# RECENT DEVELOPMENTS IN ESTATE PLANNING: THE ALBERTA ADVANTAGE WHEN USING TRUSTS

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## INTRODUCTION

Canadian federal income tax is levied at progressive rates. As income increases, so does the overall rate of tax payable on that income. In addition, a second level of income tax is levied by the taxpayer's province of residence. This rate differs from province to province. In order to reduce the overall amount of income tax payable by the family unit as a whole, taxpayers often attempt to engage in income splitting, which is often facilitated by the use of trusts. Income-splitting techniques have undergone many permutations over the years in response to the constant barrage of legislative initiatives intended to impede taxpayers. These attacks include the various attribution rules introduced over the years and in particular the tax on split income introduced in 1999, often referred to as the kiddie tax.

This paper will serve as an introduction to the use of personal trusts in this context. Personal trusts are a common tool in estate and succession planning generally. In addition to the important role they play in income-splitting strategies, trusts are used in the context of family law, incapacity, creditor proofing, and testamentary planning. In the first part of this paper, a general overview of the nature and taxation of trusts will be provided, followed by a review of the attribution rules contained in the Income Tax Act[1] and the tax on split income. Finally, available income-splitting strategies, with particular emphasis on the use of Alberta-resident trusts, will be canvassed.

## NATURE AND TAXATION OF TRUSTS

### Trusts and Categorizations

#### *General*

The origins of trusts date back to medieval times and the enforcement of uses of land by the courts of equity. The concept of a trust developed over the years and has been recognized as a relationship that arises when property is vested in a person or persons (the trustees) who are obliged to hold for the benefit of others (the cestuis que trust, or the beneficiaries) or for a charitable purpose.[2] In today's legal and social environment, trusts are used for a variety of estate and tax planning purposes.

Private trusts – that is, trusts for persons – are generally express trusts, although constructive trusts may arise by the operation of law, and resulting trusts may also occur. This paper will focus only on the express private trust, which may qualify as a personal trust under the Act. An express private trust will be created only if the intention of the settlor is clearly manifested. In order to exist, a trust must be completely constituted and the "three certainties" must be met. Title to specific property that forms the ascertained subject matter of the trust must be transferred to the trustee or trustees. There must be certainty of the intention of the settlor to create a trust. Furthermore, there must be certainty of the beneficiaries of the trust. With respect to the subject

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matter of the trust, it may take the form of any type of property as long as it is clearly identifiable property.[3]

Subsection 104(1) provides that a reference to a trust or an estate shall, unless the context otherwise requires, be read as a reference to the trustee, executor, administrator, heir, or other legal representative having ownership or control of the trust property. An exception to this rule is the bare trust arrangement, which is not discussed in this paper. Subsection 104(2) deems the trust to be, in respect of the trust property, an individual. Consequently, a trust must file tax returns and pay tax on its income. However, trusts are also subject to specific provisions of the Act that permit the trustees to allocate the income of a trust to its beneficiaries to be taxed in the hands of the beneficiaries.

As separate taxpayers, trusts therefore present themselves as entities that may be available for specific tax and estate-planning purposes. However, income-splitting opportunities are limited by the fact that inter vivos trusts do not benefit from graduated rates of tax. Under the Act, inter vivos trusts are taxed at the highest marginal rate of tax applicable to individuals (29 percent). Provincial taxes and surtax are applicable on top of the 29 percent rate. Testamentary trusts, on the other hand, are taxed at the graduated rates applicable to individuals and therefore offer an income-splitting opportunity.[4] A second limitation to income splitting through the use of trusts is the existence of subsection 104(2), which provides that where two or more trusts have received substantially all[5] of their property from a single individual and the trusts are conditioned so that the income thereof accrues, or will ultimately accrue, to the same beneficiary or group or class of beneficiaries, the minister may designate such trusts as a single individual for tax purposes.[6] Such a designation may not be made if each trust has distinct beneficiaries. This provision is aimed at preventing the creation of multiple testamentary trusts with the same beneficiary or group of beneficiaries for the sole purpose of taking advantage of the graduated rates of tax available to testamentary trusts.

Other limitations on the use of trusts for income splitting also exist, such as the various attribution rules and the kiddie tax, discussed below. Despite these limitations, trusts are still fundamental in tax and estate planning.

***Inter Vivos and Testamentary Trusts***

The two types of personal trusts are testamentary trusts and inter vivos trusts. Testamentary trusts are generally established under the will of a taxpayer, usually for the benefit of the deceased taxpayer's family members, which may include a spouse, descendants, or both. Inter vivos trusts are established by the settlor during his or her lifetime, often for the benefit of a spouse, children, or other family members. Such trusts may also be established for some other specific purpose. Inter vivos trusts must have a calendar year-end and are taxed at the highest tax rate applicable to individuals.[7] By contrast, testamentary trusts may have any year-end and may qualify to be taxed at the graduated rates applicable to individuals.[8] A further advantage associated with testamentary trusts is that they are not subject to the attribution rules because the settlor is no longer alive to receive any attributed income. Consequently, the income-splitting possibilities of testamentary trusts outweigh those of the inter vivos trust.

An inter vivos trust is defined in the Act as a trust other than a testamentary trust.[9] The Act defines a testamentary trust as a trust "that arose on and as a consequence of the death of an individual," with certain exceptions.[10] Two of these exceptions relate to situations where property is transferred to the trust, or contributions are made to the trust, by someone other than the deceased on and after his death and as a consequence thereof. In such circumstances, the trust is disqualified as a testamentary trust and is taxed as an inter vivos trust. In view of the importance of the distinction between an inter vivos trust and a testamentary trust, the exceptions are critical and are therefore reviewed below. Note, however, that the Act also provides at subsection 248(8) that the transfer of property under or as a consequence of the terms of the will of a taxpayer or other testamentary instrument shall be considered to be a transfer of property as a consequence of the death of the individual. The meaning of the term "testamentary instrument" is therefore important: the taxpayer must ensure that a transfer to a trust pursuant to such an instrument will not disqualify the trust as a testamentary trust.

Trusts may be disqualified as testamentary trusts in certain circumstances. Although a trust may receive property from an individual as a consequence of his or her death, paragraph 108(1)(a) of the definition of "testamentary trust" provides that the trust will be disqualified if it was created by someone other than the deceased individual in question. However, the wording of the Act suggests that if a testamentary trust is created on the death of one individual, another individual may on and as a consequence of his or her death also contribute property to the trust, and the trust will not lose its testamentary trust status. With respect to trusts created after November 12, 1981, paragraph 108(1)(b) provides that the trust will be disqualified before the end of the taxation year if property has been contributed to the trust otherwise than by an individual on or after the individual's death and as a consequence thereof.

In a technical interpretation dated November 2, 2001,[11] the Canada Customs and Revenue Agency (CCRA) stated that a trust created upon the death of the settlor of an alter ego trust, a joint spousal trust, or a common law partner trust does not qualify as a testamentary trust within the meaning of the Act. The CCRA is of the view that the trust is a trust created by someone other than the deceased individual and is therefore excluded by virtue of paragraph (a) the definition of "testamentary trust" in subsection 108(1). The CCRA's position is that the trust is created by the trustee of the alter ego, joint spousal, or common law partner trust, as the case may be, and not by the deceased. As a result, the property is property contributed to the trust otherwise than by an individual on or after the individual's death and as a consequence thereof. To support its position, the CCRA argues that the property settled on the alter ego, joint spousal, or common law partner trust does not belong to the settlor at the time of his or her death. As a result, the exclusions at subsection 108(1) apply and the trust in question does not qualify as a testamentary trust. This view was also adopted in other CCRA technical interpretations. Representations have been made by practitioners to the effect that the contributor to the successor trust is the settlor and not the first trust (in this example, the alter ego trust).[12] However, the CCRA reiterated the view that it is the inter vivos trust that makes the contribution, and therefore the successor trust is disqualified as a testamentary trust. The CCRA's position is that because the trust is deemed to be an individual under the Act, separate from both the settlor and the trustee, a contribution to a trust created on or after the death of an individual by an inter vivos trust settled by that individual is a contribution that disqualifies the trust as a testamentary trust within the meaning of subsection 108(1).

The technical interpretation does not explore the nature of a testamentary instrument and whether it can be said that the alter ego trust, for example, is in the nature of a testamentary instrument. If so, paragraph 248(8)(a) should apply, and the transfer of property to the successor trust created under the terms of the alter ego trust should qualify as a transfer of property as a consequence of the death of the settlor of the alter ego trust. Furthermore, subsection 104(2) does not deem a trust to be an individual, but rather provides that a trust, shall, for the purposes of the Act, be deemed to be in respect of the trust property an individual. It is clear that a trust will be taxed as an individual as a result of the application of subsection 104(2). However, it is not clear that, when a trustee holds property for the benefit of the settlor of the trust and transfers property to a successor trust as provided either in the settlor's will or in the terms of the inter vivos trust, subsection 104(2) will apply to deem that transfer to have been made by a separate individual (the trust) and not the settlor who enjoyed beneficial ownership of the property.

The same issue has arisen in the context of trusts funded with the proceeds of a registered retirement savings plan (RRSP). Two requests for a technical interpretation were submitted to the CCRA to ascertain whether a trust established to hold the proceeds of an RRSP on the death of a taxpayer, the terms of which have been established during the lifetime of the individual separate from his or her will, qualifies as a testamentary trust. In the first technical interpretation,[13] the CCRA stated that if the RRSP is held in a trust (as it is in most cases where the individual has a brokered account), the contribution to the trust on the death of the individual will be treated as having been made by the inter vivos RRSP trust and not by the deceased individual. Consequently, the RRSP-funded trust will not qualify as a testamentary trust. In the second technical interpretation, the CCRA stated that if the RRSP designation amounted to a "testamentary instrument," the trust could qualify.[14] This position confirms the CCRA's longstanding position on insurance proceeds trusts, which is that they qualify as testamentary trusts if they are funded on the death of the taxpayer with the proceeds of the insurance policy that the taxpayer owned at his or her death.[15] This is so whether the trust is established by the individual during his lifetime separate from his or her will to receive the insurance proceeds, or whether it is established in the testator's will.

The conclusions reached are interesting because of the tax and estate-planning opportunities available. Separate trusts, the terms of which are established during a settlor's lifetime, to hold insurance proceeds and the proceeds of the taxpayer's RRSP could qualify as testamentary trusts. Since the designation must amount to a "testamentary instrument" to qualify, at least with respect to the RRSP, the testator should make it in his or her will.[16] However, alter ego trusts and joint partner trusts do not benefit from testamentary trust status; furthermore, the CCRA appears to be firmly entrenched in its position that a successor trust created on the death of the settlor also will not benefit from testamentary trust status. Consequently, when a testator establishes an alter ego or joint partner trust, this disadvantage should be kept in mind.

***Spousal Trusts***

Spousal trusts are settled by one spouse (or common law partner) for the benefit of the other. Transfers of property into a spousal trust may be made either during the lifetime of the transferor or upon his or her death. As a result, the spousal trust may be either an inter vivos or a testamentary trust. In order to avoid the immediate tax consequences on the transfer of property with appreciated gain to a trust that does not qualify as a spousal trust, all conditions imposed by subsection 73(1) must be satisfied. The recipient spouse must be entitled to all the income of the trust that arises during his or her lifetime, and no person except for that spouse may receive or otherwise obtain the use of any of the income or capital of the trust that arises while he or she is alive. If these conditions are met, a transfer of capital property of the transferor spouse who resides in Canada may be made to the transferee trust, which must also reside in Canada, on a tax-deferred basis. To take advantage of this planning opportunity, the recipient spouse must, of course, not have elected out of the tax-deferred transfer permitted by subsection 73(1) for other tax-planning purposes.

When determining whether a person other than the spouse has received or otherwise obtained the use of any of the income of the trust, advisers should note that loans from the trust that are at a rate of interest that does not at least equal the prescribed rate are viewed by the CCRA as a benefit.[17] Consequently, if planning is contemplated involving a loan from a spousal trust to someone other than the spouse (or, in the case of an alter ego or joint partner trust, to someone other than the settlor or the spouse or common law partner of the settlor, as the case may be), loans should only be made on commercial terms.

***Alter Ego and Joint Partner Trusts***

Two specific types of inter vivos trusts eligible for a tax-deferred transfer were introduced in 1999: the alter ego trust and the joint spouse (or partner) trust.[18] These types of trusts have been touted as important estate-planning tools because, for instance, they allow the taxpayer to circumvent the estate administration tax (EAT) in Ontario and similar probate fee regimes. Assets held in an alter ego or a joint partner trust pass entirely outside the estate; therefore, not only is the EAT avoided, but the administration of the estate is simplified because the assets are already in the hands of the trustees and ready to be dealt with in a confidential manner in accordance with the terms of the trust. Of course, other and perhaps simpler ways of minimizing the EAT have been successfully employed in the past, including the use of multiple wills or the holding of property jointly with a right of survivorship, if appropriate.

More importantly, transfers of property into alter ego trusts and joint partner trusts, as in the case of transfers to spousal trusts, may be made on a tax-deferred basis in accordance with the provisions of subsection 73(1). In the absence of subsection 73(1), transfers to such trusts would constitute a disposition and be deemed to occur for proceeds equal to fair market value because the transferor and the transferee are not dealing at arm's length.[19] Consequently, where property that has appreciated in value is being transferred to a trust, it is important to ensure that the trust is a spousal trust, an alter ego trust, or a joint partner trust, or that the transfer is a "qualifying disposition" within the meaning of section 107.4 (discussed below) and is therefore not deemed to take place at fair market value.[20]

Subsections 73(1), (1.01), and (1.02) provide that a trust must meet certain conditions in order to qualify as an alter ego or joint partner trust. With respect to an alter ego trust, the trust must be resident in Canada and created after 1999 by a settlor resident in Canada who is at least 65 years of age at the time. The settlor must be entitled to receive all the income of the trust that arises before his or her death, and no persons other than the settlor may receive or obtain the use of any of the income or capital of the trust while the settlor is alive. With respect to the joint partner trust, either the settlor or the settlor's spouse or common law partner must be entitled to receive all of the income of the trust that arises before the later of the death of the settlor and the death of the spouse or common law partner, and no person may receive or otherwise obtain the use of any of the income or capital of the trust until the death of the last survivor of the two.

With respect to alter ego trusts, a deemed disposition of the assets of the trust occurs on the death of the settlor, and in the case of a joint partner trust the deemed disposition takes place on the death of the last surviving spouse.[21] Any resulting gain or loss will be taxed in the trust. There is no opportunity, in the case of an alter ego or a joint partner trust, to deduct any portion of the gain realized by the trust on the deemed disposition of its property pursuant to paragraph 104(4)(a) and to have that gain taxed in the hands of a beneficiary of the trust.[22] In other words, the gain realized on the deemed disposition must be taxed in the trust.[23] Furthermore, where a distribution is made by the trust to someone other than the person who settled the trust (in the case of an alter ego trust) or to someone other than the spouse or common law partner (in the case of a joint spousal or common law partner trust), and that settlor, spouse, or common law partner is still alive, a deemed disposition will result for proceeds equal to the fair market value of the property. The gain realized on the deemed disposition cannot be deducted by the trust and must be taxed in the trust.[24] Finally, note that if the settlor, spouse, or common law partner dies in the year and an actual disposition occurs prior to the end of the year, the Act precludes the trust from deducting the gain payable to a beneficiary other than the deceased settlor or the spouse or common law partner of the settlor.

The attribution rules may apply to spousal, alter ego, and joint partner trusts. In the case of the alter ego trust, income splitting between individuals will not be possible during the settlor’s lifetime because all of the income of the trust must be payable to the settlor and no person may receive or otherwise obtain the use of the capital of the trust during the settlor’s lifetime. However, as discussed below, alter ego trusts have been used to transfer income to jurisdictions that have lower tax rates. In structuring the trusts in these circumstances, it is important to avoid subsection 75(2). Subsection 75(2) need not apply to alter ego and joint partner trusts unless the settlor is a capital beneficiary. As a result, income may be shifted to a different jurisdiction if the trust is established such that the attribution rules do not apply. Joint partner trusts are similarly restricted. Income splitting between spouses is precluded by the operation of the attribution rules (discussed below).

## General Taxation

### *Transfers to Trusts*

Generally, absent a specific deferral available under the Act, when a taxpayer makes a transfer to a trust he or she will be treated as having made a disposition to the trust for proceeds equal to the fair market value of the property, and the trust will be deemed to have acquired such property at the deemed amount where the trust and the contributor do not deal at arm’s length.[25] Pursuant to section 251, a taxpayer and a trust are deemed not to deal with each other at arm’s length if the taxpayer, or any person not dealing at arm’s length with the taxpayer, is beneficially interested in the trust. Consequently, if the trust does not qualify as spousal trust, an alter ego trust, or a joint partner trust, any gain in the property will be realized on the transfer to the trust. Although transfers to a trust will generally be regarded as a disposition, if the disposition is a “qualifying disposition” there should be no adverse tax consequences to the transferor. A qualifying disposition as defined in subsection 107.4(1) is a disposition of property where all of the following conditions are met:

1. the disposition does not result in a change in the beneficial ownership of the property;

2. the disposition is not made by a trust to a beneficiary under the trust;

3. the disposition is not

   (a) made by a person resident in Canada to a non-resident trust, or

   (b) a transfer of taxable Canadian property from a non-resident person who was resident in Canada in any of the 10 calendar years preceding the transfer to a non-resident trust;

4. the disposition is not made by a partnership (other than a partnership each member of which is a non-resident) to a non-resident trust; and

5. the disposition is not made by an individual to a trust described in any of paragraphs (a) to (e.1) of the definition of “trust” in subsection 108(1).

A qualifying disposition also includes a division of trust assets to other trusts, provided that there is no change in the economic interests of the beneficiaries. On a qualifying disposition, the transferor is deemed to have received proceeds of disposition equal to the cost amount of the property. The trust’s cost of the property is the same as the transferor’s proceeds of disposition reduced by certain stop-loss rules that would affect the transferor if the property had been disposed of at fair market value by him or her at the time. With respect to depreciable property or eligible capital property, the transferee is put in the same position as the transferor when the transferee subsequently disposes of the property.

### *Taxable Income of Trusts*

A trust resident in Canada is taxed on its worldwide income pursuant to subsection 2(1). Inter vivos trusts are taxed at the highest marginal rates for individuals,[26] and testamentary trusts may be taxed at graduated rates.[27] Trusts, however, do not benefit from the tax credits available to individuals—for example, the basic personal amount.

The Act generally facilitates the taxation of income earned by a trust in the hands of the beneficiary who is entitled to the income. Subsection 104(6) provides that in computing its income, a trust may deduct any amount of its income that is payable by the trust to a beneficiary. The amount so payable must be included in the income of the beneficiary under subsection 104(13). If the amount so payable would otherwise be a taxable capital gain of the trust, and if it is designated by the trustees in respect of the beneficiary under subsection 104(21), the amount is deemed to be a taxable capital gain of the beneficiary from the disposition of capital property.[28] A separate additional designation subject to special rules must be made under subsection 104(21.2) to designate capital gains eligible for the capital gains exemption under section 110.6. It is often advantageous to make an election under subsections 104(13.1) and (13.2), which will allow the Canadian-resident trust to be taxed on income despite the fact that the income was paid or is payable to trust beneficiaries. This approach is advisable when the trust is a testamentary trust, when the beneficiaries are in a higher tax bracket relative to the trust, or when the trust has sufficient losses to offset the income.

Pursuant to subsection 104(4), all trusts resident in Canada are generally subject to a deemed disposition of their assets every 21 years. Spousal trusts have a deemed disposition of their assets on the death of the spouse. As discussed above, an alter ego trust will have its first deemed disposition on the death of the individual who created the trust. However, it is possible to elect out of the tax-deferred transfer available for an alter ego trust,[29] in which case the first deemed disposition date will be 21 years after the trust is created and every 21 years after that[30] as long as the trust is in existence. A joint partner trust will have its first disposition on the death of the last to die of the individual and the individual's spouse or common law partner.

### *Distributions from Trusts*

In general, a distribution by a personal trust of trust property to a capital beneficiary resident in Canada in full or partial satisfaction of his or her capital interest in the trust takes place on a tax-free rollover basis.[31] The rollover is not generally available if the trust is or has been subject to subsection 75(2),[32] one of the attribution rules discussed below.

If a Canadian-resident trust distributes property to a non-resident beneficiary in satisfaction of the beneficiary's capital interest, it is considered to have disposed of the property (and the non-resident beneficiary is considered to have acquired it) for proceeds equal to the greater of fair market value and the cost of the property to the distributing trust.[33] This rule is intended to ensure that accrued gains on property held in a Canadian trust are taxed on the distribution of the property to a non-resident and that unrealized losses cannot be triggered.

Provided that certain requirements are met, where a trust's income is distributed to a beneficiary or otherwise included in the income of the beneficiary, some types of income, such as capital gains, retain their source for the purposes of determining the beneficiary's resulting tax liability. Sources of income not otherwise prescribed do not retain their character when distributed to the beneficiaries and are taxed as ordinary income from property, the property being the trust interest.

## ATTRIBUTION RULES

### Personal Attribution

Sections 74.1 to 74.5, subsection 75(2), and subsections 56(2) and 56(4.1) are the primary attribution provisions. These rules generally attribute income, or in some cases capital gains, of a transferee or borrower back to the transferor or lender of the property that generated the income with a view to eliminating benefits derived from income splitting. The personal attribution rules are concerned primarily with transfers of property between non-arm's-length individuals. The word "transfer," which is used throughout the attribution provisions, is considered to include a sale, whether or not at fair market value, and a gift. The term "property," defined in subsection 248(1), includes substituted property as that term is defined in subsection 248(5).

### *Non-Arm's-Length Individuals*

The concept of "arm's length" is relevant to the section 56 attribution rules. Subsection 251(1) states that related persons are deemed not to deal with one another at arm's length. The term "related persons" is defined in subsection 251(2) and section 252 to include individuals connected by blood relationship, marriage, common law partnership, or adoption. Pursuant to subsection 251(6), a person is connected by blood relationship to his or her siblings, parents or other lineal ancestors, and children and other issue (including those who are adopted). Persons are connected by marriage when they are married to each other or to a person who is so connected by blood relationship to the other. A common law partnership connection exists when one is connected by common law partnership with the other or with a person who is connected by blood relationship to the other.

### *Transfers and Loans to Non-Arm's-Length Individuals*

*Transferring the Right to an Amount: Subsection 56(4)*

Pursuant to subsection 56(4), where a taxpayer transfers or assigns to a person with whom the taxpayer is not dealing at arm's length the right to an "amount"[34] that would otherwise be included in the taxpayer's income, such an amount will be included in the taxpayer's income for the period in the year throughout which he or she is a resident in Canada. However, this provision does not apply to an amount that is income from property if the transferor has also transferred or assigned the property to the transferee. *Interpretation Bulletin* IT-440R2[35] provides that in order to meet this exception, the property must be separate and distinct from the income that arises from it, so that it would be possible to transfer one while retaining the other. For example, the CCRA considers a life interest created under a trust to be property separate and distinct from the income that arises from it. Consequently, where a life tenant transfers to one or more remaindermen his or her life interest in an estate, this subsection does not apply, because there is a transfer of property as well as of the right to the income generated from it. Note that while subsection 56(4) does not apply to an amount if the transferor has also transferred or assigned the property, section 74.1 may apply to attribute the income to the transferor.

*Loans to Non-Arm's-Length Individuals: Subsection 56(4.1)*

Generally, subsection 56(4.1) applies where (1) a particular individual ("the debtor") (or a trust in which the debtor is beneficially interested) receives a loan from or becomes indebted to, "directly or indirectly, by means of a trust or by any means whatever," another individual ("the creditor") with whom the first individual does not deal at arm's length,[36] or to a trust that meets certain requirements; and (2) it can reasonably be considered that one of the main reasons for making the loan or incurring the indebtedness was to reduce or avoid tax by causing income from the loaned property to be included in the computation of income of the debtor. In such circumstances, any income for a taxation year from the property, or substituted property, that relates to a period in the year throughout which the creditor was resident in Canada will be attributed to the creditor.

If, however, a market value interest rate is charged and paid on a timely basis, attribution may be avoided. Subsection 56(4.2) provides that subsection 56(4.1) will not apply to income derived in a particular taxation year where (1) interest was charged on the loan or indebtedness at a rate equal to or greater than the lesser of the prescribed rate of interest in effect at the time that the loan was made or the indebtedness incurred and the rate that would, having regard to all the circumstances, have been agreed upon by the parties if they had been dealing with each other at arm's length; and (2) the amount of interest that was payable in respect of the particular year in respect of the loan or indebtedness was paid not later than 30 days after the end of the particular year.

*Indirect Payments: Subsection 56(2)*

Subsection 56(2) is a much broader provision and is not restricted to non-arm's-length relationships. It specifies that where (1) a payment or transfer of property is made pursuant to the direction of or with the concurrence of a taxpayer to some other person, and (2) the payment or transfer is for the taxpayer's benefit or is a benefit that the taxpayer wishes to confer on the other person, then the payment or transfer will be included in the taxpayer's income to the extent that it would have been included in the taxpayer's income if the payment or transfer had been made to the taxpayer.

In *Neuman v. The Queen*,[37] the Supreme Court of Canada held that subsection 56(2) does not apply to the payment of dividends. Mr. and Mrs. Neuman were shareholders and directors of a corporation. They each held a different class of shares. Dividends were declared and paid in the amount of $5,000 on the one class of shares held by Mr. Neuman and in the amount of $14,800 on the class of shares held by Mrs. Neuman. On the same day that the dividends were declared, Mrs. Neuman loaned $14,800 to Mr. Neuman.

The CCRA took the position that subsection 56(2) applied and assessed Mr. Neuman on the basis that he had directed that the dividend payment be made to his wife. The Neumans were making use of the practice of "dividend sprinkling" whereby directors could determine which spouse would receive dividends to the possible exclusion of the other. (Similarly, parents could arrange to have their operating companies pay dividends to their minor children as shareholders.) The Supreme Court of Canada in *Neuman* held that subsection 56(2) could not apply to the payment of dividends by a corporation. The court determined that implicit in the application of subsection 56(2) is the requirement that the taxpayer would otherwise have an entitlement to the transferred property, and that in fact there was no such entitlement to dividends.[38] Any unpaid dividend could simply be kept by the corporation as retained earnings and would not be taxable to any shareholder.

***Transfers and Loans to a Spouse or Common Law Partner***

The term "common-law partner" is defined in subsection 248(1) as a person who is living and has lived for one full year with the taxpayer in a conjugal relationship, or who has a child with the taxpayer. The common law partnership is deemed to continue for 90 days after the parties begin living apart because of a breakdown of the relationship. Effective in 2001, common law partners have the same status under the Act as spouses.

By virtue of subsection 74.1(1), where a Canadian-resident individual transfers or loans property to a spouse or future spouse, any income or loss arising from that property will be attributed to the transferor instead of the spouse as long as the transferor is resident in Canada. Similarly, under subsection 74.2(1), any capital gain or loss arising from the disposition of the property will be attributed back to the transferor. These rules apply where the amount is transferred or loaned directly or indirectly, by means of a trust or by any other means whatever.[39]

***Transfers and Loans to a Minor***

When an individual transfers or loans property to a non-arm's-length minor child, niece, or nephew, any income or loss arising from the property while the transferee is under 18 years of age will be included in the income of the transferor and not the transferee as long as the transferor is resident in Canada, by virtue of subsection 74.1(2). Like the rules of spousal attribution, this rule applies when the amount is transferred or loaned directly or indirectly, by means of a trust or by any other means whatever. Note that there is no rule attributing capital gains or losses realized by a minor to the transferor. Some of the potential income-splitting opportunities with respect to minors have been further restricted under the kiddie tax regime (discussed below).

***Transfers and Loans to a Trust***

Section 74.3 reinforces the notion that sections 74.1 and 74.2 apply to transfers involving trusts. Where an individual transfers or loans property to a trust and a "designated person" in respect of the individual is a beneficiary of the trust, section 74.3 will apply to determine the amount of income distributed by the trust to the designated person that is subject to attribution under either section 74.1 or section 74.2. A "designated person" in respect of a taxpayer is defined in subsection 74.5(5) to be the taxpayer's spouse, and persons under the age of 18 who are either non-arm's-length to the taxpayer or the taxpayer's nieces or nephews. Transfers and loans to these individuals will be subject to the attribution provisions in sections 74.1 and 74.2.

***Revocable Transfers to a Trust: Subsection 75(2)***

If a taxpayer transfers property to a trust, and the trust holds the property on condition that it, or property substituted for it, may

1. revert to the transferor under the terms of the trust, or

2. after the creation of the trust, pass to beneficiaries to be determined by the taxpayer, or

3. not be disposed of during the taxpayer's lifetime without his or her consent,

then any income or gain arising from the property or any property substituted therefor will be attributed to the taxpayer while he or she is resident in Canada. The effect of subsection 75(2) is to limit the taxpayer's ability to split income by using a trust where the taxpayer retains various elements of control.

Pursuant to subsection 107(4.1), if at any point in its existence a trust becomes subject to the attribution rule in subsection 75(2), any subsequent distribution of property to capital beneficiaries other than the settlor will be affected in that generally they will not be eligible for a tax-deferred transfer under subsection 107(2).[40] Consequently, before distributions of capital property are made from a trust, it is important to ascertain whether subsection 75(2) has applied to the trust.

***Exceptions to Attribution***

*Transfer or Loan at Fair Market Value*

There will be no attribution if the transferor has received consideration equal to the fair market value of the property transferred.[41] However, a transferor spouse must specifically elect not to have the spousal rollover provisions in subsection 73(1) apply. If the election is not made, subsection 73(1) will treat the transaction as a spousal rollover. Income earned or gains realized on the transferred property will be attributed to the transferor spouse, and any accrued gains at the time of the transfer will be deferred until a disposition occurs. If a portion of the consideration for the purchase is debt, the debt must meet the interest requirements described below.

*Commercial Rate of Interest Charged by Lender*

If the lender charges the borrower interest at a rate that is at least equal to the lesser of the prescribed rate in effect at the time the loan was made and the commercial rate in effect at the same time, and the interest payable in respect of a particular year is paid not later than 30 days after the end of the calendar year, then any income earned or gains realized by the borrower on the borrowed funds will not be attributed to the lender.[42] Note that if the anticipated rate of return of an investment is higher than the prescribed rate at the time the loan is made, families can achieve a degree of income splitting if members taxed at a lower rate borrow to invest from the other members of the family.

*Spouses Living Apart*

In addition to the general exceptions to the attribution rules discussed above, subsection 74.5(3) provides that there will be no attribution by virtue of either section 74.1 or section 74.2 where the spouses or common law partners are living separate and apart because of a breakdown of the relationship. In order to avoid the attribution of capital gains or losses, the parties must file a joint election not to have section 74.2 apply.

*General*

The attribution rules apply only to income from property and not to income from business.[43] Thus, if business assets are transferred or loaned to a related individual and these assets generate income in the hands of the transferee, such income will not be attributed to the transferor or lender. As well, income that is earned on attributed income is not subject to attribution.

***Kiddie Tax: Section 120.4***

*Application*

Where an individual participates in the transfer of property to a third party for the benefit of the individual or as a benefit that the individual wishes to confer on the third party, the payment or transfer will be deemed to have been made to the individual by virtue of subsection 56(2). This provision applies regardless of the nature of the relationship between the individual and the third party.

As discussed above, taxpayers have been successful in accomplishing income splitting, including income splitting with minors, notwithstanding subsection 56(2) and other attribution rules. Shortly after the *Neuman* decision[44] was released in 1998, the "kiddie tax" in section 120.4 was introduced. For taxation years after 1999, kiddie tax on certain sources of income earned by individuals aged 17 or under at the end of a calendar year is imposed. Section 120.4 is not an attribution provision, but its effect is comparable. It was introduced in response to tax planning that resulted in income splitting and avoided the application of the attribution rules described above. Section 120.4 taxes split income—that is, passive income earned by minors—at 29 percent, the highest federal marginal rate,[45] thereby reducing or eliminating the benefit of income splitting. Kiddie tax applies to a "specified individual," defined as a person who has not attained the age of 17 years before the end of the calendar year, who was a resident of Canada throughout the year, and who has a parent resident in Canada at any time in the year.

The following categories of split income are subject to the kiddie tax:

1. taxable dividends and shareholder benefits (section 15 benefits) received by the specified individual in respect of shares of private corporations, whether received by the minor directly or indirectly through a partnership or a trust, and

2. income from a partnership or a trust to the extent that it can reasonably be considered to be derived from the provision of goods (to be changed to "property" under the draft legislation of December 20, 2002)[46] or services by a partnership or trust to or in support of a business carried on by

   (a) a person who is related to the specified individual at any time in the year;

   (b) a corporation in respect of which the related person is a specified shareholder at any time in the year; or

   (c) a professional corporation in respect of which the related person is a shareholder at any time in the year.

The first type of income to which this tax applies specifically attacks the dividend-sprinkling structures accepted by the *Neuman* decision. The second type of income targeted by the tax is that derived from management partnership structures. Prior to the introduction of the kiddie tax, management partnership structures were employed to effectively split income among family members. In this type of plan, a management partnership would have been established to provide services to a professional partnership. The partners of the management partnership would often include family trusts whose beneficiaries were the children of partners of the professional partnerships. Fees received by the management partnership for services rendered could be then paid out to the beneficiaries of the family trusts and taxed in their hands. These structures have been specifically targeted by the kiddie tax and are now useful only in income splitting with adult children. The overall effect of the kiddie tax is to limit some of the income-splitting opportunities that were previously available.

*Kiddie Tax: Exceptions*

Exceptions to the application of the special income-splitting tax include, for example, income from property acquired by or for the benefit of a specified individual as a consequence of the death of a parent. Note, however, that income from property acquired as a result of the death of an uncle or aunt will not escape taxation. The tax does not apply to income of the specified individual from any inherited property if he or she is in full-time attendance at a post-secondary institution or if the minor is eligible for the disability tax credit. Income from employment or from a personal services business carried on by the minor as well as taxable dividends from shares listed on prescribed Canadian or foreign stock exchanges, held either directly or indirectly or through a trust, are also not included in section 120.4. Note that if the specified individual holds such shares through a corporation, the tax will apply to dividends received from that private corporation.

The kiddie tax overrides other personal attribution provisions. Subsection 74.5(13), which is effective for 2000 and later taxation years, dictates that subsections 74.1(1), 74.1(2), 74.3(1), and 75(2) do not apply to any amount that is included in computing the specified individual's split income for a taxation year. This is so because section 120.4 taxes income at the highest marginal rate. As well, subsection 56(5) stipulates that subsections 56(2) (indirect payments), 56(4) (transfer of rights to income), and 56(4.1) (interest-free or low-interest loans) do not apply to any amount that is included in computing a specified individual's split income for a taxation year.

## Corporate Attribution

### *Application*

Subsection 74.4(2) will apply to transfers and loans of property by an individual to a corporation, either directly or indirectly using a trust, if one of the main purposes of the transaction is to reduce the income of the transferor and to benefit a "designated person" in respect of the transferor. By operation of this provision, the transferor will be deemed to have received interest annually in the amount by which interest at the prescribed rate calculated on the fair market value of the transferred property at the time of transfer exceeds the sum of interest actually received and five-fourths of all taxable dividends received as consideration for the transfer. This provision is therefore not an attribution provision per se, but rather a more punitive provision in the sense that it will apply whether or not income is paid to the designated persons in question.

As indicated above, a "designated person" is defined by subsection 74.5(5) as someone who is either the spouse of the transferor or a minor, including a niece or a nephew, not dealing at arm's length with the transferor. Therefore, if the transferor's spouse or child holds shares in a corporation, whether through a trust or directly, a transfer or loan by the transferor to the corporation may trigger a deemed income inclusion in the hands of the transferor if the purpose test is satisfied. The corporate attribution rule is of particular concern when a taxpayer freezes his or her interest in a corporation in favour of his or her spouse and minor children or in favour of a trust with a beneficiary who is a "designated person." The transaction whereby the taxpayer exchanges his or her shares for fixed-value preference shares is considered a transfer of property to the corporation, which could trigger the application of this provision.

### *Exceptions*

An important exception is contained in paragraph 74.4(2)(c), which states that subsection 74.4(2) does not apply to transfers made to corporations that are small business corporations (SBCs). An SBC is defined in subsection 248(1) as a Canadian-controlled private corporation that has at least 90 percent of the fair market value of its assets attributed to assets that are used in an active business in Canada or are shares of the capital stock of an SBC, as defined in subsection 110.6(1). It is not sufficient that the corporation be an SBC only at the time of the transfer. If at a time subsequent to the transfer the corporation ceases to qualify as an SBC, the corporate attribution rule will be triggered.

If the corporation is not an SBC, attribution may still not result if the only interest held by the designated persons in the corporation is an interest in a trust that meets certain requirements. The trust must be a shareholder of the corporation and, under its terms, the designated persons must not be entitled to any income or capital of the trust while they are designated persons in respect of the individual who has transferred property to the corporation. There will be no deemed income inclusion under section 74.4 if the child has attained the age of majority and the spouse of the transferor is not a beneficiary of the trust. It is therefore possible for a taxpayer to freeze his or her interest in a corporation in favour of adult children without offending the corporate attribution rule.

## INCOME-SPLITTING STRATEGIES

### Introduction

Income splitting is a basic feature of tax planning in all taxation systems with progressive rate structures. When a tax system identifies only the individual as the tax unit, and not spouses or the family unit, the realistic opportunities for tax planning that makes use of income splitting increase considerably. When income is directed (through some acceptable means) from a taxpayer who is subject to taxation at a high marginal rate to a taxpayer who is subject to taxation at a lower marginal rate, significant tax savings can be achieved. As a consequence, income splitting has been a basic feature of sound tax planning in Canada since the Act was first introduced. The tax savings from income splitting flow primarily from access to multiple personal credits and multiple progressive rate structures. In Ontario, for example, each additional taxpayer added to an income-splitting plan adds additional savings. In addition to these advantages, income splitting can be used to obtain multiple access to the $500,000 capital gains deduction available in respect of the disposition of the shares of a qualified small business corporation (QSBC)[47] and to increase access to RRSP contribution deductions.

The attribution rules discussed earlier in this paper are designed primarily to restrict or prohibit income-splitting strategies; but as we saw, the Canadian income tax system continues to tolerate a number of avenues for planning. Current planning suggests at least the following basic possibilities: (1) transfers by gift or loan of investment funds; (2) payment of salaries to family members; (3) dividend sprinkling through a trust; (4) multiplication of the QSBC share deduction; and (5) estate freezes. In each case, tax planners must pay close attention to the attribution rules to ensure that nothing is done that will attract their application. Each of these approaches is discussed briefly in turn.

### Income-Splitting Strategies

#### *Gifts on Transfers of Property*

A simple way to split income is to transfer investment funds from one taxpayer to another so that the investment income is taxed in the hands of the transferee. Provided that the attribution rules in subsections 74.1(1) and 74.2(1) are avoided, the transfer of funds may be made by way of gift or loan, and it may be made directly to the transferee or indirectly through a trust of which the intended transferee is a beneficiary. For instance, assume that a taxpayer has $1,000 of after-tax income that she plans to invest in a bond to earn interest income at the rate of 10 percent. If she receives $100 of interest income, it will be taxed at the highest marginal rate of tax. If, on the other hand, the taxpayer transfers the $1,000 to her 21-year old child (either directly or through a trust), who is in a lower tax bracket, the $100 of income will be subject to a lower rate of taxation. If she transfers by gift the $1,000 to her spouse or minor child, however, subsection

74.1(1) or 74.2(1) will apply to attribute the income to her, as discussed earlier in the paper. The attribution rules in subsections 74.1(1) and 74.2(1) can also be avoided if the $1,000 is loaned to the spouse or minor child at the applicable prescribed rate of interest, provided that the interest is paid in accordance with the rules discussed above.

The decline in interest rates in recent years has made the lending of funds to be invested more attractive for taxpayers who are able to obtain investment returns higher than the relatively low prescribed rate. In a recent technical interpretation,[48] the CCRA addressed the situation in which a loan to a spouse made when the prescribed rate was 5 percent was renegotiated to allow the parties to enter a new loan arrangement to reflect the current lower level of prescribed interest rates. As the technical interpretation notes, an important question is whether the old loan has been repaid and whether the new loan is indeed a new loan.[49]

***Salaries***

In the case of an incorporated family business, one simple way to split income is to employ one's children or spouse in the business and pay them a tax-deductible salary. The Act requires that the salaries paid be reasonable and that the child or spouse actually be involved in the family business.[50] Provided that these conditions are met, the salary is taxed in the hands of the child or spouse and constitutes "earned income" for the purposes of the RRSP rules, thus allowing the earners to make tax-deductible contributions to their RRSPs.

***Dividend Sprinkling Through a Trust***

A more complex income-splitting plan may involve the use of a trust to own an interest in an existing family business corporation, allowing the payment of dividends through distributions from the trust to relevant beneficiaries. To put this structure in place, the owner-manager of the family business would freeze his or her interest in the family business corporation by converting or exchanging common shares for fixed-value preferred shares. The retraction and liquidation entitlements of the preferred shares would be fixed at current values, with any appreciation in the value of the business accruing to the common shares. These would be owned by the family trust. Dividends could then be paid on the common shares and distributed to the relevant beneficiaries.

There are numerous challenges to be met in implementing such planning. There is a substantial Canadian tax literature on estate freezes and dividend sprinkling that cannot be addressed or summarized here.[51] It is clear, however, from the Supreme Court of Canada's decision in *Neuman v. The Queen*[52] that such an approach is acceptable.

***Multiplication of the QSBC Deduction***

Since the tax on split income and the attribution rules that apply to minors do not apply to capital gains realized by minors, either directly or through a trust, income splitting is still possible in regard to capital gains. The freeze structure discussed in the previous section is also useful as a way of multiplying the QSBC deduction. If the common shares are properly transferred to a trust and they appreciate in value, the appreciation in value will accrue to the beneficiaries of the trust. If the family business is sold, the capital gain realized on the common shares may be designated pursuant to subsections 104(21) and 104(21.2). These provisions allow the character of the gain realized by the trust to flow to Canadian-resident beneficiaries, who may utilize the capital gains deduction in section 110.6 in respect of QSBC shares.

When this type of planning is implemented, care must be taken to avoid the attribution rules and, in particular, section 74.4. Recall that section 74.4 applies when property is transferred to a corporation and one of the main purposes of the transfer is to benefit a designated person and to reduce the income of the individual transferor. Section 74.4 addresses such behaviour by deeming the individual to receive a return on the outstanding amount equal to the prescribed rate, net of actual returns. A freeze effected by way of section 86 may by itself render section 74.4 applicable; the individual effecting the freeze may be considered to have made a transfer to the corporation.

### *Estate Freeze Using a Trust*

This planning also minimizes taxes due on death because the arrangement freezes the value of the individual's interest in the family business corporation. Assuming that the interest in the business or other capital assets transferred to the trust would have appreciated in value, the freeze minimizes both income tax and probate fees on death.

## Interprovincial Tax Planning

### *Introduction*

Trusts offer a variety of tax-planning and estate-planning advantages. Trusts can be a useful will substitute and power-of-attorney substitute because they offer a greater level of confidentiality. Unlike a will, which may require probate, a trust remains a private document and is not subject to probate fees or estate administration tax. Additionally, establishing a trust can simplify estate administration and may lessen the risk of estate litigation. Because the combined federal and provincial rates of tax differ from province to province, trusts may also be a useful tax-planning tool for shifting income to a lower-rate province.[53] The essence of jurisdiction planning with trusts is that a taxpayer resident in a high-tax province benefits from the lower rate of tax of another province by establishing a trust in the lower-tax jurisdiction. There are a variety of technical hurdles that can make this type of planning challenging. These are discussed in the following portion of the paper.

### *The Alberta Advantage*

One way of minimizing income tax is to utilize an Alberta-resident trust to cause income to be subject to taxation at Alberta rates rather than at the higher rates of another province. In theory, this type of plan can be effected by transferring assets to an Alberta-resident trust or by emigrating an existing trust to Alberta. For planning purposes, an election made under subsection 104(13.1) permits income to be taxed in the Alberta-resident trust but distributed to beneficiaries who are not resident in Alberta. Although in the usual case the transfer of assets to a trust constitutes a disposition at fair market value, thus triggering immediate tax consequences in the hands of the transferor or settlor, these consequences can be avoided if one of an alter ego trust, joint partner trust, or qualifying spousal trust is available and is used. Setting up a testamentary trust so that it is resident in Alberta can also be advantageous. The income of such a testamentary trust will be taxed at graduated rates that are lower than those in other provinces. It is possible to achieve the best of both worlds when a qualifying spousal testamentary trust is established on the death of the individual.

The accompanying table compares the top marginal tax rates for an individual, including a trust, in Alberta, by category of income with those in certain other provinces for 2004.

| Province | Interest and Ordinary Income | Capital Gains | Dividends |
|---|---|---|---|
| | | *percent* | |
| **Alberta** | 39.00 | 19.50 | 24.08 |
| **British Columbia** | 43.70 | 21.85 | 31.58 |
| **Ontario** | 46.41 | 23.20 | 31.34 |
| **Quebec** | 48.22 | 24.11 | 32.81 |

The difference in rates of tax between Alberta and Ontario, for instance, is significant across all types of income. In 2004, the top combined rate in Ontario applicable to dividend income is 31.34 percent, which is over seven percentage points higher than the Alberta rate of 24.08 percent. The difference can result in substantial savings where a dividend is paid to an Alberta-resident trust as opposed to a taxpayer resident in Ontario.

*Establishing Tax Residency in Alberta*

Much has been written about the rules governing the residence of a trust.[54] Given the lack of clarity and certainty on that issue, under current law, a cautious planning approach is well advised.

In order to achieve the desired tax-planning result, the trust must be a resident of Alberta for provincial income tax purposes. For federal income tax purposes, the residence of a trust is generally determined by the residence of its trustees. It probably is not wise to rely on this test alone in attempting to ensure that a trust is resident in Alberta and not in some other province. It is well to recognize that other factors may also be taken into consideration, such as the location of the trust assets, the extent of the authority of the trustees over the administration of the trust, and whether the assets of the trust are controlled by someone other than the trustees. Cautious planning would ensure that neither the trust settlor nor the trust beneficiaries control the trust assets and that all of the trustees reside in Alberta. Even if it is not possible to ensure that all of the trustees reside in Alberta, a majority must; and no person who resides elsewhere can have any power of veto or a power of appointment over the trust assets. To avoid the complexities associated with corporations, it is perhaps preferable if all the trustees are individuals. Corporate trustees may carry on various activities outside Alberta, which might cloud the conclusion that control by the corporate trustee is exercised in Alberta. It may also be desirable to include a clause in the trust instrument that trusteeship will automatically cease if a trustee ceases to be a resident of Alberta.

Cautious planning also suggests that the trustees should not delegate their authority to manage investments, prepare tax returns, maintain custody of assets, and report to beneficiaries, particularly to anyone resident outside Alberta. Bank accounts, meetings of trustees, and minutes of meetings should be maintained in Alberta as well. Similarly, income tax returns for the trust might be prepared by Alberta accountants and mailed to the CCRA from the trustee's Alberta address. The position that the trust is resident in Alberta can be further strengthened by periodically passing accounts of the trustees' administration before the Court of Queen's Bench of Alberta. This is advantageous because when an Alberta court hears an application to pass accounts, it thereby implicitly recognizes Alberta as the jurisdiction whose laws govern administration.

Care should be taken to ensure that the trustees are not considered agents of the beneficiaries; if they are, the trust will be considered a bare trust and ignored for federal tax purposes and possibly for provincial tax purposes as well, on the basis that the relationship of bare trusteeship is in fact a relationship of principal and agent. If the relationship is merely one of bare trusteeship, nothing has been achieved, since the taxpayer will remain the owner of the relevant property.

*Additional Considerations*

Before a trust is established in Alberta, a cost-benefit analysis should be performed to determine whether the tax savings realized are sufficient to warrant the setup and annual costs of maintaining an Alberta trust. The planner should also consider the potential application of the attribution rules, since the attribution of income of the trust to a non-Alberta resident would defeat the Alberta strategy. In particular, if the settlor is a capital beneficiary of the trust, has a power to appoint capital, or is a controlling trustee of the trust, subsection 75(2) may apply to attribute the income of the trust to the settlor. Finally, it should be noted that some provinces – for example, Quebec – have put in place anti-avoidance provisions designed to curtail the use of Alberta trusts for the sole purpose of income splitting.[55]

***Planning Alternatives Using Alberta-Resident Trusts***

In this section, a hypothetical fact situation and some types of interprovincial planning are discussed. In particular, the use of Alberta trust arrangements to minimize tax on dividends paid to obtain a refund of refundable dividend tax on hand (RDTOH) is addressed.

*Hypothetical Facts*

An Ontario-resident corporation has a fair market value of $10 million, $1 million in its RDTOH account, liabilities of $1 million, and a net book value of $7 million. All of the shares of the corporation, which have nominal stated capital and adjusted cost base (ACB), are owned by a shareholder who is over 65 years of age and is married. The shareholder and his spouse reside in Ontario. The corporation wishes to pay a dividend of $3 million, which will be sufficient to obtain a refund of its RDTOH balance.

*Transfer of Shares to an Alberta Alter Ego Trust*

An Alberta-resident alter ego trust can be established by the shareholder for his own benefit during his lifetime as to income and for the benefit of members of his family after his death as to capital. In order to obtain a tax-deferred transfer to the trustees of the Alberta-resident trust, the trust must meet the requirements of subsections 73(1.01) and 73(1.02).[56] The 65-year-old shareholder, as the sole trust beneficiary during his lifetime, must be entitled to receive all of the income of the trust during his lifetime, and no other person may receive or obtain the use of any of the income or capital of the trust during the shareholder's lifetime.

*1) Alter ego trust variation 1: Transfer of a portion of shares and subsequent purchase for cancellation*

Under this alternative, the shareholder might transfer only 30 percent of his shares in the corporation (having a fair market value of $3 million) to the trust. Subsequent to the transfer, the corporation purchases for cancellation the shares held by the trust. This gives rise to a deemed dividend of $3 million. Although the deemed dividend is income for tax purposes, it is generally considered capital for trust law purposes.[57] Consequently, the proceeds need not be paid to the shareholder in order to satisfy the requirements of alter ego trusts. Indeed, the trust instrument should provide that the shareholder cannot receive the proceeds from a redemption or purchase for cancellation of shares in the corporation, or any other capital of the trust. This is necessary in order to avoid the application of subsection 75(2). The trust document must also provide that no other person is entitled to any income or capital of the trust during the shareholder's lifetime, or else the trust will not qualify as an alter ego trust.

An advantage of leaving the proceeds of the purchase for cancellation in the trust is that these amounts can be reinvested by the trust and the income generated by the investment can be taxed at Alberta rates, provided that an election under subsection 104(13.1) is filed. The funds might be loaned to the corporation at the prescribed rate. The disadvantage is that the proceeds from the purchase for cancellation can never be returned to the shareholder. It is primarily for that reason that only 30 percent of the shareholder's shares in the corporation are transferred to the trust in the first place, the minimum number required in this example to fully absorb the RDTOH account when they are purchased for cancellation. Another disadvantage of this approach is that it requires a valuation of the corporation.

*2) Alter ego trust variation 2: Transfer of all shares and declaration of a dividend*

Under this alternative, the shareholder might transfer all of his shares to the trust. Following the transfer, a dividend of $3 million is declared on the shares in order to fully utilize the RDTOH balance. Although the income must be paid to the shareholder to satisfy the alter ego trust requirements, an election could be filed under subsection 104(13.1) so that the resultant income is taxed in the trust at Alberta rates. Notwithstanding the subsection 104(13.1) election, it is possible that subsection 75(2) will apply, since the income will be distributed to the shareholder. It is not clear whether subsection 75(2) could override subsection 104(13.1) and cause the income to be taxable in the shareholder's hands at Ontario rates. At the very least, there is a risk that subsection 75(2) will have priority, and for that reason this variation may not be feasible.

Although this approach has the advantage of creating a structure that can be easily used to remove RDTOH from the corporation as it accrues in the future, this comes at the price of placing all of the shareholder's shares of the corporation into the trust. The shares cannot be returned to the shareholder without attracting the application of subsection 75(2). For this reason, other methods may be preferred.

*3) Alter ego trust variation 3: Declaration of stock dividend, transfer of new shares to the trust, and subsequent redemption of the new shares*

In this scenario, a stock dividend might be declared on the existing shares held by the shareholder. The stock dividend will consist of a new class of shares with a redemption amount of $3 million and paid-up capital of $1. The stock dividend is a taxable dividend, but the amount of the dividend that is taxable will be only $1. The shareholder will transfer the new shares to an Alberta alter ego trust on a tax-free basis. Once the new shares are held by the trust, they can be redeemed, thereby triggering a $3 million deemed dividend and fully utilizing the RDTOH account balance. Like the first alternative, this approach allows the $3 million to be retained in the trust and thereby reinvested to generate income, which can be taxed at Alberta rates. The disadvantage is that the $3 million cannot be returned to the shareholder; if it is, subsection 75(2) will apply.

This approach may be easier to implement than the first alternative in situations where a valuation of the corporation presents practical difficulties. Recall that the first alternative requires the valuation of the corporation so that an appropriate percentage of the shareholder's shares in the corporation can be transferred to the trust and subsequently purchased for cancellation. Where the value of the corporation is readily determinable, the first alternative may be simpler.

*Transfer of Shares to an Alberta Spousal Trust*

*1) Spousal trust variation 1: Transfer of a portion of shares and subsequent purchase for cancellation*

There are three methods available for transferring shares of the corporation to an Alberta spousal trust. In the first alternative, the shareholder can transfer (by sale or gift) 30 percent of his shares in the corporation, having a fair market value equal to three times the balance in the RDTOH account, to the trust. Subsequent to the transfer, the corporation can purchase for cancellation the shares held by the trust. The purchase for cancellation gives rise to a deemed dividend, which is treated as capital for trust law purposes even though it is income for income tax purposes. Consequently, the proceeds need not be paid to the spouse in order to satisfy the requirements of spousal trusts, but rather can be retained in the trust if desired. No one but the spouse can be eligible to receive the proceeds or any other capital or income of the trust during her lifetime. The trust instrument will also provide that the shareholder in particular cannot receive the proceeds or any other capital of the trust; if he does, the application of subsection 75(2) might be triggered.

An advantage of this variation relative to variation 2 (below) is that it minimizes the value that needs to be given up by the shareholder. Only a portion of the shares of the corporation need be transferred to the trust, and it will be possible for the shareholder to transfer the shares for fair market value consideration such as a promissory note (even though, from a tax perspective, there has been a rollover). Since the amounts received by the trust on the purchase for cancellation will generally be considered capital for trust law purposes, they need not be distributed to the spouse but instead can be used to partially repay the promissory note.

*2) Spousal trust variation 2: Transfer of all shares and declaration of a dividend*

In this alternative, the shareholder can transfer by sale or gift all of his shares to the trust. Following the transfer, a dividend of $3 million is declared on the shares to fully utilize the RDTOH balance. Although the income must be paid to the spouse in order to satisfy the spousal trust requirements, an election can be filed under subsection 104(13.1) to tax her income in the trust at Alberta rates. If the shares were transferred for fair market value consideration, the attribution rules in section 74.1 remain applicable unless an election is made to waive the spousal rollover. However, whether the shares were sold or gifted to the trust, section 74.1 might still be avoided, provided that the subsection 104(13.1) election is filed.

In contrast to alter ego trust variation 1 (above), it may be possible to mitigate the disadvantage of placing all of the shareholder's shares in the corporation in the trust by selling the shares for fair market value (which will be net of an assumed amount of tax that would be payable if the shares were sold to an arm's-length person). The use of a spousal trust may also provide greater protection against a possible Ontario general anti-avoidance rule (GAAR) assessment, since a stronger argument can be made that the plan is being carried out for non-tax reasons such as estate planning. Furthermore, if the Ontario GAAR were to apply, query whether it would be possible to revoke the subsection 104(13.1) election and thereby ensure that although the income was taxable in Ontario, it would not also be subject to tax in Alberta.

Another advantage of the spousal trust is that it allows for the encroachment of capital in favour of the spouse. Under the alter ego trust variation, no encroachment on capital will be possible without violating one of the alter ego trust requirements or attracting the application of subsection 75(2). The other advantages and disadvantages discussed in relation to alter ego trust variation 2 are also fully applicable. This variation is recommended if the shareholder wants maximum Ontario GAAR protection and, at the same time, wants to be in a position to receive some of the funds that are paid to the trust.

*3) Spousal trust variation 3: Declaration of stock dividend, transfer of new shares to the trust, and subsequent redemption of the new shares*

This variation presents the same considerations as those discussed with respect to alter ego trusts above, with the following exceptions. First, this method allows the trustees to encroach on capital for the benefit of the spouse, subject to the attribution rules in section 74.1. Second, the transfer of the new shares to the spousal trust can occur for fair market value consideration, thus minimizing the amount of capital that must be permanently given away by the shareholder as part of the tax planning. Finally, the spousal trust variation may be less vulnerable to the Ontario GAAR than the alter ego equivalent, since it should be possible to argue that the plan is being carried out for estate-planning purposes.

Variation 2 may be preferred because the possibility of revoking a subsection 104(13.1) election provides greater comfort with respect to the Ontario GAAR. Variation 2 may also be preferred, since it establishes a structure that can be used on an ongoing basis to remove future RDTOH account balances.

### *Transfer of Shares to a Joint Partner Trust*

The same variations, with similar planning considerations, are possible when a joint partner trust is used instead of a spousal trust. However, a joint partner trust provides greater flexibility, since it enables the settlor (the shareholder) to receive income from the trust during his lifetime while still providing the power to encroach on capital in favour of his spouse. The disadvantage of a joint partner trust is that the transfer to the trust cannot occur for valuable consideration, as is the case for the spousal trust.

## CONCLUSION

There are some general issues that ought to be considered when planning with respect to the use of trusts as an income-splitting tool. A number of these may be summarized as follows:

- To the extent that the property to be transferred to the trust has accrued gains, consider utilizing alter ego or joint partner trusts. If there are no accrued gains – for example, in the context of an estate freeze – consider a more traditional trust.

- In the context of a freeze of corporate holdings, be sure to ascertain the SBC status of the corporation and to draft the trust accordingly.

- In order to avoid attribution, ensure that non-arm's-length loans bear interest at the prescribed rate and that the annual interest is promptly paid.

- When property is transferred directly to a trust, in order to avoid the application of subsection 75(2), ensure that the transferor is not a capital beneficiary of the trust.

- If the taxpayer is establishing a trust, consider having the trust administered in a lower-tax jurisdiction such as Alberta.

## Notes

1 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this paper are to the Act.

2 For a complete discussion on the development of the concept of trusts see Jill E. Martin, *Hanbury & Maudsley Modern Equity*, 13th ed. (London: Stevens & Sons, 1989); and D.W.M. Waters, *Law of Trusts in Canada*, 2d ed. (Toronto: Carswell 1984).

3 For a discussion on the requirements for the creation of a trust, see Martin, supra note 2.

4 The distinction between an inter vivos trust and a testamentary trust is therefore critical and is discussed in detail in the next section. An inter vivos trust is described at subsection 108(1) as a trust other than a testamentary trust. A testamentary trust is defined as a trust that arose on or as a consequence of the death of an individual, with certain exceptions. These exceptions relate to situations where contributions have been made to the trust by someone other than an individual on or after his death and as a consequence thereof.

5 The CCRA takes the position that "substantially all" means 90 percent or more.

6 Subsection 104(2). In CCRA document no. 9304865, May 20, 1993, the CCRA indicated that subsection 104(2) would not apply in situations where (1) a parent settles two trusts, (2) each of the trusts has one of the settlor's children as its beneficiary, (3) each trust holds different property, and (4) neither trust is revocable and the settlor has no powers, after the settlement of the trusts, concerning any aspect of either trust or property held by the trusts.

7 Subsection 249(1).

8 Subsection 104(23).

9 Subsection 108(l) definition of "inter vivos trust."

10 Subsection 108(1).

11 CCRA document no. 2001-0079285, November 2, 2001.

12 See CCRA document no. 2000-0059755, March 23, 2001.

13 CCRA document no. 2002-0143685, January 29, 2003.

14 CCRA document no. 2003-0007365, June 20, 2003.

15 CCRA document no. 9605575, December 17, 1996.

16 See Barry S. Corbin, "The 'Separate RRSP Trust,'" Practice Note (2003) vol. 22, no. 4 *Estates Trusts & Pensions Journal* 360-68.

17 CCRA document no. 2002-0127075, April 5, 2002.

18 See subparagraphs 104(4)(a)(ii.1) and (iv), which are incorporated into the definitions in subsection 248(1) of the Act.

19 Section 69. Note that a personal trust and a beneficiary of the trust are deemed not to be dealing at arm's length under paragraph 251(1)(b).

20 Section 107.4 provides that certain transfers that qualify may benefit from a rollover.

21 Paragraph 104(4)(a).

22 Paragraph 104(6)(b).

23 Subsections 107(4) and 107(2.1).

24 Paragraph 104(6)(b).

25 Section 69.

26 Subsection 122(1).

27 Section 117.

28 Subsection 104(21) provides that "[s]uch portion of the net taxable capital gains of a trust . . . as may reasonably be considered (having regard to all the circumstances including the terms and conditions of the trust arrangement) to be part of the amount that, by virtue of subsection (13) . . . was included in computing the income for the taxation year of a particular beneficiary . . . shall, if so designated by the trust . . . be deemed, for the purposes of sections 3 and 111 . . . to be a taxable capital gain for the year of the particular beneficiary from the disposition by that beneficiary of capital property."

29 Subparagraph 104(4)(a)(ii.1).

30 Paragraphs 104(4)(b) and (c).

31 Subsection 107(2).

32 Subsection 107(4.1).

33 Subsection 107(5).

34 Defined in subsection 248(1).

35 *Interpretation Bulletin* IT-440R2, "Transfer of Rights to Income," June 20, 1995.

36 There is no age restriction in that subsection 56(4.1) may apply to all non-arm's-length individuals and not just minor children, as is the case with subsection 74.1(2).

37 98 DTC 6297 (SCC).

38 See *The Queen v. McClurg*, 91 DTC 5001 (SCC) for a similar decision by the court in an income-splitting situation where the shareholder who received a dividend had made a contribution.

39 Subsection 74.1(1).

40 Subsection 107(4.1): all future distributions in satisfaction of the capital interest of a beneficiary in the trust must be taxed in trust and not in the hands of the beneficiary unless the beneficiary is the transferor who triggered the application of subsection 75(2), or the transferor's spouse.

41 Subsection 74.5(1).

42 Subsection 74.5(2).

43 Subsection 74.1(1), for example.

44 Supra note 37.

45 Subsection 120.4(2).

46 See Canada, Department of Finance, *Legislative Proposals and Explanatory Notes Relating to Income Tax* (Ottawa: Department of Finance, December 2002).

47 The capital gains exemption is discussed in detail in Jeffrey A. Nightingale, "Selected Small Business Issues," in *2002 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2002), tab 2, and Craig K. Hermann, "The Capital Gains Exemption: A Comprehensive Review," in *Report of Proceedings of the Fifty-Second Tax Conference*, 2000 Conference Report (Toronto: Canadian Tax Foundation, 2001), 29:1-59.

48 CCRA document no. 2002-0143985, October 18, 2002.

49 See *Re Prospect Mortgage Inv. Corp. and Van-5 Dev. Ltd.* (1985), 23 DLR (4th) 349 (BCCA) and *National Trust Co. v. Mead*, [1990] 2 SCR 410. In the former case, Mr. Justice Esson of the British Columbia Court of Appeal stated (at 362): "Because novation is essentially an issue of fact, it would be wrong in principle to say, as a generalization, that assumption agreements or extension agreements, or other particular classes of documents, do or do not create a novation. The question must be decided in each case having regard to all of the circumstances of which the language of the new contract is only one."

50 Section 67.

51 See, for example, Michael F.T. Addison and Gil J. Korn, "Interspousal Property Transfers: The Things They Don't Tell You at the Diamond Shop," Personal Tax Planning feature (2002) vol. 50, no. 2 *Canadian Tax Journal* 728-57; Maureen Donnelly, Joanne Magee, and Allister Young, "Income Splitting and the New Kiddie Tax: Major Changes for Minor Children" (2000) vol. 48, no. 4 *Canadian Tax Journal* 979-1018; Kathy Munro, "The Attribution Rules and the Proposed Income Splitting Tax," in *1999 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 1999), tab 13; and Heather L. Evans, "The Impact of the Proposed 'Kiddy Tax' on Income-Splitting Arrangements," in *Report of Proceedings of the Fifty-First Tax Conference*, 1999 Conference Report (Toronto: Canadian Tax Foundation, 2000), 31:1-13.

52 Supra note 37. See also *Ferrel v. The Queen*, 97 DTC 1565 (TCC).

53 See Craig M. Jones, "Alberta Trusts in Tax and Estate Planning," in *2002 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2002), tab 15.

54 The leading decision is *Thibodeau Family Trust v. The Queen*, 78 DTC 6376 (FCTD).

55 See David H. Sohmer, "Fundamental Issues in Shifting Income to Low-Tax Provinces" (2003) vol. 22, no. 2 *Estates Trusts & Pensions Journal* 127-39.

56 An "alter ego" trust is defined in subsection 248(1) as a trust to which paragraph 104(4)(a) would apply if that paragraph were read without reference to subparagraph 104(4)(a)(iii) and clauses 104(4)(a)(iv)(B) and (C). An alter ego trust has several disadvantages that should always be considered: (1) there is a deemed disposition of trust assets on the death of the alter ego which is taxed at inter vivos rates and segregated from the alter ego's other assets; (2) alter ego trusts may not benefit from the QSBC share deduction; (3) there is no possibility of a rollover to the alter ego's spouse on death; (4) there is no subsection 164(6) carryback from the alter ego trust to the deceased's alter ego's terminal return; and (5) on the death of the alter ego, the alter ego trust is not considered by the CCRA to be a testamentary trust.

57 There may be some doubt about this conclusion, since an income beneficiary might apply to court for a determination that the amount is income and not capital. This risk may be reduced if the shares are held for only a short time before they are purchased for cancellation or redeemed. This risk may be further reduced by specifically drafting the trust instrument to provide that the proceeds from a purchase of shares for cancellation or a redemption of shares is capital and not income of the trust.