



passionate  
about tax  
optimization

## STEP – Winnipeg “Alberta Trusts” – An Overview



STEP

Kim G C Moody CA,TEP  
Moody's LLP Tax Advisors  
May 15, 2006

**moodys** LLP  
tax advisors

# Alberta Trusts – What Are They?

- Of course, no statutory definition of “Alberta Trusts”.
- Common phrase for trusts that are resident in Alberta.
- What kind of trusts can be “Alberta Trusts”?
- Inter vivos trusts
  - Spousal
  - Alter-ego/joint spousal/common-law partner
  - Other personal trusts
- Testamentary trusts

## Alberta Trusts – A Review of Some Basics

- Trust is not a judicial entity but rather a legal relationship
- The relationship arises in equity whenever a person (a trustee) is compelled to hold property for the benefit of other persons (beneficiaries)
- Subsection 104(2) – trust is deemed to be, in respect of a trust property, an individual
- Subsection 104(1) – unless provided otherwise, a reference in the Act to a trust must be read to include a reference to the trustee.

## Alberta Trusts – A Review of Some Basics

- 104(6)(b) – Provides a deduction in the computation of trust income to the extent such income was paid or was payable to the beneficiaries.
- 104(13.1/13.2) – Will deem amounts that were paid/payable for the purpose of computing trust taxable income if trustee(s) designate – result is the income is taxed in the trust's hands.
- 104(24) – Paid/payable requirement.

# Alberta Trusts – A Review of Some Basics

## Attribution

- Section 74.1 – Can attribute property income back to transferor under certain circumstances.
- Section 74.2 – Can attribute capital gains/losses back to transferor under certain circumstances.
- Section 74.3 – Can cause the rules under sections 74.1 and/or 74.2 to apply under certain circumstances where property is transferred to a trust.

# Alberta Trusts – A Review of Some Basics

- General trust attribution rule – subsection 75(2).
- *Trusts [revocable, etc.] -- Where, by a trust created in any manner whatever since 1934, property is held on condition*
  - (a) that it or property substituted therefore 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, during the existence of the person while the person is resident in Canada, 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.*

## Alberta Trusts – A Review of Some Basics

- If subsection 75(2) applies, all trust income/losses or capital gains/losses will attribute back to settlor.
- Result of subsection 75(2) applying is generally no ability to income split or to otherwise plan regarding the taxation of trust income.
- If subsection 75(2) has ever applied to any trust property, capital property of the trust will not be able to be transferred to the capital beneficiaries in satisfaction of all or any part of their interest in the trust on a tax deferred basis (see subsection 107(4.1))
- Accordingly, a key aspect of “Alberta Trust” planning is to ensure that subsection 75(2) does not apply.

## Alberta Trusts – A Review of Some Basics

- Does subsection 75(2) take priority over subsections 104(13.1/13.2)?
- No case law on point.
- Better view is that subsection 75(2) likely takes priority.
- Accordingly, when using “Alberta Trusts” for income splitting purposes, the trust deed must be drafted so as to ensure that subsection 75(2) does not apply.



## Alberta Trusts – Residence of Trusts

- *Thibodeau Family Trust v. The Queen* [1978] CTC 539 [FCTD]
- Generally, residence is where the majority of trustees reside.  
[Common-law test]
- However, other factors should be considered.
- Deemed residence can also apply – section 94 – not generally relevant when dealing with Alberta trust planning.
- CRA's views in IT-447.

## Alberta Trusts – Transfers of Property to a Trust

- Generally, transfers of property to a trust occur at fair market value.
- Accordingly, such disposition of property to a trust may cause capital gains to be realized.
- Exceptions:
  - Transfers to qualifying spousal trusts;
  - Alter-ego trusts;
  - Joint spousal/common-law partner trusts;
  - “Self-benefit” trusts; and
  - Certain “qualifying dispositions” – section 107.4.

## Alberta Trusts – Spousal Trusts

- Specific conditions under section 73 (inter vivos spousal trusts) or subsection 70(6) (testamentary spousal trusts).

## Alberta Trusts – Provincial Rate Shopping

	Salary + Interest	Capital Gains	Ineligible Dividends	Eligible Dividends
Alberta	39.00	19.50	24.08	14.65
BC	43.70	21.85	31.58	24.4
Ontario	46.41	23.20	31.33	20.24
Manitoba	46.40	23.20	35.08	28.53
New Brunswick	46.84	23.42	37.26	N/A
Quebec	48.22	24.11	32.81	29.66

# Alberta Trusts – A Basic Plan #1

## Facts:

1. “MBCo” is a Manitoba incorporated company.
2. The permanent establishment of MBCo is in Manitoba.
3. The sole shareholder of MBCo is Mr. Apple.
4. Mr. Apple is married to Mrs. Apple and both are not US citizens.
5. Both Mr. and Mrs. Apple are Manitoba residents for Canadian income tax purposes.
6. MBCo has a \$3.33 million refundable dividend tax on hand (“RDTOH”) account that it would like to recover.

# Alberta Trusts – A Basic Plan #1

## Consider:

1. Mr. Apple transfers his shares of MBCo to a qualifying inter vivos spousal trust for the benefit of Mrs. Apple – section 73 requirements are met.
2. The majority of the trustees of the spousal trust are resident in Alberta.
3. A \$10 million dividend is declared and paid from MBCo to the spousal trust shareholder. [dividend would be ineligible dividend.]
4. Pursuant to the terms of the spousal trust, the \$10 million is paid to Mrs. Apple.
5. Alberta trustees designate under subsection 104(13.1) to deem dividend income to not have been paid to Mrs. Apple notwithstanding that it has been paid.

# Alberta Trusts – A Basic Plan #1

## Result:

1. \$10 million dividend is taxed in spousal trust.
2. Ineligible dividend rate = 24.08% = \$2,408,000.
3. Had dividend been taxed in MB, rate = 35.08%.
4. Savings = \$1,100,000.
5. RDTOH of \$3.33 million recovered in tax efficient manner.

## Alberta Trusts – A Basic Plan #2

Same as facts #1 except:

1. MBCo has no RDTOH.
2. The FMV of the issued shares of MBCo = \$30 million.
3. Mr. Apple has been approached to sell his shares of MBCo.
4. The ACB of the issued shares of MBCo is nominal.
5. The issued shares of MBCo are qualified small business corporation share(s)" as defined under subsection 110.6(1).
6. Mr. Apple is eligible to utilize his available capital gains deduction as provided for under subsection 110.6(2.1).



## Alberta Trusts – A Basic Plan #2

### Consider:

1. Mr. Apple transfers certain of his shares (\$30 million - \$500k of value of his shares) of MBCo to qualifying inter vivos spousal trust. Section 73 conditions are met.
2. The majority of the trustees of the spousal trust are resident in Alberta.
3. Mr. Apple sells \$500k of MB shares and utilizes his available capital gains deduction.
4. The spousal trust then sells \$29.5 million of MBCo shares and realizes taxable capital gain.
5. The \$29.5 million of proceeds are paid by the trustees of the spousal trust to Mrs. Apple.
6. The trustees of the spousal trust designate under subsection 104(13.2) to deem the amounts in #5 to not have been paid.

## Alberta Trusts – A Basic Plan #2

### Result:

1. Mr. Apple utilizes his available capital gains deduction (like he otherwise would have). Subsection 69(11) will not apply.
2. The remaining \$29.5 million of capital gain is taxed at the trust level at Alberta rates @19.5% = \$5,752,500.
3. Had such capital gain been taxed in MB, the tax rate @ 23.2% = \$6,844,000.
4. Savings = \$1,091,500.

## Alberta Trusts – A Basic Plan #3

### Facts:

1. Mr. Apple is resident in BC and is 75 years of age.
2. Mr. Apple is married to Mrs. Apple who is also 75 years old. Mr. and Mrs. Apple are not US citizens.
3. Mrs. Apple has \$10 million of capital property that generates approximately 5% income each year.
4. Mrs. Apple is concerned about BC probate costs upon her eventual passing.
5. Mrs. Apple would like to reduce taxation of the annual property income that is realized on her portfolio.
6. Mrs. Apple would also like to reduce income tax exposure upon her eventual passing.

## Alberta Trusts – A Basic Plan #3

### Consider:

1. Mrs. Apple transfers her portfolio to a joint spousal trust.
2. JST is drafted so that subsection 75(2) will not apply. This will likely require that Mrs. Apple can not access the capital during her lifetime.
3. Majority of trustees of JST are resident in Alberta.
4. Trustees designate that subsections 104(13.1)/(13.2) apply to portfolio income.

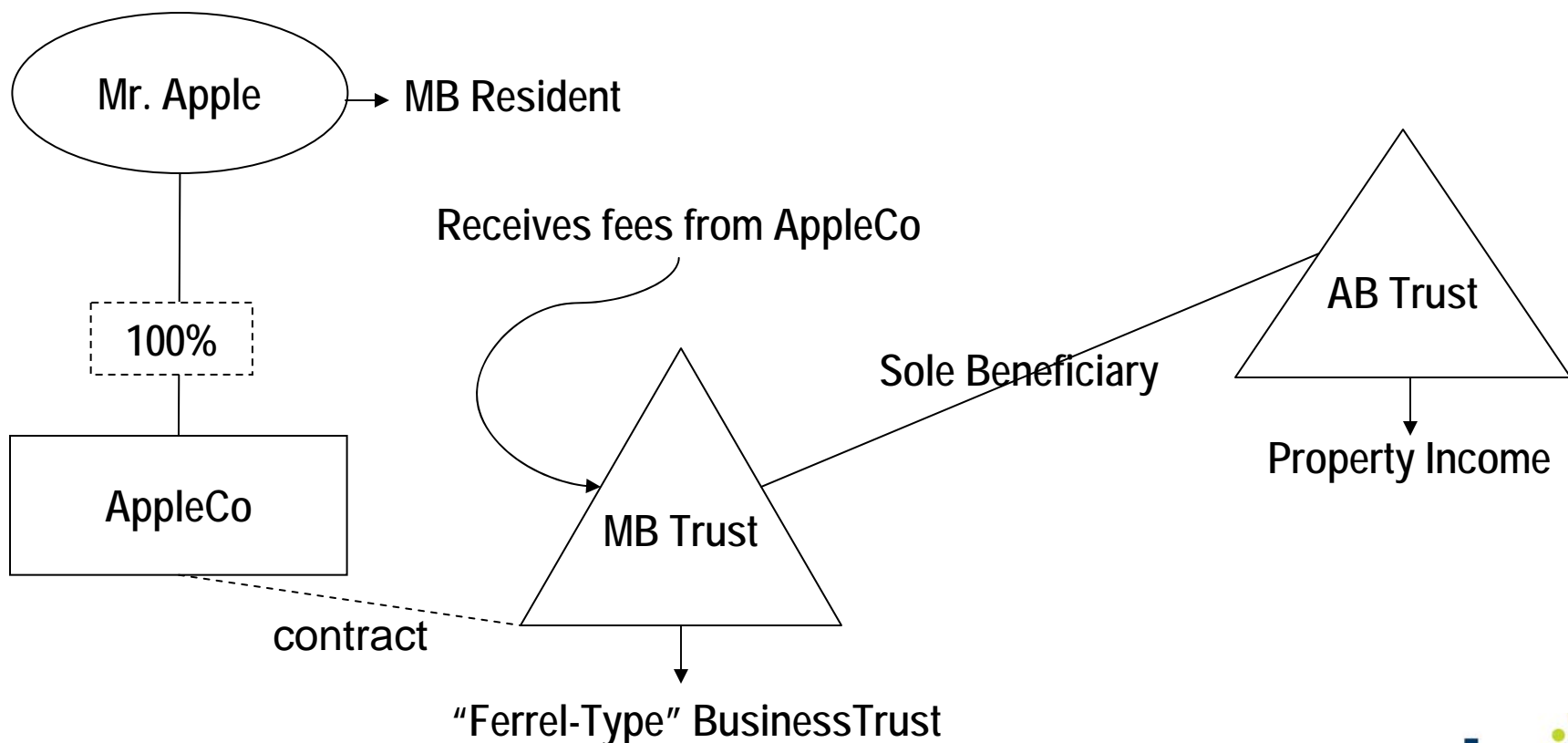
## Alberta Trusts – A Basic Plan #3

### Result

- \$500,000 of portfolio income taxed at AB tax rates – say 39% vs. 46.4%
- BC probate on assets held by JST likely not applicable on passing of Mr. or Mrs. Apple.
- Increased creditor protection? Seek legal advice.
- Upon last death of Mr. and Mrs. Apple, JST will be deemed to have disposed of its assets at FMV – 104(4)(a). Resulting capital gains, if any, can be taxed in Alberta.

# Alberta Trusts – A Basic Plan #4

## Permanent Establishment Remains Home Province



# Alberta Trusts – A Basic Plan #5

## Shareholder Loans

- Consider assigning interest bearing shareholder loans to an Alberta Trust.
- Watch subsection 56(4.1)

# Alberta Trusts – “Business Trusts” If Permanent Establishment Can be Transferred to Alberta

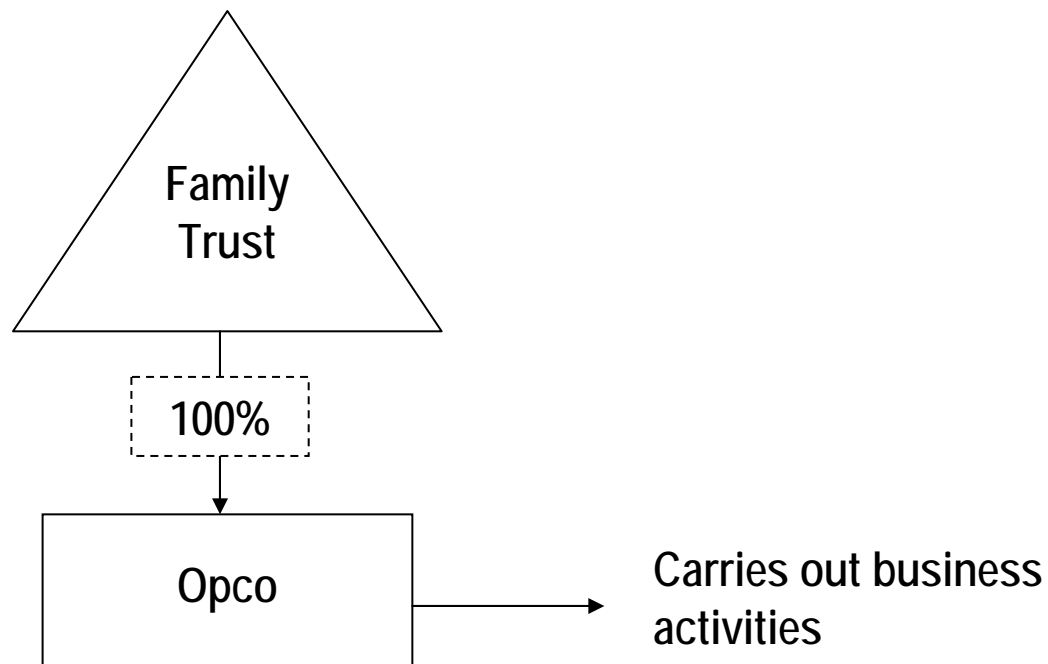
## Business Usage – Traditional

- Traditionally in Canada, a personal trust has not been a vehicle of choice to carry out the business. Instead, it has often been a shareholder of a private corporation that will carry out the underlying business.



# Alberta Trusts – “Business Trusts”

## Business Usage – Traditional



- In such a traditional structure, corporate tax is payable (in addition to tax paid at the shareholder level).

## Alberta Trusts – “Business Trusts”

### Business Usage – Traditional

- If profits of Opco exceed available small business limits (usually \$300,000) then excess profits over \$300,000 are generally “bonused out” to active, Canadian resident direct or indirect individual shareholders to preserve integration.
- However, such bonus “rule of thumb” will now need to be reviewed in light of new “eligible dividends”.
- Such bonus payment by Opco to individual is subject to reasonableness test (see section 67) (Note: CRA has released guidelines for situations when it will not apply section 67 to bonus payments. CRA has stated many times that bonus paid to a trust shareholder will be subject to section 67.

# Alberta Trusts – “Business Trusts”

## Business Usage – Traditional

### Facts:

- Trust is sole shareholder of Opco.
- Trust and Opco resident in Ontario.
- Opco’s business profits are \$1M.
- Mr. Apple – who is the main entrepreneur of Opco – and his spouse and 3 minor children are residents of Canada and beneficiaries of the trust.
- Mr. Apple is at the highest personal tax rate applicable to Ontario – 46%.

# Alberta Trusts – “Business Trusts”

## Business Usage – Traditional

### Analysis

- In order to preserve integration, Opco will pay a \$700K bonus to Mr. Apple. Income taxes of \$322,000 will be payable.
- Opco will pay corporate tax of approximately 18% on its profits - \$54,000.
- If dividends paid from retained earnings of Opco and allocated to Apple children, “kiddie tax” will apply.

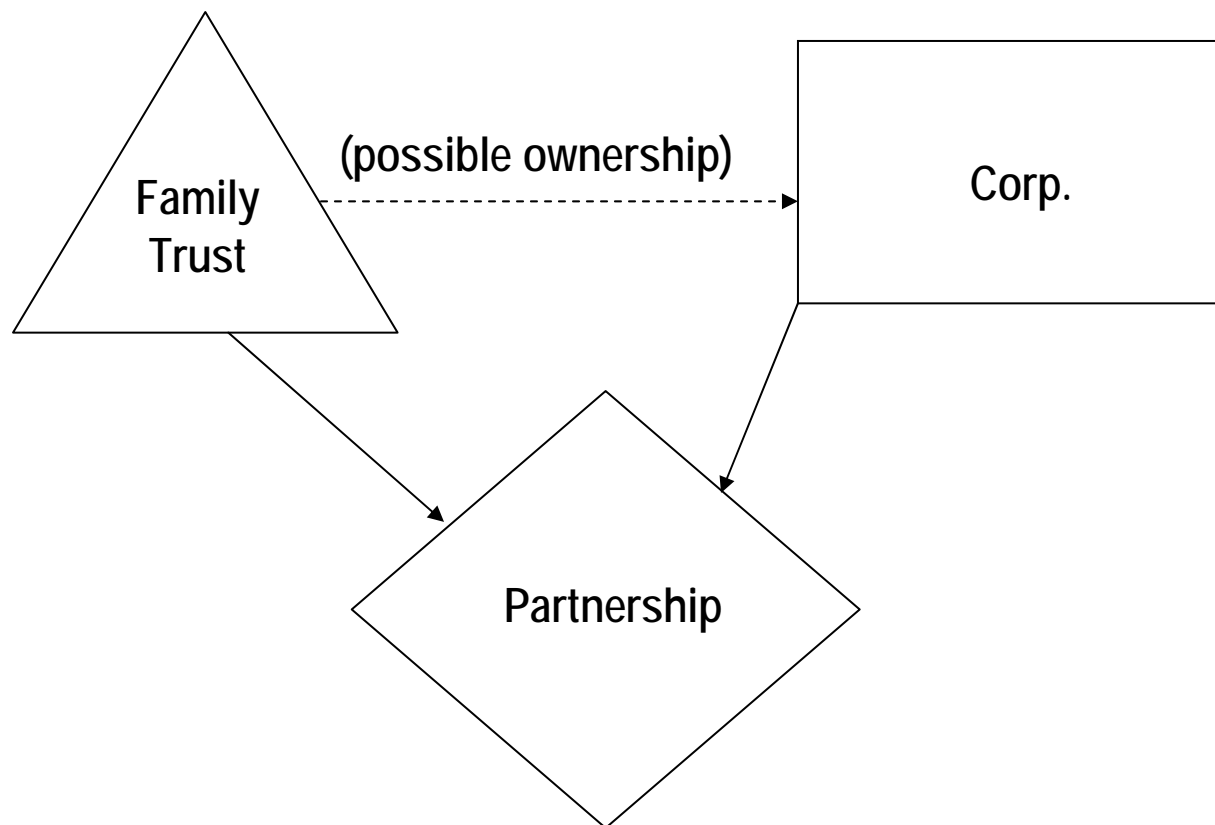
# Alberta Trusts – “Business Trusts”

## Business Usage – Partnership Structure

- Partnership is not a legal entity but a legal relationship.
- If a personal trust was in a legal relationship with another partner and the partnership carried out the business, then the following would result:

# Alberta Trusts – “Business Trusts”

## Business Usage – Partnership Structure



## Alberta Trusts – “Business Trusts” Business Usage – Partnership Structure

- Income, subject to section 103 reasonableness issues, could be allocated to trust partner thus avoiding corporate tax (except for income allocated to corporate partner).
- “Kiddie tax” would not apply for income allocated from trust to minor beneficiaries if the business income of the partnership was generated from arm’s length sources.

## Alberta Trusts – “Business Trusts”

### Business Usage – Partnership Structure

- If partnership is general partnership, then partners would have unlimited liability.
- Liability issues could perhaps be dealt with by making partnership a limited partnership and having trust as a limited partner – seek legal advice.
- If limited partnership would have losses, limited partners would be subject to “at-risk” rules for deductibility of losses – see subsections 96(2.2) and (2.3).



## Alberta Trusts – “Business Trusts” Business Usage – Partnership Structure

- The trust as a limited partner could also be subject to alternative minimum tax – see Division E.1 of Part I of Act.
- Inactive partners (for example a trust), would also need to watch draws in order to avoid deemed capital gains for amounts withdrawn in excess of ACB – see subsection 40(3.1) of Act.

## Alberta Trusts – “Business Trusts” Trust Operates Business Directly

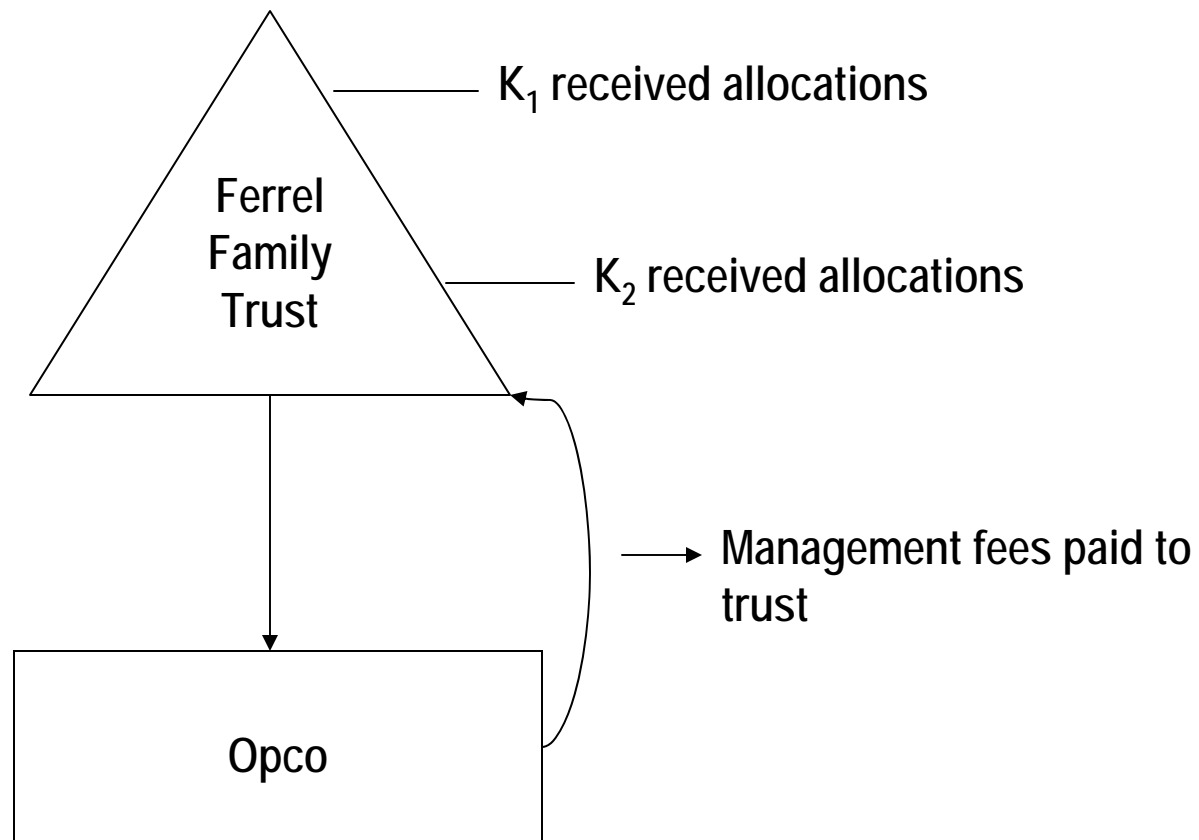
- What about carrying on the business directly through a trust?
- Such an idea is not novel. Many countries have history in the usage of a trust to carry on a business.
- In Canada, this issue was considered in a case called *Ferrel* (99 DTC 5111).

## Alberta Trusts – “Business Trusts” Trust Operates Business Directly

- *Ferre* involved the situation of a family trust that owned all of the shares of a company and the company paid “management fees” to the trust.

# Alberta Trusts – “Business Trusts”

## Trust Operates Business Directly



## Alberta Trusts – “Business Trusts” Trust Operates Business Directly

- Mr. Ferrel argued that the trust was a “business trust” in the sense that it was a trust carrying on a business.
- The CRA argued:
  - a) that subsection 56(2) applied
  - b) that subsection 56(4) applied
- The Tax Court of Canada found that the above 2 provisions did not apply. The Minister appealed to the Federal Court of Appeal.

## Alberta Trusts – “Business Trusts” Trust Operates Business Directly

- The Federal Court of Appeal agreed with the Tax Court. At paragraph 2 of the decision, Justice Linden states:

*“...we have not been persuaded that the agreements between the trust and the taxpayer and the trust and the company were illegal for purposes of the Income Tax Act (see subsection 104(2)) nor improper under trust law, which now appears to permit structures called “business trusts”, which conduct businesses...”.*

# Alberta Trusts – “Business Trusts” Trust Operates Business Directly

## Advantages

- Eliminate incidence of corporation taxation.
- Eliminate “kiddie tax” if business income of the trust is generated from arm’s length sources and such income is allocated to minor beneficiaries.
- Possibility for long-term double taxation eliminated.

# Alberta Trusts – “Business Trusts” Trust Operates Business Directly

## Advantages (cont’d.)

- No need to “bonus down” profits like that in CCPC scenario – accordingly, section 67 issues eliminated.
- Part I.3 tax (large corporations tax) not an issue – now eliminated January 1, 2006 pursuant to Budget 2006.
- Capital gains splitting can occur on business asset sale unlike that in traditional corporate scenario.
- Can provincial rate-shop to the extent that trust is resident in lower-rate province like Alberta and permanent establishment of business is in such province of residence.



# Alberta Trusts – “Business Trusts”

## Trust Operates Business Directly

### Disadvantages

- Not commonly thought of as a business vehicle – may have to explain to financial institutions and other interested parties.
- Financial statements of trust would have a different balance sheet – trust equity vs. retained earnings.
- If business requires significant capital, would need to plan carefully as to how trust would obtain capital without causing subsection 75(2) to apply.

# Alberta Trusts – “Business Trusts” Trust Operates Business Directly

## Disadvantages (cont’d.)

- “Bona-fide loans” to trust to overcome 75(2)?
- Would likely not be ideal if small business limits are available and the ability to retain earnings is available.
- Are beneficiaries of personal trusts liable for liabilities of the business activities of the trust? Obtain legal advice.
- Part XII.2 tax issues would need to be carefully reviewed if trust has non-resident beneficiary(ies).

# Alberta Trusts – “Business Trusts”

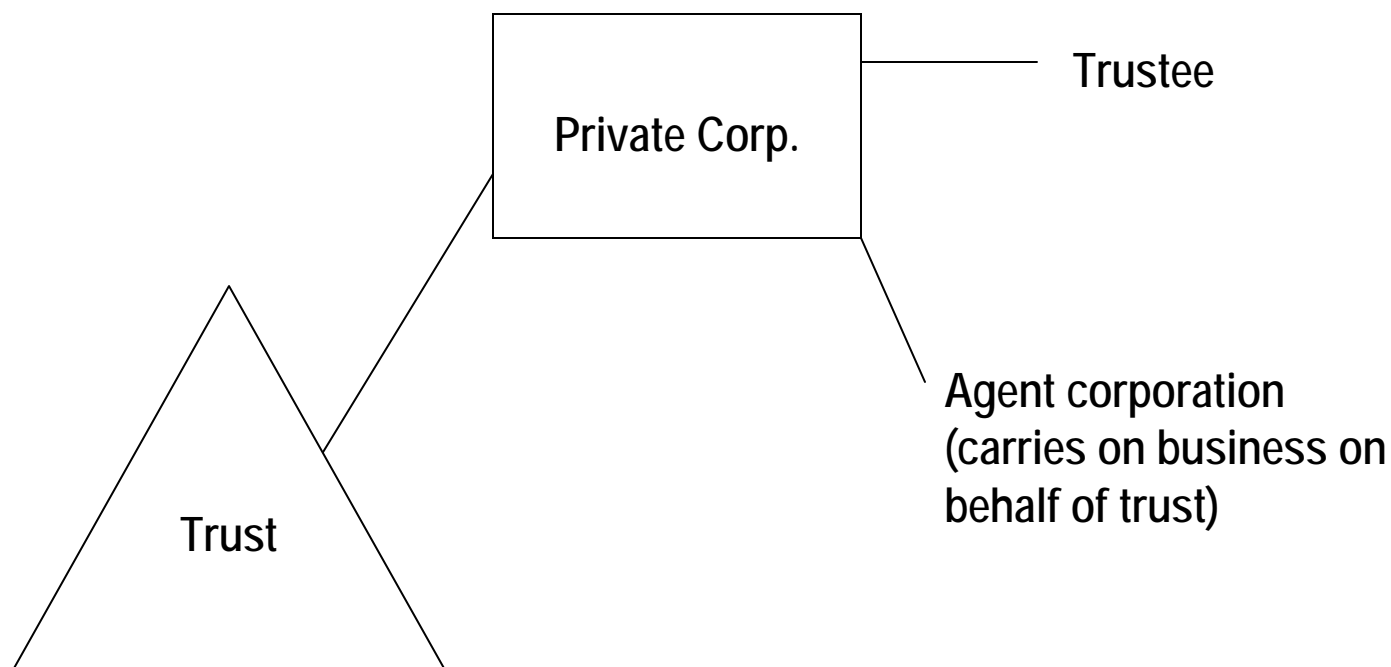
## Trust Operates Business Directly

### Awkward Business Structure

- As mentioned earlier, the use of a personal trust to carry on a business is not common.
- To avoid confusion, perhaps an agent corporation could be utilized on behalf of the trust to carry on the business.
- Disclosure issues?

# Alberta Trusts – “Business Trusts”

## Trust Operates Business Directly



- Liability issues may still exist for beneficiaries.
- Could the same private corporation be both the trustee and agent?

# Alberta Trusts

## Provincial Anti-Avoidance Rules

- Need to carefully review “home province” general anti-avoidance legislation (“GAAR”).
- Consider non-tax reasons to implement plans.
- Quebec response – see Quebec Info. Bulletin 2002-8.
- Ontario response?
- Alberta’s comments in recent Budget.

## Alberta Trusts

### Excellent References

1. Sian Matthews, "Water Runs Downhill: Interprovincial Tax Planning", Report of Proceedings of Fifty-Sixth Tax Conference, 2004 Tax Conference (Toronto: Canadian Tax Foundation, 2005), 25:1-45. [Very excellent Paper!]
2. Martin Rochweg, "Using Trusts as Income-Splitting Tool", Report of Proceedings of Fifty-Fifth Tax Conference, 2003 Tax Conference (Toronto: Canadian Tax Foundation, 2004), 18:1-28.