

# SPOTLIGHT On Trusts

In May 2011, the Supreme Court of Canada quietly made a decision that confirmed the importance of proper implementation and documentation when family trusts are involved. The Supreme Court reaffirmed the findings of the Tax Court of Canada in the *Antle* case. In this case the Tax Court had concluded that the trust did not exist, primarily because it was never set up properly and the actions of those involved demonstrated a lack of intention to create the trust. The judge's concluding comments emphasize the importance of proper execution to any planning strategy:

*This conclusion emphasizes how important it is, in implementing strategies with no purpose other than avoidance of tax, that meticulous and scrupulous regard be had to timing and execution. Backdating of documents, fuzzy intentions, lack of transfer documents, lack of discretion, lack of commercial purpose, delivery of signed documents distributing capital from the trust prior to its purported settlement, all frankly miss the mark – by a long shot. They leave an impression of elaborate window dressing. In short, if you are going to play the avoidance game, it is not enough to have brilliant strategy, you must have brilliant execution.*

In recent months, there has been a flurry of developments centered on the proper “execution” of tax planning arrangements involving trusts, including more audits by the Canada Revenue Agency (CRA). CRA auditors are apparently focused on a number of items including:

- the use of promissory notes for payments to beneficiaries that may have become unenforceable due to the Ontario Limitations Act;
- determining whether the trustees were withdrawing funds from the trust for their own use even though these funds were purportedly being paid to the beneficiaries;
- an absence of proper accounting records or trustee minutes for the trust; and
- inability to locate the original settlement property; and compliance with the 21-year rule.

CRA has also been requesting trustees to complete questionnaires aimed at determining if the trustees understand the role and responsibilities of a trustee.

## Ensuring the Trust is Valid

Three certainties must be present to create a valid trust. If any one does not exist, the trust is void.

1. Certainty of intention: - Was there the intention to create a trust and transfer beneficial ownership of trust property? Did the settlor intend to give up control of that property? This intention should be manifested irrevocably in the written trust deed. The *Antle* decision could mean that the courts (and CRA) could look beyond the deed to consider the external facts and circumstances.
2. Certainty of subject matter: - Where is the original settled property? Can you prove to CRA that it existed; CRA has stated that failure to provide evidence of the settled property would void the trust agreement. Did title to the property actually pass and get registered with the trust as owner?
3. Certainty of object: - Certainty regarding who the beneficiaries of the trust are.

## Ongoing Documentation

CRA will be looking for documentation to support deductions claimed by the trust. The requirement to maintain books and records means CRA is looking for:

- financial statements of the trust to show what it owns;
- accounting records for the trust;
- the trust's bank statements;
- any investment account statements
- receipts to support deposits with explanations of where the receipts came from;
- cancelled cheques and supporting invoice;

- any loan documents;
- trustee's resolutions; and
- original documents to substantiate all deductions.

The trust should have a separate bank account, as should each of the beneficiaries.

If the trust acquires investments, such as common shares in a company, payment for the shares should come from the trust's bank account. The funds to acquire the shares could come as a loan from an unrelated person, deposited to the trust account. Dividends paid on the shares can then be used to repay the loan, with interest at the prescribed rate, as soon as practical.

Dividends paid to the trust should be deposited to the trust bank account. Expenses related to the trust should be paid by the trust. If an expense of the trust is paid by another party, it should be evidenced by a loan and repaid as soon as possible. When income is earned in the trust it should retain sufficient funds to pay its own expenses. For example, the trustee should ensure the trust has sufficient funds in its account to pay for items such as bank charges, accounting fees and income taxes of the trust. Once the trust has sufficient income, it should repay any outstanding loans. Any amounts declared as payable to beneficiaries, but not paid to beneficiaries at end of year, should be tracked to ensure they are ultimately paid.

Where amounts were not paid to the beneficiaries by the end of the year, but considered "payable", CRA would want to see:

- an irrevocable resolution declaring the income of the trust is payable to the beneficiary; and
- a demand promissory note to the beneficiaries who should be entitled to enforce payment at any time, and proof that the amount was later paid to the beneficiaries.

Where payments have been made to third parties on behalf of a minor beneficiary, CRA will look to see that the payments were incurred for the benefit of the child and that proper books and records were maintained to substantiate the deduction.

Where taxable allocations/distributions are made to children as beneficiaries, parents should not be taking the proceeds for their own use regardless of the intention to replenish the child's bank account sometime in the future. This could end up being fatal to the tax plan. Distributions to beneficiaries should be for their use. If they are not invested on behalf of the beneficiary, then it is advisable to ensure that distributions are spent for items benefiting the particular child.

### Income Attribution

It is important to take care with a trust to ensure income is not attributed back to someone other than the beneficiaries. One of the situations that CRA will be looking for is where someone contributes property to a trust, but retains some control over that property. In that situation any income or loss is taxed in the hands of the contributor, not the beneficiary. There are several ways income attribution could apply, and CRA can be expected to review all possibilities.

Sometimes the trust will borrow money to acquire investments. CRA will want to review the loan documentation and satisfy itself that the interest rate is at least the prescribed rate, determine when the loan was entered into, and ensure interest was paid each year before January 30 of the subsequent year.

If you have any questions or concerns about your documentation requirements, please contact us. We would be pleased to assist in ensuring your strategy is properly executed.

**This newsletter was prepared by McLarty & Co's taxation services group for the benefit of clients and other interested parties.**

**Clients are invited to contact the director of the taxation services group, Martha Skeggs, CA, CPA (Illinois) or their relationship manager if they have any questions about Trusts or another tax or business matter.**

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