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Canadian Trust, Estate and Tax Traps with a Budget 2022 Chaser

Presented: May 31, 2022

By: Blair L. Botsford BA, LLB, MA, TEP

Partner, Dentons Canada LLP, Toronto

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Trusts, Estates and Tax in Canada - Overview

- Canada is a common law jurisdiction, other than Quebec which recognizes trusts but not beneficiary designations on registered plans (insurance designation are okay but there are special rules)
- Contracting state to the Hague Convention on the Law Applicable to Trust and their Recognition. Not a signatory to EU regulation 650/12 related to choice of succession law (the “Succession Regulation”), but still may affect Canadians with assets in participating EU member state
- We have federal and provincial income tax systems. Federally indirect taxation is permitted under the Constitution but not provincially. There is variation amongst provincial tax rates which can motivate jurisdiction shopping
- Trusts, including estates, are taxed as individuals on income earned and retained in the trust (which includes capital gains). Generally, this is at the top marginal rate applicable to individuals, with exceptions for graduated rate estates and certain testamentary trusts
- Transfers to trust are a deemed disposition under the ITA, unless rollover treatment is permitted (e.g. spousal, alter ego and joint partner trusts, self-benefit trusts)
- Trusts used to be a means for splitting income amongst family members, but it is more difficult now due to various attribution rules as well as the new TOSI rules
- Magnifying of the capital gains exemption of about $900k per person is still available through a trust and popular planning for clients with private companies

Canadian Federal Budget 2022 – Highlights for Private Client Practitioners

- Trust reporting rules
  - Currently, trusts only have to file a T3 return if it has tax payable or makes a distribution to beneficiaries. Personal information about trustees, beneficiaries or settlors is not reported to CRA
  - For trust tax years ending on or after Dec 31, 2022, all non-resident trusts that have to file a T3 return and express trusts that are resident in Canada, with a few exceptions, will be required to report additional information as part of their T3 return each year
  - The additional disclosure information cannot be separated from the T3. Therefore, even if a T3 would not otherwise be required, it is now
  - Bare trusts are caught by the new rules
  - Affected trusts must report additional information on all trustees, beneficiaries, settlors and each person who has the ability to exert control or override trustee decisions over appointment of income or capital (i.e. protector)
    - Name, address, DOB, Jurisdiction of residence, Taxpayer ID number
- Query who is a “beneficiary” of a discretionary trust, how do trustees get this information and how far to they have to go, and desire for privacy by settlors

Exceptions to Trust Reporting Rules

- Trusts that have been in existence for less than three months
- Trusts that hold assets not exceeding $50,000 in total fair market value throughout the year (where the only assets are cash, certain government debt obligations, a share, debt or right listed on a designated stock exchange, a share of a mutual fund corporation, a unit of a mutual fund trust, and an interest in a related segregated fund)
- Certain regulated trusts, such as a lawyer’s general trust account
- Trusts that qualify as non-profit organizations or registered charities
- Mutual fund trusts, segregated funds, and master trusts
- Graduated rate estates
- Qualified disability trusts
- Employee life and health trusts
- Certain government funded trusts
- Trusts under or governed by certain registered plans
- Cemetery care trusts and trusts governed by eligible funeral arrangements

Trust Reporting Penalties

- Greater of:
  - $2,500
  - 5% of the highest total fair market value of all the property held by the trust in the year
- Existing penalties related to T3 returns continue to apply.
  - $25 per day for failing to file with a minimum of $100
  - Can increase up to $2,500

Canadian Budget Highlights Cont'd

- Non-CCPC planning eliminated by introduction of the concept of a "substantive CCPC" to which the usual refundable tax regime will apply
  - Substantive CCPC – private corporations resident in Canada that are ultimately controlled in law or fact by Canadian-resident individuals
  - Other benefits applicable to an actual CCPC will not apply
- Employee ownership trusts proposed but no mechanics announced
- Adjustment to the FAPI rates. Budget 2022 eliminates the lower 25% foreign tax requirement for Canadian corporations.
- Disbursement quota for registered charities to be increased from 3.5% to 5% for the portion of property in excess of $1 million that is not used in charitable activities or administration. Also, ITA to be amended to clarify that expenses for administration and management are not qualifying expenditures for the quota.
- Additional measures to allow charities to make qualified disbursements to organizations that are not otherwise considered qualified donees.
- 21 year planning for discretionary trusts under suspicion (21 year rule does not apply to fixed interest trusts)
- Non-resident beneficiary planning under suspicion

Canadian Budget Highlights Cont'd

- GAAR may be modernized. However, it may also apply to transaction that affect tax attributes that have not yet been used to reduce taxes.
- Reportable and notifiable transactions revised
  - Canada's existing mandatory disclosure rules in respect of reportable transactions require the transaction to be an "avoidance transaction" within the meaning of the GAAR in subsection 245(2) of the ITA, and to have two of three "generic hallmarks" – (i) a contingent fee arrangement for a promoter or tax advisor; (ii) confidential protection for a promoter or tax advisor and (iii) contractual protection for a taxpayer.
  - Under the Draft Legislation, only one of the above hallmarks is required for a transaction to be reportable, provided that it can be reasonably concluded that one of the main purposes of entering into the transaction is to obtain a tax benefit (a lower threshold than the existing "primary purpose" test required for an avoidance transaction under the GAAR).
- Notifiable transactions is a new category introduced that include transactions that the CRA has found to be abusive, and transactions identified by the CRA to be "transactions of interest". The concept is similar to "listed transactions" under US tax rules. Query how solicitor-client privilege is impact.

Canadian Budget Highlights Cont'd

- A notifiable transaction is defined to mean a transaction that is the same as, or substantially similar to, a series of transactions that has been designated by the Minister (with the concurrence of the Minister of Finance).
- The six types of transactions designated by the Minister deal with the following matters:

1. Manipulating CCPC status;
2. Straddle creation transactions using a partnership;
3. Avoiding the 21-year deemed disposition rule for trusts;
4. Manipulation of bankrupt status to reduce debt forgiveness;
5. Avoidance of acquisition of control of a corporation in certain circumstances; and
6. Back-to-back lending to avoid either thin capitalization rules or non-resident withholding tax.

For more information about the Canadian Federal Budget 2022

https://www.dentons.com/en/insights/guides-reports-and-whitepapers/2022/april/8/canada-federal-budget-2022

Canadian Tax Barriers to Trust Planning

- s.75(2) is an attribution section that can have highly punitive implications and is one of the greatest obstructions to trust planning
- **75 (2)** If a trust, <u>that is resident in Canada</u> and that was created in any manner whatever since 1934, holds property on condition
  - **(a)** that it or property substituted therefor may
    - **(i)** revert to the person from whom the property or property for which it was substituted was directly or indirectly received (in this subsection referred to as “the person”), or
    - **(ii)** pass to persons to be determined by the person at a time subsequent to the creation of the trust, or
  - **(b)** that, during the existence of the person, the property shall not be disposed of except with the person’s consent or in accordance with the person’s direction,

any income or loss from the property or from property substituted for the property, and any taxable capital gain or allowable capital loss from the disposition of the property or of property substituted for the property, shall, <u>during the existence of the person while the person is resident in Canada</u>, be deemed to be income or a loss, as the case may be, or a taxable capital gain or allowable capital loss, as the case may be, of the person.

[Emphasis added.]

Canadian Tax Barriers Cont'd

- Implications of 75(2)
  - Attribution back to settlor/contributor
  - Prevents rollout to Canadian resident beneficiaries at cost base (deemed disposition at FMV instead). Distributions to non-resident beneficiaries is at FMV without 75(2).
- As an aside, a capital distribution from a trust is treated for Canadian tax purposes as a disposition of a portion of the beneficiary's capital interest in the trust. For estates, if greater than 50% of the value of the estate is derived from real property, the interest in the estate is considered taxable Canadian property and a s.116 certificate is required.
- A violation of 75(2) can sometimes be corrected but this only corrects the attribution issue. Once triggered, even for a day, the denial of rollout treatment is permanent.
- How do Canadian's avoid s.75(2)? Use a "dummy" settlor for the initial settlement. For example, a friend or remoter family member is asked to settle the trust with $20 (which cannot be repaid). This can raise questions about the certainty of intention.
- Further contributions to the trust are also a settlement for the purposes of 75(2). Options here are loaning property into the trust at a minimum of the prescribed rate. Alternatively, corporate reorganizations are done with the family trust subscribing for new growth shares from treasury at nominal value. The frozen preferred shares are held personally.

Canadian Tax Barriers Cont'd

- 21 year deemed disposition rule for discretionary trusts
- Always a problem, particularly if trust holds lumpy assets, and now the proposed Notifiable Transactions rule increases scrutiny
  - The Minister identified three designated transactions with respect to avoidance or deferral of the 21-year deemed realization rule or the avoidance of the rules in subsections 107(5) and (2.1) of the ITA:

1. The indirect transfer of trust property to another trust by transferring the property to a holding company owned by the recipient trust on a tax-deferred basis prior to its 21-year anniversary.
2. The indirect transfer of trust property to a non-resident by transferring the property to a holding company owned by one or more non-resident beneficiaries of the trust on a tax-deferred basis prior to its 21-year anniversary.
3. The transfer of trust value using a deemed dividend resulting from the redemption of shares in the capital of an operating company held by a trust that is designated by that trust to be received by a holding company owned by the recipient trust.

Canadian Estate Law Quirks

- Loans to trusts create a receivable in the contributor's estate which is subject to probate fees (possible exception if the loan is forgiven in the Will). Some people will do secondary Wills (in provinces where that is allowed) in order to deal with the loan receivable and other "non-probatable" assets
- Multiple Will strategy does not work in all provinces. Two provinces where it is used the most is ON and BC because of the high probate fees. In BC the different Wills need different executors, but not in ON. The risk with multiple Wills is the perception by CRA that there are multiple estates only one of which can be the graduated rate estate (GRE).
- Pour over clauses in Wills are not permitted unless contained in a Will validly made in a jurisdiction where they are permitted (however, see Waslenchuk and Quinn in BC, MacCallum Estate in NS, and Vilenski v. Weinrib-Wolfman in ON)
- Interference with shareholder agreement restrictions on who can be a permitted transferee or restrictions on transfers
- Coordinating funding of qualified disability trusts ("QDTs")
- Delays in obtaining probate (6-9 months in Toronto)
  - Accounts frozen during this time
  - Lack of liquidity to pay bills
  - Difficult to sell real property
  - Inconsistency of policies at financial institutions

Probate Planning – A National Past time

- Probate fees, estate administration tax as it's called in Ontario, can be as high as 1.7% of the value of the estate (or top tier). Ontario is 0% on the first $50k of value and 1.5% on values over $50k (rounded to the nearest $1000) with no upper limit (i.e. $15k per million of value).
- Probate is not mandatory in Canadian jurisdictions, so people try to avoid it to their detriment at times
- What is not subject to probate in a province?
  - Property held in joint tenancy with rights of survivorship (presumption of resulting trust does not apply)
  - Life insurance (this includes annuities and segregated funds) – legislated exemption
  - Plans with valid beneficiary designations (depends on the province)
  - Real property outside the province
  - Property held in trust (although an interest in a trust can be caught and similarly property over which there is a general power of appointment)

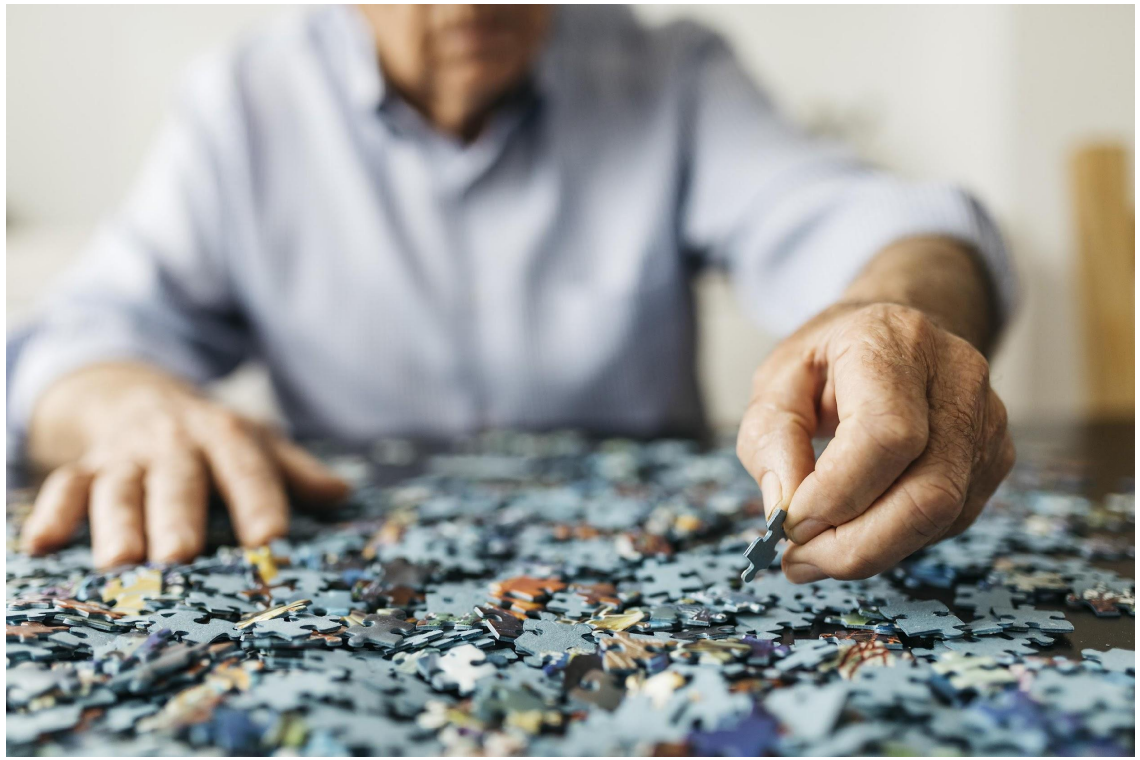
Probate Planning – Tips and Traps

- Tip #1 – Be good
- Tip #2 – If you cannot be good, be careful
- Methods
  - Joint ownership (no resulting trust)
  - Beneficiary designations
  - Multiple Wills – in the provinces where this is permitted (BC and ON are main ones) / foreign Wills
  - Trusts
  - Bare trusts
- Traps
  - SCC decision in Pecore regarding the presumptions of resulting trust and advancement
  - Taxation of trusts as well as the cost and complexity
  - New trust reporting rules which catch bare trusts and not just “regular” express trusts
  - BC requires different executors for the multiple Wills, NS does not allow multiple Wills

Resulting Trusts and SCC Decision in Pecore

- Pecore v. Pecore, 2007 SCC 17 (CanLII), [2007] 1 SCR 795
- SCC modernized the presumption of advancement to have it apply both to fathers and mothers if minor children
- Confirmed that the presumption of resulting trust applies to gratuitous transfers but was unclear about exactly what constituted a “gratuitous transfer”
- Stated that you can gift the “right of survivorship” and distinguish this from the US rules for Totten trusts
- Deviated from previous SCC decision in Edwards v. Bradley, 1957 CanLII 17 (SCC), [1957] SCR 599 regarding the presumption of resulting trust
- This case led to an avalanche of resulting trust cases, one of most notorious by Calmusky v. Calmusky, 2020 ONSC 1506 (CanLII, which tried to apply the concept to beneficiary designations for registered plans and insurance
- Mak (Estate) v. Mak, 2021 ONSC 4415 (CanLII), and Fitzgerald Estate v. Fitzgerald, 2021 NSSC 355 (CanLII) have attempted to swing the pendulum back
- The result has been a significant uptick in litigation around testator intention, but not necessarily intention in the sense contemplated by Edwards v. Bradley
- Situation has descended to the point that some practitioners are advocating for the abolition of probate fees and statutory reform regarding what forms estate and how designations to be recognized

Canadian Estate Puzzle – Not a DIY Project



- Personally held assets (wherever situate)
- Assets held jointly in tenancy in common
- Assets held in joint tenancy with rights of survivorship (presumption of resulting trust vs. advancement)
- Assets with beneficiary designations or successor subscribers (tricky under some legislation where there can be more than one surviving spouse)
- Assets held in trust or through corporations
- Taxes and other liabilities on death
- Family law rights and obligations
- Estate succession rights and obligations
- Disability planning
- Foreign estate and succession rules
- Conflict of laws

Blair’s Canadian Private Client Pet Peeves, eh

- Taxation of trusts generally and 75(2) and the 21 year rule more specifically
- Misunderstanding the nature and importance of trusts as a wealth management tool for families – by public and government
- Missteps with insurance and insurance trusts
- Public focus on price rather than value
- DIY planning and bad drafting
- Quality of judicial decisions related to trusts and estates
- Regulatory barriers to multi-disciplinary practice
- Lack of custom fiduciary services, or affordable fiduciary services for trusts for minors or other vulnerable people
- Shortage of sophisticated trust and private client lawyers in Canada

Thoughts on “Mind and Management”

- Residency of corporations and trusts for Canadian tax is based on the control test or “mind and management”
- Where control is exercised is key – location, location, location
  - Where directors/trustees meet – physically
  - Where principal business is done
  - Where books and records located
  - Where company seal located
  - Location of bank accounts
  - Not based on place of incorporation/settlement or residence of directors/trustees
- Trusts can be deemed resident in Canada (e.g. Canadian resident beneficiaries)
- Many Canadian trusts are used in conjunction with Canadian Controlled Private Corporations (CCPCs). Loss of CCPC status can have negative tax implications for active businesses
- What does this mean for Cayman professionals and providers of fiduciary services?

Cayman – Canada Opportunities

- Is there a “middle way” between a fully Cayman-resident solution and a fully Canadian-resident solution?
- Trust, fiduciary and family office services for Canadians – taxable in Canada wholly or partially
- Designer PTCs, incorporated in Canada, with back-office services provided on contract by Cayman fiduciary companies?
- PTC share can be held by Canadian NFP corporation that could act as a protector and house family governance rules
  - PTC share will not be subject to:
    - Canadian substitute decision rules (i.e. attorney for property or guardianship)
    - Family law
    - Estate succession
  - Advantage is to institutionalize values, goals and purposes of the “family enterprise” for long term sustainability
- Shared purpose by clients and advisors that focuses on goals and values may offer solutions

Q & A

- Thank you STEP Cayman!!

- More information about Blair
- https://www.dentons.com/en/blair-botsford
- www.linkedin.com/in/blairbotsford