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Trusts and Tax Audits: Look Out – Here They Come!

The Canada Revenue Agency (the "CRA") has recently started cracking down on family trust arrangements, so now might be a good time to get things in order. The CRA's increased scrutiny should cause lawyers, tax advisors and trustees to reflect on whether the trusts they manage are fully compliant with tax and trust law.

The CRA initiative

Through a program that advisors are calling the trust audit initiative, the CRA has embarked on an ambitious project of comprehensive family trusts audits across the country. The CRA appears to be focused particularly on Alberta and domestic trusts. An Alberta trust arrangement takes advantage of differences in provincial tax rates by having the sole trustee or a majority of the trustees reside in Alberta while the settlor and one or more beneficiaries reside outside Alberta. "Domestic trusts," on the other hand, the focus of this newsletter, are trusts in which the settlor, trustee and all or some of the beneficiaries reside in one province.

In pursuit of its domestic trust audit initiative, the CRA has created a "regional trust team" in the Golden Horseshoe region, focusing on Mississauga, Hamilton, Kitchener, London and Windsor. Significant audit activity is now underway. As many issues with trust tax compliance are being identified in the course of these audits, the program has now been expanded to cover the whole country. In September 2010, the CRA also appointed a Trust and Estate Coordinator for the Ontario Region who is responsible for coordinating trusts and estates compliance.

The CRA's main concern is that some trusts were never properly constituted and others are not being managed in accordance with applicable trust and tax law. CRA auditors are looking in particular at how the trust was set up, which was the focus of the recent case of *Antle v. The Queen*. The Federal Court of Appeal held that the trust at issue in *Antle* was not validly constituted, largely because of irregularities in the documents setting up the arrangements and transferring property into the trust and because parties doing business with the trust were unaware of its existence.

Trust residency is also on the CRA's radar, following the recent decision of the Supreme Court of Canada in *St. Michael Trust Corp. v. The Queen* (known as *Garron* in the courts below). In that case, the Court held that the residency of a trust should be determined with regard to where central management and control over the trust's property is exercised, rather than focusing only on where the trustees reside.

The CRA is also concerned with whether ongoing trust maintenance is being properly carried out, *i.e.*, whether the trust's tax returns are being filed each year and whether other rules in the *Income Tax Act* are being followed. If the CRA determines that a trust is operating outside these rules, it may reassess the trust or its beneficiaries for income tax, penalties and interest.

Taking names and asking questions

In connection with its trust audits, the CRA has sent detailed questionnaires to settlors, trustees and advisors, often to several parties at the same time, increasing the likelihood of inconsistent responses in respect of a particular trust. Some of the questions included in the questionnaire aimed at settlors, for example, request details about how the trust was created, how the trustee(s) became involved and how property was transferred into or dispersed by the trust. Trustees are asked about how they were appointed, whether they physically possessed the property used to settle the trust and whether they prepared the trust's tax returns. They are also asked to supply copies of all relevant trust documents. Advisors have also been asked to provide copies of documents for the period that is under review, including documents relating to the planning and formation of the trust, lists of trust assets, directors' resolutions for all dividends paid to the trust, and correspondence between the trust and its settlor, beneficiaries and other parties. In addition, the CRA has also started requesting interviews with various trustees in the course of the audit.

The CRA's questions provide advisors with insight into the issues CRA will be investigating in its audits. They also suggest the best practices that should be employed in trust administration to withstand audit scrutiny. The CRA's

questions have emphasized the following common issues:

- Trust validity, including the location and existence of original settlement property, accounting records, trustee minutes and other related documentation;
- The use of promissory notes for payments to beneficiaries that have become unenforceable due to the expiry of the applicable limitation period;
- Compliance with the 21-year rule regarding the deemed fair market value disposition of capital property;
- Withdrawal of trust funds by trustees (who are often parents) using those funds for their own use rather than for the benefit of the beneficiaries;
- Scrutiny of loans made to the beneficiaries where interest has not been paid to the trust within 30 days after calendar year end, giving rise to possible attribution of income or capital gains.

How to survive a CRA trust audit

Here are some steps you can take to prepare for a possible trust audit:

1. Ensure the trust is properly constituted

To properly constitute a trust, there must be: 1) certainty of intention; 2) certainty of subject matter; and 3) certainty of objects. Non-compliance with any of these conditions for valid trust settlement is an easy audit target for the CRA.

Certainty of intention requires it to be clear that the settlor intended to create a trust to hold property on behalf of the beneficiaries. In order to establish an intention to create a trust, however, there is no need for any technical words or expressions. Intention may be discerned from the settlor's actions and words in setting up the trust. Settlors, trustees and advisors should be aware that the signature of a settlor on a trust document is only one evidentiary factor to be considered in establishing certainty of intention—the settlor's signature alone is insufficient. In many circumstances, such as where professional advisors are involved or the arrangements are purely tax-motivated, the settlor is not informed of the contents of the trust document. When the settlor has not read the trust document and cannot explain it, it is easy for the CRA to argue that the settlor never really intended to create a trust.

In the *Antle* decision, the Tax Court of Canada found that the settlor's actions and the surrounding circumstances could not support a conclusion that he had any true intention to settle a discretionary trust. The timing of the facts was crucial in the Tax Court's decision, specifically with respect to the supposed establishment of the trust. For example, the Barbados trustee had signed the trust deed a month and a half before it was dated, while Mr. Antle, one of the trustees, did not sign the trust deed until several days after its purported settlement. Other trustee resolutions were also not signed until after the trust had purportedly been settled. As a result, the Tax Court concluded (and the Federal Court of Appeal affirmed) that the trust had not been validly constituted due to defective settlement and uncertainty of intention.

Settlors, trustees and advisors should be aware that disorderly trust procedures may not go unnoticed by the CRA. In addition, care should be taken not to create a "sham" trust arrangement. Sham trusts are those using a transactional instrument that reflects something other than the true intentions of the parties. Rather, the terms appearing in the transactional instrument are meant to mislead others and the instrument is declared void. A sham trust may arise where both the settlor and the trustee intend that the arrangement they are entering into not be a trust so the trust deed does not reflect their true intentions.

So what are best practices in order to establish certainty of intention regarding the creation of a trust? A settlor should review and understand the trust documents and the legal implications of settling a trust. In addition, notes of meetings and related correspondence should be kept to help establish the settlor's knowledge and understanding of the content of the trust documents.

Certainty of subject matter requires that the property used to settle the trust can be identified and that the amount held in trust for each beneficiary can be determined. While there is no rule in trust law that the settlement property must be retained at all times, trust auditors dislike hearing that trust settlement property, such as the typical gold coin, has been misplaced. To avoid this situation, the settlement property (together with the signed trust deed) should be retained, as it is strong evidence of the establishment of a trust in the

event that its existence is challenged. If the original settlement document cannot be kept, photocopies should be taken. Affidavits sworn by the settlor and trustees at the time of settlement and describing the settlement property are also strong indicators of the certainty of the subject matter.

If settlement property is missing and no subsequent gift to the trust has been documented, the CRA may challenge the trust's validity. As the onus to establish validity will be on the taxpayer, it may be advisable to take steps to locate the settlement property. If the settlement property cannot be located, affidavits from the settlor, trustees and others who may have observed or have knowledge of its transfer to the trustee may satisfy the CRA.

Certainty of objects is largely a drafting issue as a trust will fail automatically if its beneficiaries are not identified.

2. Know where the trust resides at law

Many Canadian tax practitioners assume that a trust is resident in the jurisdiction in which a majority of its trustees reside. This view was unchallenged until recently, as there was little case law on this issue. A questionnaire sent by the CRA to several prominent Alberta trustees in 2009, however, focused on determining a trust's residence based on "central management and control." This test is usually applied to determine a corporation's residence. The scope of the CRA's questions suggest that CRA wanted to know who had real authority to make decisions concerning the trust, including decisions related to the trustees' qualifications, expertise and experience; the trustees' duties and responsibilities and the method by which decisions were made in relation to the trust property.

This question was also considered in *Garron*, in which the Supreme Court of Canada affirmed the application of the central management and control test. Although that case involved a Barbados trust, the CRA recently confirmed that its principles would be extended to domestic trusts.

Depending on the circumstances, the application of the central management and control test may result in a trust's residency being somewhere other than where a majority of the trustees reside. A competent advisor should be consulted where there is any uncertainty with respect to the residence of a trust.

3. Maintain proper records

Trust advisors know that a trust is entitled to deduct amounts that it makes payable in the year to beneficiaries of the trust in computing its income for a taxation year. The CRA takes the position that legal documents must be in place *prior to the end of the year* to meet this requirement. To avoid running afoul of this CRA requirement, trusts must maintain proper books and records to substantiate payments to beneficiaries, *e.g.*, trust accounting records, financial statements, bank statements, cancelled cheques, applicable loan documents, trustees' resolutions and original documents to substantiate all deductions.

4. Comply with tax filing requirements

Tax compliance, meaning the preparation and filing of tax returns, is usually regarded as the work of accountants. Trust lawyers should also be involved at the filing stage, however, to educate clients about the role of the settlor, the duties of trustees and the entitlements of beneficiaries. Ensuring that the trust documentation satisfies legal requirements and that the trustee's exercise of discretionary and fiduciary powers are well documented through the maintenance of a trust "minute book" are both vital to satisfying the CRA.

The bottom line

The CRA says that its audit efforts have uncovered many instances in which the attribution rules have applied to tax the trust's income and capital gains in the hands of persons who contributed property to the trust. Clear reporting, careful attention to detail and creating paper trails are all key to avoiding this undesirable result, as they prevent the CRA from making assumptions about missing or undocumented facts. Further, the CRA may expand the scope of its audit initiative to scrutinize other issues, such as questionable share structures (where, for example, shares of a corporation are acquired by a trust for inadequate consideration) and "homemade amendments" to a trust (where, for example, beneficiaries are invalidly added or deleted in the trust documentation).

As CRA trust audits become more regular, prudent settlors, trustees and advisors will want to review their trusts to ensure that the documents they have on hand are appropriate,

relevant and adequate so they can respond in a timely fashion to any CRA audit enquiries. Given the CRA's high standards and degree of scrutiny, the average lay person may not be adequately equipped to take on the role of trustee without considerable assistance from professional advisors.

An advisor should also be consulted with respect to any uncertainties relating to past or future trust transactions. We recommend that you review your existing trust structures and, if trustee decisions made over the years have not been properly documented, ensure that trustee minutes or resolutions are prepared and retained to confirm the validity of prior acts. We also recommend that annual resolutions and minutes of trustee meetings are prepared going forward to ensure that trustee decisions are properly documented. Trustees should consider meeting with their advisors at least annually and in advance of the trust's year end. At these meetings, trustees and advisors should ensure appropriate trustee resolutions and minutes are in place and discuss general trust activity, such as operational or administrative concerns, and review the progress of the work plan.

These steps will go a long way in reducing the stress and uncertainty associated with a CRA audit. If you need any help to prepare or respond to the CRA, please feel free to contact one of the members of our Wills, Estates and Trusts Group.

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Pallett Valo LLP Wills, Estates & Trusts Practice

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