# PRACTICAL CONSIDERATIONS FOR THE FAMILY TRUST IN AN ESTATE FREEZE


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# INTRODUCTION

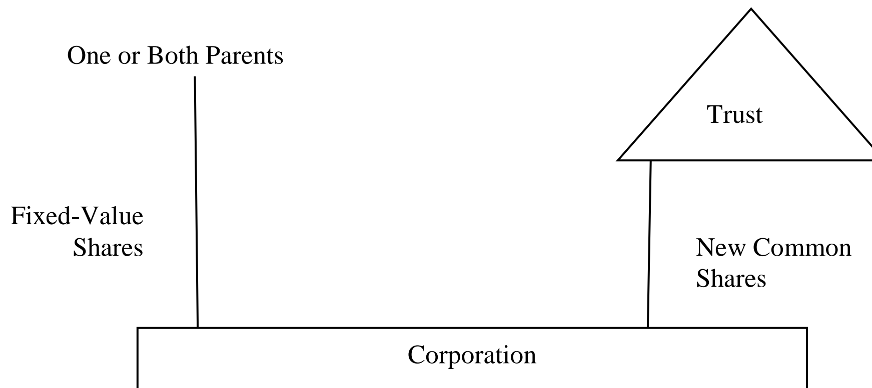
This paper will concentrate on the considerations involved in setting up a family trust as part of an estate freeze of Canadian assets owned by one or both parents.

In order to place the family trust into an estate freeze context, the paper will briefly review the principles of an estate freeze. The estate freeze discussion will relate only to those aspects of the estate freeze that have an impact on the family trust. The estate freeze discussion is not comprehensive.

After setting out the estate freeze context, the paper will then focus on family trusts. However, the discussion will focus on trust principles that are relevant to a family trust established in an estate freeze context. The paper will not discuss other uses of trusts or other forms of trusts, such as offshore trusts, alter-ego trusts or joint partner trusts.

**The Estate Freeze Context**

An estate freeze is typically illustrated as follows.




In a typical estate freeze, parents will hold a valuable asset (such as real estate or shares of a corporation). That asset will have increased significantly in value. The parents will have reached the stage in life at which the parents are primarily concerned with cash flow and less with asset value. In fact, any future increase in the value of the asset means that the estate of the surviving parent will have a larger capital gain on death. Any such larger capital gain will result in the payment of additional capital gains tax. The additional capital gains tax could result in a forced sale of the asset, meaning that the asset itself (and the income generated by that asset) will not pass to the next generation. While the next generation will have the after-tax proceeds of a sale of that asset, the income generated by investing those after-tax proceeds of sale may not be as lucrative as if the asset had been retained.

In this situation, the parents will typically engage in an estate freeze in order to prevent their interest in the asset from growing in value. If the asset is common shares of a corporation ("**Freezeco**"), the parents might exchange those common shares for fixed-value redeemable

retractable shares with an aggregate redemption value equal to the value of the shares owned by the parents. If the common shares held by the parents have an aggregate value of $1 million, the parents are left with shares with a fixed value of $1 million. Assuming that capital gains tax rates do not change, the parents now know how much capital gains tax will be payable on the death of the surviving parent. As the parents are no longer dealing with a moving target, they may now find it easier to take steps to fund that capital gains tax liability. In essence, the parents will have capped the value of their estate. Consequently, one could refer to an "estate cap" transaction. Canada being a northern country, however, we have adopted the term "estate freeze".

The fixed-value shares taken back by the parents are shares at law but are akin to a demand promissory note. This quasi-debt status arises primarily (but not solely) from the holder's right of retraction -- in other words, the holder of the shares can demand at any time that the corporation redeem the shares and cash the shareholder out. Because of these special attributes, the shares act like a sponge and "soak up" all the value of Freezeco. This allows Freezeco to issue new shares to the next generation (i.e. the children or the trust) for a nominal price.[1] Any future growth in value will now accrue to the new common shares held by the next generation and will be a problem for the members of the next generation at some point in the future. Assuming that the next generation survives the parents (as is usually the case), however, this defers the taxation of that future growth in value to a time that is later than the death of the surviving parent.

As noted, the fixed-value shares taken back by the parents need to have specific attributes that are required for income tax purposes in order to avoid the conferral of a benefit on the shareholders who subscribe for new common shares immediately after the estate freeze. In 2008, the Canada Revenue Agency (the "**CRA**") was asked whether the retractability feature was the sole absolutely essential feature of estate freeze shares. The CRA response indicated that it could not boil the essential attributes of estate freeze shares down to just a single attribute.[2]

> [...] the CRA is normally disposed to accept that the FMV [fair market value] of estate freeze preferred shares of the capital stock of a corporation is equal to the FMV of the common shares of the corporation that are exchanged for the preferred shares, when the estate freeze preferred shares summarily have the following

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[1] For the reason behind this procedure, see *Kieboom* v *MNR*, 1992 CarswellNat 308, 92 D.T.C. 6382 (FCA). If the parent simply allowed the new shareholders to subscribe for common shares at a nominal price without first doing the freeze, part of the value of the parent's common shares would spill over into the new common shares. This would result in the conferral of a taxable benefit. That transfer of value would also be a transfer of property and could give rise to attribution of income on the new common shares back to the parent.

[2] CRA document number 2008-0285241C6, being a response to question 23 at the 2008 Conference of the APFF (Association de planification fiscale et financière, based in Montreal). Given that the focus of this paper is on family trusts, I was going to place the CRA comments in a footnote. However, the footnote would have been too long. I can justify placing the comments in the body of the paper because the share attributes are necessary in order to allow the family trust to subscribe for shares without the conferral of a taxable benefit.

attributes:

* redeemable at the option of the holder at a redemption price equal to the FMV of the common shares exchanged, plus any declared and unpaid dividends;

* no dividend can be paid on other classes of shares for an amount that would reduce the FMV of the preferred shares below their redemption price, or that would result in the corporation not having the necessary net assets for the redemption of the preferred shares;

* they must have, at least, voting rights on any matter involving a modification to the attributes attached to them (these voting rights can be provided by the relevant corporate law or the articles of incorporation);

* absolute priority on all other classes of shares in the event of the distribution of the assets of the corporation on a winding-up or a dissolution of the corporation or any other distribution of its assets, up to the redemption price, plus any declared and unpaid dividends;

* absolute priority on all the other classes of shares with respect to the redemption of the shares, and the corporation cannot acquire shares of others classes before the redemption of all the preferred shares;

* no restriction with respect to the transfer of the preferred shares (other than the restrictions required, if applicable, by the relevant corporate law in order to qualify as a private corporation); and

* containing a price adjustment clause for the redemption price of the preferred shares which is applicable when the redemption price agreed to by the parties is not equal to the FMV of the common shares exchanged, and also containing other appropriate adjustments when the shares have already been redeemed at the time of an adjustment of the redemption price.

Moreover, the FMV of estate freeze preferred shares containing the above attributes, cannot be reduced because of the existence of a shareholders agreement.

It is obviously impossible to anticipate all the possible variations with respect to the attributes of estate freeze preferred shares, and consequently, we cannot give you specific examples of cases

> where the redemption right at the option of the holder could be omitted for estate freeze preferred shares. However, the general principle is that the redemption right at the option of the holder could be omitted only if the FMV of the estate freeze preferred shares would still be equal to the FMV of the common shares exchanged, notwithstanding the absence of this redemption right.
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> Consequently, one cannot generally maintain that the only essential attribute that estate freeze preferred shares must contain is that they are redeemable at the option of the holder.

To this point, this paper has been describing an estate freeze carried out in winter-or, more precisely, the winter of one's life. This rather poor attempt at poetic imagery is a way of bringing up the issue of the proper time for an estate freeze. The time cannot be too late in the winter of one's life because the estate freeze assumes that the parents (or, more accurately, at least one parent) will survive the estate freeze long enough so that value accrues to the common shares held by the next generation. If the parents were to die the day after the estate freeze, the estate freeze will have accomplished nothing because no capital gains tax will have been deferred (the new common shares would not have had the time to grow in value). Consequently, the estate freeze always assumes that at least one parent has some life expectancy remaining and that Freezeco will continue to grow during that remaining life expectancy.

The parents have to be comfortable that they have enough value in the new fixed-value shares to see them through to the end of their days. Generally, the parents will be more interested in cash flow rather than value growth. However, they will still be concerned to make sure that they have control over that cash flow and that the cash flow will be sufficient. For example, one would generally not conduct an estate freeze if the parents are in their 50's. I have heard of some situations in which estate freezes were conducted too early and the children ended up being worth more than the parents. This situation was not terribly comfortable for the parents.

Of course, it is possible to do an estate freeze-type of transaction in order to introduce new shareholders to a corporation without capping the interest held by the parents in that corporation. In this case, the purpose of the "estate freeze" is not to permanently cap the value of the estate of the parents but is rather to introduce at least one new shareholder without that new shareholder having to pay fair market value for his or her shares. Back when income-splitting with minor children was more popular (in other words, before introduction of the "kiddie tax"), it was a common technique to implement an estate freeze type of reorganization for the purpose of having a family trust subscribe for new shares. In this situation, the parents (as well as the children) were generally beneficiaries of the family trust. Dividends paid to the family trust were then sprinkled among the various family members in the most tax-effective manner. This structure is still available for university-aged children and for the purpose of multiplying access to the capital gains exemption on a future sale of shares of an active business corporation.

**The Family Trust**

This brings us to the family trust, which is the primary focus of this paper.

When considering whether to establish a family trust as part of an estate freeze, one has to first determine whether a family trust is warranted. This involves consideration of the various reasons that might exist for establishing a family trust. What purpose does the family trust serve? That purpose will generally determine the terms and conditions of the family trust.

In some cases, the family corporation will involve an actual operating business and the parents will not have decided which child will be taking over control of the business. If this is the primary reason for establishing the family trust, one will want a fully discretionary trust so that the parents can decide at a later time as to how the future value (and control of Freezeco) will be allocated among the children. In too many cases, however, no child is actually interested in (or capable of) taking over the business and the parents use the discretionary nature of the family trust as a way of not having to deal with that issue. By doing the freeze and setting up the trust, the parents will have taken an estate planning step -- but only one step. Too often, however, the parents think that they do not have to proceed beyond that first step to the subsequent steps of dealing with the actual issue of who is to take over the business and how the transition is to be managed.

Parents will often establish a family trust so that they can continue to have control over the trust and that future growth in value. This is in many cases a legitimate concern. However, the parents also need to have some kind of a plan for passing on control at some point in the future. The plan should have specific time frames and specific ways of involving the children. For example, the children could become more involved in the decisions taken by parents as trustees. Whether or not the children actually become co-trustees, there is no prohibition against the trustees considering the views of beneficiaries. Too often, the parents hang on to exclusive control and do not involve the children at all. This means that control passes on the death or incapacity of the last parent and there has been no opportunity for the parents to see how the children will deal with the assets or with the decision-making process.

The family trust is often established because the parents do not know who their children will marry or have concerns about an existing marriage. The desire is generally to have the family assets pass down to direct lineal descendants and not to have any of those assets go to a separated or divorced spouse. In the past, trusts have been fairly useful in preserving assets for the benefit of direct lineal descendants. There have been cases in which the courts have mused about possibly treating a beneficial interest as a family asset. Courts may make an adjustment in the division of assets to account for the value that will likely arise to the person who is a beneficiary of the family trust.

With the imminence of the new Family Law Act, considerable uncertainty exists as to the treatment of interests in a family trust in a matrimonial context under that new legislation. Until the full effects of the new legislation become clear, reliance should probably be placed on pre-nuptial and marriage agreements rather than on the existence of the trust itself.

If no child is really in a position to take over the business, it may still be worthwhile to set up the family trust so as to multiply access to the capital gains exemption by having the children hold some of the future value of Freezeco. In that case, however, the parents have to start thinking about marketing Freezeco because actually selling a private corporation can take from 5 to 10 years. This means that the estate freeze is really a way of introducing additional shareholders in

anticipation of a future sale of the corporate shares. This is a case in which an "estate freeze" might be accomplished while the parents are still fairly young and active in the business so that additional value can add up while the parents are in the process of selling the business.

## SETTING UP THE FAMILY TRUST

### Terminology

In terms of terms and terminology, here are a few terms.[3]

As noted above, I will use the term "Freezeco" to refer to the corporation that is being frozen as part of the estate freeze.

At law, the person who establishes the trust is referred to as the "settlor" and the act of establishing the trust is called the "settlement" of the trust. For most clients, however, a "settlement" is a new community founded by those who have trekked across the prairies in Red River carts (we have to use Canadian imagery). As well, "settlor" sounds too much like "settler" -- being a person who moves into the settlement. I find that clients have an easier time of it if I refer to a "trustmaker" "establishing" a trust. I realize that these are controversial terms but I will nevertheless use them in this paper.[4]

Finally, I will base relationships on the parents who are implementing the estate freeze. A reference to children means the children of those parents. A reference to a grandparent, however, means a grandparent of the children of the parents (meaning the parents of the parents) because a reference to a parent of the parents looks too much like a typo.

### Investment Powers

Typically, the shares of Freezeco will be the sole investment asset of the family trust (the initial trust property will be the only other asset). As a result, it is necessary to modify the statutory investment powers.

The *Trustee Act* adopts a "prudent investor" standard in determining the type of investments that can be held inside a trust.[5] It is doubtful that a prudent investor would hold shares in an illiquid private corporation. Certainly, a prudent investor would attempt to diversify investments and would not put all the trust's eggs into a single basket.

In order to make sure that the family trust can hold shares of Freezeco, the investment powers in the trust deed should expressly authorize the trustee to hold shares of Freezeco as the sole investment asset of the trust (without any need to diversify into other investments).

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[3] This sentence was intentionally redundant, because my English teacher hated the overuse of "in terms of".

[4] This may actually make it easier for me to switch to using the term "willmaker", which will be the new term for "testator" if the *Wills, Estate and Succession Act* (WESA for short) ever comes into force.

[5] *Trustee Act*, RSBC 1996, c. 464, section 15.1.

As the *Trustee Act* provides default rules that apply only if the actual trust document is silent on the matter, it is possible for the investment powers in the trust deed to override the prudent investor standard.[6] If the trust deed fails to insert provisions overriding the prudent investor standard, however, the trustees could be committing a breach of trust by acquiring shares of Freezeco.

**Identity of Trustmaker**

In an estate freeze, it is important to carefully consider the identity of the person who will actually establish the trust. More often than not, this is a grandparent or a family friend or some other person who will have nothing to do with the operation of the trust and who will never be a beneficiary of the trust.

When selecting a trustmaker, one is most often concerned to avoid specific income tax attribution rules. Most specifically, one wants to avoid the application of subsection 75(2) of the Income Tax Act (the "**ITA**").

Subsection 75(2) is often thought of as a rule that applies to reversionary trusts. However, it is much broader than that. The rule applies if a person (call that person the "contributor") contributes property to a trust and certain conditions apply. In order to illustrate the rule, assume that the contributor gifts a $100 bill to the trust. Subsection 75(2) will apply if any one of the following conditions applies.

- It is possible for the $100 (including any property for which the $100 has been substituted) to revert back to the contributor.
    - For example, this can arise if the contributor is a beneficiary of the trust and the trustees have the power to distribute the $100 to the contributor as a distribution from the trust.
    - It can also arise if the $100 is used to buy shares of the family corporation (after the freeze) and the trustees can distribute any of those shares to the contributor as a distribution from the trust. This is because the shares have been substituted for the $100 (i.e. the $100 was used to buy the shares, which means that the $100 was replaced by the shares).
- The $100 (or any substituted property) cannot be disposed during the lifetime of the contributor without the consent of the contributor.
    - The CRA takes the view that this will be the case if the contributor is one of two trustees, as the contributor then has a veto over any distribution decisions of the trustee.
    - The CRA also takes the view that this will be the case, of course, if the contributor is the sole trustee.

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[6] Footnote 5, section 21.

- This will arise if the contributor has any kind of a veto power over decisions of the trustee in respect of the $100 or substituted property.

- The contributor can, during his or her lifetime, direct who is to receive the $100 or substituted property. This can apply if the contributor has a power of appointment.

If any one of the above conditions apply, the Canadian tax result is as follows.

- Any income or capital gain from the $100 (or substituted property) is treated as income and capital gain of the contributor.
  - This is the case even though the income and capital gain belongs to the trust and even if the income and capital gain is distributed to some other person.
  - For example, assume that the trust uses the $100 to buy new common shares of Freezeco after completion of the estate freeze. Because the shares are substituted property, any dividends on the shares are taxed as income of the contributor. As a result,the contributor ends up paying tax on all dividends generated by the common shares.
- If *any* capital property (not just the $100 and property that has been substituted for the $100) is distributed from the trust during the lifetime of the contributor, the distribution can be made on a tax-deferred basis only if the property is distributed to the contributor or the spouse of the contributor. A distribution to anyone else (even a Canadian resident) will be treated as a sale at fair market value.
  - If the capital gain is realized on shares that were purchased with the contributor's $100, of course, that capital gain will be taxed as a capital gain of the contributor.
  - If the capital gain is realized on some other property, there will still be a capital gain.

There are clever and complicated techniques for getting around the above rules, but the safest course of action is to make sure that the rules do not apply in the first place. This means careful selection of the trustmaker.

In an estate freeze context, the trust does not need a significant capital base in order to purchase the new common shares of Freezeco. Remember, those shares are considered to have only a nominal value. For that reason, the trust can be established with only a minor amount of initial property. This is often a gold coin, a silver coin or simply a $100 bill. To establish the trust, therefore, one does not have to find someone with deep pockets.

In order to steer a wide berth around subsection 75(2), I suggest following these simple rules.

- The trustmaker should be an individual who will have nothing to do with the trust after establishment of the trust. The trustmaker should be considered as the one person in the world who can never receive anything from the trust, who can never act as a trustee and who can never exercise any other function in respect of the trust (other than starting the

trust).

- As a backup, the only purpose of the initial trust property is to establish the trust. The initial trust property should be placed in an envelope, should be stapled to the trust deed and should remain stapled to the trust deed until future termination of the trust. The initial property should be the last piece of trust property that is distributed and should not change form at all during the existence of the trust.[7]

- Tell the parents that they must not reimburse the trustmaker for the initial trust property. The trustmaker must contribute the initial trust property as a gift. If the parent reimburses the trustmaker for the gift, there is a risk that the trustmaker will have acted as agent of the parent and that the parent will be considered to have contributed the initial trust property.

If one uses the initial trust property solely to establish the trust, how does the trust buy new common shares of Freezeco after the estate freeze? The usual technique is for the trustees to borrow funds from a third party (not the trustmaker) and agree to pay a reasonable rate of interest on the loan. The trustees then use the borrowed funds to buy the shares. After about a month, Freezeco pays a small dividend to the trustees and the trustees use that dividend to repay the loan and the accrued interest. It is important to remember to actually repay the loan.

While the interest expense will be deductible in computing the income of the trust, there is no deduction for the portion of the dividend that is used to repay the loan principal. As a result, the trust will have a small amount of taxable income and will have to pay a small amount of income tax. This is not a bad thing, of course, as it helps to establish the existence of the trust for income tax purposes.[8]

In one sense, it is best to use a family friend as the trustmaker because the family friend is not related to any of the trust beneficiaries. However, I prefer to use a grandparent if one is available. A grandparent is a lineal ascendant of the beneficiaries. If one of the beneficiaries becomes disabled, and if that beneficiary is a direct lineal descendant of the trustmaker, it will be possible for the trust to make a preferred beneficiary election in respect of the beneficiary. By making the preferred beneficiary election, income earned by the trust can be taxed at the tax rate of the disabled beneficiary-even if the disabled beneficiary is under the age of 17. As long as

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[7] It is not strictly necessary to keep the initial property until the termination of the trust. For example, the initial property could be distributed to one of the beneficiaries at any time (as long as some other property continues to be held in the trust -- if no property is held in trust, the trust ceases to exist as of that point in time). However, CRA auditors like to see the initial property and it is easier to retain the initial property than to explain the intricacies of trust law. As well, keeping the initial trust property stapled to the trust deed ensures that the trust continues to exist as it always has at least some property until the day that one makes the conscious decision to distribute the initial property as the final act of the trustee.

[8] The portion of the dividend that is used to repay the loan principal cannot be made payable to a beneficiary and taxed as income of the beneficiary, of course, as the amount has been repaid to the lender. If one made the principal payment amount payable to the beneficiary, one would have to distribute some of the shares that had been purchased with that loan principal. This would defeat the purpose of having established the trust in the first place.

there is no actual distribution of income to the disabled beneficiary, the “kiddie tax” does not apply and the trust can, in a subsequent year, use the capitalized income for the benefit of that disabled beneficiary. By “disabled beneficiary”, I mean somebody who qualifies for the Disability Tax Credit.

If one of the trust beneficiaries is currently disabled, of course, one will want to use a grandparent as the trustmaker so as to make sure that the disabled beneficiary is a preferred beneficiary. If the children of the parents are adults, however, one should consider the possibility that the children of the parents will produce grandchildren prior to termination of the trust. It is of course possible that one of those grandchildren could be disabled.

Even though the trustmaker is often somebody who should not have any involvement with the operation of the trust, the role of the trustmaker is crucial. In order to establish a trust, the trustmaker must intend to establish a trust. If there is no intention to create a trust, there is no trust. Consequently, it is not just a question of having somebody supply some initial property and sign some documents. The trustmaker has to realize that the trustmaker is setting up a trust. If the trustmaker does not have this realization, of course, the trustmaker cannot have any intention to set up a trust and the trust will of necessity fail.

This is not just a theoretical concern. A court will look at the fundamentals of trust law and the intention of the trustmaker. This was illustrated by the Federal Court of Appeal in its 2010 judgement in *Antle*.[9] The appellant in that case signed documents that seemed to establish a spousal trust resident in Barbados and then signed documents contributing shares of a Canadian corporation to that trust. The plan was to take advantage of provisions of the Canada-Barbados Tax Treaty in order to avoid tax on the sale of the shares to a third party.

The plan failed to get past first base. The Federal Court of Appeal upheld the following finding of the Tax Court judge in the matter.[10] The emphasis in the following passage was inserted by Noël JA, writing the judgement for the Federal Court of Appeal.

> I reach the inevitable conclusion that [the appellant] did not truly intend to settle shares in trust with [the trustee]. He simply signed documents on the advice of his professional advisers with the expectation the result would avoid tax in Canada. I find that on December 14th, he never intended to lose control of the shares or the money resulting from the sale. He knew when he purported to settle the Trust that nothing could or would derail the steps in the strategy. This is not indicative of an intention to settle a discretionary trust. Frankly, I have not been convinced [the appellant] even fully appreciated the significance of settling a discretionary trust, beyond an appreciation for the result it might

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[9] *Antle* v *The Queen* (2010), 61 E.T.R. (3d) 13, 2010 CarswellNat 3894 (FCA). For a purely Canadian trust that failed due to lack of intention to create a trust, see *MNR* v. *Ablan Leon (1964) Ltd.*, 1974 CarswellNat 205, [1974] C.T.C. 610, 74 D.T.C. 6451 (FCTD).

[10] *Antle*, note 6, at paragraph 8.

> provide. I conclude that his actions and the surrounding circumstances cannot support a conclusion that signing the Trust Deed, as worded, reflects any true intention to settle shares in a discretionary trust. *I do not find that [the appellant] is saved by the language of the Trust Deed itself, no matter how clear it might be. It does not reflect his intentions.*

There was no magic in the elaborate and finely-crafted documents. It all hinged on a failure to observe the basic principles of trust law.

Interestingly enough, the appellant in *Antle* did not dispute that he never intended to grant the trustee control of, or discretion over, the shares in question.[11] The appeal had to be based on a question of law, so the appellant argued that the Tax Court was not permitted to look beyond the wording of the documents themselves. The Federal Court of Appeal made it quite clear that the court can take the actions of the parties into account in order to determine whether the purported trustmaker actually had an intention to create a trust. As there was no intention in this case, there was no trust. The elaborate documentation was nothing more than a sham because they described a trust that did not exist.[12]

If one reads the Tax Court judgement, the absence of intention was based on timing of signatures, some acts that were inconsistent with the trust having been established, and a lack of actual transfer of the property to the trustee.[13]

Ideally, the lawyer should actually meet with the trustmaker and make sure that the trustmaker realizes that the trustmaker is setting up a trust. This requires that the trustmaker understand the basic concept of a trust and understand that the trustmaker is making a gift that will be managed by a trustee for the benefit of selected individuals. The trustmaker does not have to be an expert on trust law but has to understand this basic feature of a trust. Given that the trustmaker is the one establishing the trust, the draft trust deed should be sent to the trustmaker for review by the trustmaker. There is a tendency to send the trust documents to the parents and to deal with the trustmaker as an afterthought or as a mere "technical detail" of the trust establishment. In actual fact, the trustmaker is the linchpin of the trust.

It follows, of course, that the trustmaker must know who he or she is naming as beneficiaries of the trust. I like to use a trustmaker who has some connection with the family such that it would not be considered unusual for that individual to make a gift for the benefit of the family. Ideally, the trustmaker should be someone who has assisted the family in the past. Setting up the trust is like making a Christmas gift to the family.

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[11] *Antle,* note 6, at paragraph 9.

[12] *Antle*, note 6, at paragraphs 15 to 22. There is no requirement for *mens rea* or an intent to deceive for documents to be a sham. The documents are a sham if they describe a transaction as being other than what the transaction actually is.

[13] The Tax Court of Canada judgment is reported at 2009 D.T.C. 1305, 2009 CarswellNat 2792.

The lawyer has to consider whether the lawyer is acting for the trustmaker in setting up the trust. Indeed, the instructions for the trust have to come from the trustmaker or there is no trust. As a result, the lawyer has to take instructions from the trustmaker. In doing so, therefore, the lawyer should clearly indicate whether the lawyer is providing legal advice to the trustmaker or whether the trustmaker has to obtain independent legal advice from some other source. As a practical matter, the trustmaker will usually be an accommodating party and will not be thrilled about incurring expense for independent legal advice. Given that the lawyer has to make sure that the trustmaker has the necessary intention to create the trust, the lawyer should approach the trustmaker as if the trustmaker were a client. Certainly, the lawyer is going to owe some kind of a fiduciary duty to the trustmaker and needs to explain to the trustmaker exactly what the trustmaker is doing.

Given that the lawyer will be structuring the trust document, the lawyer also has a duty to make sure the trust document is structured in such a way that the trustmaker will not suffer any adverse impact from having created the trust. Specifically, this means making sure that none of the attribution rules will apply so as to attribute trust income to the trustmaker. This is another reason for not using the initial property to purchase the new common shares of Freezeco. If the trustmaker is a grandparent or other person related to the beneficiaries and the initial trust property is used to acquire the new common shares, dividends on those common shares could in some circumstances be attributed back to the trustmaker.[14] It is best to avoid any possibility of this happening.

Ensure that the trustmaker is a resident of Canada and that the trustmaker is not subject to the general tax laws of any jurisdiction outside of Canada. Having a non-resident act as trustmaker may seem like a way around the income tax attribution rules and may even sound exotic, but it may end up subjecting the trust to the tax laws of a foreign jurisdiction. It at least obligates you to consider the tax laws of that foreign jurisdiction and how those laws might apply to an "offshore" trust -- being a trust established by a tax resident of that other jurisdiction in a place outside of that other jurisdiction. If a Canadian resident were to establish a trust in the United States for the benefit of relatives in the United States, that United States trust could easily be a deemed resident of Canada under our still-draft offshore trust rules. The same may apply in reverse if the trustmaker is a citizen of the United States.[15] France is introducing special reporting requirements that will apply if a trust has a French trustmaker, trustee or beneficiary.[16]

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[14] Various attribution rules set out in sections 74.1, 74.2 and 74.3 of the ITA could apply in certain circumstances. For more details, see my 2011 paper entitled "Income Tax Attribution Rules", presented at the Conference on *Tax Fundamentals for the Estate Practitioner,* held in Vancouver, British Columbia on February 4, 2011. The Conference was sponsored by the Continuing Legal Education Society of British Columbia. The paper deals with the law as it stood on January 12, 2011.

[15] The Canada-United States Tax Treaty does not contain any useful tie-breaker rules if a trust is considered to be a tax resident of both Canada and the United States. In this case, the CRA and the IRS have to "negotiate" over which country the trust will be considered resident in for tax treaty purposes. It is best not to go there unless absolutely necessary.

[16] See Decree n° 2012-1050 of 14 September 2012, published on 15 September 2012, which details the reporting obligations applicable to trustees introduced by LFR 2011-900 of 29 July 2011.

## Choice of Trustee

In an estate freeze context, the parents usually want to act as trustees in order to keep control over the trust assets (the future growth and value of Freezeco). An issue is whether a third trustee should be involved.

Having a third trustee involved helps to formalize the trust because it is not just the parents making decisions over the dinner table and then not bothering to formalize the decisions. Once a trust is properly established, the trust has to be maintained. The danger is that maintenance is often sloppy or non-existent (especially if the trustees choose to maintain their own trust records). Having a third trustee involved can make it more likely that trustee decisions will be formalized due to the necessity of involving that third trustee. However, merelyhaving a third trustee is not a panacea. If it is not easy to get together with the third trustee, it becomes more likely that trustee documentation will be non-existent.

If a third trustee is involved, there is a better chance of continuity for the trust if the parents were to die in an accident while the trust was still in existence. This is probably not as important a factor as one might think, however, as long as a professional advisor is involved in the operation of the trust. For example, an accountant will be up to speed on the details of the trust if an accountant has been preparing the trust income tax return.

I have been referring to a "third trustee" (meaning someone beside the parents) rather than a "third party". The third trustee can be one of the adult children as a way of preparing at least one of the children to manage the family asset. Or it could be some other relative of the parents (as long as the parents are comfortable with that relative knowing about the family wealth).

A third trustee could be a professional adviser. If a professional adviser is a trustee and the professional adviser controls some other corporation (such as the adviser's professional corporation), however, the adviser's position as third trustee could in some circumstances result in Freezeco being associated for income tax purposes with the professional's corporation. This is because the trustees hold common shares of Freezeco. If the parents (the other two trustees) die in an automobile accident and the professional is left as the sole trustee of the trust, the professional could end up having actual or deemed control of Freezeco until such time as other trustees are appointed. Two corporations are associated for income tax purposes in a taxation year if they are associated at any time in the year -- even for a millisecond. The professional (as sole trustee) will have deemed control of Freezeco if the trust holds common shares of Freezeco and the value of those Freezeco common shares have more than 50% of the value of all issued Freezeco common shares.[17] Typically, the trust will hold all the common shares.[18] In determining the value of common shares for this purpose, all common shares are considered to

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17 ITA paragraph 256(1.2)(c)(ii).

18 In this context, common shares means common shares as defined in ITA subsection 248(1). The ITA defines "common share" in the negative as follows.

> ...a share the holder of which is not precluded on the reduction or redemption of the capital stock from participating in the assets of the corporation beyond the amount paid up on that share plus a fixed premium and a defined rate of dividend.

be non-voting.[19]

A third trustee could also be a friend or some other person unrelated to the family. Having an unrelated trustee, however, brings up acquisition of control issues.

For example, assume a corporation has non-capital (business) losses that are being carried forward from prior years. The corporation wants to use those losses against future income once the economy recovers and the corporation once again starts to make a profit. If the corporation undergoes an acquisition of control before it returns to a profitable position, however, the losses carry-forwards are "streamed" and can be used by the Company only to the extent that the future profit is from the same or a similar business. If there has been an intervening acquisition of control, the corporation cannot use the losses against income from a new business that it starts in an attempt to respond to the gloomy economy.

In the above context, a 2005 CRA technical interpretation comments on the following fact situation.[20]

> - Lossco is a Canadian-controlled private corporation ("CCPC") as defined in subsections 125(7) and 248(1) of the Income Tax Act (the "Act"). The sole shareholder of Lossco is a discretionary trust for the members of Family A ("Trust 1");
>
> - There are three trustees of Trust1: Trustees B, C and D;
>
> - The trustees are not related to each other or to members of Family A;
>
> - The decisions of the trust are made by a simple majority of the trustees;
>
> - Lossco has non-capital and net capital losses.

The CRA took the position that a change in *any* of the trustees would result in an acquisition of control of Lossco. The CRA justified this position on the following basis.

> The test of de jure control contemplates the ownership of shares that give the holder the ability to elect a majority of directors. Where a trust is a shareholder, case law has referred to the trustees in assessing corporate control, since the trust is not a legal entity, but a relationship between the trustees and the beneficiaries. (See *M.N.R.* v. *Consolidated Holding Company Limited*, 72 DTC 6007 (SCC)). Where a trust has multiple trustees, the determination as to which trustee or group of trustees controls the corporation can only

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19 ITA paragraph 256(1.2)(g).

20 CRA Views 2004-0087761E5, dated May 24, 2005.

> be made after a review of all the pertinent facts, including the terms of the trust instrument. However, in the absence of evidence to the contrary, we would consider there to be a presumption that all of the trustees would constitute a group that controls the corporation.

The above position is likely based on the CRA tendency to view small groups of shareholders as always acting in concert.[21] Whether any two or three holders of shares actually act in concert to control a corporation is a question of fact, however, and not a rule of law.[22] While trustees all have to act in the best interests of the beneficiaries, each trustee is independently responsible for fulfilling that duty and cannot just "go along" with the view of another trustee. Unrelated trustees are more akin to unrelated shareholders in the sense that each is working toward a common objective but each has independent reasons for wanting to achieve that objective. As a result, I am not sure that the CRA can be as dogmatic on this issue as the CRA appears to be.

That having been said, clients often want to avoid being test cases and will for that reason have to be cautioned about bringing in an unrelated trustee. Even if the corporation does not have loss carry-forwards to worry about, the CRA view can result in a change of trustee triggering a deemed year-end of the corporation. Of course, one can ask a trustee to resign as of the end of a corporate fiscal year but that may not be possible due to the personal circumstances of the unrelated trustee. For example, the trustee may end up becoming a non-resident of Canada prior to the end of the fiscal year.

In a family trust context, the trust is inevitably a domestic trust that is resident in Canada for income tax purposes. In order for the trust to be resident in Canada, the trust has to be managed in Canada. Practically speaking, this will require that the trustees reside in Canada.

One does not want the family trust to become subject to the tax laws of any non-Canadian jurisdiction, so it is best to make sure that the trustees not only reside in Canada but that the trustees are not subject to the tax laws of any jurisdiction outside of Canada. The United States imposes tax on the basis of citizenship, so you will want to make sure that no trustee is a US citizen. If a trustee is a US citizen, you will have to consider potential cross-border issues. As this is a complex area, it is best not to go there unless it is absolutely necessary.

It may be necessary to change trustees during the existence of the trust. It is useful for the trust deed itself to set out a clear procedure for trustee succession.

This procedure could name specific successors, but situations change over time. A successor named in the deed may have moved to another location by the time that the successor is called

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[21] See Interpretation Bulletin IT-64R4 "Corporations: Association and Control [Consolidated]" (October 13, 2004), at paragraph 24.

[22] *Gestion Yvan Drouin Inc.* v *The Queen*, [2001] 2 C.T.C. 2315, 2000 CarswellNat 3035 (Tax Court of Canada), at paragraph 84. Paragraphs 61 to 96 summarize the case law in this area and provide a good analysis of when 50/50 shareholders can be considered to be acting in concert to control a corporation. There is no general rule that 50/50 shareholders act in concert, however. As stated in paragraph 89 of the judgement, "a distinction must be made between having a common goal and having a common interest".

upon to take up his or her duties as trustee and may no longer be an appropriate choice for that reason. Consequently, it may be better to insert a specific procedure for the appointment of successor trustees rather than naming successors.

Various possible procedures exist. If a person's judgment was trusted enough for that person to be named as a trustee, it might be appropriate to simply allow that person to appoint his or her successor. That way, the choice of successor can be modified from time to time. However, the choice of successor must actually be made in order for this method to be effective. As part of the process of creating the trust, the initial trustee should appoint a successor. That choice of successor should be reviewed annually (at tax return filing time) to make sure that the choice is still appropriate.

Of course, the trustmaker (or anyone else who has contributed to the trust) should never be appointed as a successor trustee. Having the trustmaker act as a trustee risks the application of the rules in ITA subsection 75(2) and 107(4.1), as discussed above. As the clients are likely to forget this sage advice, I usually have the trust deed itself prohibit the trustmaker from ever taking up the position of trustee.

**Beneficiaries**

Trust law requires that the beneficiaries be clearly identified or identifiable.

One approach is to describe the beneficiaries as a class. For example, the class might be "the children and other descendants of the marriage of X and Y". It is probably preferable to refer to the children of the marriage or to the children of both spouses rather than to just the children of one spouse. One does not want to have to inquire about possible children born out of wedlock. Referring to the children of just one parent could result in an unintended beneficiary.

In the case of blended families, however, you will have to raise the question whether the beneficiaries are to include just the children of the new marriage or also children from prior marriages. It may also be prudent to name all the existing children and then to provide for future children (if that is a possibility) as children of the specific couple in question.

If naming specific individuals, of course, it is important to spell the names correctly. I prefer to use full legal names and to include nicknames if applicable. Sometimes, everyone knows a specific individual by a name that has nothing to do with the individual's legal name.

The tendency is to have a broad class of beneficiaries. However, there may be a need to impose some restrictions on the breadth of that class.

This will be the case if the estate freeze involves a corporation that is not a small business corporation or that may become a small business corporation at some time during the existence of the trust. In order to be a small business corporation, a corporation needs to use substantially all its assets (measured by fair market value) in the pursuit of an active business carried on in Canada. The CRA generally regards "substantially all" as meaning at least 90%. This administrative simplification of the test is not the law but is a benchmark that one generally tries to meet.

If Freezeco owns rental property that is not used in an active business carried on by an associated corporation, Freezeco will not be a small business corporation. Even if Freezeco is a small business corporation at the time of the freeze, Freezeco may cease to be a small business corporation at some time in the future. For example, Freezeco may own real estate that is leased by a related corporation for use in the active business of the related corporation. If the active business ceases or the active business is sold, however, Freezeco will no longer qualify as a small business corporation.

Deemed income can arise under section 74.4 if Freezeco is not (or later ceases to be) an active business corporation, the estate freeze involves a transfer of property by an individual to a corporation, a purpose of the transfer is to income split and the trust beneficiaries include "designated persons" in respect of the freezor. Designated persons include the following.[23]

- A spouse of the freezor.
- A person who is under 18 years of age and who
    - does not deal at arm's length with the freezor (i.e. is related to the freezor or does not deal at arm's length as a matter of fact); or
    - is a nephew or niece of the freezor.

An estate freeze will almost always involve an income splitting purpose, so one can be sure to avoid this deemed income provision only if the trust does not include "designated persons" as beneficiaries while the individuals have the "designated person status".

For children and other descendants, it is fairly easy to avoid section 74.4. The trust can simply provide that a child or other descendant will not be a beneficiary while the child or other descendant is under the age of 18 and the transferor is living.[24] Given that kiddie tax applies in respect of dividends paid to a child who is under 17 at the start of a taxation year, and given that the emphasis will be on redeeming the fixed-value shares held by the parents in the early years of the estate freeze, this is not usually a significant restriction. However, it is a significant restriction if the goal of the estate freeze is to multiply access to the capital gains exemption on a future sale of share to an arm's-length buyer. Kiddie tax would not apply to a capital gain realized on an arm's-length sale of shares, so excluding minors as beneficiaries means that their capital gains exemptions cannot be used if the sale occurs before the minors reach age 18.

If multiplication of the capital gains exemption is the objective, the above restriction is a

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[23] ITA subsection 74.4(5).

[24] ITA subsection 74.4(4). The CRA takes the position that this statutory exception is not applicable if the trust deed says that designated individuals are excluded from benefitting under the trust only at times that Freezeco is not a "small business corporation". This is presumably because such wording allows the designated individual to benefit from the trust while the person is a designated person and Freezeco is a small business corporation. Paragraph 74.4(4)(b) applies only if the trust prohibits the individual from benefitting from the trust while the individual is a designated person (presumably whether or not the corporation is a small business corporation).

problem. Excluding the transferor's spouse as a beneficiary of the trust might also be problematic if income-splitting with the spouse is an objective and the spouse does not already own any shares in Freezeco. In that case, it might be advisable to have the trust beneficiaries include minors and the spouse and ensure that Freezeco pays sufficient dividends on the fixed-value shares each year to eliminate the section 74.4 deemed income. In this sense, section 74.4 is akin to a minimum tax rule in that it requires the transferor to receive a minimum amount of income on the fixed-value shares. The minimum amount of annual income required will be determined by the applicable dividend gross-up rate and the CRA prescribed rate of interest, which is currently 1% and is likely to stay at 1% until the general economic situation improves.

If the fixed-value shares have a redemption value of $1 million and no promissory note has been issued as part of the estate freeze, the annual dividend required to eliminate the deemed income will be a dividend that, after application of the appropriate gross-up rate, will result in a grossed-up dividend equal to 1% of $1 million (in other words, $10,000). For example, assume that Freezeco pays only ordinary taxable dividends that are grossed-up by 25%. In that case, Freezeco would have to pay a dividend of $8,000. After application of the 25% dividend gross-up, the transferor would report grossed-up dividend income of $10,000 (which is equal to 1% of $10 million).

If the plan is to redeem the fixed-value shares over time, this merely reduces the rate at which the fixed-value shares are redeemed.Only actual dividends count toward reaching the minimum income level for purposes of section 74.4. Deemed dividends that arise on the redemption of fixed-values shares do not count for that purpose. So if the transferor wished to extract $50,000 per year from Freezeco, Freezeco would pay an $8,000 cash dividend to meet the minimum dividend requirements and would redeem $42,000 worth of fixed-value shares.

Another way to avoid having to restrict the trust beneficiaries is to implement the estate freeze by way of a stock dividend.This can be accomplished by issuing a stock dividend to the current shareholders rather than having the current shareholders exchange their existing shares for fixed-value shares.

The shares issued on the stock dividend would be fixed-value estate freeze shares with a nominal par value. As long as the stock dividend is paid to all holders of common shares and is paid proportionate to the values of those common shares, the amount of the stock dividend for income tax purposes will be the aggregate par value of the shares issued on the stock dividend. This should be a nominal amount. However, the full redemption amount of the shares may have to be included in income if the stock dividend shares are distributed to the common shareholders on anything other than a pro-rata basis.[25]

The issuance of shares on a stock dividend is an issuance of shares by the corporation and does not involve a transfer of any property to the corporation. Accordingly, section 74.4 should not apply.

After the stock dividend, the shareholders will be left with common shares with only a nominal value. Those common shares could be eliminated by having the corporation purchase the shares

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[25] ITA section 15(1.1).

for cash consideration.  While this does involve a transfer to a corporation, the value involved is nominal. If the corporation pays cash for the shares, there will be no non-cash consideration received by the individuals in respect of the transfer and therefore no non-cash consideration on which to base any deemed interest income.

The fixed-value shares issued on the stock dividend would contain a price adjustment provision so as to ensure that all the value of the existing common shares is taken up by the fixed-value shares. The CRA has indicated that it will not accept a price adjustment clause as part of a stock dividend freeze because such a price adjustment clause would not comply with the CRA's stated position on price adjustment clauses.[26] However, I have never seen the CRA actually take any assessment action on the basis of this position. It is difficult to see why a price adjustment clause would be respected if the clause is set out in the terms and conditions of shares issued on a share exchange estate freeze but not if the clause is set out in the terms and conditions of shares issued on a stock dividend. Even if the CRA reassessed, a properly-drafted price adjustment provision in the share conditions should provide a basis for an application for a rectification of the director resolution setting the redemption amount of the shares issued on the stock dividend.

Of course, a stock dividend freeze will not be possible if an individual is transferring assets to a corporation.

A stock dividend freeze will also not be an option if the estate freeze involves the crystallization of a capital gains exemption. In that case, the corporation will be an active business corporation so that section 74.4 will apply only if the corporation loses active business corporation status at some point in the future.

Another way to avoid section 74.4 is to have the corporation ("**Oldco**") transfer its assets to a new corporation ("**Newco**") in return for fixed-value shares of Newco. This transfer would be effected on a tax-deferred basis under ITA section 85. The new shareholders would hold shares of Newco.

This can be illustrated as follows.

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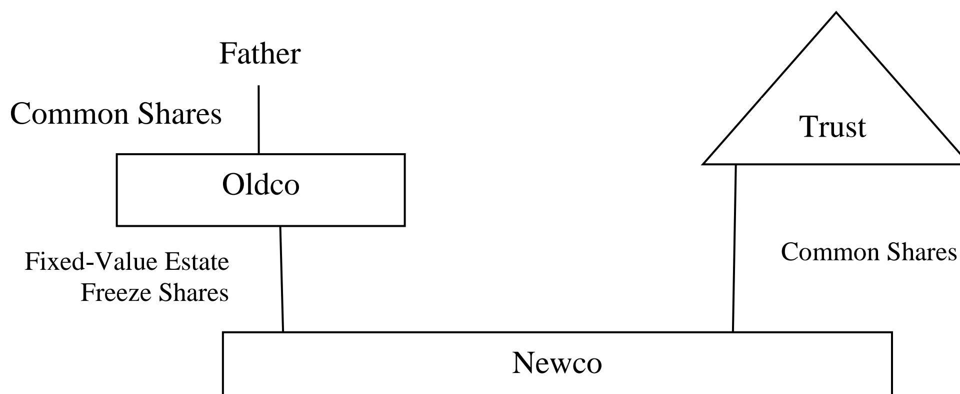
[26] See CRA technical interpretation 2003-0004125, dated April 1, 2003, and Interpretation Bulletin IT-169, "Price Adjustment Clauses," issued August 6, 1974.




While the shareholders of Oldco continue to hold common shares of Oldco, the value of Oldco is fixed because the value of Oldco consists entirely of its fixed-value shares in the capital of Newco. As long as this is the case, the common shares of Oldco will not grow in value.

Section 74.4 would not apply in this situation because the shareholders of Oldco would not have transferred any property to a corporation. This presumes, of course, that the transfer of assets from Oldco to Newco is not an *indirect* transfer of assets by the shareholders of Oldco. This will be a question of fact. If the shareholders of Oldco transferred assets to Oldco and then, as part of that same series of transactions, caused Oldco to transfer the assets to Newco, the transfer of the assets from Oldco to Newco would likely be an indirect transfer of assets by the shareholders of Oldco. This will be a question of timing and other relevant circumstances. The more time that elapses between the two transfers, the better – but no specific period of time will provide absolute insulation from this characterization. It will all depend on the facts.

**Beneficiaries Grow Up**

Another beneficiary issue is that beneficiaries grow up and lead independent lives. While all parents want this, it can introduce issues for the estate planner.

Are any of the beneficiaries likely to move to some other country (such as the United States) in the future? If a beneficiary becomes a United States Person for US tax purposes, a Canadian domestic trust will be viewed as an offshore trust by the US. This could impose reporting obligations in respect of the trust and the corporation underlying the trust. For this reason, it may be prudent for there to be a mechanism allowing for the exclusion of a person as a beneficiary. Depending on the offshore trust laws of the jurisdiction in question, it may be necessary to actually remove the emigrant beneficiary rather than having the emigrant remain as a beneficiary and just not receive distributions.

The assumption will generally be that the beneficiaries are involved in the family business. However, some beneficiaries may have chosen not to pursue the family business and may have pursued other lines of business. For example, one of the children may have gone to law school and may have incorporated a law corporation. If that child is a discretionary beneficiary of the

family trust, the child's status as a discretionary beneficiary could lead to the child's law corporation becoming associated with the corporation of the parents.

Various complex rules apply to determine whether two corporations are associated. One of those rules is that the two corporations are controlled by the same person. The associated corporation rules go on to provide various deemed ownership rules. In this context, ITA paragraph 256(1.2)(f) provides as follows.

> (f) where shares of the capital stock of a corporation are owned, or deemed by [ITA subsection 256(1.2)] to be owned, at any time by a trust,
>
> (i) [omitted, as this deals only with testamentary trusts],
>
> (ii) where a beneficiary's share of the accumulating income or capital therefrom depends on the exercise by any person of, or the failure by any person to exercise, any discretionary power, those shares shall be deemed to be owned at that time by the beneficiary, except [exception applicable only to a testamentary trust],
>
> (iii) in any case where subparagraph (ii) does not apply, a beneficiary shall be deemed at that time to own the proportion of those shares that the fair market value of the beneficial interest in the trust of the beneficiary is of the fair market value of all beneficial interests in the trust, except [exception applicable only to a testamentary trust], and,
>
> (iv) in the case of a trust referred to in subsection 75(2), the person referred to in that subsection from whom property of the trust or property for which it was substituted was directly or indirectly received shall be deemed to own those shares at that time;

In the case of a discretionary trust, subparagraph 256(1.2)(f)(iii) provides that each beneficiary is deemed to own all the shares that are held inside the trust. This is the case even if the beneficiary is an adult child with his or her own active business corporation.

Assume that the child decides to pursue a career as a lawyer and incorporates a professional legal corporation in order to take advantage of the low corporate tax rate applicable to active business income. Professional rules require that the child hold all the voting shares of his professional corporation. If the child controls the professional corporation and is a beneficiary of a trust that controls Freezeco, the child is deemed to own all shares owned by the trust and accordingly will be deemed to control Freezeco. As a result, the child's law corporation will be associated with Freezeco for income tax purposes. This means sharing the $500,000 limit on active business

income. It also means combining the capital of the corporations when considering whether the corporations are too large to qualify for the low corporate tax rate.

Having the family trust hold only non-voting shares of Freezeco does not necessarily solve this problem. This is because of another deeming rule, which provides that a corporation can be deemed to be controlled by a person even if that person does not own voting shares.[27] Specifically, a discretionary beneficiary will be deemed to control Freezeco if the trust owns

(a) Freezeco shares having a fair market value of more than 50% of the fair market value of all the issued and outstanding Freezeco shares; or

(b) Freezeco common shares having a fair market value of more than 50% of the fair market value of all the issued and outstanding Freezeco common shares

The latter of the above deeming rules is usually the problem, as the family trust usually owns all the common shares of Freezeco. After all, the purpose of the estate freeze is to push future growth to the family trust and growth is a feature of common shares.[28]

The first of the above deeming rules would initially not be an issue because virtually all the share value will be in the fixed-value shares held by the parents in the years immediately following the estate freeze. However, this deeming rule could become problematic down the road. The corporation may be redeeming the fixed-value shares in order to reduce the inherent capital gain in those shares. As the fixed-value shares are redeemed, the common shares may be growing in value. There may eventually come a point at which the common shares held by the trust exceed the aggregate value of the unredeemed fixed-value shares. The relative values of the two types of shares have to be monitored.

While discretionary trusts are very flexible, they have an inherent risk of causing inadvertent association of corporations. This has to be constantly monitored because a beneficiary who is in university at the time of creation of the trust could start his or her own corporate entity at some time after establishment of the trust.

If association of corporations is an issue, it can be addressed by limiting the interest of that specific beneficiary to less than 25%.[29]If the child is deemed to own less than 25% (i.e. no more than 24.9%) of the shares held by the trust, this will usually solve the associated corporation issues. However, this will require an exercise of discretion by the trustees and will have to result in limiting the interest of that beneficiary for all time. The impact of this on the overall estate plan will have to be considered, however. As well, the trust deed will have to provide the trustees with the power to limit the interest of a beneficiary.

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[27] ITA section 256(1.2)(c).

[28] The ITA definition of common shares applies for this purpose. See footnote 18.

[29] In the case of association by common shareholders, the person who controls the other corporation can own no more than 25% of the shares of the other corporation without causing association. See ITA 256(1).

## Maintenance of the Trust

Assuming that the family trust has been properly established, the trust also has to be properly maintained. There needs to be clear agreement on who is to do that maintenance.

Unlike a corporation, a trust does not have to file an annual report with the Registrar of Companies. If the trust is not receiving any dividends from Freezeco and has no capital gain, the trust does not even have to file an income tax return annually.[30] It may still be prudent for the trust to file a nil income tax return each year, however, so that the return can be assessed and limitation periods can start to run. In any event, the trust should file an initial income tax return as it will have to report and pay tax on the income that is used to repay the loan that was used to acquire the shares of Freezeco.

The trustees will have to file a copy of the trust deed when filing the initial income tax return of the trust.

If the trust is used to flow income to beneficiaries, however, it will be necessary for the trustees to decide how to deal with that income. Most of the time, the income will be flowed through to beneficiaries. If that is the case, the trustees need to make that decision and need to record that decision in trustee minutes. It is not sufficient to simply record the flow-through by having the trust report the distribution in the trust income tax return and to have the trust issue a T3 slip to the beneficiary in question. Income tax filings do not create distributions. An income tax return merely reports matters that are relevant to income tax liability. If the trustees have not actually approved the distribution, an income tax return that reports a distribution is simply an inaccurate return.

Accordingly, the trustees need to keep a written record of decisions that involve an exercise of discretion (such as the distribution of income). Whenever Freezeco declares a dividend on the shares held by the family trust, there needs to be a director resolution declaring that dividend. It follows that a trustee resolution should be prepared at the same time dealing with that dividend if the dividend is being flowed through to beneficiaries. At the very least, trustees should review the trust records at least once a year to ensure that trustee decisions have been properly recorded.

Written trustee records need to be kept in an organized fashion. A trust minute book can be useful for this purpose. The minute book can be in a loose-leaf binder format with separate tabs (similar to a corporate minute book) or can even be in the form of an accordion file with separate sub-files. Either format works, as long as the records are maintained and organized. Usually, records will be inserted in reverse chronological order so that the most recent documents are on top.

A trust minute book can be similar to a corporate minute book, although the documents kept in the two minute books will differ.

A trust minute book or file should contain at least the following information, separated into tabs

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[30] ITA subsection 150(1.1), which modifies the rule in ITA paragraph 150(1)(c). For income tax purposes, a trust is considered to be an individual.

or sub-files.

- The original trust deed.
- The initial trust property and documents confirming the proper establishment of the trust.
- Original trustee minutes.
- A register of trustees.
- Original documents relating to the resignation and replacement of trustees.
- Copies of tax returns and other tax material filed by the trustees.
- The reporting letter on the establishment of the trust and any other legal advice received by the trustees.

If a professional is maintaining the trust minute book, the professional will have to check periodically with the trustees to make sure that the minute book is up to date.

In 2009, the CRA began a project that involved the audit of a number of family trusts. The project seems to have started in Alberta. The CRA initiated each review by posing the following written questions to the trustees.[31]

1) How, by whom, when, and why was the trustee appointed? What is the trustee's relationship to the trust? Copies are requested of the trustee agreement and/or contracts the trustee entered into.

2) What are the trustee's qualifications, expertise, and experience?

3) Does the trustee receive a fee for his services? What is the fee's amount and how is it determined and paid? Copies are requested of all billings/invoices issued to the trust with regard to the fees during the periods under review.

4) A list of the trustee's duties and responsibilities is requested.

5) Does the trustee have control over the trust's investment portfolio and any other trust assets?

6) What signing and/or contracting authority does the trustee have? Does the trustee have the power to contract and deal

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[31] See *Canadian Tax Highlights*, Volume 17, number 7 (July 2009), article “Trust Residence Questioned”.

with the trust advisers such as accountants and lawyers?

7) Is the trustee responsible for the management of any business or property owned by the trust and, if so, how is that done?

8) Is the trustee responsible for banking and financing arrangements, for the trust and, if so, how is that done?

9) Is the trustee responsible for preparing the trust's accounts and reporting to the beneficiary and, if so, how is that done? Copies are requested of all correspondence, memoranda, faxes, e-mails, handwritten notes, minutes, and/or records of meetings and conversations, etc. with respect to communications between the trustee, the settlor, and the beneficiary during the periods under review.

10) How, where, and by whom are decisions made in relation to the trust property? Are the decisions documented, and who signs off on them? Copies are requested of all correspondence, memoranda, e-mails, handwritten notes, minutes, and/or records of meetings and conversations, etc. with respect to all decisions made by the trustee in relation to the trust property during the periods under review.

11) By whom and where was the decision made to distribute income from the trust to the beneficiary and to elect to have the income taxed in the trust during the periods under review? Copies are requested of all correspondence, memoranda, e-mails, handwritten notes, minutes and/or records of meetings and conversations, etc. with respect to these decisions.

While this project focused on the residence of the trusts involved, the questions posed give an indication of the factors being examined by the CRA. In particular, the questions focus on the trustee’s understanding of his or her role in respect of trust governance and asks for documentation of trustee decisions. This stresses the importance of proper operation of the trust (as opposed to having nothing more than a really impressive trust deed).

**Effect of the Trust**

The parents have to realize that creation of the trust makes a difference. While the parents are managing the future growth and value, they are not managing that future growth and value for themselves. They are managing that future growth as fiduciaries and owe duties to the beneficiaries.

There is a danger here in overemphasizing the discretionary nature of the trust. The trust document will inevitably include the following provisions.

- A provision stating that the trustees have the same power in respect of the trust property as if the trustees were the sole beneficial owners of the trust property.

- A statement that the trustees may exercise discretionary powers in the "sole absolute and unfettered discretion" of the trustees.

The above provisions are oxymorons, however, as the trustees do not in fact have beneficial ownership of the trust property and do not in fact have "unfettered discretion". Trustees always have a fiduciary duty to act in the best interests of the beneficiaries and to fulfill the purposes of the trust. Indeed, if the discretion were actually unfettered or if the trustees actually had beneficial ownership of the trust property, there would be no trust.

The best way to illustrate this is to refer to the *Fox* case.[32] This involved a testamentary trust as opposed to an *inter vivos* trust, but the trust law principles are the same.

*Fox* involved a Jewish family. The deceased father gave his wife (I will refer to her as the widow) a life interest in estate residue. If the son survived the widow (the mother of the son), the son was to receive the remaining capital. The widow was executrix and had a wide power to encroach on capital for the benefit of the son's children (the grandchildren of the deceased and the widow).

After the death of the father, the son divorced his wife (the mother of the son's children). Three years later, the son remarried but married someone who was not a member of the Jewish religion. The widow (the son's mother) was upset by this and made a new will disinheriting the son. The widow also started to sell estate assets and to distribute the sale proceeds to the son's children (the grandchildren of the deceased) under the power to encroach on capital for their benefit. The son complained about this exercise of discretion and asked for removal of the widow as executrix.

The Ontario Court of Appeal granted the son's request. While the court unanimously agreed that the widow had exercised her discretion improperly, each member of the court wrote separate concurring reasons.

Gilligan JA ruled that the discretion had been exercised improperly because the widow had exercised the discretion primarily for the purpose of punishing the son for marrying outside of the family's religious faith. If the widow had encroached on capital out of a concern for the welfare of the grandchildren, this would have been a proper exercise of discretion. By using that power to punish the son, the widow was acting outside of her duties as trustee. This is often described as a *mala fides*act of the trustee, but the term *mala fides* is a misleading term because the trustee can act on a *mala fides* basis without being guilty of fraud.[33] It is sufficient if the trustee is acting for a purpose extraneous to the trust.

Gilligan JA also decided that the action of the widow had to be set aside on public policy

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32 *Fox* v *Fox Estate* (1996), 10 E.T.R. (2d) 229, 1996 CarswellOnt 317 (Ont CA).

33 *Fox*, note 29, at paragraph 12.

grounds.[34] This was, however, a separate reason from the finding that the trustee had acted for a purpose extraneous to the trust.

Interestingly, Gilligan JA acknowledged that the widow was perfectly within her rights to remove the son as a beneficiary of her own will and speculated that the deceased might even have done the same if the deceased had still been living at the time of the son's remarriage.[35]

> The exercise of a testator's right of disposition is not subject to supervision by the court. But a trustee's exercise of discretion is subject to curial control. Admittedly, because he would not be subject to judicial supervision, [the deceased father], if alive, could have disinherited [the son] for reasons which would have contravened public policy. However, [the father] is not alive and is not preparing a new will. [The widow], while acting as a trustee, on the other hand is subject to judicial control and that control can and must prevent her from exercising her discretion in a fashion which offends public policy.

McKinlay JA decided that the widow had exercised her discretion improperly because she had not considered the terms of the trust at all in exercising that discretion. Instead, she had acted as if the estate assets were her own property (in the wording of most trust documents, as if she were the beneficial owner of the assets).[36] She was not in fact entitled to treat the trust assets as her own.

The third presiding judge, Catzman JA, agreed with the foregoing conclusions but added a separate judgement in which he wondered whether having an inappropriate motive was fatal to the exercise of the discretion or whether the exercise of discretion can be saved if the trustee also has a concomitant proper basis for exercising the discretion. Catzman JA found no clear answer to this question but expressed the view that an inappropriate motive would not necessarily be fatal if the trustee had also relied on a proper basis in exercising the discretion.[37] One has to infer that this will be a question of degree in any situation as to the relative importance of the various motivations.

While trustees never have unfettered discretion, trustees can be given very broad discretionary powers and can exercise those powers over the objections of beneficiaries as long as the trustees do so properly. *Martin* -- another Ontario case -- illustrates this point.[38] The plaintiff was a beneficiary of two discretionary *inter vivos* trusts established as part of an estate freeze. On termination of the trusts, the trustees did not distribute any assets to the plaintiff. In this situation, the court upheld that exercise of discretion.

The trustee of the first trust was the uncle of the plaintiff and stated that he had exercised his

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[34] *Fox*, note 29, at paragraphs 16 to 18.

[35] *Fox*, note 29, at paragraph 20.

[36] *Fox*, note 29, at paragraph 49.

[37] *Fox*, note 29, at paragraphs 63 to 66.

[38] *Martin* v *Banting* (2001), 37 E.T.R. (2d) 270, 2001 CarswellOnt 405 (Ont SC).

discretion on the following factors.[39]

- A concern about the plaintiff's ability to handle money.
- Knowledge that another person had already provided significant assets to the plaintiff.
- A belief that the plaintiff did not share the trustee's work ethic.
- For the past 10 years, the plaintiff had been living off his investment portfolio.
- The plaintiff had been estranged from the rest of the family.
- The plaintiff lacked integrity, principles, good business practices and morals.

The trustee of the second trust was the mother of the plaintiff and gave the following reasons for her exercise of discretion.[40]

- The plaintiff had an attitude of entitlement ("that he was owed things and entitled to make demands as of right without having to work or achieve on his own").
- The plaintiff had acted less than honestly in respect of certain asset that had been transferred to the plaintiff.
- Based on the manner in which the plaintiff had handled several real estate matters, the plaintiff lacked judgement and responsibility.
- The plaintiff had a cold and hostile attitude towards the trustee.
- The plaintiff did not appreciate gifts that had been made to the plaintiff previously.

As this was a motion for summary judgement, all evidence was given by affidavit. The plaintiff's affidavit alleged that the trustees had acted out of spite, that the plaintiff had been successful in the real estate industry, that the plaintiff had "cleaned up" real estate problems left by his late father, explained why real estate matters that he managed for his mother (one of the trustees) did not turn out well, accused his uncle of hypocrisy and (in the court's words) aired a great deal of the "dirty laundry that is endemic to families whose members have not learned to live in harmony".[41] However, the plaintiff's affidavit did not directly challenge the beliefs held by the trustees. As well, the plaintiff did not cross-examine either trustee on their respective affidavits. The court concluded that there was no evidence to contradict any of the statements made by either trustee or that the trustees actually held the beliefs that they expressed.

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[39] *Martin*, note 35, at paragraph 14.

[40] *Martin*, note 35, at paragraph 16.

[41] *Martin*, note 35, at paragraph 32.

The court summarized the law by quoting the following passage from the 2nd edition of *The Law of Trusts in Canada* (Donovan Waters).[42]

> First, it must be ascertained as a matter of construction to what task the discretion is attached. For instance, a discretionary trust may impose the duty upon the trustees to distribute the whole of the trust fund, but confer upon them a discretion as to the members of the class of beneficiaries who are to receive payments, and how much each is to receive. Again, a trustee may have a duty to maintain, and this requires him to act as the law defines maintenance, but at the same time he may have a discretion as to the times at which, and the manner in which, he makes payments for this purpose. Sometimes the line between duty and discretion is not easy to discover, but a trustee who interprets himself to have discretion when in fact he has a duty does so at his peril. Secondly, the court will not intervene simply because the beneficiaries or any other complainants do not agree with the decision of the trustees in the exercise of their discretion. Nor will it intervene merely because it would not have come to the same decision itself. The court will intervene, however, if (1) the decision is so unreasonable that no honest or fair-dealing trustee could have come to that decision; (2) the trustees have taken into account considerations which are irrelevant to the discretionary decision they had to make; or (3) the trustees, in having done nothing, cannot show they gave proper consideration to whether they ought to exercise the discretion.

The court noted that a trustee has no obligation to give reasons for the exercise of a discretionary power.[43] The trustees having given reasons in this case, those reasons were uncontradicted as an evidentiary matter and were not irrelevant to the discretion as set out in the trust deed.

In *Martin*, the court also expressed the view that the presence of an improper motive would not invalidate an exercise of discretion if proper and relevant reasons supported the exercise of the discretion.[44] In this, the court relied on the *obiter dictum* expressed by Catzman JA in the *Fox* decision.

The contrast between *Fox* and *Martin* indicates that trustees need to be discrete when dealing with trust matters in a family context. One wonders whether the outcome in *Fox* would have been different if the widowed mother had been less vocal about her son’s second marriage. In any event, the *Martin* decision clearly sets out factors that are relevant in a fully discretionary family trust context. These factors have a mix of business (lack of judgement) and parental (sense of entitlement and estrangement from the family) considerations.

While *Martin* is a strong case in support of the types of factors that a trustee can take into account, one gets the sense that the plaintiff may have shot himself in the foot by the tone of his affidavit. For example, the plaintiff complained of trustee mismanagement because the trust corpus, which had stated at just under $7,000, had reached “only” $6 million at the end of 20

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[42] *Martin*, note 35, at paragraph 25.

[43] *Martin*, note 35, at paragraph 33.

[44] *Martin*, note 35, at paragraph 34.

years (a thousand-fold increase in value). The plaintiff took the position that a properly-managed portfolio would have been worth $10 million.[45] One gets the sense that the judge may have been relieved not to have to sit through a trial with *viva voce* testimony from the plaintiff.

**Trustee Obligations**

Each Trustee has to realize that trusteeship means accepting certain obligations, burdens and potential liabilities. One of the other papers at this conference sets out the obligations of a trustee. It is important that trustees realize the extent of this obligation.

Professionals have a tendency to think of a trust as an entity. For example, I have seen many documents that purport to be signed by a trust in the following manner.

The XYZ Trust, by its trustees

______________________________
Authorized Signatory

The above signature is a corporate-style signature in which an authorized signatory is signing on behalf of a corporation, which is a separate legal entity. This form of signature line is completely inappropriate for a trust because a trust is not a separate legal entity. A trust is a series of obligations imposed upon a trustee. Consequently, the signature line should be as follows.

__________________________________________
John Smith, acting as a Trustee of The XYZ Trust

The above distinction has practical significance. Whereas a director of a corporation is not liable for defaults of Freezeco (except in specific instances of statutory liability or a liability arising because the director was negligent in managing the corporate entity), a trustee is personally liable for all obligations entered into by the trustee. This liability is not limited to the assets of the trust. If a trustee signs a contract, the trustee is obligated personally under the contract. The phrase “in capacity as trustee” merely means that any benefit from the contract is held as property of the trust. Any liability, however, is a liability of the trustee because the trustee is the contracting party. In order to limit contractual liability, therefore, the trustee must insert a specific clause providing that the trustee’s liability is limited to the assets in the trust from time to time.

## CONCLUSION

This paper has summarized issues relevant to the establishment of a family trust established in the context of an estate freeze. As noted at the start of the paper, this is not a comprehensive discussion of trust law or of issues that might arise when trusts are used in other contexts.

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45 *Martin*, note 38, at paragraph 35.