "Tax Planning with Trusts", Hoffstein, M., 2007 OC p.13A:30.

[5] The CRA's position is that a taxable benefit under subsection 105(1) will not arise to the parent as a consequence of the trust paying (in accordance with the terms of the trust indenture or will) expenditures for the support, maintenance, care, education, enjoyment and advancement of the child, including the child's necessaries of life, including those that the parent would otherwise have been legally obligated to incur for the support, maintenance, etc., of the child pursuant to applicable provincial and/or federal statutes. See *Income Tax Technical News* No. 11, September 30, 1997.

[6] For further discussion of this topic, see "Restructuring Income Splitting Loans — Planning in Tough Economic Times", Karen Yull, *Tax Hyperion*, April 2009.

[7] It is not always clear what the precise result of some of the deficiencies identified by the CRA might be. Perhaps they would be factors in asserting that the trust arrangement itself is not "valid" – e.g., it is an agency or sham.