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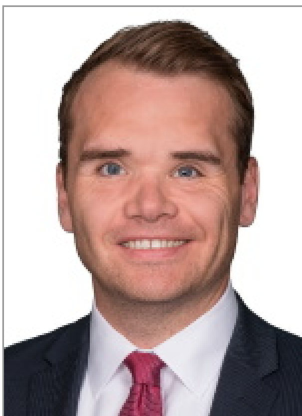
Phone: (800) 668-6481 | Fax: (905) 479-3758 | John.Carson@lexisnexis.ca

**Tax**

# Tax planning strategies in a market downturn: Trusts

By **Martin Sorensen, Marshall Haughey and Hennadiy Kutsenko**

Martin Sorensen



Marshall Haughey

Hennadiy Kutsenko

(June 9, 2020, 2:45 PM EDT) -- In last week's article, we discussed some tax-planning strategies for taking advantage of lower business and asset valuations brought about by COVID-19 in the context of personal and estate planning. This week, we will discuss certain asset-protection measures that taxpayers may wish to undertake when worried about possible lawsuits or creditor claims.

During tough economic times, parties may face financial distress, be unable to perform their contractual obligations, or devote less attention to their business. These actions create fertile ground for lawsuits. As such, if one has not already done so, the beginning of an economic downturn is a good time to think about creditor protection.

**Trusts as creditor protection tool**

The unique nature of a discretionary trust makes it an optimal vehicle for use in creditor protection planning. The trustees hold legal title to the trust's property while the beneficial ownership belongs to the beneficiaries of the trust. However, because the trust is fully discretionary, the beneficiaries do not have a fixed, definable right to the assets in the trust.

As a result, a creditor of a beneficiary generally cannot seize these assets of the trust since all the beneficiary has is a right to be considered as a recipient of trust property. It is not until the trustees exercise their discretion to vest property in a beneficiary (which they generally should not do if there is a risk of the beneficiary being sued) that the beneficiary's interest in the trust property crystallizes.

The transfer of property to a trust may or may not occur on a tax-deferred basis depending on the type of trust that is being utilized. Transfers of property to the typical fully discretionary family trust (i.e., where the parents and their descendants are all beneficiaries and the trustees have full discretion to apply income and/or capital to any of the beneficiaries at any time) generally must occur on a taxable basis, meaning any accrued gains on the transferred property are realized on the transfer.

Any accrued losses on the assets will not be realized by the transferor and will instead generally be added to the tax cost of the property acquired by the trust. Due to the recent decline in asset values, now might be a good time to consider transferring assets to a discretionary family trust if there would be little or no tax payable on the transfer.

There are several special kinds of trust under the *Income Tax Act* that a person can transfer property to on a tax-deferred basis. These include:

- a *spousal trust* — a trust under which the person's spouse receives all of the income of the trust during their lifetime and no one but the spouse can receive income or capital of the trust until after the spouse's death;

- an *alter ego trust* — a trust created after the person turns 65 and under which the person receives all of the income of the trust during their lifetime and no one but the person can receive income or capital of the trust until after the person's death; and
- a *joint spousal or common law partner trust* — a trust created after the person turns 65 and under which the person and their spouse or common law partner receive all of the income of the trust during their lifetimes and no one but the person and the spouse or common law partner can receive income or capital of the trust until after the last to die of the person and spouse or common law partner.

These types of trusts may not be quite as useful from a creditor protection perspective as they tend to limit the persons entitled to be beneficiaries (at least during the person or his spouse or common law partner's lifetime) and require the income of the trust to be paid out annually.

That being said, if little or no income is expected on the trust's assets (or the amount of income can be managed), these trusts may be more favourable from a tax perspective while still offering sufficient creditor protection.

All of the trusts described above are generally taxed at the highest individual marginal tax rates on any income, unless the income is paid out to beneficiaries, in which case the income is taxed in the beneficiaries' hands. The character of the income paid out (such as capital dividends, taxable dividends or capital gains) can be retained in the hands of the beneficiary providing the requisite designations are made by the trustees.

Generally, the discretionary family trust described above would be subject to a deemed disposition of its assets every 21 years. So unless the trust's property is distributed to beneficiaries before that time (which can often be done on a tax-deferred basis provided the beneficiaries are resident in Canada), the trust may realize capital gains on its 21st anniversary. Distributing the properties to the beneficiaries may undo the creditor protection benefit of the trust, but the risks that caused the need for creditor protection may no longer be an issue at that point.

The 21-year deemed disposition rule does not apply to spousal, alter ego or joint spousal and common law partner trusts. Instead, the deemed disposition occurs on the death of the spouse (in the case of spousal trusts), on the death of the individual (in the case of alter ego trusts), or on the last to die of the individual and their spouse or common law partner (in the case of joint spousal or common law partner trusts).

Where a person who transfers property to a trust is a beneficiary or a trustee of the trust, a special attribution rule may apply. If it applies, the result would be that any income of the trust would be attributed back to the transferor and the ability of the trust to later distribute the property out to a beneficiary on a tax-deferred basis (other than to the transferor or their spouse) would be compromised. As such, it can be important to navigate this special attribution rule when setting up the trust.

**Separate ownership of business property**

The assets of an operating company are generally available to the creditors of the company in times of distress. Since an operating company is where the risks lie, it is often advisable to have the business assets owned in a different entity, where possible. There are a number of ways this might be accomplished. For example, the operating company might form a subsidiary which then becomes the operating company. The assets (such as land, buildings and equipment) remain in the former operating company (now the parent company) and are leased to the subsidiary.

**Secured loans to operating company**

In some circumstances, it may not be possible or convenient to hold some of or all business assets in an entity separate from the operating company. In such cases, consideration should be given to creating secured indebtedness owing by the operating company to its parent company, so the parent has priority over unsecured creditors of the operating company to the extent of the debt.

Techniques to maximize the amount of indebtedness include:

- contributing any new funds to the operating company as loans rather than as equity contributions;
- converting any "paid-up capital" in the shares of the operating company into debt owing to the parent company by a share redemption or return of capital on a tax-free basis; and
- paying dividends to the parent company which are satisfied by the issuance of debt. Taxable dividends can often be paid between Canadian corporations tax-free and capital dividends can be paid tax-free providing the dividend payor has sufficient "capital dividend account;" and
- the parent company (or another related company) can provide select services to the operating company that are unlikely to attract liability (such as managerial, consulting and administrative or other back-office services), which can be paid by the operating company through indebtedness.

**Key takeaway**

Before the lemons of creditor and tort claims come tumbling in, the measures described above can often be put in place to provide not only water for the lemonade but maybe even a dash of sugar, in the form of lower capital gains taxes due to lower valuations of assets. Grandma would certainly be proud here and may even ask about the refreshing drinks we will be pouring next week when we consider strategies to mitigate financial distress and make use of tax losses to shelter income.

This is part two of a three-part series. Part one: Tax planning strategies in market downturn: Estate freezes, income splitting.

*Martin Sorensen's practice focuses on tax planning and tax litigation at* Bennett Jones LLP. *He has particular experience in matters involving complex corporate, individual and international tax planning. Marshall Haughey practises tax law at Bennett Jones with a focus on corporate tax and transaction structuring. He also has a keen interest in estate planning transactions involving tax-effective restructuring of businesses and intergenerational transfers of wealth. Hennadiy Kutsenko is a tax associate in the Toronto office of Bennett Jones and practises in all aspects of income tax, GST/HST and provincial tax, with an emphasis on corporate reorganizations, cross-border transactions and public and private mergers and acquisitions.*

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