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COMMENT

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RESIDENCE OF A TRUST

In order to protect its tax base, the Canadian government taxes foreign trusts on the disposition of taxable Canadian property, and taxes certain foreign trusts on their income as if the trusts were resident in Canada. By taxing foreign trusts, Canada frustrates those tax planning strategies that move capital offshore to escape Canadian taxation. By imposing tax on the disposition of taxable Canadian property, Canada is able to tax capital growth realized in Canada.

In order for an offshore trust to fall within the tax net of Canada, the following two conditions must be present:

- a beneficiary is a Canadian resident, a corporation or trust that deals at non-arm's-length with a Canadian resident, or a controlled foreign affiliate of a Canadian resident, at any time in the taxation year, and
- the trust acquired the property from that beneficiary (or individual at non-arm's length to the beneficiary) who was resident in Canada at any time during the 18 month period before the trust's taxation year-end, and, in the case of an individual, who was resident in Canada for any period(s) of more than 60 months.

This deeming rule catches most tax strategies that entail Canadians simply placing capital into an offshore trust while retaining access to the capital by naming Canadian beneficiaries. While there are a few exceptions, they are generally somewhat remote and beyond the scope of this article.

In a recent court decision, the Canadian tax net was extended to two foreign trusts that were established to avoid the conditions listed above. The taxpayers' strategy was unsuccessful because the decision-making and control over the trust assets was exercised from Canada.

A summary of the relevant facts is as follows:

- Two Canadian individuals (unrelated but shareholders of the same company) settled two offshore trusts in Barbados to hold the common shares of the company issued as part of an estate freeze. St Michael Trust Corporation acted as trustee for the Fundy Settlement and the Summersby Settlement.
- The underlying operating company grew in value and was eventually sold. The two offshore trusts realized substantial capital gains, claimed that the capital gains were exempt from taxation in Canada (as disposition of taxable Canadian property) pursuant to the Canada - Barbados Tax Treaty, and claimed refunds of tax withheld and remitted by the purchaser of the company.

The Canada Revenue Agency (CRA) assessed the trusts as being liable for income tax in Canada on the basis that the trusts were resident in Canada. The CRA took the position that irrespective of the factual residency of the trustees, the mind and management of the trusts was in Canada because all of the important decisions with respect to the disposition of the company were made in Canada.

The taxpayer appealed the CRA's assessment to the Tax Court of Canada, who affirmed the assessment, stating that the responsibility for the trust's decisions was carried out not by the Barbados-resident trustee, but by two of the trust's beneficiaries who were resident in Canada.

The taxpayer appealed the Tax Court's decision to the Federal Court of Appeal who affirmed the lower court's decision. The Federal Court of Appeal stated that the residence of a trust may not always be determined by the residence of its trustees and the test of central management and control should be applied. Finally, in April of 2012, the Supreme Court of Canada heard an appeal of the case and again affirmed that the residence of a trust should be determined based on the central management and control test.

This case has important implications to all trust planning. No longer will a simple test of trustee residence be applied, but rather the location of mind and control will be a factor to be considered. This applies to offshore trusts as well as interprovincial planning involving locating trusts in other provinces.

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INSURED ANNUITIES

The insured annuity or "back-to-back" strategy is a popular concept to provide retirement income or to enhance the rate of return on the fixed-income portion of a portfolio. The basic strategy involves the purchase of an annuity to provide a lifetime stream of income, and a life insurance policy to replace the capital used to fund the annuity upon death.

When the insured annuity is personally owned, the annuity can qualify for prescribed tax treatment, which levelizes the annual taxable portion of the annuity. However, sometimes the capital to be used for the annuity is corporate-owned. Setting up an insured annuity under corporate ownership has some drawbacks but also some interesting additional features.

The first drawback is that the annuity will not qualify for prescribed tax treatment when it is owned by a corporation. This means that the annuity is taxed much like a mortgage; the first payment is mostly interest and little principal while a payment twenty years later is mostly principal and very little interest. As much as this is a drawback, there is a silver lining to the disadvantage – the after-tax cash flow from a non-prescribed annuity increases every year, creating an element of inflation protection.

An advantage created by corporate ownership of the insured annuity is the lowering of income taxes realized in the estate. Upon death, a person is deemed to have disposed of all of his or her capital assets, which would include the shares of the corporation. The value of those shares would reflect the assets in the company, which would include the life annuity and the insurance policy on the life of the shareholder who just passed away.

The Income Tax Act contains a special deeming rule for purposes of valuing the corporation's shares upon the death of a shareholder. This rule provides that the value of a life insurance policy on the life of the deceased shareholder is its cash surrender value, irrespective of any other valuation technique.

The value of a life annuity might be determined by the same deeming rule, because by definition a life annuity is considered to be a life insurance policy under the Income Tax Act. However, a life annuity would not usually have a cash surrender value. The CRA has previously stated that a life annuity is not a life insurance policy for purposes of the deemed value of shares held upon death. In that case, valuing the life annuity is problematic. A valuator would likely take into account the criteria listed by the CRA in Information Circular 89-3 for valuing life insurance policies, including such items as state of health, replacement value, etc. For example, one would generally not buy a life annuity on an individual with a short life expectancy because the capital investment may never be fully returned in the form of annuity payments. Needless to say, the value of a life annuity would probably decline in value very sharply within a few years of issue.

If the value of the life insurance and life annuity are both low, it will reduce the value of the shares of the corporation. The lower share value means a lower accrued capital gain resulting in a lower tax consequence pursuant to the deemed disposition rules at death.

The second advantage of a corporate-owned insured annuity is the credit to the company's capital dividend account arising because of the receipt of life insurance proceeds. The credit would allow the executor or beneficiaries to draw out tax-free capital dividends or structure post-mortem planning to further lower the income tax liability of the estate.

Consider the following example of a corporate-

owned insured annuity in the amount of $500,000 on a male aged 70, in good health.

	1st year Age 71	5th year Age 76	10th year Age 81	15th year Age 86
Annuity payment (annual)	$39,992	$39,992	$39,992	$39,992
Taxable portion of payment	Zero	$6,219	$4,652	$3,431
Corporate tax (net of RDTOH)	Zero	$1,244	$930	$686
Insurance premium (annual)	$18,944	$18,944	$18,944	$18,944
Dividend to shareholder	$21,048	$19,804	$20,117	$20,361
Equivalent rate of return	5.3%	5.0%	5.0%	5.1%

The above table shows the tax liability associated with the annuity payment net of refundable dividend tax on hand (RDTOH). The company's income tax liability is calculated taking into account taxable dividends paid in the year which would generate a refund of the refundable portion of corporate income taxes. This means that dividends associated with the corporate-owned insured annuity must be paid in the tax year in which the taxable income arises.

The equivalent rate of return is much higher than that available in the market place today for conservative interest-bearing investments. However, the individual should be aware that the investment is locked-in and does not have any liquidity.

Additionally, as discussed above, the insured annuity adds little or no value to the tax value of the corporate shares, which could be worth $500,000 less from an income tax point of view. This could save the estate between $100,000 and $125,000 in taxes depending on provincial residence. The company has the same economic value, because the life insurance is designed to replace the amount of capital invested in the life annuity.

Planning involves taking into account the facts of the situation and using new strategies to rearrange the taxpayer's current situation to better accomplish the specific objectives. Sometimes this means reviewing strategies typically designed for individuals and testing them in corporate scenarios. Of course, as with most planning strategies, there are numerous other details to be considered in implementing any plan, and the advice of a professional tax and estate planning advisor is crucial.

I/R 5200.01

A SCORE THAT TRULY MATTERS

Credit is a precious privilege that allows individuals to expand their purchasing power; yet, as an intangible, few think about it on any regular basis. Without credit, purchasers rely completely on cash flow so the ability to accumulate assets is limited to an individual's ability to save. With credit, the ability to purchase a home or car becomes more achievable in a shorter period of time.

Whether applying for a credit card, car loan, mortgage or cell phone plan, individuals have to demonstrate their ability to make the required payments. The company issuing the credit looks to the individual's credit score, more commonly known as credit rating, to assess the individual's financial health. In general terms, it is through the use of credit that individuals acquire a credit score. The credit score is an overall assessment of the individual's risk profile in terms of ability to handle credit – the probability of defaulting on a credit obligation or repaying the obligation within the terms of the obligation.

In days gone by, companies were anxious to issue credit cards to university students. This allowed young adults to easily begin developing a credit history. Today, it can be more difficult as many companies are looking for a steady income before issuing credit to young people or are requiring a co-signer who is typically a parent with a steady income stream. The challenge, of course, is that without credit it is difficult to lease a car or obtain a loan on one's own financial strength.

For the parent, loans on which they have co-signed are often noted as an obligation on the parent's credit history which can affect their ability to seek personal credit. It can be beneficial to both the young adult and the parent to obtain the credit card without a co-signer even if it means a smaller credit limit to begin with.

When individuals who have sufficient assets opt not to use credit because they do not need the mortgage or car loan, they can be limiting their ability to demonstrate credit worthiness. Similarly, when a couple opt to put credit in one

person's name, the other person is not building a credit history. So, whether or not the credit is truly needed, it can be helpful to have a credit card to help build and maintain a record of credit worthiness.

Maintaining a strong credit score helps ensure access to credit. Each provider of credit typically reports information about an individual's credit history to credit-reporting agencies, such as Equifax Canada and TransUnion Canada, who gather the information and maintain a credit profile on every individual. To maintain a good credit rating:

- Use credit cards wisely. Paying the full credit card balance on a monthly basis will be viewed very positively in the credit assessment and, in doing so, it is likely that the individual is living within his or her financial means. At minimum, it is essential to make the minimum payment outlined on the monthly statement, in order to avoid a negative adjustment.
- Pay monthly cell phone bills on time.
- In some cases, applying for several sources of credit in a short period of time can be viewed negatively. By carefully considering the rationale for the credit application, individuals are in a better position to anticipate possible options and can help minimize negative responses.
- Recently, there have been stories in the media about some cities sending outstanding parking tickets to a collection agency. This type of action against an individual can be a negative that could send the wrong message to a potential creditor.
- When the loss of a job impedes an individual's ability to meet the monthly mortgage or other payment, it is important to discuss this with the lender in an effort to ascertain interim options. Credit providers are typically more open to a dialogue rather than surprises.

Individuals can request a copy of their credit report, either via regular mail or the internet. The cost varies depending upon the information being requested, but there should be the option to request this information once a year at no cost. Identification acceptable to the rating agency will be required. If mistakes are found, it is important to correct the error. Reviewing one's personal credit score is worth the time and effort as it helps to keep the information current and correct. It can also help uncover the possibility of identity theft.

Although an intangible, one's credit score is a direct reflection of personal financial health that will influence the ability to acquire credit. It is a score that can truly make a difference.

Here are a pair of links to learning more on how to request a credit report:

http://www.equifax.com/ecm/canada/EFXCreditReportRequestForm.pdf

http://www.transunion.ca/ca/personal/creditreport/consumerdisclosure_en.page

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