

# TAX ALERT

## A New Chapter in **TAXATION OF TRUSTS**

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The recent decision of the Tax Court of Canada in *Garron Family Trust v. R* (2009 DTC 1568) has cast doubt on some common international and inter-provincial tax planning structures that involve the use of trusts. Generally, these trust structures reallocated income to jurisdictions that had either lower tax or no tax at all on certain types of income. This was accomplished by implementing a tax strategy that involved a trust and relying on the residency of that trust to determine the jurisdiction in which the trust's income would be taxed.

For over thirty years, tax professionals have relied on the principles set out in the well-known *Thibodeau Family Trust* case (78 DTC 6376) to determine the residency of a trust. Now, as a result of the decision in the *Garron Family Trust* case, we appear to have

a new set of rules for determining the residency of a trust. These new rules can have a serious impact on any trust tax planning strategy that relies on the old residency rules of the trust to minimize or eliminate taxation.

Pursuant to the *Thibodeau* case, the residency of a trust was based on the residency of the managing trustees. The *Thibodeau* trust had three trustees, one resident in Canada and two in Bermuda. The trust was administered in Bermuda and the books and records of the trust were in Bermuda. The Court concluded that the trust resided in Bermuda because the trust document required that a majority of trustees agree on all matters of trustee discretion, and

the majority of trustees resided in Bermuda. The Court rejected the notion that the residence of a trust should be similar to that of a corporation, and therefore disregarded the "management and control" test used for corporations. The Court then concluded that the residence of a trust should be determined based on residency of the trustees.

Just over thirty years later, we now have a different opinion from the Tax Court regarding this issue. With the *Garron Family Trust* decision, the Court has now embraced the notion that the residence

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of a trust should be similar to that of a corporation. The Court will look to the management and control of the trust to determine residency of the trust. The Court concluded that adopting a similar test of residence for trusts and corporations promotes the important principles of

consistency, predictability and fairness in the application of tax law.

With an update in the jurisprudence related to the residency of trusts, the Canada Revenue Agency (CRA) is now aggressively reviewing tax planning structures involving trusts to reduce tax avoidance through international and inter-provincial tax planning.

The CRA recently hired additional auditors to review the residency of Alberta trusts. During the past several years, it has been attractive and popular for individuals located in provinces other than Alberta to set up an Alberta resident trust to access Alberta's low provincial tax rates. With this review of Alberta Trusts, the CRA is seeking

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to determine the “management and control” over the trust assets. As a result, it has distributed questionnaires to Alberta trustees, requesting the following information:

- a list of the duties and responsibilities as the trustee;
- the signing and/or contracting authority of the trustees; and
- the responsibility of the trustees for the management of any business or property owned by the trust, the banking and financing arrangements for the trust, and the preparation of the trust’s accounts and reporting to the beneficiaries.

If the CRA determines that the management and control over the trust assets rests with any person(s) other than the Alberta trustees, it may determine the residence of the trust to be other than Alberta and reassess the provincial taxes accordingly.

Based on the 2010 Federal Budget, and the Department of Finance’s desire to close various loopholes in the *Income Tax Act*, and to try to find ways to generate revenue to assist in reducing the deficit, we can anticipate the CRA will also apply the same aggressive nature toward international tax planning strategies involving trusts.

This may be a new chapter in the taxation of trusts, but the story is not over yet. The Garron Family Trust has requested leave to appeal to the Federal Court of Appeal. We will have to wait for the outcome of that appeal to see whether a new chapter is written once again, or if the book is closed for the foreseeable future.

For now, we recommend that you contact your Collins Barrow Tax Advisor to discuss the implications that this case may have on your own tax planning strategies. §

## Canada Revenue Agency’s **AUDIT INITIATIVES**

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### **Are You Ready?**

Our system of taxation in Canada is such that residents of Canada are taxable on their worldwide income and the *Income Tax Act* governs what comprises that income and what expenses may be claimed. Our system is one of self reporting, where taxpayers are responsible for completing and filing accurate returns on a timely basis. Although many people feel that when they receive a notice of assessment from the Canada Revenue Agency

(CRA) their returns have been “approved” by the government, this is not necessarily the case. In fact, the notice of assessment simply acknowledges that the CRA has received a return and has assessed it as filed for the time being. The CRA generally does not review tax returns in

detail upon original assessment. It has the right under the *Income Tax Act* to review the return at a later date, within certain timelines.

It appears that the CRA is undertaking new specific initiatives to review some taxpayers’ income tax returns and related structures. Those taxpayers have received letters from the CRA indicating that they should review their personal tax returns to ensure that they have been filed properly. It appears that the CRA is targeting taxpayers with rental or business income and those claiming motor vehicle or business use of home expenses. These particular letters do not indicate that the tax returns are being audited by the CRA. They simply advise the taxpayers that they should ensure that things have been reported properly, with T1-ADJ forms attached for taxpayers to notify the CRA of any errors.

The letters also make reference to the Voluntary Disclosure Program (VDP), offered by the CRA

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to encourage taxpayers to report errors and/or omissions in previous filings. If the conditions under the VDP are met, the CRA will not assess penalties. One of the conditions for such a disclosure is that the CRA must not already have contacted the taxpayer in respect of any of the tax years involved in the disclosure. Whether these random letters sent out now by the CRA will disqualify a subsequent filing under the VDP is not clear.

This initiative appears to be an attempt by the CRA to target a large group of taxpayers with relatively little effort and resources. If taxpayers receiving these letters are confident that their returns have been filed accurately, no action is required. If, however, a taxpayer is concerned about a previous tax filing, regardless of whether he or she has received such a letter or not, that taxpayer should discuss these issues with a Collins Barrow professional advisor.

Another initiative that the CRA is undertaking is the review of trusts. Often, family trusts are used in tax planning strategies to minimize income tax while retaining control over assets. When we structure such trusts for clients, we review in detail the client's situation to ensure that such a structure can be tax effective. If so, we then work with the client's lawyer to ensure that the trust is properly constituted and set up in accordance with the *Income Tax Act*. In particular, the trust must establish that there is certainty of intention, certainty of subject matter and certainty of object. Beyond those primary requirements, proper accounting records must be maintained and proper legal documents are required as evidence of decisions made annually by the trustees. Trustees also must ensure that income tax returns are filed each year and that the rules in the *Income Tax Act* have been complied with.

Generally, one does not want a trust that has been set up during one's lifetime to have income taxed in the trust, as all of that income would be taxed at the

highest marginal tax rate. Consequently, any such income must be paid out of the trust to a beneficiary during the year or must be payable to a specific beneficiary. The CRA has strict interpretations as to what is considered payable, and legal documents must be in place prior to the end of the year to meet these requirements. Income earned by trusts that are created by will is subject to the same marginal income tax rates as apply to individuals. As a result, it is generally preferable for such income to be

taxed in the trust rather than in the beneficiary's hands. Again, several rules must be met to allow this to happen. These are just a few of the concerns that must be considered when administering trusts; there are many more issues to be addressed.

It appears that the CRA intends to review such structures and likely will be looking to ensure that the initial structuring of the trust was sound and that the requirements under the *Income Tax Act* are followed. It is important for trustees to ensure they understand what is required and that all of their books and records for any trust structures are complete and ready for the CRA to review.

Contact your Collins Barrow advisor to find out more about these CRA initiatives. §

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## Tax Issues for VICTIMS OF FRAUD

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Although not equal in size to Bernie Madoff's \$50 billion-plus Ponzi scheme in the United States, we here in Canada are not immune to fraudulent activity. From the alleged mis-dealings of the Pigeon King in Southwestern Ontario, to the Manna scheme in B.C., and the Earl Jones fiasco in Montreal, many Canadian taxpayers have suffered significant losses. Having suffered a permanent loss of capital, these individuals will hope to recover some of their losses through the tax system.

In some of these fraud cases, the Canadian taxpayers reported income in prior years that was, in reality, just a fictional amount they had *thought* was income. Under the current fairness provisions of the *Income Tax Act*, investors in this situation should be able to go back and request adjustments for the past ten years to recover taxes paid on this fictional income.

Unfortunately, obtaining tax assistance on the lost capital may be a greater problem. In the United States, the Internal Revenue Service (IRS), issued a specific ruling in March, 2009 dealing with the tax treatment of losses arising from Ponzi schemes. Under normal U.S. rules, such losses would be treated as ordinary investment losses, for which deductions are capped at \$3,000 per year. The recent IRS ruling allows these losses to be treated as a “theft loss,” permitting a deduction against any type of income of up to 95% of the investment. There is, however, no relief for U.S. taxpayers who invested through retirement plans such as a 401(k).

As yet, the Canada Revenue Agency (CRA) has not made any formal ruling regarding any similar tax relief for Canadian taxpayers. In July, 2009, however, Jean-Pierre Blackburn, the Minister of National Revenue, issued a statement in respect of the alleged (now proven) fraud situation surrounding financial advisor Earl Jones. Mr. Blackburn encouraged affected taxpayers to contact the CRA to discuss their situations, promising that CRA agents “will work together with affected individuals to resolve any problems on a case-by-case basis.” He went on to mention the fairness policies and the ability to waive or cancel penalties and interest, but stopped short of announcing any specific relief. The end result is that affected Canadian taxpayers must look for relief within the current rules.

In order to maximize tax assistance, any loss must be claimed and allowed as a business loss, which may be deducted against any source of income. Alternatively, a capital loss claim will

provide for a deduction of one-half of the actual loss against taxable capital gains. If there are no capital gains in the current year, such a loss may be carried back three years to recover tax paid on capital gains in those years, and carried forward indefinitely. The Canadian jurisprudence typically favours the CRA in disputes about such loss claims. For example, in *Heppner v. R.* (2008 DTC 2001), a taxpayer sought to deduct approximately \$300,000, which he claimed to have invested and lost in a Nigerian fraud scheme. The Minister disallowed the deduction on the basis that there was no legitimate source of income from which to deduct the loss. The Tax Court agreed, ruling such losses are only deductible if they are “incurred in the course of a *bona fide* business.”

For some taxpayers, part of their original investment involved loans that were allegedly made to earn above market rates of interest. These investors sometimes argue that such loans were part of a money-lending business and the losses are thus fully deductible. Here again, the jurisprudence does not favour the taxpayer. In *Ellaman Holdings Inc. v. M.N.R.* (87 DTC 480) the taxpayer had purchased interests in a number of different mortgages that went into default. The taxpayer sought to deduct his losses from other income as fully deductible business losses. The Minister disallowed the claim and the Tax Court agreed, ruling that the taxpayer, “did not conduct its management of this portfolio as a money lender would.”

It would appear that, barring any last minute relief from the CRA, the best result for which Canadian victims of fraud can hope is a recovery of tax on fictional income and a capital loss on funds invested.

For further information, please contact your Collins Barrow advisor. §

Collins Barrow publishes a quarterly Tax Alert for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada. While Tax Alert suggests general planning ideas, we recommend professional advice always be sought before taking specific planning steps.

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