CANADIAN TAX Highlights

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# Risks of Assigning a Trust Interest

An assignment of an interest in a trust may give rise to many unintended tax consequences. It is therefore increasingly important that, when drafting the terms of a trust, careful consideration be given to the class of beneficiaries set out in the trust deed and the trustees' amendment powers.

In a technical interpretation (2017-0683021I7, June 8, 2018), the CRA considered the tax implications resulting from the assignment of a capital interest in a family trust ("the trust"). The trust, which was approaching the 21-year deemed realization date under paragraph 104(4)(b), held all the issued shares of a holding corporation ("Holdco") for the benefit of two non-resident individuals. The corporate group, including Holdco, underwent a reorganization that involved the incorporation of an unlimited liability company ("ULC"), whose common shares were issued to the non-resident beneficiaries.

The trustees resolved to increase the stated capital of the Holdco shares and elected that a portion of the resulting deemed dividend be treated as a capital dividend, with the balance as a taxable dividend paid to the trust. Moreover, the trustees, having full discretion as to distributions of the income and capital of the trust, further resolved to distribute an equal capital share of trust property to each beneficiary at a future vesting date. Once fully vested, the beneficiaries would assign their trust capital interests to ULC in exchange for additional shares of ULC, all on a tax-deferred basis under subsection 85(1) (the assignment). The CRA was asked whether the trust could designate, pursuant to subsection 104(19), the taxable portion of the deemed dividend to ULC as a taxable dividend.

### ULC as a Trust Beneficiary

First, the CRA considered the statutory definitions of the terms "beneficiary" and "beneficially interested" in subsection 108(1) and paragraph 248(25)(a), respectively, and noted that a beneficiary refers to "beneficiary of a trust in the ordinary sense" and requires a "finding of fact based on all the relevant information, including the terms of the Trust." The CRA further noted that a beneficiary is a "person (other than a protector) who has a right to compel the trustee to properly enforce the terms of the trust, regardless of whether that person's right to any of the income or capital is immediate, future, contingent, absolute or conditional on the exercise of discretion by any person."

Turning to the trust terms, the CRA noted that (1) the class of beneficiaries was limited to the named individuals and their issue; (2) ULC was not named or created by the trust terms; (3) the trustees could not vary the trust terms and could not add new trust beneficiaries; and (4) the trustees' discretion as to distributions of trust capital and income was limited to "[b]eneficiaries from time to time *living* at such time," thus implying a reference to natural persons. Thus, the CRA found that ULC was not a trust beneficiary that had a right to compel the trustees to properly enforce the trust terms. Accordingly, the trust could not designate the taxable dividend to ULC.

### Transfers for the Benefit of the Beneficiaries

As a preliminary matter, although not specifically addressed in the TI, any allocation of "phantom income" to a beneficiary, such as the deemed dividend resulting from a paid-up capital increase, presupposes that the trust indenture defines "income" as income for tax purposes. Specifically, the CRA considers deemed income to be a "nothing" for trust-law purposes and, absent a specific provision in the trust indenture, does not permit a deduction under subsection 104(6) in respect of such income allocations.

Having concluded that, notwithstanding the assignment, the beneficiaries remained the capital and income beneficiaries under the trust, the CRA found the following:

- The taxable dividend allocated to ULC would be considered a payment made for the benefit of the (income) beneficiaries, being the sole shareholders of ULC. Accordingly, pursuant to subsection 104(13), the taxable dividend would be included in their income for the year.
- The taxable dividend (as well as the capital dividend) allocated to ULC for the benefit of the beneficiaries would be subject to part XIII withholding tax, pursuant to paragraph 212(1)(c).
- The transfer of the Holdco shares to ULC would be considered a transfer made for the benefit of the (capital) beneficiaries. Accordingly, pursuant to subsection 107(2.1), the trust was deemed to have disposed of the Holdco shares for FMV proceeds.

### Allocating the Taxable Dividend to a Capital Beneficiary

The CRA reiterated its longstanding position, based on the decisions in *Succession Terrill* (87 DTC 492 (TCC)) and *Munro* ((1992), 47 ETR 5 (QCSC)), that a discretionary power granted to the trustees to distinguish between income and capital items cannot have the effect of recharacterizing an income receipt as a capital receipt. Thus, a taxable dividend (whether deemed or otherwise) cannot be recharacterized by the trustees to permit its allocation to a capital beneficiary.

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Notwithstanding the CRA's views, under general trust principles, an increase to the stated capital of a share is on account of capital and not income. It follows that the deemed income resulting from such increases should be allocable to the capital beneficiaries (unless, as discussed above, income is defined in the trust indenture as income for tax purposes).

## *Alternative Assessing Positions*

An income inclusion under subsection 104(13) requires that an amount be made "payable in the trust's year to the beneficiary." In the circumstances set out in the TI, it could be argued that the payment of the taxable dividend to ULC was not an amount made payable to the beneficiaries. However, the CRA confirmed that it would seek to apply the following provisions as possible alternatives:

**Indirect payments.** Subsection 56(2) provides that a payment (the taxable dividend) made pursuant to the direction of, or with the concurrence of, a taxpayer (the beneficiaries) to some other person (ULC) for the benefit of the taxpayer, or as a benefit that the taxpayer desired to have conferred on the other person, is included in computing the taxpayer's income to the extent that it would be if the payment or the transfer had been made to the taxpayer. In that respect, the CRA considers that all four conditions for the application of subsection 56(2) are satisfied, such that the taxable dividend would be included in the beneficiaries' income. Moreover, in light of the fact that the taxable dividend was not made payable to the beneficiaries, no corresponding deduction would be available to the trust under subsection 104(6).

**Benefits under a trust.** Subsection 105(1) includes in the taxpayer's income the value of all benefits derived by the taxpayer from or under a trust. According to the CRA, there is no requirement that the taxpayer deriving such benefits be a beneficiary of the trust for this provision to apply. As a result, the taxable dividend would be included in ULC's income in the year of payment. In addition, the CRA would seek to apply this rule to the transfer of the Holdco shares to ULC in the event that such transfer fell outside the scope of subsection 107(2.1).

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