READING 9-1

Trusts — General

LEVEL 1

Definition of trust

Before examining the tax treatment of a trust, we need to define trusts in legal terms and in tax terms.

In legal terms

In legal terms, a **trust** is an arrangement under which a person (the settlor of the trust) entrusts property to another person (the trustee) to be held and administered for the benefit of predetermined persons (the beneficiaries).

The settlor of the trust creates the trust and specifies the rules that the trustee must observe during the administration period. The settlor also specifies the beneficiaries of the income and capital of the trust and the circumstances in which they are entitled to that income and capital.

The trustee must administer the property placed in trust, including income or gains from the property, until required to transfer it to certain persons (the beneficiaries) under the terms of the deed creating the trust. There may be one or more trustees. A trustee may be an individual or a corporation authorized by law.

Income beneficiaries are entitled to receive the income from the trust throughout its existence. Capital beneficiaries are entitled to the capital of the trust, either during its existence or when it is wound up. Capital beneficiaries may be the same individuals as the income beneficiaries or they may be different individuals.

LEVEL 2

A trust may either be created voluntarily by a person or imposed by a law or the judgment of a court, although the latter case is very rare. In some jurisdictions, a trust created verbally will be recognized, but this is exceptional. Generally, a contract is drawn up to govern the rights, obligations, and functions of the parties involved, namely the settlor, the trustee, and the beneficiary or beneficiaries. In the case of a testamentary trust, the will of the deceased is generally the trust deed.

While a trust created under Quebec civil law and a trust created under the common law of the other provinces have many points in common, there is a fundamental difference resulting from differing concepts concerning the right of ownership in the two legal systems. Under common law there is a division of ownership between the legal ownership of the property that is in the hands of the trustee and the beneficial ownership of the property that is in the hands of the beneficiaries. Under Quebec civil law, such a separation of ownership is not conceivable, and the property transferred in trust is a patrimony independent and separate from the property of the settlor of the trust, the trustee, and the beneficiaries.

This distinction between the two legal systems is especially important when dealing with the tax consequences of a trust established in Quebec, since the ITA generally draws on the common law concept of a trust when speaking of legal ownership and beneficial ownership [for example, see paragraph (e) of the definition of "disposition" in subsection 248(1)]. This situation sometimes creates uncertainties as to the tax treatment of some transactions in Quebec. However, CRA has expressed the opinion that Quebec trusts should receive the same treatment as other Canadian trusts, making the necessary adaptations when interpreting the legislative provisions. Furthermore, paragraph (f) of subsection 248(3) states that a person

who has a beneficial right in a Quebec trust is deemed to have beneficial ownership of the property of the trust, which solves the problem in most cases.

LEVEL 1

In tax terms

The ITA has a broader concept of trust. Subsection 104(1) states that an estate is considered a trust and is therefore subject to the same rules as a trust. The liquidators are considered trustees and the heirs are considered income and/or capital beneficiaries.

In the case of Quebec residents, a usufruct, a right of use or habitation, and a substitution are deemed under subsection 248(3) to be a trust for the purposes of the ITA. These civil law institutions do not exist in the common law provinces.

From a tax standpoint, a trust is considered to be a person. Subsection 104(2) states that the trust is *taxed as an individual* even though a number of deductions or tax credits are not available to the trust.

A trust must file an annual income tax return on a special Form T3RET, "T3 Trust Income Tax and Information Return." Under paragraph 150(1)(c), this return must be filed no later than 90 days after the trust's year end.

Categories of trusts in tax terms

There are a number of classes of trusts for purposes of the ITA. First, there are two large classes, testamentary and *inter vivos* trusts, which are then subdivided into other categories.

It is important to determine whether a trust is a testamentary trust or an *inter vivos* trust. An *inter vivos* trust is subject to a higher tax rate than a testamentary trust. In addition, it is possible to choose the year end of a testamentary trust, whereas this is not the case with an *inter vivos* trust.

Testamentary trusts

A testamentary trust is defined in subsection 108(1). It includes all trusts arising on and as a consequence of the death of an individual, all the property of which was contributed by the deceased individual. An estate is therefore a testamentary trust.

A testamentary trust may cease to qualify as a "testamentary trust" if a person subsequently transfers property to the trust. According to proposed amendments to the ITA initially announced in December 2002 and currently contained in Bill C-10, which passed third reading in the House of Commons on October 29, 2007 and which is still being studied in the Senate, for taxation years ending after December 20, 2002, a testamentary trust may also cease to qualify if it incurs a debt or other obligation to pay an amount to a beneficiary or any person with whom any beneficiary does not deal at arm's length, other than a debt incurred in satisfaction of that beneficiary's right over the income or capital of the trust. For example, a trust created on the death of a grandparent for a grandchild will no longer be considered a testamentary trust if a parent lends any money to the trust. However, the testamentary trust will not cease to qualify if the debt

- is incurred in satisfaction of the right of a beneficiary to enforce payment of an amount of the trust's income or capital gains payable to him or to otherwise receive any part of the capital of the trust
- arises because of a service rendered for or on behalf of the trust, such as the fees of the executor of the estate or the liquidator of the trust

- arises because of a payment made for or on behalf of the trust, such as the funeral expenses of the deceased person, provided that the trust reimburses the amount within a year after the payment is made and also provided that it is reasonable to conclude that the person who made the payment would have done so if dealing at arm's length with the trust

This legislative amendment, which has not yet been adopted, is **not examinable**.

A testamentary trust is subdivided into

- a spousal or common-law partner trust

and

- other trust

Inter vivos *trusts*

An ***inter vivos*** trust is defined in subsection 108(1) and includes all trusts other than a testamentary trust.

Inter vivos trusts are subdivided into several groups:

- *inter vivos* spousal or common-law partner trusts
- alter ego trusts
- joint spousal or common-law partner trusts
- alter ego trusts with no age limit
- *inter vivos* trusts other than those mentioned above
- unit investment trusts (this category includes mutual fund trusts)
- trusts governed by a deferred income plan; this category includes
  - a DPSP
  - an RRSP
  - an RPP
  - an RESP
  - an RRIF

Since spousal or common-law partner trusts, alter ego trusts, joint spousal or common-law partner trusts, and alter ego trusts with no age limit can roll over property transferred to them when they are created and are subject to other specific rules, it is important to know the criteria that determine whether they qualify as such.

The definition of a **post-1971 spousal or common-law partner trust**, whether testamentary or *inter vivos*, is set out in subsection 248(1).

This is a trust created after 1971 under which

- the spouse or common-law partner of the settlor of the trust is entitled to receive all of the income of the trust,

and

- no person except the spouse or common-law partner could, before the death of the spouse or common-law partner, receive or otherwise obtain the use of any of the income or capital of the trust.

These requirements, set out in clauses 104(4)(a)(i)(A) and (B), are identical to those in subparagraphs 70(6)(b)(i) and (ii) on the transfer of property to a spousal or common-law partner trust on death. However, you will recall that for the rollover to be possible under subsection 70(6), the trust must be created by the deceased person's will. It is therefore a testamentary trust.

Where the will or the deed creating the spousal or common-law partner trust limits the amount of income that is to be paid annually to the spouse or common-law partner, or where it provides that the income shall cease to be paid to the spouse or common-law partner in

certain circumstances, such as in the event of remarriage, the trust does not qualify as a spousal or common-law partner trust.

The will or spousal or common-law partner trust deed may contain a clause allowing the trustee to use part of the capital for a child in exceptional circumstances such as a serious illness. Such a clause has the effect of disqualifying the trust as a spousal or common-law partner trust.

The **alter ego trust** is defined in subsection 248(1), which refers to subsection 104(4). This is an *inter vivos* trust that meets the following criteria:

- it is created by an individual during his lifetime after 1999
- the individual, that is, the settlor of the trust, is at least 65 years of age
- the settlor of the trust is entitled to receive, during his lifetime, all the income of the trust

and

- no person except the settlor of the trust may, before the death of the settlor, receive or otherwise obtain the use of any of the income or capital of the trust

The **joint spousal or common-law partner trust** is also defined in subsection 248(1), which refers to subsection 104(4). This is an *inter vivos* trust that meets the following criteria:

- it is created by an individual during his lifetime after 1999
- the individual, that is, the settlor of the trust, is at least 65 years of age
- the settlor of the trust and the settlor's spouse or common-law partner are entitled to receive during their lifetime all the income of the trust

and

- no person other than the settlor of the trust and the settlor's spouse or common-law partner may, before the death of the later of these two to die, receive or otherwise obtain the use of any of the income or capital of the trust

The **alter ego trust with no age limit** is not defined as such in the ITA. This term is used by some practitioners to designate an *inter vivos* trust which has the following characteristics and which receives tax treatment similar to the three defined above:

- it is created by an individual during his lifetime after 1999
- the individual, that is, the settlor of the trust, is entitled to receive during his lifetime all the income of the trust
- no person other than the settlor of the trust may, before the settlor's death, receive or otherwise obtain the use of any of the income or capital of the trust

and

- the transfer of the property of the trust does not change its beneficial ownership, and no person or partnership, other than the settlor, have any absolute or contingent rights as a beneficiary of the trust; in other words, the trust must not provide for any other beneficiaries before or upon the settlor's death.

Personal or commercial trusts

A **personal trust**, defined in subsection 248(1), means a trust, whether *inter vivos* or testamentary, in which an interest was not acquired for a consideration payable directly or indirectly to the trust or to a person who has made a contribution to the trust. It is usually created for family reasons. For example, when a parent creates a trust for the benefit of a minor child and transfers certain property to the trust, the child has not purchased the interest and the trust is therefore a personal trust. In this course, a **commercial trust** means an *inter vivos* trust in which the interest is purchased by a taxpayer.

This review of trusts focuses on testamentary and *inter vivos* personal trusts resident in Canada. You will not study the tax treatment of unit investment trusts (which have very specific rules) or trusts governed by deferred income plans, which are usually tax exempt.

Nor will you study the rules applicable to non-resident trusts having a settlor or beneficiary resident in Canada which are presumed to be resident in Canada and which receive a particular tax treatment.

Residence of a trust

Where a trust is resident in Canada, all its income is subject to Canadian income tax. If the trust is not resident in Canada, it is taxable in Canada only on its Canadian source income.

The residence of a trust is usually based on the residence of its trustees. CRA's policy on the method of determining the residence of a trust is explained in IT-447. This policy was based on the case of *Thibodeau v. The Queen*, [1978] DTC 6376 where the test of management and control by the trustees was used.

Creation of a trust

LEVEL 1

General rule

On the creation of a trust, the settlor of the trust is the person who transfers property to the trust. In the case of a personal trust, the transfer will be done by way of gift or by a disposition upon death. The tax consequences of a disposition upon death were explained previously and will not be reviewed here. The tax consequences of a gift will be studied in Module 10. For now, note that a disposition of capital property to

- a spousal or common-law partner trust,
- an alter ego trust,
- a joint spousal or common-law partner trust,

or

- an alter ego trust with no age limit

has no tax consequences unless an election is made for the disposition to be carried out at FMV [section 73 for a transfer to a trust during the lifetime of the transferor, subsections 70(6) and (6.1) for a transfer on death].

Disposition to any other type of trust is carried out at FMV [subparagraph 69(1)(b)(ii) for a transfer to a trust during the lifetime of the transferor; paragraph 70(5)(a) for a transfer on death].

A trust will be deemed to have acquired each property for an amount equal to the transferor's deemed proceeds of disposition (DPOD). In the case of depreciable property, if the transferor's DPOD are less than the capital cost (CC) of the property, the trust is deemed to have acquired the property at the CC of the transferor and to have claimed CCA for an amount equal to the excess of the CC over the DPOD [subparagraph 13(7)(e)(iii) for a transfer to a trust during the lifetime of the transferor; paragraph 70(5)(c) for a transfer on death].

Paragraph 13(7)(e) may apply to reduce the CC of the property for the trust for purposes of computing CCA if the transferor's DPOD exceed the capital cost of the property. Paragraph 13(7)(e) does not apply where property is acquired by a trust following the death of an individual.

Example 9-1 illustrates the tax consequences of transferring property to a testamentary trust that is not a spousal or common-law partner trust.

EXAMPLE 9-1

Patrick Carpentier died on February 22, 2008. According to his will, all his property is transferred to a trust for his minor child, Marjorie. At the time of his death, Patrick had the following property:

	ACB or CC	FMV
Cash in bank		$ 10,000
Term deposits		$ 25,000
Listed shares	$ 400,000	$ 500,000
Rental property		
• land	$ 20,000	$ 50,000
• building (UCC: $80,000)	$ 100,000	$ 175,000

Tax consequences

For Patrick:

Cash and term deposits			No consequences
Shares			
DPOD [70(5)(a)]			$ 500,000
ACB			(400,000)
Capital gain			$ 100,000
Taxable capital gain (1/2)			$ 50,000
Land			
DPOD [70(5)(a)]			$ 50,000
ACB			(20,000)
Capital gain			$ 30,000
Taxable capital gain (1/2)			$ 15,000
Building			
Capital gain			
DPOD [70(5)(a)]			$ 175,000
ACB			(100,000)
Capital gain			$ 75,000
Taxable capital gain (1/2)			$ 37,500
Recapture			
The lesser of:	DPOD [70(5)(a)]	$ 175,000	
	CC	$ 100,000	$ 100,000
Less: UCC			(80,000)
Recapture			$ 20,000

For the trust:

Acquisition cost [70(5)(b)]	
• Shares	$ 500,000
• Land	$ 50,000
• Building	$ 175,000

Example 9-2 illustrates the tax consequences of transferring property to an alter ego trust.

EXAMPLE 9-2

Xenia Pastou is 70 years of age, and she wants to create during her lifetime a trust for which she will be the sole beneficiary of the income and capital during her lifetime. On her death, the remaining capital in the trust will be divided equally among her children. Xenia would transfer the following property to the trust:

	ACB	FMV
Cash in bank		$ 5,000
Term deposits		$ 300,000
Investment portfolio	$ 800,000	$ 1,150,000

Tax consequences

For Xenia:

The trust created by Xenia would qualify as an alter ego trust, since
- it is created by an individual, Xenia, during her lifetime, after 1999
- Xenia is at least 65 years of age
- Xenia, the settlor of the trust, is entitled to receive during her lifetime all the income of the trust

and
- no person except Xenia, the settlor of the trust could, before Xenia's death, receive or otherwise obtain the use of any of the income or capital of the trust.

Since the trust is an alter ego trust, the capital property may be transferred to it by means of a rollover under subsection 73(1). Thus, the investments would be deemed to be disposed of at their ACB and there would be no tax consequences for Xenia.

Xenia can elect to dispose of any or all of the investments at their FMV if she so desires. This election will generally be made only if Xenia has net capital losses or can claim the CGD with respect to qualified small business corporation shares.

For the trust:

Under paragraph 73(1)(b), the cost of the property for the trust is equal to the POD for Xenia.

LEVEL 2

Exceptions

Where property is transferred to a trust in an arrangement under which the trust can reasonably be considered to act as an agent for all the beneficiaries, this does not result in a disposition of property, because the ITA does not recognize the existence of the trust in this case [subsection 104(1)].

In general, this provision applies to a "bare trust," that is, a trust that has the following characteristics:

- the trustee has no major responsibilities or powers and can act only according to the instructions of the settlor
- the only function of the trustee is to hold legal title to the property
- the settlor is the only beneficiary and can at any time demand that the property be returned to him

A bare trust may be set up, for example, when a person holds an interest in a building but wants the legal title to the building to be registered in the name of another entity, namely the trust, while retaining control over the building.

Furthermore, section 107.4 addresses the possibility of transferring property to a trust resident in Canada without tax consequences where the transfer does not result in a change in the beneficial ownership of the property and where, immediately after the disposition, no person other than the contributor has an absolute or contingent right as a beneficiary. This rollover does not apply to the transfer of capital property by an individual to an alter ego trust or an alter ego trust with no age limit that can take the rollover under section 73. However, it may apply to the transfer of inventory property by an individual to such a trust.

READING 9-3

Taxation of a trust resident in Canada

LEVEL 1

A trust whose beneficiaries are all resident in Canada is subject to Part I tax only. When a trust has one or more non-resident beneficiaries, it may be subject to Part XII.2 tax. That special tax will not be studied in this course.

Part I tax

As mentioned previously, a trust is taxed as an individual. However, it is not entitled to

- personal tax credits [122(1)]

or

- the CGD, except for the situation provided for in subsection 110.6(12) whereby a spousal or common-law partner trust may claim the unused CGD of the beneficiary spouse or common-law partner in the taxation year of the trust during which the spouse died

Taxation year

As for an individual, the taxation year of an *inter vivos* trust is the calendar year [paragraph 249(1)(b)]; however, a testamentary trust may choose to end its taxation year at any time within the 12-month period following its creation [paragraph 104(23)(a); under Bill C-10, subsection 149(5)]. Example 9-3 illustrates choosing a year end for a testamentary trust.

EXAMPLE 9-3

Leila Kelly died on February 28, 2008. The taxation year of the trust created on Leila's death may end at any time between March 1, 2008, and February 28, 2009.

The choice of the end of the taxation year of the testamentary trust may allow for deferral of the tax payable on the income of the trust.

As you will see later, the income of the trust payable to a beneficiary may be taxed in his hands rather than in the trust. Paragraph 104(23)(c) provides that a beneficiary includes in his income the income he receives from the trust, not in the taxation year in which he receives it, but in the taxation year during which the taxation year of the trust ends. Example 9-4 illustrates the effect of the choice of the taxation year of a testamentary trust.

EXAMPLE 9-4

Return to the example of Leila Kelly, who died on February 28, 2008. Assume that the end of the taxation year of the trust is set at February 28, 2009.

For the taxation year ending February 28, 2009, the trust has an income of $30,000 that it pays to the beneficiary of the income of the trust as follows:

September 30, 2008:	$ 10,000
November 30, 2008:	$ 5,000
December 15, 2008:	$ 8,000
February 28, 2009:	$ 7,000

Tax consequences

The income of $30,000 received by the beneficiary will be included in his income for his 2009 taxation year, even though he received $23,000 in his taxation year ending December 31, 2008.

If a taxation year-end of December 31, 2008, had been chosen for the trust, then the beneficiary would have had to include in his income the amount of $23,000 in the 2008 taxation year.

Income tax rates — Part I tax

Under subsection 122(1), an *inter vivos* trust must compute its income tax at a rate equal to the maximum personal rate, being 29%. This high rate of tax on the taxable income of an *inter vivos* trust nullifies any advantage for an individual to create an *inter vivos* trust for income splitting purposes.

Certain *inter vivos* trusts created before June 18, 1971, are not subject to the maximum 29% tax rate. Read subsection 122(2) and IT-406R2.

The income of a testamentary trust is taxed using the same tax rates applicable to individuals. It is therefore possible in some circumstances to split income with a testamentary trust so that income will be taxed in the trust at progressive rates.

To prevent tax avoidance or a reduction of income taxes through the creation of several trusts, subsection 104(2) states that where more than one trust has been created and the income thereof accrues to the same beneficiary, or group or class of beneficiaries, the income of the trusts may be combined and taxed as if it were the income of a single trust.

Computing net income

The net income of a trust is computed using the same rules as are applicable to any other individual. For example, a trust may claim CCA with regard to its income-producing property and the trust may deduct from its income any expense incurred in order to generate income.

The fees paid to the trustee or liquidator are generally not deductible in computing the income of the trust, although the trustee or liquidator is taxable on the amount paid to him. The fees paid to the liquidator and trustee are paid to him for administering the assets of the estate or trust. The only situation in which the fees may be deductible in whole or in part is where it can be demonstrated that all or part of them were paid in order to generate income.

In addition to the deductions usually claimed in computing net income, a trust may deduct from its income

- the portion of its income which is **payable** to the beneficiaries or for the upkeep and maintenance of property of a life tenant, and which it must include in its income under subsection 105(2) [paragraph 104(6)(b)]

and

- any portion of the income for which a preferred beneficiary election has been filed [subsection 104(12)]

These deductions are allowed because the beneficiary will be taxed on the portion of the income payable to him or in respect of which a preferred beneficiary election has been filed. Thus, a trust may be used as a "conduit" for the beneficiaries.

Example 9-5 illustrates how the net income and tax payable of an *inter vivos* trust are computed.

EXAMPLE 9-5

During her lifetime, Marianne Gingras created a trust for the benefit of her child Larry, age 25. Fifty percent of the trust's income must be paid annually to Larry, and the balance accumulates in the trust. When Larry reaches age 35, all the capital of the trust will be paid to him.

On December 31, 2008, the trust's net income is:

Interest	$ 20,000

Ignore provincial income tax.

Tax consequences

1. For the trust:

Income	$ 20,000
Income payable to the beneficiary (50%) [104(6)]	(10,000)
	$ 10,000
Federal tax (29%)	$ 2,900

2. For Larry:

Income from the trust to be included in his income	$ 10,000

A trust cannot allocate losses to beneficiaries. For example, if in a taxation year, the trust's allowable capital losses exceed its taxable capital gains, the trust cannot allocate the excess to the beneficiaries. The trust may carry forward the net capital losses against capital gains not allocated to beneficiaries of the trust, such that the capital gains are taxed in the trust.

Income payable

Subsection 104(24) states that income is payable to a beneficiary for a given year if it has been paid to the beneficiary during the year or if the beneficiary was entitled to enforce payment thereof in the year.

It is the terms of the deed establishing the trust that determine whether income is payable to a beneficiary in the year within the meaning of subsection 104(24). In the case of a fixed-benefit trust, for example, a trust that provides that the income beneficiary is entitled to 80% of the income each year, the amount payable to this beneficiary is easily determined. But in the case of a discretionary trust where the trustee has the discretion to determine to whom and in what proportion the income will be distributed, the situation is more delicate. So long as the trustee has not exercised his discretion, income is not payable to any beneficiary. Thus, if the trustee has not exercised his discretion with regard to the distribution of income for a year before the end of the year, no deduction may be claimed for income payable, since no beneficiary would be entitled to enforce payment of income during the given year.

Note that in legal terms, under property law, income does not include capital gains. Thus, unless the deed establishing the trust specifically provides otherwise, capital gains are not payable to income beneficiaries. In the event that income beneficiaries are not entitled to capital gains, the capital gains realized in a year may be deducted when computing the income of the trust if they are payable to the capital beneficiaries in the year, that is, if they are paid in the year or if the capital beneficiaries can enforce payment of them in the year.

CRA recognizes that payments made directly to third parties for the benefit of a minor or disabled beneficiary are amounts payable to the beneficiary provided that they represent costs that are clearly identifiable as being for the benefit of the beneficiary. Thus, in the case of a trust set up for a minor child, payments made to the minor's parents as reimbursement for everyday household expenses were not recognized as being for the beneficiary in *Degrace Family Trust v. MNR*, [1999] DTC 453.

Under subsection 104(18), an amount that has not become payable in the year is deemed to be payable to a beneficiary of a trust resident in Canada if the following conditions are met:

- the beneficiary is less than 21 years of age at the end of the year
- his right to the income is vested by the end of the year
- his right to that income does not depend on the exercise or non-exercise of a discretionary power
- his right is not subject to any future condition (other than a condition that the individual survive to an age not exceeding 40 years)

The presumption in subsection 104(18) is useful in tax planning, since it makes it possible to set up trusts for minor children under which the income is taxed in their hands without being payable to them until they reach age 21. Naturally, the trust deed must be worded carefully so that all the criteria set out in subsection 104(18) are satisfied.

Election to deduct income payable

The trust may choose to deduct all or part of the income payable to the beneficiaries under paragraph 104(6)(b). Where an amount has not been deducted by the trust, the beneficiaries will not be taxable on this amount [subsections 104(13.1) and (13.2)]. This election is made on line 47 of form T3RET, "T3 Trust Income Tax and Information Return." In general, the trust will choose not to deduct from its income all the income payable to the beneficiaries:

- in the case of a testamentary trust to which the progressive rates apply, enabling it to split income between the trust and its beneficiaries
- where the trust has loss carryforwards from prior years which it wishes to use

Subsections 104(13.1) and (13.2) contain presumptions under which the amounts payable to beneficiaries but not deducted in computing the income of the trust are deemed not to be payable to them, which allows for them not to be taxed on these amounts. Subsection 104(13.2) contains a presumption with respect to taxable capital gains realized by the trust, and subsection 104(13.1) contains a similar presumption with respect to other income.

According to subsection 104(13.2), the amount deemed not payable to a beneficiary with respect to capital gains is calculated as follows:

$$\frac{A}{B} \times C$$

where

A = amount of capital gains allocated to a beneficiary under 104(21)

B = total capital gains allocated to all beneficiaries under 104(21)

C = amount of capital gains determined by the trust, generally consisting of the portion of capital gains that is payable to beneficiaries and will be taxed in the trust

The amount deemed not payable to the beneficiary under subsection 104(13.1) is calculated as follows:

$$\frac{A}{B} \times (C - D - E)$$

where

A = beneficiary's share of the income of the trust without reference to the ITA (including capital gains if the trust deed so provides)

B = total of all beneficiaries' shares of the income of the trust without reference to the ITA (including capital gains if the trust deed so provides)

C = total income payable to all beneficiaries within the meaning of the ITA

D = amount deducted by the trust under subsection 104(6)

E = amount calculated in C under subsection 104(13.2)

Example 9-6 illustrates the decision not to deduct all income payable in computing the income of a trust under paragraph 104(6)(b), and shows how the beneficiary's income is computed under subsections 104(13), 104(13.1), and 104(13.2). Note that taxable capital gains are treated separately from other income through the application of subsection 104(13.2).

EXAMPLE 9-6

Trust Romano is a testamentary trust resident in Canada, having an income beneficiary, Jason Romano. All of the income of the trust is payable to Jason annually, including taxable capital gains.

In 2008, Trust Romano has the following income payable to Jason:

Investment income	$ 8,000
Taxable capital gains eligible for the CGD	12,000
	$ 20,000

Trust Romano also has a non-capital loss of $10,000 from a prior year.

In order to use its non-capital loss, under paragraph 104(6)(b), Trust Romano chooses to deduct only $10,000 in computing the income of the trust. Trust Romano wants Jason to be taxed on the capital gains, before any other income, because Jason may claim the CGD with respect to these gains. Consequently, the trust chooses to be taxed on the investment income of $8,000 plus $2,000 of taxable capital gains.

Tax consequences

1. For Trust Romano:

Income before allocation to beneficiary	$ 20,000
Amount deducted under 104(6)(b)	(10,000)
Net income of the trust	10,000
Loss carryforward under 111(1)(a)	(10,000)
Taxable income	$ —

2. For Jason:

Amount to be included in income		
Amount payable under 104(13)		$ 20,000
Less: amount deemed not payable under 104(13.2)		
$\frac{A}{B} \times C$		
where		
A = capital gains allocated to Jason under 104(21)	$ 12,000	
B = total capital gains allocated to all beneficiaries under 104(21)	$ 12,000	
C = amount of capital gains determined by Trust Romano (this is the portion of capital gains payable which will be taxed in the trust)	$ 2,000	
$\frac{\$12,000}{\$12,000} \times \$2,000$		(2,000)
		$ 18,000
Less: amount deemed not payable under 104(13.1)		
$\frac{A}{B} \times (C - D - E)$		
where		
A = Jason's share of the income of the trust without reference to the ITA	$ 20,000	
B = total shares of all beneficiaries in the income of the trust without reference to the ITA	$ 20,000	
C = total income payable to all beneficiaries	$ 20,000	
D = amount deducted by the trust under 104(6)(b)	$ 10,000	
E = amount C in the preceding computation under 104(13.2)	$ 2,000	
$\frac{\$20,000}{\$20,000} \times (\$20,000 - \$10,000 - \$2,000)$		(8,000)
Trust income allocated to Jason		$ 10,000

Under subsections 104(21) and 104(13.2), this income of $10,000 will be considered to be a taxable capital gain for Jason.

Capital gain allocated under 104(21)	$ 12,000
Amount of reduction under 104(13.2)	(2,000)
	$ 10,000

The decision to deduct a lesser amount than the income payable to the beneficiary has no tax impact on the ACB of the beneficiary's capital interest in a personal trust.

For more information on the concept of income payable to a beneficiary and the tax treatment of such income, read IT-286R2, IT-342R, and IT-381R3.

Preferred beneficiary election

Under the preferred beneficiary election provided for in subsection 104(14), a qualifying beneficiary may be allocated a share of the income even if it is not payable. This election is usually made when the beneficiary has little income, thereby subjecting the income to lower rates of tax. It should be kept in mind that the preferred beneficiary who is taxed on undistributed income of the trust, for which the election is made, does not receive this income from the trust. Income taxes payable on the allocated income, if any, must be paid with funds from another source.

A **preferred beneficiary** is defined in subsection 108(1) as an individual resident in Canada who:

- is entitled to the credit for severe mental or physical impairment provided for in subsection 118.3(1)

or

- is a person of more than 18 years of age who is the dependant of another individual because of mental or physical infirmity and whose income for the year does not exceed $9,600 (in 2008)

and who is:

- the settlor of the trust
- the spouse or former spouse of the settlor of the trust
- the child, grandchild, or great grandchild of the settlor of the trust

or

- the spouse of the child, grandchild, or great grandchild of the settlor of the trust

The preferred beneficiary election is an annual election. It must be made within 90 days after the end of the taxation year of the trust. Where the trust has more than one preferred beneficiary, not all preferred beneficiaries are required to make the election. Lastly, the preferred beneficiary may elect with respect to all or a portion of the accumulating income of the trust for which he is allowed to make the election.

Accumulating income is usually the income of the trust for the year after deducting the maximum amount of income payable to the beneficiaries during the year. The amount of this accumulating income allocated to the preferred beneficiary is provided for in subsection 104(15). Generally, all the accumulated income is allocated to him.

Note that the income allocated and taxed in the hands of the preferred beneficiary will be capitalized in the trust and will not be taxed again on distribution, even if it is distributed to someone other than the preferred beneficiary.

Example 9-7 explains a situation in which the preferred beneficiary election may be made.

EXAMPLE 9-7

During his lifetime, Albert Lee creates a trust for the benefit of his child Zachary, who is physically disabled and qualifies for the credit for mental or physical impairment provided for in subsection 118.3(1), and he gifts the trust $100,000.

Under the terms of the trust, the income of the trust accumulates in the trust until Zachary reaches age 35. He is presently 22 years old. When Zachary reaches age 35, the capital of the trust will be turned over to him.

For its 2008 taxation year, the trust has income of $10,000. Zachary is a student and has no income.

Tax consequences

The trust created by Albert is an *inter vivos* trust having a tax rate equal to the maximum personal rate.

Zachary is a preferred beneficiary of the trust. Because he has no other income, it would be advantageous to make the preferred beneficiary election so that Zachary rather than the trust may be taxed on the income of $10,000. Thus, Zachary would be able to:

1. take advantage of progressive tax rates

and

2. claim the personal tax credit and the credit for severe mental or physical impairment.

Therefore, there would be no income tax payable on the income of $10,000.

If Zachary had income from other sources and, thus, had income taxes to pay on the income of $10,000, the election would nevertheless be advantageous if Zachary's marginal tax rate were less than 29%. If Zachary did not have the required funds to pay those taxes, Albert could personally lend him the funds. The trust deed may also allow a partial distribution of capital to Zachary, before maturity, at the discretion of the trustees. This provision may be used to distribute an amount of money to Zachary to enable him to pay the income taxes on the income allocated by the trust.

Note that if Zachary were under 18 years of age, the income attribution rules might apply. The effect of these rules would be that the trust income that was the object of a preferred beneficiary election would be taxed in the hands of Albert rather than of Zachary.

Attribution rule [75(2)]

Where a person (the transferor) transfers property to a trust and one of the following three circumstances applies:

- the transferred property, or the property substituted for it, can revert to the transferor (for example, where the transferor is the capital beneficiary of the trust)
- the transferred property, or the property substituted for it, can be transferred to persons who may be determined by the transferor subsequent to the creation of the trust
- during the life of the transferor, the property cannot be disposed of except with his consent or in accordance with his instructions (this could be the case, for example, if the transferor is the sole trustee or, where he is one of several trustees, the decisions must be made unanimously or he has a veto right)

the income from the property received from the transferor by the trust, or the property substituted for it, during the life of the transferor, will be deemed to be income of the transferor and not of the trust. This rule also applies to any capital gains realized on such property.

Thus, subsection 75(2) applies each time a person transfers property to a trust and continues to exert a certain control over the property. It is important when creating an *inter vivos* trust to pay special attention to this rule to avoid having the settlor taxed on the income of the trust.

This rule will generally apply to the alter ego trust, the joint spousal or common-law partner trust and the alter ego trust with no age limit, since the settlor of the trust will generally be the beneficiary of the capital of the trust during his lifetime.

It should also be noted that subsection 75(2) applies not only to the settlor but also to any person who might subsequently transfer property to the trust if the conditions set out in subsection 75(2) apply.

Example 9-8 illustrates the application of the attribution rules in subsection 75(2).

EXAMPLE 9-8

Edith Martin creates a trust for the benefit of her children, Mark and Julie, to finance their university education in Europe. She transfers $500,000 to the trust by way of gift. Albert McGillivray is the sole trustee.

Under the terms of the trust deed, the trustee has full discretion to distribute the annual income between Mark and Julie according to their respective needs. The trust will be terminated when Mark and Julie have both completed their education, and the capital of the trust will then be turned over to them. However, the determination of the share of each beneficiary in the capital will be determined by Edith if she is still alive at that time; otherwise, it will be determined by the trustee.

In 2008, the income from the trust totalled $40,000, and the entire amount was distributed equally between Mark and Julie.

Tax consequences

Subsection 75(2) applies, since Edith, the person who transferred $500,000 to the trust, reserved the right to determine how the property of the trust will be disposed of when the trust terminates. Therefore, in 2008, Edith must include the income of $40,000 in her income. The trust, Mark, and Julie have no income to declare.

In practical terms, although losses, taxable capital gains, and allowable capital losses from property or substituted property belong to the transferor during his lifetime and while he resides in Canada, CRA considers that the trust must nevertheless report the income on its T3RET form and then deduct the same amount. Also, it must prepare a T3 information slip to indicate that the income belongs to the transferor.

Summary table

The distinction between a testamentary trust and an *inter vivos* trust is essential for determining the tax treatment of the trust. The taxation rules for these two types of trust are compared in summary form in Exhibit 9-1.

EXHIBIT 9-1

	Testamentary trust	*Inter vivos* trust
Definition	Trust arising on and as a consequence of the death of an individual, all the property of which was contributed by the deceased	Any trust other than a testamentary trust
Fiscal year	Choice of year end	Year end: December 31
Federal tax rate	Progressive rates: same rates applicable to individuals	Only one rate: 29%
Computation of net income, taxable income, and tax credits		
• General rules	Considered as an individual, which implies the following: • gross-up of dividends of Canadian corporations and dividend tax credit • interest reported according to the anniversary rule	Identical to testamentary trust
• Exceptions	• Not eligible for the CGD, except for a spousal or common-law partner trust in the taxation year of the trust during which the spouse or common-law partner dies • No personal tax credits • Deduction in computing income: o income payable to beneficiaries: may be deducted either wholly or in part; amount deducted is included in beneficiaries' income o income that has been the object of a preferred beneficiary election: the amount deducted is included in the income of the preferred beneficiary	Identical to testamentary trust

READING 9-4

Taxation of beneficiaries

LEVEL 1

The income **deducted** in computing the trust's income, either because it was payable to the beneficiary or because the preferred beneficiary election was made, must be included in computing the beneficiary's income under subsections 104(13) to 104(13.2). Where the beneficiary is a non-resident, non-resident tax (Part XIII) applies. Read IT-465R for further information.

Note that under the income attribution rules, the income payable to a beneficiary who is the spouse or common-law partner or a minor child of the settlor of an *inter vivos* trust may be included in the transferor's income. The same is true for income that has been the object of an election by a preferred beneficiary who is the transferor's spouse, common-law partner, or minor child, see subsection 108(5). You will also see that a special tax, called "tax on split income," is applicable on some income attributed to a minor child. It is therefore necessary to check to see whether the attribution rules or the tax on split income apply where one of the beneficiaries of the trust is a minor child or the spouse or common-law partner of the transferor of the property of the trust.

Benefits from a trust are included in income in accordance with section 105. Under subsection 105(2), where a trust pays out of its income the maintenance costs, property taxes, and other taxes with respect to a property enjoyed by one or more beneficiaries, a reasonable portion of the amounts paid by the trust must be included in the income of each beneficiary who enjoyed the property. Under paragraph 104(6)(b), these amounts included in the beneficiaries' income are deductible from the trust's income.

Under subsection 105(1), where a trust confers a benefit on a taxpayer and that benefit does not otherwise have to be included in that person's income, the value of the benefit is taxable. In a case where subsection 105(1) applies, no deduction in computing the trust's income is provided for. An interest-free loan granted by a trust to a beneficiary does not constitute a taxable benefit for the purposes of subsection 105(1), as established by *Cooper v. The Queen*, [1988] DTC 6525.

Under subsection 108(5), the amounts included in the income of a beneficiary are considered to be income from property unless a specific provision of the ITA allows the nature of the income, deduction, or credit to flow through. The following types of income, if they are received by a trust that is resident in Canada for the entire year, retain their character when they are attributed to beneficiaries on form T3SCH9, "Income Allocations and Designations to Beneficiaries":

- Canadian-source taxable dividends and dividend tax credit [subsection 104(19) and IT-524]
- non-taxable dividends from the CDA [subsection 104(20)]
- taxable capital gain [subsections 104(21), 104(21.1), 104(21.2), 104(21.3)]
- foreign non-business income and foreign tax credit [subsection 104(22)]
- retiring allowance and death benefits [subsections 104(27) and 104(28)]

Note that all of the above is income to which specific tax provisions apply.

With respect to taxable capital gains on the disposition by the trust of qualified farm or fishing property or qualified small business corporation shares (QSBCS), they may be eligible for the CGD if they are payable to a beneficiary or are allocated to a preferred beneficiary under an election. Where the terms of the trust do not specify that the capital gain is part of the trust income payable to income beneficiaries, the capital gain must be taxed in the trust

unless the preferred beneficiary election is made or the capital gain is paid or payable to the beneficiary of the capital in the year in which it is realized. This is because the taxable capital gain included in income under section 3 for income tax purposes is not income in the legal sense and is therefore not payable to income beneficiaries unless otherwise stated in the trust deed.

Amounts taxable in the hands of beneficiaries must be reported by the trust on T3 slips, "Statement of Trust Income Allocations and Designations," a copy of which is provided to the beneficiary along with a summary of the information on the slips on form T3SUM, "Summary of Trust Income Allocations and Designations." The return completed by the trust must be filed within 90 days from the end of the taxation year [Regulation 204].

Examples 9-9 and 9-10 illustrate the taxation of the trust and beneficiaries where the trust earns income from different sources.

EXAMPLE 9-9

John Carpenter died in 2003. Under his will, all his property was transferred to a trust. His spouse Judith and his son Matthew are the beneficiaries of the income of the trust, at 50% each. The capital of the trust is to be distributed to Matthew when he reaches age 45. The will does not state how capital gains are to be treated.

For the taxation year of the trust ending December 31, 2008, the income of the trust is as follows:

Interest	$ 16,000
Eligible dividends received from Canadian corporations	$ 24,000
Taxable capital gains	$ 6,000

No election is made to tax in the trust the income payable to the beneficiaries.

Tax consequences

1. For the trust:

Interest income	$ 16,000
Eligible dividends received from Canadian corporations	24,000
Taxable capital gains	6,000
	46,000
Deduction [104(6)(b)]	(40,000)*
Income of the trust	$ 6,000

* Since the will does not specify that capital gains are considered income, they cannot be attributed to the beneficiaries of the income. Furthermore, since the capital gains are not paid or payable to Matthew, the capital beneficiary, in the year in which they are realized, they must be taxed in the trust.

The trust must complete form T3SCH9: "Income Allocations and Designations to Beneficiaries" in order to attribute the dividends of Canadian corporations to the beneficiaries and thus enable them to benefit from the gross-up and credit. It will indicate $24,000 on line 949, "Actual amount of eligible dividends" and $16,000 on line 926, "Other income." In addition, no later than March 31, 2009, the trust must file T3 information slips, "Statement of Trust Income Allocations and Designations" as well as the T3SUM

2. For Judith:

Judith must include in her income the following:

Property income (50% × $16,000 interest)	$ 8,000
Grossed up eligible dividends of Canadian corporations (50% × $24,000 × 1.45)	$ 17,400
Judith will be able to claim the dividend tax credit in computing her tax payable equal to 11/18 of the gross-up (11/18 × $5,400)	$ 3,300

3. For Matthew:

Same consequences as for Judith.

EXAMPLE 9-10

Return to the data in Example 9-9 but assume this time that the trust chooses to deduct only $11,000 of the income payable to the beneficiaries in order to have an income of $35,000 on which federal tax of 15% is applicable.

Tax consequences

1. For the trust:

Interest income	$ 16,000
Eligible dividends received from Canadian corporations	24,000
Taxable capital gains	6,000
	46,000
Deduction [104(6)(b)]	(11,000)
	35,000*
Gross-up of unattributed eligible dividends ($24,000 – $11,000) × 45%	5,850
Income of the trust	$ 40,850
In computing its income, the trust may claim a dividend tax credit equal to 11/18 of the gross-up (11/18 × $5,850).	$ 3,575

* The income of the trust consists of capital gains that are not payable to the beneficiaries and income payable to the beneficiaries on which the trust has chosen to be liable for tax ($40,000 – $11,000 = $29,000). If the intention is for the $11,000 that is taxable in the hands of the beneficiaries to be taxable as eligible dividends from Canadian corporations, the trust must complete form T3SCH9 "Income Allocations and Designations to Beneficiaries" and attribute the $11,000 on line 949, "Actual amount of eligible dividends." In addition, no later than March 31, 2009, the trust must file T3 information slips, "Statement of Trust Income Allocations and Designations" as well as the T3SUM. The trust retains $13,000 of eligible dividends which it must gross up and for which it will get the dividend tax credit, since the trust is taxed as an individual.

2. For Judith:

The income of $20,000 payable to Judith is reduced by the amounts deemed not to be payable to her under 104(13.1) and 104(13.2). Since the capital gains are not payable to the beneficiaries, there is no amount to calculate under 104(13.2). The amount to deduct under 104(13.1) is $14,500, calculated as follows:

$$\frac{A}{B} \times (C - D - E)$$

where

A =	Judith's share in the income of the trust without taking the ITA into account	$ 20,000
B =	total of the shares of all the beneficiaries in the income of the trust without taking the ITA into account	$ 40,000
C =	total income payable to all the beneficiaries	$ 40,000
D =	amount deducted by the trust under 104(6)	$ 11,000
E =	amount C of the formula under 104(13.2)	$ 0

$$\frac{\$20{,}000}{\$40{,}000} \times (\$40{,}000 - \$11{,}000 - \$0) = \$14{,}500$$

Consequently, the income on which Judith must pay tax is $5,500 ($20,000 – $14,500). This amount is considered as eligible dividends from Canadian corporations, since the trust made the required attribution. Judith must include the following in her income:

Grossed-up eligible dividends of Canadian corporations $5,500 × 1.45	$ 7,975
In computing her income tax payable, Judith will be able to claim a dividend tax credit equal to 11/18 of the gross-up (11/18 × $2,475).	$ 1,513

3. For Matthew:

Same consequences as for Judith.

READING 9-5

Deemed disposition of trust property after 21 years

LEVEL 1

A trust is a legal entity which, under the terms of the trust deed, may have a very long or unlimited life. Consequently, tax on the gains accrued on the trust property could be deferred indefinitely, unlike an individual who, as you have seen, is taxed on the income arising from the deemed disposition of his property at the time of death (or the death of his spouse).

Therefore, subsection 104(4) provides for a deemed disposition of trust property on certain dates. As a rule, there is a deemed disposition on the day of the 21st anniversary of the creation of the trust and every 21 years thereafter. However, in the case of trusts to which property was rolled over when they were created and trusts created before 1971, the dates of deemed disposition are as follows:

- post-1971 spousal or common-law partner trust: on the death of the beneficiary spouse or common-law partner and every 21 years thereafter
- alter ego trust: on the death of the settlor of the trust and every 21 years thereafter, unless an election is made to have the day of the first deemed disposition correspond to the 21st anniversary of its creation. Where this election is made, the rollover of the property of the trust under section 73 is not possible
- joint spousal or common-law partner trust: the day of the death of the settlor of the trust, or the day of the death of the spouse or the common-law partner, whichever falls later, and every 21 years thereafter
- alter ego trust with no age limit: on the death of the settlor of the trust and every 21 years thereafter
- other trusts created after 1971: the day of its 21st anniversary and every 21 years thereafter
- spousal trusts created before 1971: the day that is the later of the day on which the spouse dies and January 1, 1993, and every 21 years thereafter
- other trusts created before 1972: January 1, 1993, and every 21 years thereafter

At the prescribed dates, the trust is deemed to have disposed of all its property, at the end of the specified day, at the following amounts [subsections 104(4), (5), and (5.2)]:

- capital property (including depreciable property) FMV
- land included in inventory FMV
- resource property FMV

The DPOD become the cost of the property for the future. However, in the case of depreciable property, if the DPOD are less than the CC of the property before the deemed disposition, the CC of the property remains as the original amount and the trust is deemed to have claimed the excess as CCA.

In light of this deemed disposition every 21 years rule, the terms of the deed creating a trust often provide that the trust is to be liquidated in its twentieth year, or the terms allow the trustee the discretion to liquidate the trust if he deems it appropriate due to the income tax payable resulting from the deemed disposition. A personal trust can generally be liquidated without there being any immediate tax consequences for the beneficiaries or for the trust.

READING 9-6

Income interest of a trust

LEVEL 1

A personal trust always has an income beneficiary and a capital beneficiary, and these beneficiaries may or may not be the same person. A beneficiary's interest in the income of the trust is called an income interest and that of the capital beneficiary is called a capital interest.

An **income interest** in a trust is defined in subsection 108(1) as a right of a beneficiary to receive all or any part of the income of the trust. This right may be immediate or future, absolute or contingent. Income interest includes the right to require payment of an amount arising from the income interest.

Sale to a third party

Under paragraphs 106(2)(a) and (b), a beneficiary who disposes of his income interest to a third party must include the total proceeds of disposition (POD) in income and the amount of any capital gain or loss is deemed nil. Read IT-385R2. There are only two cases where an amount will be deducted from the POD:

1. When the income interest includes the right to require of the trust payment of any amounts relating to this interest, which have already been included in the beneficiary's income under subsection 104(13), these amounts may be deducted from the POD to be included in income, so as to avoid double taxation [subparagraph 104(2)(a)(ii)]. This might be the case where the income payable to the beneficiary for the preceding year, which the beneficiary included in his income for the preceding year, has not yet been paid to him at the time of the sale of the income interest.

2. When this beneficiary has an acquisition cost for his interest, he will be authorized to deduct this cost from the POD provided that it was not deducted in a previous year, as will be discussed under the heading "Deduction: Interest acquired for consideration." However, he cannot create a loss with this deduction [subsection 106(1)].

Distribution of property of the trust in settlement of the interest

Moreover, where a trust distributes property to a beneficiary as complete or partial proceeds for his income interest, the trust is deemed to have disposed of the property for an amount equal to its FMV and the beneficiary is deemed to have acquired the property at the same amount [subsection 106(3) and paragraph 106(2)(c)]. The beneficiary is not required to include in his income the FMV as POD of his income interest [paragraph 106(2)(a)], and any capital gain or loss from the disposition of the income interest is deemed to be nil [paragraph 106(2)(b)].

Deduction: Interest acquired for consideration

Where an income beneficiary has acquired his income interest for consideration, the cost of the interest may be claimed as a deduction against the annual income from the trust, subject to some exceptions where the income itself is deducted in computing a corporate beneficiary's income under subsections 112(1) and 138(6). Note that under subsection 106(1.1), the cost of an income interest is nil, unless the interest was acquired from a former income beneficiary or a cost was established under the rules on taxpayer migration.

The annual deduction allowed under subsection 106(1) is limited to the lesser of

- the income from the trust allocated to the beneficiary

or

- the portion of the cost of the income interest that has not been deducted in a previous year

Any balance of the cost which has not been deducted may reduce the POD of the income interest on the subsequent disposition, as previously covered.

Example 9-11 illustrates the rules that apply in the acquisition and disposition between third parties of an income interest in a trust.

EXAMPLE 9-11

In January 2007, Cathy Lancaster created a trust with Steven as the income beneficiary for a period of 10 years. After 10 years, the capital of the trust will be distributed to Hannah.

The annual income of the trust is estimated at $10,000.

In 2007, Steven requires cash and decides to sell his income interest in the trust to Ben for $50,000.

In 2007 and 2008, Ben receives the following taxable income from the trust:

2007	$ 9,000
2008	$ 11,500

In 2009, Ben sells his income interest in the trust for $35,000.

At the respective times when Steven and Ben sold their income interest, there was no amount relating to this interest that was already taxed by virtue of subsection 104(13).

Tax consequences

1. For Steven:

Income on the sale of the income interest under 106(1) and 106(2)	**2007**
POD	$ 50,000
Cost of the income interest under 106(1.1)	—
Amount to be included in income	$ 50,000

2. For Ben:

Amount to be included in income for		**2007**		**2008**
Income included under 104(13)		$ 9,000		$ 11,500
Deduction under 106(1)				
The lesser of:				
• income for the year under 104(13)	$ 9,000		$ 11,500	
• price paid	$ 50,000		$ 50,000	
less: deductions previously claimed	(—)		(9,000)	
	$ 50,000		$ 41,000	
		(9,000)		(11,500)
		$ —		$ —

Amount to be included in income for		**2009**
POD to be included in income under 106(2)(a)		$ 35,000
Deduction under 106(1)		
The lesser of:		
• income under 106(2)(a)	$ 35,000	
• price paid	$ 50,000	
less: deductions previously claimed		
($9,000 + $11,500)	(20,500)	
	$ 29,500	
		(29,500)
		$ 5,500

READING 9-7

Capital interest and liquidation of a trust

LEVEL 1

A **capital interest** is defined in subsection 108(1) as all the rights of a beneficiary in a trust, except income interest.

A capital interest is a capital property the disposition of which gives rise to a capital gain or loss. The rules governing capital interests are contained in section 107.

Personal trust

The disposition of an interest in the capital of a personal trust is subject to special rules whether this disposition arises from the settlement of the interest by the trust or from the sale of the interest to a third party.

Distribution of property of the trust in settlement of the interest

Under paragraphs 107(2)(a) and (b), where property of a personal trust is distributed to a beneficiary in satisfaction of all or any part of his capital interest:

- the trust is deemed to have disposed of the property at its cost amount, and
- the beneficiary is deemed to have acquired the property at the same amount.

The cost of the property for the beneficiary may be increased if the beneficiary has acquired his interest for consideration and if the ACB of the beneficiary's capital interest in the trust exceeds his portion of the cost amount of the property [see 107(2)(b) and (b.1)]. The cost amount of the property, defined in subsection 248(1), means the tax cost or

- the ACB of capital property
- the UCC of depreciable property
- the cost of inventory
- 4/3 of the CEC of ECP

Where a depreciable property is transferred to a capital beneficiary, under paragraph 107(2)(d):

- the capital cost of the property for the beneficiary is deemed to be equal to the capital cost of the property for the trust

and

- the excess of the capital cost of the property over the cost amount of the property for the beneficiary is deemed to be the CCA taken by the latter

Thus, any CCA recapture deferred on the rollover of the property from the trust to the beneficiary may be taxed when the beneficiary disposes of the property.

Paragraph 107(2)(f) contains similar provisions for ECP with respect to CECA deductions claimed under paragraph 20(1)(b).

With regard to the interest in the capital of the trust, its cost amount for the beneficiary is deemed to be equal to the cost amount of the property transferred to him, plus any money distributed to him [paragraph (a) of the definition of cost amount in subsection 108(1)]. In most cases, this amount is also equal to

- the POD of the capital interest [see 107(2)(c)]

and

- the ACB of the capital interest [see 107(1)(a)]

so that no capital gain is realized on the disposition of the capital interest.

The property of the trust is therefore rolled over to the beneficiary. Given this rollover, and to avoid the deemed disposition rules every 21 years, it is generally preferable to provide for the distribution of trust property in the twentieth year of the trust or to authorize the trustees to make the distribution when appropriate. Example 9-12 illustrates the rollover provided for in subsection 107(2) in the case of a personal trust liquidation.

EXAMPLE 9-12

Denis Hébert is the capital beneficiary of a personal trust that owns the following property:

	FMV	**ACB**
Cash	$ 50,000	
Property 1	$100,000	$ 10,000
Property 2	$ 80,000	$ 50,000

On October 1, 2008, the trust is liquidated and all the property is distributed to him in satisfaction of his interest. The cost of Denis's capital interest is zero.

Tax consequences

1. For the trust:

   None. The trust is deemed to have disposed of each property for an amount equal to its ACB.

2. For Denis:

   Denis will be deemed to have acquired each property for an amount equal to the ACB of the property for the trust.

Property 1	$ 10,000
Property 2	$ 50,000

   Under paragraph 107(2)(c), Denis is deemed to have disposed of his capital interest for an amount equal to:

Cash received	$ 50,000
ACB Property 1	10,000
ACB Property 2	50,000
	$110,000

   Under paragraph (a) of the definition of cost amount in subsection 108(1) and paragraph 107(1)(a), the cost amount and the ACB of Denis's interest is deemed to be equal to:

Cash received	$ 50,000
ACB Property 1	10,000
ACB Property 2	50,000
	$110,000

Therefore, there is no gain or loss on the disposition of the interest.

POD	$110,000
ACB	(110,000)
	$ —

Exceptions

The rollover provided for in 107(2) does not apply in the following circumstances:

- the trust elects on the prescribed form not to take the rollover provided for in subsection 107(2) in its return of income for the taxation year in which the property is distributed [subsection 107(2.001)]
- when a spousal or common-law partner trust distributes property to a beneficiary other than the spouse or common-law partner during the spouse's or common-law partner's life [subsection 107(4)]
- an alter ego trust distributes property to a person other than the settlor of the trust during the settlor's lifetime [subsection 107(4)]
- a joint spousal or common-law partner trust distributes property to a person other than the settlor of the trust or the spouse or common-law partner during their lifetime [subsection 107(4)]
- when a trust, to which subsection 75(2) applied at any time, distributes property to a person other than the person who transferred the property to the trust while the transferor is still living [subsection 107(4.1)]
- when the beneficiary to whom the property is transferred is a non-resident [subsection 107(5)]

In all these cases, under subsection 107(2.1), the trust is deemed to have disposed of the property at its FMV and the beneficiary is deemed to have acquired it for the same amount. Furthermore, the beneficiary will generally be deemed to have disposed of his interest in the capital of the trust for an amount that should not result in a capital gain or loss.

Sale to a third party

On the sale of the capital interest of a personal trust to a third party, the capital gain will be equal to the excess of the POD over the ACB determined under paragraph 107(1)(a), being the greater of

- the ACB of the capital interest as otherwise determined, which is, under subsection 107(1.1), generally equal to zero. The ACB cannot be different from zero unless the interest was acquired from a previous capital beneficiary or was subject to the rules on acquisition of control or migration;

or

- the cost amount of the capital interest as defined in subsection 108(1)

This rule cannot be used to create or increase a capital loss on the disposition of a capital interest. A capital loss on a sale to a third party is the excess of the ACB of the capital interest over the POD received [paragraph 107(1)(b)].

As mentioned, the cost amount of the capital interest is defined in subsection 108(1) and represents the beneficiary's proportionate share in the cost amount of the trust assets less its liabilities.

The result of paragraph 107(1)(a) is that the capital beneficiary is not taxed on a gain that is greater than the gain that would have been realized if the trust had sold the beneficiary's share

in the trust assets at a price equal to the price which he received for his interest. Thus, potential double taxation is avoided, on the disposition of a capital interest and on the disposition of trust assets. Example 9-13 illustrates this.

EXAMPLE 9-13

Estela Flores holds a capital interest in a personal trust for which her ACB is nil.

The trust has one property.

	FMV	ACB
Property 1	$100,000	$ 50,000

Tax consequences

1. If Estela sells her capital interest for $100,000:

POD		$100,000
Less: the greater of:		
• ACB	$ —	
• cost amount	$ 50,000	(50,000)
Capital gain		$ 50,000
Taxable capital gain (1/2)		$ 25,000

2. If Property 1 is sold by the trust and then the trust is liquidated:

   a. For the trust:

POD	$100,000
ACB	(50,000)
Capital gain	$ 50,000
Taxable capital gain (1/2)	$ 25,000

If the capital gain is allocated to a beneficiary, the trust will not be liable for any income taxes. If the capital gain is not allocated to a beneficiary, the trust will pay income tax on the gain and the excess will be available for distribution.

   b. For Estela (assuming that the capital gain has been allocated to her):

POD = cost amount of the property received		$100,000
Less: the greater of:		
• ACB	$ —	
• cost amount of the property received	$100,000	(100,000)
Capital gain		$ —

Estela will be required to include in her income the taxable capital gain of $25,000 allocated to her by the trust.

Clearance certificate

To avoid personal liability, every trust, before liquidating or transferring any property of the trust, must obtain a certificate from CRA certifying that all income taxes, interest, and penalties payable by the trust have been paid. These rules are contained in subsections 159(2) and 159(3).

Any transfer of property without the certificate renders the trust liable for the unpaid income taxes, interest, and penalties, to the extent of the FMV of the property distributed.

However, CRA will issue a clearance certificate even if the income taxes are not paid in full provided that security, in the form of a mortgage or other charge against the property of the deceased taxpayer or another person or security of any other person, is provided. Refer to IC 82-6R6 for more details on the need to obtain a clearance certificate. The procedure for requesting a clearance certificate has been to file the prescribed Form TX19, "Asking for a Clearance Certificate."

READING 9-8

Use of a trust

LEVEL 1

Testamentary or *inter vivos* personal trusts may be useful from a number of standpoints. Their usefulness often surpasses the objective of reducing income taxes. Below are some situations in which the creation of a trust may be advantageous, as well as comments on some practical aspects of trusts.

Income splitting

Despite the tightening of the attribution rules, an *inter vivos* trust for the benefit of minor children may still be used for income splitting purposes.

For example, capital gains realized on property transferred or money loaned to the trust by a parent are not subject to the attribution rules. It may therefore be advantageous to create a trust for the benefit of children who would realize capital gains. The gains may be taxable to the children if they are paid out or payable to them, or if the preferred beneficiary election is made in the case of a child with a physical or mental impairment.

Also, income earned on income subject to the attribution rules is not subject to these rules. Thus, it may be advantageous to make a substantial loan to a trust in favour of a minor child, thus creating income subject to the attribution rules. If this income is invested to earn income, such income will not be subject to the attribution rules.

A testamentary trust created following a taxpayer's death for the benefit of a minor child is not subject to the attribution rules because the settlor of the trust is deceased. Therefore, to split income among family members, it may be useful to create trusts for the benefit of minor children. The income from the trusts could be used to pay school fees and/or the children's personal expenses. Where such trusts are created, it should be kept in mind that the property of such trusts will be deemed to have been disposed of by the deceased at FMV. Consequently, money or property the disposition of which does not result in any tax consequences is usually bequeathed to such trusts.

Note that the "tax on split income" applicable on the receipt of income by minor children from

- dividends of unlisted companies
- taxable benefits under section 15
- a trust or partnership that derived the income from the business of providing goods or services to a business carried on by a relative of the child or in which the relative participates

is not applicable on the income from a property acquired, whether directly or indirectly, as the consequence of the death of a parent by way of a trust for the benefit of the child.

A testamentary trust is also a good way to split income by creating one or more taxpayers each benefiting from progressive income tax rates. For example, if a bequest is made to a spousal trust rather than directly to the spouse, the trust income payable to the spouse can be taxed partly in the trust and partly in the hands of the spouse, so as to benefit twice from progressive tax rates. This same planning can be done with respect to testamentary trusts for children or other persons.

Estate freeze

An *inter vivos* family trust is very useful for holding participating shares in a family corporation in provinces where it is impossible or very difficult for a minor child to hold such shares. The discretionary family trust is also an ideal tool for delaying the final distribution of shares among family members, especially when the children are still in school and it is not possible to evaluate their interest or involvement in the business. In such cases, attention should be paid to the rule on deemed disposition after 21 years. Liquidation of the trust in the twentieth year is usually provided for.

Control and administration of property

Sometimes, a family trust, whether testamentary or *inter vivos*, is used by the settlor to provide a source of income to a given person without giving him the control or administration of the income-producing property. Where a trust is created, the trustees have control over the trust property. Generally, this situation arises with respect to

- minor children
- incapable persons
- persons who, for various reasons, are not able to administer the property bequeathed or gifted

Transmission of property

Often a person will use a trust to ensure that the property gifted or bequeathed will be transferred to the person of his choice after having benefited another person.

The spousal or common-law partner trust is an example. The settlor of the trust wishes to benefit the spouse during the spouse's lifetime; however, the settlor stipulates that the property held by the trust will be transferred on the death of the spouse or common-law partner, generally to the children. Under this arrangement, the settlor of the trust is ensured that the children will ultimately inherit the property and that the spouse will have a comfortable lifestyle.

Protection of assets

It is possible to shelter certain assets from the claims of creditors by transferring them to a trust which must meet various criteria depending on the jurisdiction in which it is established. Naturally, to be valid, this transfer of assets may not be carried out at a time when there are problems with creditors or just before a bankruptcy.

In the case of elderly or ill persons, transferring property to a trust can allow for the property to be sheltered from undue pressure from family members or friends who would like to get their hands on it, since the trustee will be responsible for administering it.

Substitute for a will

Sometimes a trust will be used as a substitute for a will for transmitting some property. The property transferred to a trust — generally an alter ego trust or a joint spousal or common-law partner trust — will not be part of the estate of the settlor of the trust on his death. This will serve to

- avoid probate fees in provinces where they exist
- ensure greater confidentiality regarding the property transmitted and
- avoid testamentary disputes regarding the property

When thinking of using a trust as a substitute for a will, it should be kept in mind that a trust is not as easy to change as a will. Also, if the trust continues to exist after the death of the settlor, as for example when the beneficiaries are still young, this trust is an *inter vivos* trust taxed at the maximum rate.

Practical aspects

From a legal standpoint, a trust is an arrangement involving several parties who must follow complex rules based on the trust deed and the legislation of the province that regulates it. The drafting of the deed establishing the trust must therefore be done with care and attention, and input from various professionals is required in order to obtain the desired results. Generally, it is the legal advisor who drafts the document, following meetings and discussions with other professionals such as a tax advisor, a financial planner, and the client's accountant. Naturally, the client for whom the trust is established must be kept informed and consulted at all times so that the final document will be consistent with his wishes and respond to his concerns. Each case is unique and must be treated as such.

The trust deed is generally fairly long and must deal with the following aspects:

- the particulars of the property transferred to the trust;
- who the beneficiaries are and the nature of their right: income or capital, fixed or discretionary, conditional or otherwise;
- the designation of the trustee(s), the procedure for replacing him or them, and the rules for decision-making if there is more than one trustee;
- the powers and obligations as well as the discretion that the settlor of the trust is willing to confer on the trustee.

When the trust is established, the trustee has control over the property transferred to the trust and must manage it in accordance with what is set out in the deed. He has a duty to report on his administration to the beneficiaries and must comply with all filing requirements, such as filing income tax returns. It is therefore essential to design and implement adequate management and accounting systems, taking account of the value and nature of the assets to be managed and the complexity of management pursuant to the instructions set out in the deed. Also, if there is more than one trustee, it will be necessary to keep minutes of the meetings of the trustees, in which the decisions made are carefully recorded. The latter aspect is very important in the case of a trust that gives the trustees discretionary powers, so as to have evidence in writing of the exercise of discretion. Even when there is only one trustee, it is recommended that the trustee have evidence in writing, which generally takes the form of a letter to the beneficiaries in which the trustee informs them of his decision.

The CGA who prepares the income tax return of a trust must have a grasp of what a trust is and how it operates, from both a legal and a tax standpoint, since the tax treatment of the income of the trust is closely linked to legal rules. To complete the return, he must

- have a copy of the deed establishing the trust and understand its content. If he has any doubts on the interpretation of a clause that may affect the tax treatment, he must consult another professional to clarify the interpretation to be given.
- examine the minutes of any meetings of the trustees. In the case of a discretionary trust, this will enable him to determine when discretion was exercised and whether the income was "payable" to the beneficiaries within the meaning of subsection 104(24) during the fiscal period.
- have a list of the property initially transferred to the trust, the balance sheet for previous fiscal periods, and a year-end balance sheet, as well as a statement of income and expenses for the fiscal period. Especially when the accounting system is unreliable, this makes it possible to verify, through comparison and conciliation, that all income sources and capital gains and losses have been recorded.

- have copies of the returns from previous years. This will also make it possible to do conciliations and comparisons that are useful for determining that nothing has been omitted.
- take any action and ask any question considered useful or necessary in order to carry out the work in the circumstances specific to the case, including consulting other professionals or experts.