BUCHANAN BARRY LLP
CHARTERED ACCOUNTANTS

TAX NEWSLETTER

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TAXATION OF TRUSTS

General Rules

A trust is a taxpayer under the *Income Tax Act* (Canada) (“ITA”), and is deemed by the ITA to be an "individual", so that it must file a tax return, subject to many exceptions to the tax rules that apply to individuals. There is a special return for a trust, the T3, *Trust Income Tax and Information Return*, along with relevant schedules. An estate (after a person's death) is considered a trust for purposes of the ITA.

In many ways, a trust computes its income and taxable income in the same manner as other individuals. For example, it will determine its income from business or property, or taxable capital gains, using most of the same rules that apply to individuals. A trust’s tax payable is computed by applying the relevant tax rates to its taxable income.

Deduction and Flow-through of Income to Beneficiaries

In computing a trust's income, it can normally deduct any income (including taxable capital gains) for the year that is paid or payable to a beneficiary. This amount is then included in the beneficiary’s income.

As a general rule, the beneficiary’s income from the trust is considered generic income from property.

However, in some cases, the trust can designate an amount paid out so that it retains its character to the beneficiary as a different kind of income.

For example, if the trust pays out a taxable capital gain to the beneficiary and makes the appropriate designation, the amount retains its character for the beneficiary as being a taxable capital gain. The flow-through of character can be beneficial if the beneficiary has capital losses available, since such losses can only offset capital gains and not other kinds of income.

Similarly, a trust can designate taxable dividends that it received and pays out to a beneficiary, so that they remain taxable dividends in the beneficiary's hands. An individual beneficiary can then use the gross-up and dividend tax credit mechanism that applies to dividends received from Canadian corporations. A beneficiary that is a Canadian corporation can deduct the dividends in computing its taxable income.

In each case, the trust must provide the beneficiary with a T3, *Statement of Trust Income Allocations and Designations* slip for the year, indicating the amount and type of income distributed to the beneficiary.

Tax Rate of Trust

A "trust" is normally subject to a flat tax rate equal to the highest marginal rate, which is currently 29% for federal tax purposes. With provincial taxes, the combined rate for a trust is resident in Alberta is 40.25% for 2015 (44% for 2016).

However, as discussed above, trust income paid or payable to a beneficiary is normally taxed to the beneficiary rather than the trust. Such income will of course be subject to the graduated tax rates applicable to the beneficiary.

Until the end of 2015, a "testamentary trust" is subject to the same graduated tax rates as other individuals rather than the high flat rate. Generally, a testamentary trust is one that arises upon the death of an individual, including an estate and any trust set up by the deceased's will.

However, starting in 2016, a testamentary trust will be subject to the same flat tax as other trusts. There will be two exceptions, where the graduated rates will continue to apply. The first exception is a "graduated rate estate", which essentially means a deceased's estate for up to 36 months after death. The second exception is a "qualified disability trust", which is generally a testamentary trust with a disabled beneficiary who is entitled to the disability tax credit. As above, trust income paid or payable to a beneficiary will be subject to tax at the beneficiary's graduated tax rates.

Election Available Where Trust Has Loss Carryforwards

As noted, a trust's income that is distributed (paid or payable) to a beneficiary is normally deducted in computing the trust's income and included in the beneficiary's income.

However, a trust can make a special election under which this income remains the income of the trust rather than that of the beneficiary (even though the income has been distributed to the beneficiary). This election is useful where the trust has loss carry-forwards available, which can be claimed against the income. The beneficiary then receives the income tax-free, since it is taxed at the trust level and not the beneficiary level.

> ***Example***
>
> A trust has an unused business loss carryforward of $50,000 from 2013. In 2015, it has $40,000 of income, which it distributes to its beneficiary.
>
> For 2015, the trust can make the special election with respect to the $40,000 distributed to the beneficiary. The $40,000 remains income of the trust, but it can be offset by $40,000 of the trust's loss carryforward (out of the $50,000 available).
>
> As a result, the trust will have no taxable income and pay no tax. Similarly, the $40,000 amount distributed to the beneficiary will be tax-free to the beneficiary.

Note: Beginning in 2016, this special election is available only if the trust's taxable income is *nil*. Basically, this means the trust must use all available "Division C" deductions under the ITA to bring its taxable income down to *nil* – loss carryforwards being the main such deduction. This new rule would not affect the example above, since the trust's taxable income, after applying the loss-carryforward, was *nil*.

Situations Where Beneficiary is Taxed on Income Retained in Trust

There are two situations under which the trust gets a deduction for its income that is not distributed to a beneficiary and thus retained in the trust. In these cases, the income is taxed to the beneficiary rather than the trust.

First situation: Where a trust has a "preferred beneficiary". Basically, this means a disabled beneficiary who is the settlor of the trust, the spouse or common-law partner of the settlor, or a child, grandchild or great grandchild of the settlor.

The trust and the preferred beneficiary can jointly elect in a taxation year for any of the beneficiary's share of the trust income for the year to be included in the beneficiary's income rather than the trust. This election can be useful where the beneficiary's average tax rate is lower than that of the trust, which will often be the case.

Second situation: This situation deals with a trust where a beneficiary is less than 21 years of age. In this case, if the beneficiary's right to trust income in a year is "vested" in the beneficiary but is not distributed to the beneficiary in the year, it is included in the beneficiary's income rather than the trust's income. The right must vest unconditionally, or with the sole condition being that the beneficiary must survive to an age not exceeding 40.

Tax Instalments

A trust is generally required to make quarterly instalments of tax, if its net tax for the taxation year and one of the two preceding years exceeds $3,000 ($1,800 federal tax for trusts resident in Quebec).

For 2015, a testamentary trust is not required to make instalments. However, beginning with the 2016 taxation year, testamentary trusts other than graduated rate estates (see above) will be required to make instalments.

Regardless of the kind of trust, current Canada Revenue Agency ("CRA") administrative policy is not to impose either interest or penalty on a trust for unpaid or under-paid instalments, so many trustees ignore the requirement to pay instalments.

Taxation Year

As of 2016, trusts must generally have a taxation year that coincides with the calendar year. However, a graduated rate estate can use an off-calendar year end.

TRANSFER OF DIVIDEND TO HIGHER INCOME SPOUSE

Treatment of Taxable Dividends

If you receive a taxable dividend from a Canadian corporation, you must "gross-up" the dividend by a percentage and include that grossed-up amount in your income. However, you are then entitled to a dividend tax credit, which is roughly meant to credit you for tax paid at the corporate level on the income from which the dividend was paid.

The gross-up and dividend tax credit mechanism results in taxable dividends being subject to a lower tax rate in your hands than ordinary income.

For example, for an individual resident in Alberta in 2015, the highest marginal tax rate on "eligible dividends" (combined federal and provincial) is 21.02%, whereas the highest marginal tax rate on non-eligible dividends is 30.84%. In contrast, the highest marginal tax rate on regular income is 40.25% in 2015 for the same individual.

In very general terms, an eligible dividend is paid out of a corporation's business income that was subject to the general corporate tax rate and **not** the lower preferential rate that applies to small business income. A non-eligible dividend includes a dividend paid out of income that was subject to the small business rate, which applies to the first $500,000 of active business income of a Canadian-controlled private corporation.

The dividend tax credit is not refundable. It can reduce your tax to zero, but not lower. (It can generate a refund of instalments or source deductions you paid, but only to get your tax for the year down to zero.) It cannot be carried forward or back to another year. In other words, you either use it or lose it.

Transfer of Dividend to Spouse or Common-law Partner

However, there may be relief where a lower-income spouse (or common-law partner) may not be able to use the dividend tax credit, or where the credit will only save a nominal amount of tax. In such case, the lower-income spouse can transfer the dividend to the higher-income spouse, who may be able to use the credit and save tax.

Basically, the spouses can elect that the dividend (and dividend tax credit) be transferred to the higher-income spouse, if the exclusion of the dividend from the lower-income spouse's income either creates or increases the spousal tax credit for the higher-income spouse. The federal spousal credit for 2015 is:

> 15% of ($11,327 minus your spouse's income for the year)

As such, the credit for a higher-income spouse is eliminated once the lower-income spouse's reaches $11,327. Put another way, the higher-income person's spousal tax credit can be created or increased only if the lower-income person's income is pushed below that number. The parties must determine whether the transfer of the dividend to the higher-income spouse saves tax overall.

Example (involving federal tax only)

In 2015, Bill has ordinary income of $5,327 and he also receives a grossed-up eligible dividend of $6,000. He is in the lowest federal tax bracket of 15%.

His spouse Joanne is in the 22% federal tax bracket and the transfer of the dividend to her would keep her in the 22% bracket.

They want to know whether they should make the election to transfer the dividend to Joanne.

Result without the election: Bill would pay no tax because the personal credit amount ($11,327) would fully offset the tax otherwise payable on his income. The dividend tax credit could not be used.

Joanne would get no spousal tax credit and no dividend tax credit.

Result with the election: Bill would still pay no tax because of his personal credit amount.

Joanne would include the $6,000 grossed-up dividend in income. The initial federal tax payable on that amount would be $1,320 (22% of $6,000). She could claim a dividend tax credit equal to 15.02% of the grossed-up dividend, equal to $901. Furthermore, her spousal credit would equal 15% of ($11,327 minus $5,327), or $900. Her overall federal tax savings would be: $901 + $900 − $1,320 = $481. Therefore, the election would be advantageous in this case.

SHAREHOLDER LOANS

General Rule

If you are a shareholder of a corporation or “connected” with a shareholder of a corporation, and you receive a loan from the corporation, you may be required to include the **entire** principal amount of the loan in your income under the “shareholder loan” provisions of the ITA. In most cases, you will be connected with a shareholder if you do not deal at arm’s length with the shareholder. In turn, you will not deal at arm’s length with a shareholder if you are "related" to the shareholder (as defined in the ITA).

Obviously, the rule can be quite harsh. The basic intent of the rule is to prevent shareholders of private corporations from extracting funds tax-free from their corporations in the form of loans, which might not be repaid for a long time, if at all.

Exceptions

Fortunately, there are exceptions where the shareholder loan rule does not apply.

1) The rule does not apply if you repay the loan in full within one year after the end of the corporation’s taxation year in which you received the loan, as long as the repayment is not a series of loans and repayments. For example, if the corporation has a taxation year ending every March 31 and you received a loan in April 2014, you could repay it by March 31, 2016 and the rule would not apply. In this example, you can see that the repayment period can actually be close to 2 years.

2) Another exception applies if the corporation provides you with the loan in the course of its money-lending business, and *bona fide* arrangements are made for the repayment of the loan within a reasonable time. For example, if you are a shareholder of and work for a bank or trust company or credit union, you can normally qualify for this exception.

3) The other main exception applies to shareholders who are also employees of the corporation. The exception varies, depending on whether you are a “specified employee” of the corporation. If you are **not**, this exception can apply if you receive the loan in your capacity as employee (rather than shareholder) and *bona fide* arrangements are made for the repayment of the loan within a reasonable time. If you **are** a specified employee, further criteria must be met – the loan must be used for one of the following purposes:

    - To purchase new shares from the corporation;
    - To purchase a home or other dwelling in which you will reside; or
    - To purchase a car to be used for employment purposes.

For these purposes, a “specified employee” includes an employee who owns at least 10% of the share of any class in the corporation, or who does not deal at arm’s length with the corporation. Furthermore, for the purposes of the 10% threshold rule, you are deemed to own shares owned by any person not dealing at arm's length with you – for example, your spouse, your children, another corporation that owns the shares, among others.

In terms of the "in capacity as employee" test, the CRA takes the general view that the test will be met if all other employees at your level receive the same opportunity to receive a loan from the corporation. In all cases, it will depend on the facts.

Deduction for repayment

If the rule applies and you are required to include the loan in your income, you get a deduction in the year in which you repay the loan. You get a partial deduction if you repay part of the loan.

Deemed Interest Rule (if Shareholder Loan Rule Does not Apply)

If the shareholder loan rule does not apply because you fall within one of the exceptions, you may still be taxed on a benefit from "deemed interest", if the loan is made at a rate that is less than an arm's length commercial rate (one that would apply if the corporation was in the money lending business). Basically, where this rule applies, you will be required to include the prescribed rate of interest on the loan while it is outstanding.

However, the inclusion will be reduced to the extent you pay interest for the year or by January 30 of the following year. Therefore, if you pay the prescribed rate of interest that applied throughout the year, there will be no net inclusion. For these purposes, the prescribed rate is set every calendar quarter, and it is 1% for the current quarter and has been that rate for several quarters.

AROUND THE COURTS

Losses from Sports Blog Deductible as Business Losses

If you run a business that includes a personal element, you can deduct any business losses from all sources of income. On the other hand, if your activities do not constitute a business, any losses will normally be considered personal or without a source of income, which means they are not deductible.

In the recent *Berger* case, Howard Berger had been employed as a sports journalist on the Toronto "Fan 590" sports radio station. For about 20 years, he had two program slots each day, and developed a solid following for his hockey insights, particularly with respect to the Toronto Maple Leafs.

The radio station had a management change and laid off several employees. The taxpayer felt his job might be in jeopardy. Accordingly, he devised a plan so that, if he lost his job, he would continue to write a hockey sports blog and make a living doing that. For 5 years he wrote the blog. Unfortunately, his employment was subsequently terminated.

In the first couple of years after his employment, Berger continued the sports blog and incurred losses in doing so. The losses resulted largely from his travel expenses incurred in travelling with and following the Maple Leafs, including airfare, and car and hotel costs. There were other incidental expenses. He did not charge subscription fees for his blogs. Instead, he thought he would eventually attract sponsors and advertisements, which would allow him to make a profit. During the two years in question, he had only one sponsor. However, he notified about 500 hockey insiders of his blog, including well-known hockey analysts like Don Cherry and Ron MacLean.

In the meantime, Berger deducted the losses in the first two years as business losses. The CRA re-assessed the taxpayer on the grounds that he was not carrying on a business.

On appeal, the Tax Court of Canada allowed Berger's appeal and the deduction of the losses. The Tax Court judge reviewed the following factors to determine that Berger's blogging was a business:

- There was sufficient "commerciality" to his blogs, even though there was a personal element;
- There was enough evidence to show that he intended to profit, even though he did not make a profit in the two years in question;
- Berger had significant training as a sports journalist and therefore sufficient business knowledge in the area; and
- Although the judge was not convinced that the blogs would ever turn a profit, he felt that Berger had a predominant intention to make a profit, and in the first two years he behaved in a reasonable businesslike manner to pursue that end.

As a result, the judge held that a business existed, and Berger's blogging losses were deductible.

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