



# Common Legal Issues and Concerns in Wealth Management

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# Discussion Topics

- Use of trusts (private)
  - tax and fiduciary concerns
  - professional advisor liability

# Inter vivos Discretionary Trust

- So-called “family” trusts have proliferated
  - use in estate planning or estate freeze to hold shares of private (family owned) corporation
  - income splitting trust which received a prescribed rate loan and invested proceeds
- Suppose trustees wish to exercise discretion
  - can the trustees discriminate among the beneficiaries?

# How discretionary is a discretionary trust?

- Words such as “absolute” or “unfettered” or “uncontrolled” may be used in the trust agreement with reference to the discretionary powers granted to trustees
  - this does not mean that the trustees have unlimited power and complete freedom of choice in their actions and decisions.

# How discretionary is a discretionary trust?

- A court will be loathe to substitute its discretion for the decision of the trustee in the exercise of his/her discretion
  - did the trustee act in good faith
  - is the trustee's decision authorized by the power conferred upon the trustee in the trust agreement
  - even hand rule and duty to act impartially among beneficiaries

# How discretionary is a discretionary trust?

- is it clear that the trustee would not have acted as he/she did (a) had he/she not taken into account considerations which he/she should not have taken into account, or (b) had he/she not failed to take into account considerations which he/she ought to have taken into account
- was the discretion exercised in a capricious, arbitrary, perverse manner contrary to what may be gleaned as the settlor's expectations and purpose

# How discretionary is a discretionary trust?

## *Fox Estate* 1996 CanLII 779

- Estate trustee (grandmother) encroached on capital for benefit of grandchildren which deprived son (who married secretary) of any interest

## *Martin v. Banting* 2002 CanLII 13032

- Distribution to one beneficiary alone

## *Edell v. Sitzer* 2004 CanLII 654

- Distribution to one beneficiary alone

# Prudent record keeping for tax purposes

- An inter vivos trust is taxed as an individual at the top marginal rate
- If income “paid or payable” to a beneficiary
  - deducted from income of trust
  - included in income of beneficiary

# Paying beneficiary expenses

- The Fiduciary Issue
  - terms of trust must be respected
  - need separate trust bank account and financial records
    - cannot simply pay expenses of household where minor beneficiaries reside
    - expenses must “unequivocably” be for benefit of the beneficiary
    - need evidence of exercise of discretion

# “Payable” evidence

- The Income Tax Issue – what is needed to satisfy CRA
- T3 Supplementary not sufficient
- Trustee resolution/minutes before December 31
  - evidence of decision made on irrevocable basis
  - notice to beneficiaries
  - promissory note

# Second marriage and stepchildren

- Is the stepchild a beneficiary?
  - careful review of trust agreement needed
  - was the stepchild adopted?
  - if not, consider application for variation of trust to extend class of beneficiaries?
    - deemed disposition and resettlement issues for tax purposes

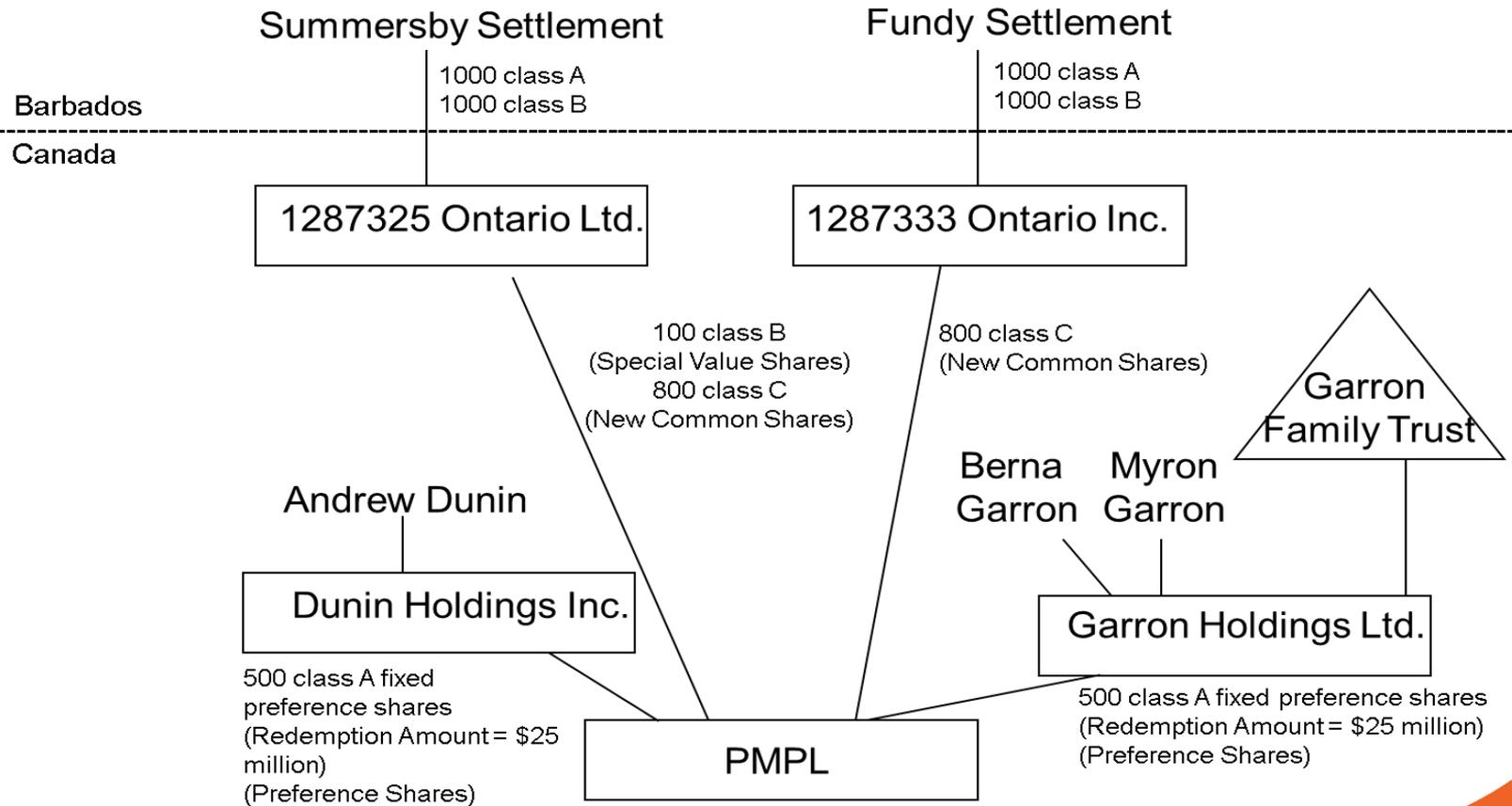
# What happens if you distribute to a non-beneficiary?

- Potential double tax problem upon distribution to a person who is not a beneficiary
  - could be taxed in the hands of the stepchild as a s.105(1) benefit but not deducted in computing income of trust
    - deduction in computing income of trust pursuant to s.104(6) refers to amount that became payable in the year to a beneficiary
  - if property with accrued gain distributed to stepchild, the s.107(2) roll-out would not be available for the same reason
- Is the trust a sham?

# Residency of Trusts

- The Old Rule
  - assumption of residency based on residence of trustees
- The New(er) Rule
  - look to central mind and management
- Has raised questions from the CRA
  - province of residence (e.g. Alberta resident trusts)
  - whether non-resident

# Garron 2012 SCC 14



## Residence of a Trust – Central Management and Control

- Where are the powers and discretions of the trustees really being exercised?
  - may often be the same as the place of residence of the trustees, but not necessarily
- In *Garron*
  - Mr. Garron/Dunin (appointer) could replace protector who could replace trustee
  - limited role of Barbados trustee understood by all upfront (decisions to be made by Mr. Garron/Dunin and implemented by Barbados trustee)

## Residence of a Trust – Central Management and Control

- no evidence that Barbados trustee took any active role except execution of documents and administrative and accounting matters
- Full documentation/evidence of decision making and active participation by trustees in dealing with property of the trust becomes important
  - where residence is an issue
  - generally to show that trustees are fulfilling their role

# Death of the Immigrant Trust

- The Old Rule (before 2014 Federal Budget)
  - individual immigrating to Canada could establish non-resident trust
  - trust holds investments outside Canada
  - no Canadian tax up to 5 years (60 months)

# Death of the Immigrant Trust

- 2014 Federal Budget
  - eliminated Immigrant Trusts
  - immigrant Trusts existing on February 11, 2014
    - no grandfathering
    - exemption eliminated January 1, 2015 if no contributions made after February 11, 2014
    - exemption eliminated retroactive to January 1, 2014 if contributions made after February 11, 2014

# Death of the Immigrant Trust

- deemed disposition of virtually all assets (excluding taxable Canadian property) at FMV immediately before relevant elimination day above
- after above elimination day, immigrant jointly and severally liable for trust's tax plus s.75(2) implications

# Trusts with Non-Resident “Involvement”

- Canadian income tax rules increasingly complex
- Amendments to taxation of non-resident trusts enacted in 2013 with some rules retroactive to 2007
- Essentially three categories
  - Canadian Resident Trust
  - Deemed Resident Trust
  - Non-Resident Trust

# Canadian Resident Trust and non-resident beneficiary

- Taxed on worldwide income at top marginal rate
  - will also apply to testamentary trust (other than graduated rate estate or qualified disability trust) after 2015
  - result of 2014 Federal Budget
- Non-resident withholding tax on distribution of income

# Canadian Resident Trust and non-resident beneficiary

- Part XII.2 tax (36%) in respect of distributed “designated income”
  - e.g., Canadian source business income; capital gain on sale of Canadian real estate; Canadian rental income (s.216 election)
  - intended to avoid minimization of Canadian tax
- Deemed disposition of capital property – 21 year rule
  - may require tax planning as distribution to non-resident beneficiary otherwise triggers deemed disposition at FMV

# Deemed Resident Trust

- Broad rules
  - trust which is otherwise non-resident may be deemed resident
    - central mind and management outside Canada
  - examples
    - Canadian resident made a “contribution”
    - “contribution” made by a non-resident who becomes Canadian resident within 60 months of the contribution if there is a Canadian resident beneficiary

# Deemed Resident Trust

- Deemed resident for most purposes of *Income Tax Act*
- Generally taxable on worldwide income (with a few modifications)
- Not liable for Part XIII non-resident withholding tax
  - i.e., payments by trust to non-resident beneficiary
- Payors to the trust must withhold and credited as payment of tax on T3
  - e.g., Canadian source dividends paid to trust

# Deemed Resident Trust

- Complicated rule to adjust deduction to trust where Canadian source income paid to non-resident beneficiary
  - proxy for Part XIII non-resident withholding tax
  - intended to put Deemed Resident Trust in same tax position as a Canadian Resident Trust

# Deemed Resident Trust

- Joint and several liability of “resident contributor” and “resident beneficiary” for trust’s tax and filing obligations
  - “recovery limit” concept can limit extent of liability of a “resident beneficiary”

# Non-Resident Trust

- Still possible provided it does fall into Deemed Resident Trust or Canadian Resident Trust categories
  - e.g., “granny trust”
    - non-resident funds the trust
    - watch out for deemed contribution rules
    - central mind and management outside Canada

# Due Diligence to Protect Yourself (Professional Advisor)

- Trusts raise many tax issues
  - civil liability
    - standard of care
    - what if you aren't a tax specialist?
  - does the retainer include tax advice?
    - implied terms of engagement
  - the sophisticated client
    - are the obligations to warn of tax risk different?



# Thank you

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