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1. Introduction

Trusts are vehicles through which property is managed and administered for the benefit of others, and are established for both tax and non-tax reasons. Trusts provide individuals with the benefits of property ownership in circumstances where they are unable to manage the property personally: a trust may be set up for beneficiaries who lack business knowledge, for minors or for incompetent persons who are incapable of managing their affairs.

Historically, trusts have been prevalent in the common law jurisdictions of Canada. The province of Quebec, a civil law jurisdiction, formalised the trust concept in its 1994 Civil Code. This chapter summarises the principles governing the taxation of personal trusts and their beneficiaries under the Canadian Income Tax Act.[1] The provisions applicable to the taxation of trusts have been designed to neutralise the effect of the interposition of the trust, with a view to equating its circumstances where property is being held directly by the contributors to the trust or the beneficiaries of the trust. The basic framework for the taxation of personal trusts and their beneficiaries is found in Sections 104 to 108 of the Income Tax Act. On the one hand, it attempts to ensure that income or capital gains of a trust are taxed either at the trust level or in the hands of its beneficiaries. On the other hand, losses or capital losses of a trust are recognised for tax purposes only in the trust. Special rules attempt to ensure that the Canadian tax net is not avoided where non-resident trusts or beneficiaries are involved.

2. Who is liable for tax in Canada?

2.1 Residents

Canadian residents – whether individuals, corporations or trusts – are taxable on global income regardless of the source, subject to foreign tax credits that may be available. Taxation in Canada is based on residency, a concept which refers to the legal and economic link of a person to Canada. An individual who is physically present in Canada for 183 days or more throughout the year is generally a 'deemed resident' of Canada under the Income Tax Act; in certain circumstances, an individual may be considered ordinarily resident in Canada under the common law.

[1] RSC 1985, as amended. References to the act do not include legislation not yet in force unless otherwise indicated.

2.2 Non-residents

Non-residents of Canada are subject to tax under the Income Tax Act generally either under Part I in respect of taxable income earned in Canada or under Part XIII in respect of withholding tax on amounts paid or credited to them.[2] To be taxable under Part I of the act, a non-resident must have been employed in Canada, have carried on business in Canada or have disposed of taxable Canadian property in that year or in any previous year. If a person has never been resident in Canada, Part I tax is most likely to become applicable by a disposition of 'taxable Canadian property'. Non-residents are subject to withholding tax under Part XIII of the act on a variety of payments derived from Canadian sources, including:

- interest (subject to exceptions);
- dividends (including capital dividends);
- income from trusts and estates (including gains from the disposition of taxable Canadian property);
- rents and royalties;
- most pensions;
- death benefits;
- certain unemployment insurance payments;
- retirement compensation payments and allowances; and
- payments under registered retirement savings plans or registered retirement income funds, registered education savings plans, deferred profit sharing plans and the income component of other annuity payments.

3. General tax concepts applicable to trusts

3.1 Definition of 'trust'

Section 104(1) of the Income Tax Act provides that a reference to a trust or estate is to be read as a reference to the trustee or the executor, liquidator (in Quebec), administrator, heir or other legal representative having ownership or control of the trust property. This is an interpretational guide as opposed to an express definition – one must have recourse to principles of ordinary law in order to determine whether a trust relationship exists. Assuming that a trust exists, the act deems a trust to be an individual for tax purposes. If two or more trusts have received substantially all[3] of their property from one individual, and the trusts are set up so that the income therefrom accrues or will ultimately accrue to the same beneficiary or group or class of beneficiaries, the minister of finance may designate such trusts to be a single individual for tax purposes.[4] This does not apply to trusts each of which has distinct beneficiaries.

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[2] Upon becoming a non-resident of Canada, an individual is deemed to have disposed of all capital property. Section 128.1(4)(b) of the Income Tax Act permits emigrants from Canada to elect to post security with the Canada Revenue Agency to defer the payment of tax that results from the deemed disposition of property, without interest, until the property is actually sold. It is significant that the February 1998 budget introduced the treatment as a non-resident of any individual who would otherwise be resident in Canada but who, after 24 February 1998, has become entitled under a tax treaty, as a resident of another country, to an exemption from or reduction in Canadian income tax.

[3] The Canada Revenue Agency takes the position that 'substantially all' means 90% or more.

[4] Section 104(2). In a technical interpretation dated 20 May 1993, the Canada Revenue Agency indicated that Section 104(2) would not apply in situations where:

- a parent settles two trusts;
- each of the trusts has one of the settlor's children as the beneficiary;
- each trust holds different property; and

The effect of deeming a trust to be an individual for tax purposes is to subject trusts to those provisions in the act dealing with individuals (with certain exceptions), as well as those provisions dealing specifically with trusts.

3.2 Types of personal trusts

Generally speaking, the most commonly encountered types of personal trust are:

- testamentary trusts, usually established on the death of a testator for the benefit of a deceased's spouse, descendants or both; and
- *inter vivos* trusts, established by a settlor during his or her lifetime, often for the benefit of a spouse, children, spouse and children, or for some other specific purpose.

A testamentary trust arises as a result of the death of an individual, usually under the terms of a will.[5] Prior to 1 January 2016, testamentary trusts had a significant tax advantage over *inter vivos* trusts, as a testamentary trust was subject to tax at the graduated marginal rates applicable to individuals. In addition, a testamentary trust could have a taxation year that did not coincide with the calendar year.

In the 2014 federal budget, the government announced proposed changes to eliminate the preferential treatment of testamentary trusts over *inter vivos* trusts. Following consultations with industry groups, including the Society of Trust and Estate Practitioners Canada, amendments to the Income Tax Act were introduced that, among other things,[6] eliminated the graduated rate taxation of testamentary trusts, subject to two exceptions:

- neither trust is revocable and the settlor has no powers after the settlement of the trusts concerning any aspect of either trust or the property held by the trusts.

However, in 2002 the Canada Revenue Agency took the position that the section could apply to overlapping beneficiaries. Further, beginning in 2016, as discussed below, the purpose of this provision – to prevent the multiplication of testamentary trusts with the same beneficiaries to multiply the graduated rates – is no longer relevant.

[5] A 'testamentary trust' is defined in Section 108 of the Income Tax Act. In addition to a trust arising under a will, it includes a trust created under an order relating to provincial dependants' relief legislation. However, if property is transferred to what would otherwise be a testamentary trust by someone other than the deceased on or after the deceased's death or as a consequence thereof, the trust is disqualified as a testamentary trust and becomes an *inter vivos* trust for tax purposes. (See below regarding the 2016 amendments to the taxation of testamentary trusts, which have essentially eliminated the preferential tax treatment of testamentary trusts.)

[6] The new rules, effective from 1 January 2016, also eliminated the following benefits previously enjoyed by testamentary trusts:

- exemption from income tax instalment rules;
- exemption from the requirement to have a calendar taxation year;
- exemption in computing alternative minimum tax;
- preferential treatment under Part XII.2 of the act;
- the ability automatically to qualify as a personal trust; and
- the ability to make investment tax credits available to a trust's beneficiaries.

The amendments initially included provisions regarding the taxation of the capital gain arising in a testamentary spousal trust on the death of the life tenant spouse that shifted the tax burden to the estate of the life tenant spouse. However, after a series of consultations, on 15 January 2016 the Department of Finance announced amendments to the new rules that effectively ensured that the life tenant spouse's estate would not be liable for the tax on the deemed disposition of the assets in the testamentary spousal trust.

- Graduated rates will apply for the first 36 months of an estate that arises on, and as a consequence of, an individual's death;[7] and
- Graduated tax rates will continue to apply in respect of testamentary trusts for the benefit of disabled individuals who are eligible for the disability tax credit.[8]

Following the first 36 months of a graduated rate estate, any further income arising in the estate and not allocated to a beneficiary will be taxed in the estate at the highest marginal tax rate.

An *inter vivos* trust is, for tax purposes, any trust other than a testamentary trust. The income that arises in an *inter vivos* trust is taxed at the maximum individual tax rate for the year, unless allocated to a beneficiary and taxed in the beneficiary's hands. In addition, settlors of and contributors to *inter vivos* trusts may be subject to various attribution rules in the Income Tax Act, such as Section 75(2).

The term 'settlor' is used in the Income Tax Act for both testamentary and *inter vivos* trusts.[9] Trusts with special terms to benefit the settlor, a spouse, a common law partner or a combination may qualify for a rollover of assets to the trust[10] and deferral of the capital gains tax until the death of the beneficiary or joint beneficiaries. These trusts are generally referred to as spouse trusts,[11] alter-ego trusts and joint partner trusts.[12]

3.3 Transfer of property to a trust

Except with respect to spouse trusts, alter-ego trusts and joint partner trusts, when a trust is created and property is transferred to the trust, the contributor generally is treated as having disposed of the property at its fair market value at that time, and is taxable on any capital gain that arose as a result. The trust is deemed to have acquired the property at the same amount.[13] Thereafter, except

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[7] To be eligible for the graduated rates in the first 36 months and certain other tax benefits, an estate will be required to fit the definition of a 'graduated rate estate' in Section 248(1) of the act.

[8] Where the beneficiary is disabled, there may be an opportunity for the trust to have access to the graduated rates if the trust meets the definition in Section 122 of the act. This is particularly important for disabled beneficiaries who receive government benefits.

[9] Section 108(1) provides that a settlor of a testamentary trust means the individual by virtue of whose death the trust arises. In the case of an *inter vivos* trust, it means the person who created the trust, provided that the fair market value of the property contributed by him or her exceeds the fair market value of the property contributed by all other persons at any time. The value of contributed property is determined by reference to the time the various contributions are made. The act also provides for situations where an individual and his or her spouse are the creators of the trust. In that case, it is their joint property contributions that are weighed against contributions by other persons.

[10] This is also the case with respect to assets left to a testamentary spouse trust; the taxation of the capital gains on the death of the testator is deferred to the later of the disposition of the assets and the death of the spouse.

[11] Section 70(6) for testamentary trusts and Section 73(1.01) for *inter vivos* trusts require that, among other things, all trust income be paid to the spouse, and that during the spouse's lifetime no distributions of capital be made to anyone other than the spouse.

[12] Section 73(1.02) requires that, among other things, the settlor have attained 65 years of age at the time the trust is settled.

[13] However, if the transfer is made for proceeds which are less than the fair market value of the property (but the transfer is not a gift), the cost to the trust of the property will be equal to the amount paid to acquire it. This is so despite the fact that the transferor will be deemed to have disposed of the property for proceeds equal to its fair market value. Double taxation may result.

with respect to a spouse, alter-ego or joint partner trust, there will be a deemed disposition of the property every 21 years pursuant to Section 104(4) of the act.

3.4 Residence of a trust in Canada

The residence of a trust is determined with reference to the residence of those who have control over the trust property. Prior to 2009, the leading Canadian case for determining the residence of a trust was *Thibodeau Family Trust v The Queen*.[14] Two decisions[15] released in the autumn of 2009 and subsequently upheld on appeal, found that the appropriate test to determine the residence of a trust is similar to the common law test for residency of a corporation – namely, "where the central management and control actually abides".[16] It is the position of the Canada Revenue Agency that the residence of a trust is a question of fact, and a determination of residence of the trust is made by reference to the trustee(s), executor(s), administrator(s), heir(s) or other legal representative(s) who manage the trust or control the trust's assets, and not merely by reference to the location where the majority of the trustees reside. Therefore, if an intention exists to establish a trust's residence in a specific jurisdiction, the trust must be organised and conducted in such a way as to settle the issue with reasonable confidence.

3.5 Taxation of trusts in Canada

A trust resident in Canada is taxed on its worldwide income pursuant to Section 2(1) of the Income Tax Act. Except with respect to spouse trusts and alter-ego or joint partner trusts, when establishing a trust, the contributor will be treated as having made a disposition to the trust at the deemed fair market value of the property and the trust will be deemed to have acquired such property at the deemed amount. Thereafter, as mentioned, there will be a deemed disposition of the property every 21 years. Income earned and retained by a trust is taxed in the trust. Income payable[17] from a trust to a beneficiary is taxed in the hands of the beneficiary. A trust may generally deduct an amount that is payable to a beneficiary from its taxable income and may also deduct amounts paid out of the income of the trust for upkeep, maintenance or taxes of or in respect of property that, under the terms of the trust arrangement, is required to be maintained for the use of the life tenant. Deductions and losses of a trust cannot be flowed out to beneficiaries, but must be claimed at the trust level.

An exception from the trust's ability to deduct amounts payable to beneficiaries is found in Section 104(7) of the act. This section provides that neither resident nor non-resident trusts will be eligible for a deduction in computing their income under Section 104(6) in respect of amounts payable to designated beneficiaries under Section 210 of the act. The effect of this exception is that a designated beneficiary's share of taxable income earned by the trust in Canada will be subject to Canadian income tax in the trust. Were it not for this provision, income earned in Canada by a non-resident trust could be

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[14] 78 DTC 6376 (Federal Court – Trial Division).

[15] *Garron v The Queen*, 2009 DTC 1287 (Tax Court of Canada), affirmed 2010 FCA 309, affirmed 2012 SCC 14; and *Antle v The Queen* and *Renee Marquis-Antle Spousal Trust v The Queen*, 2009 DTC 1732 (Tax Court of Canada), affirmed 2010 FCA 280.

[16] Garron, para 162. See 19 September 2014 Income Tax Folio S6-F1-C1, Residence of a Trust or Estate. This income tax folio replaces and cancels Interpretation Bulletin IT-447, Residence of a Trust or Estate.

[17] Pursuant to Section 104(24), an amount shall be deemed not to have become 'payable' to a beneficiary in a taxation year unless it was paid in the year to the beneficiary or the beneficiary was entitled in the year to enforce payment of the amount.

paid to a designated beneficiary with the result that neither the non-resident trust nor the beneficiary would be subject to Canadian income tax on the amount of income earned by the trust in Canada. The term 'designated beneficiary' is defined to include a non-resident person, a non-resident owned investment corporation, certain tax-exempt entities and certain partnerships and trusts.

Section 104(7.1) is an anti-avoidance provision which will operate where it is reasonable to consider that one of the main purposes for the existence of any term, condition, right or other attribute of an interest in a trust is to give a beneficiary a percentage interest in the property that is greater than its interest in the income of the trust. If these circumstances exist, no amount may be deducted under Section 104(6)(b) of the act.

For withholding tax purposes, payments from a trust are deemed to be payments of income unless they are distributions of capital. Although, in general, references in the act to trust capital refer to capital in the trust accounting sense, amendments to the act make it clear that capital gains and capital dividends received by a non-resident beneficiary are intended to be taxable.[18] Withholding tax on payments from a resident trust to a non-resident beneficiary generally applies whether the trust derived the income from Canadian or foreign sources. Withholding tax is generally levied on the gross amount without deductions, although exceptions apply for payments from a Canadian resident trust which has a non-capital loss carry-forward which can be used to shelter part of the payment, and in respect of rents and timber royalties if the non-resident elects to pay tax on such amounts under Part I of the act as if resident in Canada.

3.6 Taxation of capital distributions to beneficiaries

In general, a distribution by a personal trust of trust property to a capital beneficiary resident in Canada in full or partial satisfaction of the beneficiary's capital interest in the trust takes place on a tax-deferred basis.[19] A 'capital interest' is defined as a right (whether immediate or future, and whether absolute or contingent) to receive all or any part of the capital of the trust. On such a distribution, the trust is deemed to have disposed of the property at its cost amount, and the beneficiaries are deemed to acquire the property at the same amount. Under Sections 107(2) and (5) of the act, a trust can transfer property to a non-resident beneficiary in satisfaction of a capital interest on a tax-deferred or rollover basis in respect of only certain limited types of property, such as Canadian real property. With few exceptions, where a Canadian resident trust distributes taxable Canadian property to a non-resident beneficiary in satisfaction of the beneficiary's capital interest, it will be considered to have disposed of the property (and the non-resident beneficiary to have acquired it) for proceeds equal to the greater of fair market value and the cost of the property to the distributing trust. This rule is intended to ensure that accrued gains on property held in a Canadian trust are taxed on the distribution of the property to a non-resident and that unrealised losses cannot be triggered.

Certain types of property, however, can still be distributed on a tax-deferred basis to a non-resident beneficiary. These types of property include:

[18] Amendments to Section 212(1)(c) made in 1988 provided that Part XIII tax may apply to certain capital distributions and 1991 amendments ensure that capital dividends will be subject to Part XIII tax.

[19] To understand the provisions of Section 107, one must distinguish between the adjusted cost base of the capital interest under Section 107(1), the adjusted cost base of the capital interest otherwise determined, the cost amount of the capital interest under Section 108(1) and the cost amount of the property in the trust under Section 248.

- real property situated in Canada;
- Canadian resource properties;
- timber resource properties;
- property of a business carried on through a permanent establishment in Canada;
- rights to receive amounts under deferred plans;
- rights to certain benefits under employee profit-sharing plans, employee benefit plans, employee trusts and salary deferral arrangements;
- certain property of short-term residents;
- employee stock options;
- interests in specified trusts, generally linked to employee compensation;
- interests in personal trusts resident in Canada not acquired for consideration;
- interests in non-resident testamentary trusts not acquired for consideration;
- interests in life insurance policies, other than interests in segregated fund policies; and
- certain property of a short-term non-resident.

3.7 Attribution

Pursuant to Section 75(2) of the act, where property is held in a trust on the condition that it may revert to the person from whom it was received, any income or gain from the property will be attributed to that person while resident in Canada.[20]

3.8 Flow-through provisions

Provided that certain requirements are met, where a trust's income is distributed to a beneficiary or otherwise included in the income of the beneficiary, some types of income, such as interest and capital gains, retain their character for the purposes of determining the beneficiary's resulting tax liability. Sources of income not otherwise prescribed do not retain their character when distributed to the beneficiaries and are taxed as ordinary income from property, the 'property' being the trust interest. Dividends received from Canadian resident corporations and capital gains realised by the trust which are included in the income of the beneficiary will, to the extent so designated in the trust's tax return for the year, constitute dividends and capital gains, respectively, to the beneficiary. This allows the individual to experience the same tax treatment as if he or she had earned the income directly. In the case of dividends, the beneficiary would be subject to the normal gross-up and dividend tax credit regime, and in the case of capital gains, would have only one-half of the gain included in income.[21] The Income Tax Act also contains provisions dealing with the flow-through of pension benefits, deferred profit-sharing plan benefits and death benefits received by a trust and passed out to its beneficiaries.

Section 212(1)(c) provides that amounts paid or credited to a non-resident as income of, or from, an estate or trust will be subject to a withholding tax of 25%, to the extent that such amount would be included as income under Part I if that

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[20] If Section 75(2) applies to a trust, the property cannot be rolled out of the trust to the resident beneficiaries at the trust's adjusted cost base (Section 107(4.1)). This is significant when planning for the deemed disposition at the 21st anniversary.

[21] The provision which gives the trustee the power to designate that a beneficiary has incurred a taxable capital gain does not deal with the source of the beneficiary's receipt. In the absence of any statutory provision, some attempt at tracing must be made, and it is imperative that receipts and disbursements of the trust be properly recorded.

non-resident were a resident.[22] Reductions to the 25% withholding tax requirement under a tax treaty will generally fall under the 'other income' article in the treaty.[23] Section 108(5) of the act provides that, except for specific flow-throughs as provided in the act, an amount payable to a beneficiary of a trust shall be deemed to be income in the year from an interest in the trust and not from any other source. Section 212(11)[24] in Part XIII of the act is the counterpart of Section 108(5)(a) in Part I of the act with respect to withholding tax; however, there are no flow-through provisions in Part XIII of the act. Instead, certain items of income are exempt from the application of Section 212(1)(c) of the act. For the purpose of Section 212(1)(c) of the act, Section 212(11) provides that an amount paid by a trust to a beneficiary is deemed to be paid as income of the trust.

As a result of these provisions, income paid to a non-resident beneficiary loses its character when it is paid out from a trust resident in Canada, unless it is paid to a beneficiary under a mutual fund trust[25] or is within the limited exclusions of Section 212(9).[26]

Pursuant to Section 212(2)(b) of the act, a capital dividend paid (or an amount distributed by a trust that may reasonably be considered to relate to a capital dividend) to a non-resident of Canada is subject to Part XIII withholding tax.

4. Emigration of trusts

Since the mid-1990s, Canada has implemented a comprehensive departure tax, which also has application to personal trusts. Since 1972, capital gains have been taxed in Canada. Gains realised in respect of all types of property by residents of Canada are subject to tax, but the Income Tax Act taxes non-residents (who are not carrying on business in Canada) primarily in respect of gains realised from the disposition of taxable Canadian property.[27] In contrast

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[22] Where such amount is deemed by Section 104(21) to be a taxable capital gain of a non-resident investor in a mutual fund trust, withholding taxes will not apply.

[23] See, for example, Article XXII(2) of the Canada-US Tax Treaty.

[24] With respect to treaty application, the Canada Revenue Agency's position is that in determining whether an amount will be considered capital or income for purposes of applying a treaty, reference will be made to Section 212(11) of the Income Tax Act. Therefore, the amount paid from the trust to the beneficiary will be deemed an amount paid as income of the trust regardless of the source from which the trust derived the funds.

[25] Section 104(21)(a)(I). Some questions remain with respect to the use of Section 104(21) with mutual fund trusts.

[26] Section 212(9) provides an exemption from withholding tax under Part XIII of the Income Tax Act to the extent that a trust's income is received from non-resident owned investment corporations, or certain artistic royalties are paid or credited to a non-resident beneficiary under the trust. The exemption will also apply with respect to all interest allocated to a non-resident beneficiary that is received by a mutual fund trust maintained primarily for the benefit of non-resident beneficiaries, provided that no Part XIII tax would have been payable on the interest had it been paid directly to the non-resident.

[27] Amendments to the definition of 'taxable Canadian property' have excluded shares of corporations and interests in partnerships or trusts (other than an income interest in a trust resident in Canada) if such shares or interests do not derive more than 50% of their fair market value from real or immovable property situated in Canada, Canadian resource or timber resource property, and options in respect of or interests in the foregoing, at any time during the 60-month period prior to the relevant time (usually the time of disposition). This measure aligned Canada's domestic tax rules with Canada's tax treaties, so that generally exempt shares and interests in partnerships or trusts will be excluded from the definition of taxable Canadian property, from Canadian taxation and from the

to most other countries that include capital gains in their tax base, Canada taxes not only actual dispositions, but also deemed dispositions. Since 1972, individuals who have emigrated from Canada have been deemed to have disposed of all of their property, except taxable Canadian property and certain other types of property that would continue to be taxed in Canada. The deemed disposition tax ensures that taxes are imposed at the time of emigration, since Canada loses the right to impose tax in the future. Tax treaties, however, have always limited Canada's right to tax capital gains realised by non-residents except as they relate to real property situated in Canada. The treaties may also limit Canada's right to tax gains realised by a non-resident who was previously a resident of Canada in respect of the portion of the gains accrued during the time when that person was resident in Canada. Past rules even permitted an emigrant individual to elect to treat non-taxable Canadian property as taxable Canadian property, with the result that, with proper planning, gains in respect of taxable Canadian property not primarily attributable to real estate and non-taxable Canadian property could escape Canadian taxation. Pursuant to Section 128.1(4)(b), an individual or trust that emigrated from Canada after 1 October 1996 is treated as having disposed of all property for its fair market value and then to have reacquired the property at a cost equal to that value. All accrued gains and losses are realised and subject to tax. This provision applies to all property other than real property situated in Canada, interests in trusts resident in Canada and certain other minor exceptions. As a result, shares which are taxable Canadian property are no longer exempted and one can no longer elect that any property be exempted. Posting of security to defer payment of tax is permissible.

5. Transfers to a trust

5.1 General rule

The general rule, set out in Section 69(1)(b), is that, except as otherwise provided, the proceeds of a disposition arising from an *inter vivos* gift, or a disposition either for no consideration or for consideration less than fair market value to a person whom the transferor did not deal at arm's length, are the fair market value of the property transferred. The Canada Revenue Agency's position has been that it is a question of fact whether a settlor or beneficiary deals at arm's length with a trust. Section 251(1)(b) mandates that a taxpayer and a trust will be deemed not to deal with each other at arm's length where the taxpayer, or any person not dealing at arm's length with the taxpayer, is beneficially interested in the trust. Accordingly, it is possible that if a taxpayer is one of many beneficiaries under a discretionary trust, but has no connection with or influence over the trustees, the taxpayer will nevertheless be considered not to deal at arm's length with the trust.

Under Section 248, a transfer of property to a trust or a transfer of property from a trust to a beneficiary under the trust is a disposition, unless the transfer resulted only in a change in the legal ownership of the property, without any change in the beneficial ownership of the property, other than a transfer by a trust resident in Canada to a trust not resident in Canada.

5.2 Qualifying dispositions

Section 116 clearance certificate procedures for dispositions of taxable Canadian property after 4 March 2010.

Although a transfer to a trust will generally be regarded as a disposition, if the disposition is a 'qualifying disposition', there should be no adverse tax consequences to the transferor. A 'qualifying disposition' is defined in Section 107.4(1) as a disposition of property where a long list of conditions are met, including that because of the disposition, there is a change in the legal ownership of the property that does not result in a change in the beneficial ownership of the property. A qualifying disposition will also include a division of trust assets to other trusts, provided that there is no change in the economic interests of the beneficiaries.

The beneficial tax consequences of a qualifying disposition are that the transferor is deemed to have received proceeds of disposition equal to the cost amount of the property. The cost of the property for the trust is the same as the transferor's proceeds of disposition reduced by certain stop-loss rules that would affect the transferor if the property had been disposed of at fair market value by the transferor at the time. With respect to depreciable property or eligible capital property, the transferee is put in the same position as the transferor if the transferee subsequently disposes of the property.

6. Taxation of non-resident trusts and foreign investment entities

6.1 Non-resident trusts

In certain instances, a non-resident trust is treated as a resident of Canada and is therefore liable for tax in Canada on its income as a resident. Since 1999, numerous versions of draft legislation regarding non-resident trusts were proposed by the federal minister of finance. New rules were enacted in June 2013, with application to taxation years after 2006. Amended Section 94 of the Income Tax Act restricts the use of offshore trusts as a means of limiting or deferring the payment of tax in Canada.[28] Generally, where a trust that is otherwise not resident in Canada has a Canadian resident contributor or a Canadian resident beneficiary, it will be deemed to be resident in Canada and liable to tax under Section 94(3) of the Income Tax Act.

Under the non-resident trust rules,[29] a 'resident contributor' is defined as a person who is a resident of Canada at the relevant time and has made a contribution to the non-resident trust at or before that time. The definition of 'contribution' is broad and can include a loan or a deemed transfer.

A non-resident trust will also be liable for Canadian tax under Section 94 if, at the end of the trust's year, there is a resident beneficiary. Determination of whether a non-resident trust has a resident beneficiary involves a two-pronged test – whether there is a resident beneficiary and whether there is a connected contributor:

- A 'resident beneficiary' is a person (other than a 'successor beneficiary' or an 'exempt person', as set out in Section 94(1)) who is a beneficiary of the non-resident trust and a resident of Canada.
- A 'connected contributor' is any person that is a contributor to the non-resident trust, unless the person made all of his or her contributions to the trust at a 'non-resident time'. A contribution will generally be considered to have

[28] Until 2015, an exception was available for 'immigration trusts', which were trusts established by an immigrant to Canada for the first five years following immigration. The February 2014 federal budget eliminated immigration trusts.

[29] The non-resident trust rules are lengthy and complex. For a comprehensive discussion, see Chapter 18 of *Miller Thomson on Estate Planning* by John M Campbell. See also Mary Anne Bueschkens and Rae Rechtsman, "Recent changes in Canada in the areas of trusts and estates law", *Trusts & Trustees*, Volume 21, No 1&2, February/March 2015, at 117–132.

been made at a non-resident time if the person was not a resident of Canada at the time of the contribution and throughout 60 months prior to and after making the contribution.

When caught by the deeming provisions of Section 94, the non-resident trust is deemed to be resident in Canada throughout the taxation year for purposes of computing its income and determining the liability for tax for that taxation year. In addition, each person who is at any time in the particular taxation year a resident contributor to the non-resident trust, or a resident beneficiary of the non-resident trust, is jointly and severally liable for the trust's tax in Canada.[30]

Canadians with family members outside Canada may be able to benefit from non-resident trusts without engaging the non-resident trust rules. If, for example, a parent or grandparent who has never been a resident of Canada establishes an *inter vivos* or testamentary trust for a Canadian resident, the trust, if drafted and established properly and administered outside of Canada, would be able to accumulate income without Canadian tax for the benefit of Canadian resident beneficiaries.

6.2 Foreign investment entities

Section 94.1 of the Income Tax Act sets out rules for the taxation of investment funds located outside Canada (the foreign investment entities rules). These rules may be engaged where a taxpayer has an interest in property that is a share in the capital stock of, an interest in, or a debt of, a 'non-resident entity'. As with the non-resident trust rules discussed above, amendments to the Income Tax Act were initially proposed in 1999, and were subject to criticism for their complexity and for imposing Canadian tax in a number of arguably inappropriate circumstances. The 2010 federal budget pulled back from the previous proposals. Instead, the government implemented relatively minor amendments to the existing Section 94.1.

7. Reporting requirements

Section 233.1 of the Income Tax Act requires Canadian residents to file annual information returns if they own foreign property. These rules require Canadians to report property held in the form of foreign bank accounts, rental property outside Canada, foreign securities and interests in foreign trusts, partnerships and other foreign entities. The stated purpose of the rules is to provide the Canada Revenue Agency with a more complete picture of a taxpayer's offshore investments and interests so that it can verify the taxpayer's tax returns.

Information returns with respect to trusts are generally required to be filed in two circumstances:

- where a transfer or loan is made to a non-resident trust; and
- where a distribution is received from a non-resident trust or where a beneficiary is indebted to a non-resident trust.

7.1 Transfers or loans to a non-resident trust

Pursuant to Section 233.2(4) of the Income Tax Act, an information form, Form T1141, must be filed by any person resident in Canada who has, at any time before the end of the trust's tax year, made a transfer or loan to:

- a specified foreign trust; or

[30] If a non-resident trust receives contributions from residents and non-residents, it can elect that Canada will tax only the income and capital gains from the property contributed by the Canadian residents; see Section 94(3)(f) of the Income Tax Act.

• a corporation that, at the time of the loan or transfer, would have been a controlled foreign affiliate of the specified foreign trust had the trust been resident in Canada.

A 'specified foreign trust' is a non-resident trust which satisfies any of the following conditions:

• There is a specified beneficiary[31] who is resident in Canada, is a corporation or trust with which a person resident in Canada does not deal at arm's length, or is a controlled foreign affiliate of a person resident in Canada;
• The terms of the trust permit persons to be added as beneficiaries who are not beneficially interested in the trust at that time and who may be resident in Canada at the time of being added; or
• The terms of the trust allow property to be distributed to another trust that, immediately after receipt of the distribution, can reasonably be expected to be a specified foreign trust.

If the trust is a specified foreign trust as a result of having a beneficiary that is a specified beneficiary, a non-arm's length indicator[32] must apply to the trust in order to require the filing. However, a non-arm's length indicator is not required to create an obligation to file the appropriate form where the trust is a

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[31] A 'specified beneficiary' is any person who is beneficially interested in the trust who is not:

• a mutual fund corporation or trust;
• a non-resident-owned investment corporation;
• a person exempt from tax under Part I of the Income Tax Act;
• a 'trust' as defined in Section 108(1), paragraphs (a) to (e.1);
• a registered investment under Section 204.4 of the act;
• a trust in which all persons beneficially interested are persons described above;
• a person beneficially interested in the trust solely because that person is beneficially interested in an 'exempt trust' or beneficially interested in a trust that is exempt from tax under Part I of the act, a mutual fund trust or a trust described in any of paragraphs (a) to (e.1) of the definition of 'trust' in Section 108(1) of the act; or
• a person who is beneficially interested in a trust only because of a right that is subject to a contingency, where at the time the identity of the person as a person beneficially interested in the trust is impossible to determine.

[32] Under Section 233.2(2) a non-arm's length indicator occurs when any of the following conditions apply:

• The transferor is:
  - a specified beneficiary under the trust or related (within the meaning of Section 251 of the Income Tax Act) to a specified beneficiary under the trust;
  - an uncle, aunt, nephew or niece of a specified beneficiary under the trust; or
  - a trust or corporation that had previously acquired directly or indirectly the transferred property from any of the above persons.
• The transferor receives consideration that is less than the fair market value of the transferred property, including any debt which does not bear a reasonable rate of interest or a debt the interest payable on which at the end of the calendar year remains unpaid for 180 days but the repayment is part of a series of loans or other transactions and repayments.
• The property transferred is a share of the capital stock of a corporation that is related to a specified beneficiary of the trust.
• The loan made to the trust does not bear a reasonable rate of interest or the interest payable on the loan at the end of a calendar year remains unpaid 180 days after the end of the calendar year or is repaid within the 180 days but the repayment is part of a series of loans or other transactions and repayments.
• The transfer or loan was made as a part of a series of transactions or events one of the purposes of which was to avoid the application of a non-arm's length indicator.

specified foreign trust as a result of the terms of the trust permitting beneficiaries to be added or allowing property to be distributed.

(a) Exceptions

Notably, certain trusts are exempt from the above-described reporting requirements. These include:

- a trust governed by a foreign retirement account;
- a non-resident trust principally providing superannuation, pension retirement or employee benefits primarily to non-resident beneficiaries that does not pay tax in the taxing jurisdiction where it is resident; and
- a trust which is governed by a foreign mutual fund where there are at least 150 beneficiaries who are beneficiaries in respect of the same class of units of the trust, and 150 or more of those beneficiaries each hold at least one block of units of that class, each unit having a total fair market value of at least C$500.

Further, the Income Tax Act exempts individuals (other than trusts) from having to file an information form for the year in which they first become resident in Canada.

(b) Partnerships

If a transfer or loan is made by a partnership, then the property is deemed to have been transferred or loaned by each individual partner. In this case, each individual partner is required to file the appropriate form. However, individuals can elect for joint filing of the return.

(c) Joint filing

Pursuant to Section 233.2(5), where more than one individual is otherwise required to file the form for a non-resident trust, one of the individuals can elect, in writing, to have the second individual file the return on his or her behalf. However, should the second individual fail to file or provide any false statements, the individual making the election may be held liable for any penalty that may result.

(d) Filing the return

The reporting requirements apply for all taxation years beginning after 1995. Form T1141 must be filed on or before the date the income tax return is due. Corporations must file within six months of the end of their fiscal year and trusts are required to file within 90 days of the end of the reporting trust's tax year.

7.2 Distributions received from a non-resident trust

Section 233.3 requires that where a specified Canadian entity[33] is a beneficiary of a non-resident trust at any time in the year, and has received a distribution

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[33] Under Section 233.3(1), a 'specified Canadian entity' is a taxpayer resident in Canada in the year that is not:

- a mutual fund corporation;
- a non-resident-owned investment corporation;
- a person who is exempt from tax under Part I of the Canadian Income Tax Act;
- a mutual fund trust;
- a trust defined in paragraphs (a) to (e.1) in Section 108(1);
- a registered investment;
- a trust in which all persons are beneficially interested are those listed above; and not a partnership where all of the members are corporations or trusts referred to above, or where the share of the partnership income or loss of non-resident members is 90% or more.

from or was indebted to a non-resident trust in the year, the entity shall file the prescribed form (T1135) with the minister. Certain non-resident discretionary trusts, as defined in Section 94 of the Income Tax Act may, also have to file this return.

(a) Exceptions

As with the form required for transfers to non-resident trusts, several forms of trust are exempted from the reporting requirements. They include:

- a trust governed by a US individual retirement account;
- a non-resident trust principally providing superannuation, pension, retirement or employee benefits primarily to non-resident beneficiaries, which does not pay income tax in the taxing jurisdiction where it is resident; and
- a non-resident trust for which other forms, including the T1141, "Information Return in Respect of Transfers or Loans to a Non-Resident Trust", is required.

(b) Filing requirements

The filing requirements for this form are identical to those discussed above when transferring or loaning money to a non-resident trust; however, in 2014, the Canada Revenue Agency released a streamlined reporting option for taxpayers who hold certain specified foreign property.

8. Conclusion

Given the multitude of uses of trusts, the Canadian Income Tax Act has evolved over the years into a sophisticated set of rules allowing a trust to be taxed in substantially the same way as individuals. As illustrated in this chapter, the provisions applicable to the taxation of trusts have been designed to neutralise the effect of the interposition of the trust, allowing for the flow-through of sources of income, tax-free distributions to Canadian resident capital beneficiaries, similar rules as for individuals with respect to emigration from Canada and many other areas. This chapter has merely highlighted some of the important provisions of the act, as to deal comprehensively with all areas of trust taxation would be the subject of an entire book.