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CONTENTS

INTER VIVOS DISCRETIONARY TRUSTS ARE STILL RELEVANT

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Although the 2014 federal Budget Plan restricted some family tax planning measures involving *inter vivos* trusts, such trusts remain relevant. Beyond goals such as protecting assets, minimizing the taxes payable upon death, or purification for purposes of the eligibility of shares for the $800,000 capital gains deduction, the relevance of the trust for the purpose of splitting income and capital gains with minor children may still be a critical factor in the cost-benefit analysis of the implementation of such a structure.

This article discusses the income-splitting techniques to avoid, as well as those which, when correctly structured and documented, comply with federal and Quebec provincial tax legislation.

In short, the purpose of an income-splitting structure is to allocate income or capital gains to a minor child and thus benefit from his progressive tax rates and personal tax credits.

SPLITTING TECHNIQUES WITH MINOR CHILDREN SEVERELY SANCTIONED BY TAX LEGISLATION

Business or rental income allocated to a minor child in certain circumstances

The business or rental income of a trust which is allocated to a minor child is subject to a special tax calculated at the highest marginal rate ("**Minor Child Special Tax**") when a person "related" to the minor child either (i) is actively involved in the income generating activity, or (ii) holds an interest in the partnership from which the trust indirectly derives such income.

Taxable dividends from certain private corporations

Taxable dividends from shares of Canadian and foreign corporations which are not listed on a "designated stock exchange" (except for mutual fund corporations) ("**Private Corporation**") allocated by a trust to a minor child are also subject to the Minor Child Special Tax.

Taxable capital gain realized on certain sales of shares of Private Corporations

A minor child to whom a trust allocates a taxable capital gain from the sale of shares of a Private Corporation to a person with whom the minor child is not dealing at arm's length is deemed to receive this amount twice as a taxable dividend other than an "eligible dividend". The deemed taxable dividend will be subject to the Minor Child Special Tax.

SPLITTING TECHNIQUES WITH MINOR CHILDREN ALLOWED BY TAX LEGISLATION

Currently, dividends received by a trust from corporations listed on a "designated stock exchange" and allocated to minor children are not subject to the Minor Child Special Tax. A tax election must be made for the dividends so that their status is not changed when they are allocated to the minor beneficiaries, and a written resolution must be validly prepared and signed by the trustees in this respect.

Capital gains realized by a trust on the sale of property to a person with whom the minor child is dealing at arm's length, whether such property consists of shares in a Private Corporation, a Corporation listed on an exchange, or an immovable, may be allocated to him without triggering the Minor Child Special Tax. When the property on which the capital gain is realized consists of "qualified small business corporation shares", the $800,000 capital gains deduction of the minor child may be available.

FINANCING OF THE TRUST IN THE CONTEXT OF SPLITTING WITH MINOR CHILDREN

The success of a splitting structure mainly depends on the ability of the trust to finance its investments. A loan made directly by a parent, or indirectly through a management corporation, is a solution that is both simple and efficient from a tax perspective.

The measures intended to deter income splitting, particularly some allocation rules and the Minor Child Special Tax, do not apply to income derived from a loan made to the trust at an interest rate equal to or higher than the prescribed interest rate in force at the time the loan is made, if and only if the interest is paid before January 31 of each year. In addition, the allocation rule commonly referred to as "75(2)", which re-allocates the income from property to the person from whom the said property was received, should not apply to such an arrangement.

At the present time, since the prescribed rate is at an all-time low, *i.e.* 1%, and the terms of such loans are not limited in time, splitting income with minor children through a loan to a trust should translate into significant savings, subject to the performance level obtained on the investments made by the trust.

A TRAP TO AVOID

It is important to keep in mind that, when income is allocated to minor children through a trust, it is the children who must benefit from the amounts so allocated. Thus, so that the children can be considered the true beneficiaries of the income allocated by the trust, the income must be entirely available to them for their own benefit. With this in mind, the tax authorities will consider the following circumstances when reviewing these amounts: (i) the manner in which the amounts are received, (ii) the person with effective control over such amounts, (iii) the obligations and restrictions on the manner of disposition thereof, and (iv) the use made of them by the minor children, or the persons actually benefiting therefrom.

The risk to taxpayers of income or capital gains splitting with minor children is that the tax authorities may take the position that the children acted as accommodating parties, whether as agents or as a front, for the parents. The success of a splitting operation therefore depends on adequate documentation proving that the amounts which are allocated to the minor child, and thereafter reimbursed to the parents, represent the repayment of expenses paid by the parents for the child's benefit.

The use of a trust for purposes of investment and income splitting with minor children poses quite a few challenges, but remains a fundamentally worthwhile tax-savings tool in the appropriate circumstances. The implementation of such a structure should be fine-tuned by your tax expert.

A MATTER OF TRUSTS: REVIEW OF THE MOST FREQUENT PITFALLS

Carolyne Corbeil and Emmanuel Sala

For this special edition *Ratio* on trusts, we propose a review of the most frequent pitfalls in tax planning schemes involving discretionary family trusts.

THE SETTLOR IS ALSO THE BENEFICIARY OF THE TRUST: LOSS OF TAX-DEFERRED ROLLOUT

One still all too frequently sees cases in which the settlor of the trust, *i.e.* the person who made an irrevocable gift in favour of the trust for the purpose of constituting an autonomous and separate trust patrimony, is also designated as a beneficiary of that trust. This mistake generally occurs when several classes of persons are named as beneficiaries and the link between the settlor and the taxpayer wishing to implement the trust is not clearly identified. For instance, the trust deed may designate the father and mother of the taxpayer and the father and mother of the taxpayer's spouse as beneficiaries while the taxpayer's father-in-law acts as the settlor. Such circumstances result in the application of subsection 75(2) of the *Income Tax Act* ("**ITA**"), with the result that the trust property cannot be distributed without triggering tax consequences to the beneficiaries of the trust other than the settlor (hereinafter "**Rollout**").

TRANSFER OF PROPERTY TO A CORPORATION OF WHICH THE TRUST IS A SHAREHOLDER: DEEMED INTEREST

A freeze transaction must generally be carried out when one is planning to insert a trust within an existing corporate structure. A freeze consists of exchanging all the participating shares issued by the corporation (generally, the common shares) for preferred shares redeemable at a value equal to the fair market value of the corporation immediately prior to the freeze transaction ("**Preferred Shares**"). The trust may then subscribe to participating shares of the corporation for a nominal consideration. From a legal point of view, a given taxpayer will then have "transferred" participating shares to the corporation for a consideration consisting of preferred shares (hereinafter, the "**Transferred Shares**").

When a trust is established in favour of the spouse and/or minor children of the person initiating the freeze to allow him to split his income, and no clause in the trust deed restricts the allocation of income to the spouse and the minor children, the attribution rule in subsection 74.4(2) ITA may apply, unless the corporation qualifies as a "small business corporation"[1].

Generally, this attribution rule results in the taxing of a specifi ed amount of interest, calculated at the prescribed rate on the value of the Transferred Shares, in the hands of the person initiating the freeze. This interest attributed to the person initiating the freeze may however be reduced by the amount of a taxable dividend which is declared and paid by the corporation in respect of the Preferred Shares.

Unless one is certain that the corporation will at all times remain a “small business corporation”, we recommended that one provide for the payment of a taxable dividend on the Preferred Shares calculated at the prescribed rate in order to avoid the occurrence of this attribution rule.

INTEREST-FREE LOAN TO THE TRUST: LOSS OF THE ROLLOUT AND ATTRIBUTION RULES

On frequently seen situations in which a person, who is both a trustee and beneficiary of a family trust established for the benefit of his family (hereinafter “**Trustee/Beneficiary**”), transfers funds to the trust for the purpose of enabling it to acquire shares or other property, or pay certain expenses. However, it is important to remember that the trust possesses a patrimony which is separate and autonomous from that of the Trustee/ Beneficiary, and that there should generally be no transfer of funds between the latter and the trust. Unless such a transfer constitutes an actual loan within the meaning of the applicable law (*a bona fide loan*), the attribution rule in subsection 75(2) ITA will apply and all the income or capital gains derived therefrom will be re-attributed directly back to the Trustee/Beneficiary. As a result, the splitting sought with the spouse and/or minor children of the Trustee/Beneficiary will not be achieved. Furthermore, if subsection 75(2) ITA applies, the trust will lose the Rollout in favour of the minor children (*i.e.* the beneficiaries other than the Trustee/ Beneficiary and his spouse).

In addition, where it is reasonable to consider that the income earned by the trust from the funds thus loaned is thereafter allocated and paid to the minor children and/or the spouse of the Trustee/Beneficiary, these loans should be at the prescribed interest rate, failing which certain attribution rules will generally apply, causing the income earned by the trust from the funds loaned and allocated to the minor children and/or the spouse of the Trustee/Beneficiary to be attributed to the Trustee/Beneficiary.

VOTING SHARES OF A CORPORATION HELD BY THE TRUST: RISK OF ACQUISITION OF CONTROL FOR PURPOSES OF THE ITA.

When the shares of a corporation with a majority of the voting rights, that is, shares providing for the election of a majority of directors of the corporation, are held by a trust, the case law has held that it is the trustees who control the shares of the corporation, and they hold de jure control thereof. In such circumstances, the position of the tax authorities is generally that there is an acquisition of control of the corporation for purposes of the ITA when one of the trustees is replaced, unless none of them is dealing at arm’s length with the others. An acquisition of control at a given time may have adverse tax consequences for the corporation, particularly in respect of the use of its losses realized prior to that time, the imposition of a year-end immediately prior to that time, and the application of certain restrictions respecting expenses and investment tax credits for scientific research and experimental development.

Accordingly, it is generally preferable for trusts to only hold participating, non-voting shares.

FAILURE TO DOCUMENT TRANSACTIONS INVOLVING THE TRUST: DIFFICULT AUDIT WITH TAX AUTHORITIES

Similarly to corporations, it is imperative for trusts to document the transactions they conduct during the year and maintain their trust “book”. This practice allows for subsequent follow-ups to be done to substantiate the transactions and distributions of the trust (*e.g.*, prove that a bona fide loan was entered into and repaid) and ensure their tax treatment is accurate. In the event of an audit, an up-to-date trust book will serve as an important tool for defending the tax treatment of the trust’s operations.

[1] Generally, to be considered a “small business corporation”, all or substantially all of the value of the assets of the corporation must be attributable to assets that are used principally in an active business carried on primarily in Canada: section 248(1) ITA, “small business "corporation”.