

3000-700 9th Avenue SW
Calgary, AB
Canada T2P 3V4
Tel. 403.298.2400
Fax.403.262.0007
www.millerthomson.com



MILLER THOMSON LLP

Barristers & Solicitors, Patent & Trade-Mark Agents

TORONTO VANCOUVER WHITEHORSE CALGARY EDMONTON WATERLOO-WELLINGTON MARKHAM MONTRÉAL

LEGAL, TAX AND PRACTICAL ISSUES INVOLVED WITH USING A TRUST TO CARRY ON BUSINESS

By William J. Fowlis

and

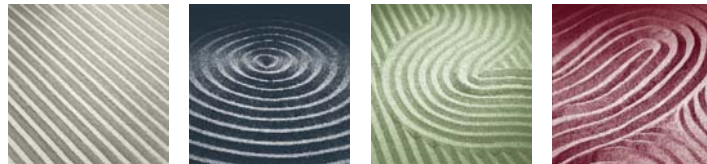
Natalie M. Fenez

JANUARY 20, 2005

MILLER THOMSON LLP

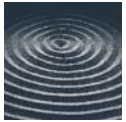
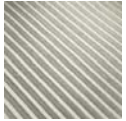
Barristers & Solicitors, Patent & Trade-Mark Agents

Legal, Tax and Practical Issues Involved with Using a Trust to Carry on Business



Date: January 20, 2005

Presented by: William J. Fowlis and
Natalie M. Fenez



A. INTRODUCTION

What is a Trust?

- A legal relationship created when a person (trustee) holds property for the benefit of another person (beneficiary)
- Relationship whereby all actions are taken through the trustee
- A trust provides a legal mechanism through which certain defined property is preserved by a trustee for the benefit and use of a beneficiary



What is a Trust? (cont'd)

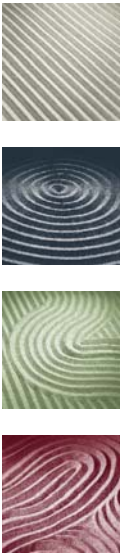
- A trust arrangement normally consists of four characteristics:
 - The Settlor
 - The Property
 - The Trustees
 - The Beneficiaries
- Trust law is a matter of provincial jurisdiction



Comparison of Forms of Business Structures

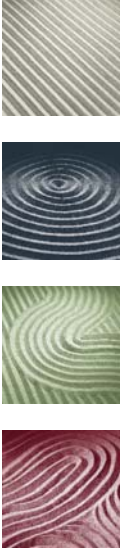
- Trust

- Not a separate legal entity
- No limitation of liability for trustees
- Trustee is entitled to be indemnified from the trust property
- Beneficiaries may be liable to the trustee for expenses properly incurred by the trustee in connection with the trust
- Created by the existence of the legal relationship
- Usually created and/or governed by a Trust Deed or a Will
- Deemed disposition after 21 years
- Income may be taxed at trust or beneficiary level



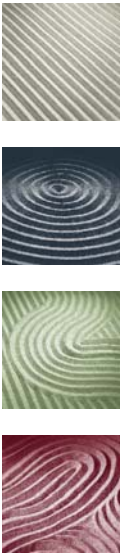
Comparison of Forms of Business Structures (cont'd)

- Corporation
 - Separate legal entity
 - Limited liability for directors
 - Created by statute
 - Perpetual existence unless struck, wound-up, dissolved or amalgamated
 - Income is taxed first at corporate level and shareholders are taxed on certain distributions



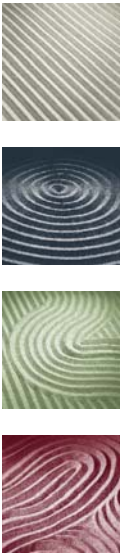
Comparison of Forms of Business Structures (cont'd)

- Partnership
 - Not a separate legal entity
 - Each partner is jointly and severally liable
 - Created by existence of legal relationship
 - Usually governed by Partnership Agreement
 - Period of existence is determined by agreement
 - Taxable income is calculated at the partnership level but is taxed in each partner's hands
 - All corporate partners share entitlement to low rate of corporate tax



Comparison of Forms of Business Structures (cont'd)

- Limited Partnership
 - Not a separate legal entity
 - Limited liability for limited partners
 - Limited liability is governed by statute
 - Registration of Certificate of Limited Partnership at Corporate Registry
 - Period of existence is determined by agreement
 - Taxable income is calculated at the partnership level but is taxed in each partner's hands
 - All corporate partners share entitlement to low rate of corporate tax



Comparison of Forms of Business Structures (cont'd)

- Joint Venture
 - Not a separate legal entity
 - No limitation of liability
 - Usually created by agreement
 - Period of existence is determined by agreement
 - Taxable income is calculated and taxed in each joint venturer's hands



Advantages of a Trust

- A discretionary trust provides a number of advantages which include:
 - Asset protection
 - Tax planning: including income splitting, multiplying access to the capital gains deduction, and reduction of taxes on death
 - Probate: avoids the expense, delay and public disclosure of probate
 - Control without ownership
 - A person may provide for those who are unable to manage their own affairs (children or disabled persons)



Advantages of a Trust (cont'd)

- Wealth preservation: allows for the preservation of assets rather than a complete distribution upon death
- Continuity: ensures the continuation of a family business by transferring the shares of the business to the trust
- Flexibility: a discretionary trust can provide a structure that is capable of rapid change as circumstances demand



Taxation of a Trust

- *Income Tax Act* treats trust as separate individual
- Five broad groups for tax purposes: testamentary, inter vivos, unit, mutual fund, and deferred income plan trusts
- A personal inter vivos trust taxed at the top marginal tax rate for individuals
- Any income left in trust after payment of taxes becomes capital and may be distributed to beneficiaries tax free



Taxation of a Trust (cont'd)

- Usually, income paid out of trust (trust claims deduction) and is taxed in hands of beneficiaries. Income splitting opportunities.
- The residence of a trust is normally where the trustees reside and administer the trust which allows for provincial rate shifting.
- 21 year deemed disposition



Liability of Trustees for Trust Debts

- Trustees are held liable for any liabilities under statutory and common law incurred by them while trustees even if they are later removed as trustees.
- Trustees may incur substantial liabilities under the *Income Tax Act*. Subsection 159(3) specifies that trustees are personally liable for the tax liabilities of a trust.



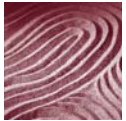
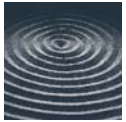
Liability of Trustees for Trust Debts (cont'd)

- Further, if trustees fail to deduct or withhold taxes under section 212 of the *Income Tax Act*, they will be liable to a penalty under subsection 227(8). A trustee should obtain a section 116 clearance certificate prior to making any distributions to non-residents.



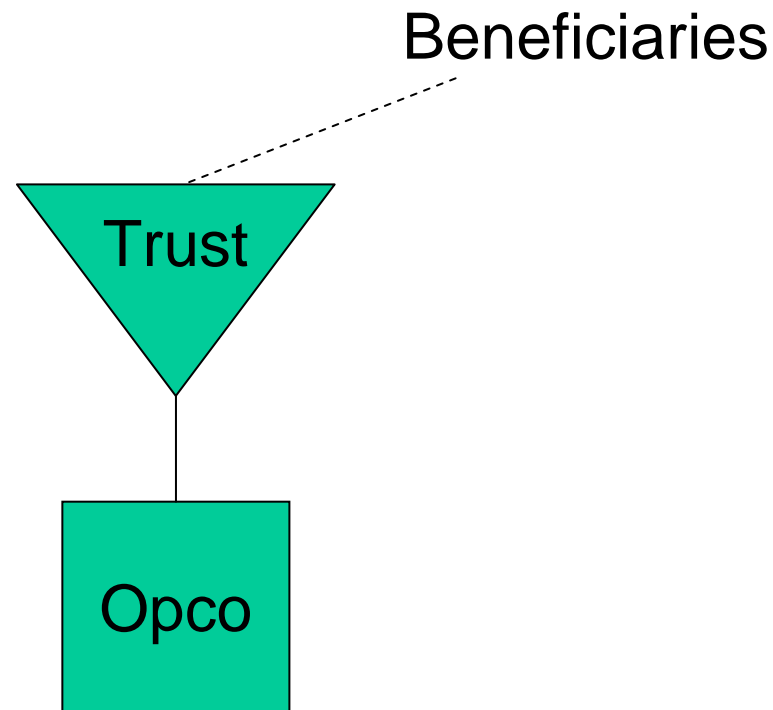
Liability of Beneficiaries for Trust Debts

- Beneficiaries may be liable to the trustee for expenses properly incurred by the trustee in connection with the trust
- Beneficiary may be personally liable to trustee where he expressly or impliedly contracted to indemnify the trustee
- Beneficiary may be personally liable for taxes of the trust to the extent of any distributions received from the trust



B. USE OF TRUSTS TO EARN BUSINESS INCOME

1. Traditional Structure





Advantages

- Set up
 - Rollover of business/assets to corporation is available
 - Freeze/transfer of business
- Ongoing Operations
 - Limited liability
 - Clear governance rules
 - Capital Gains Deduction is available
 - Good for succession and estate planning

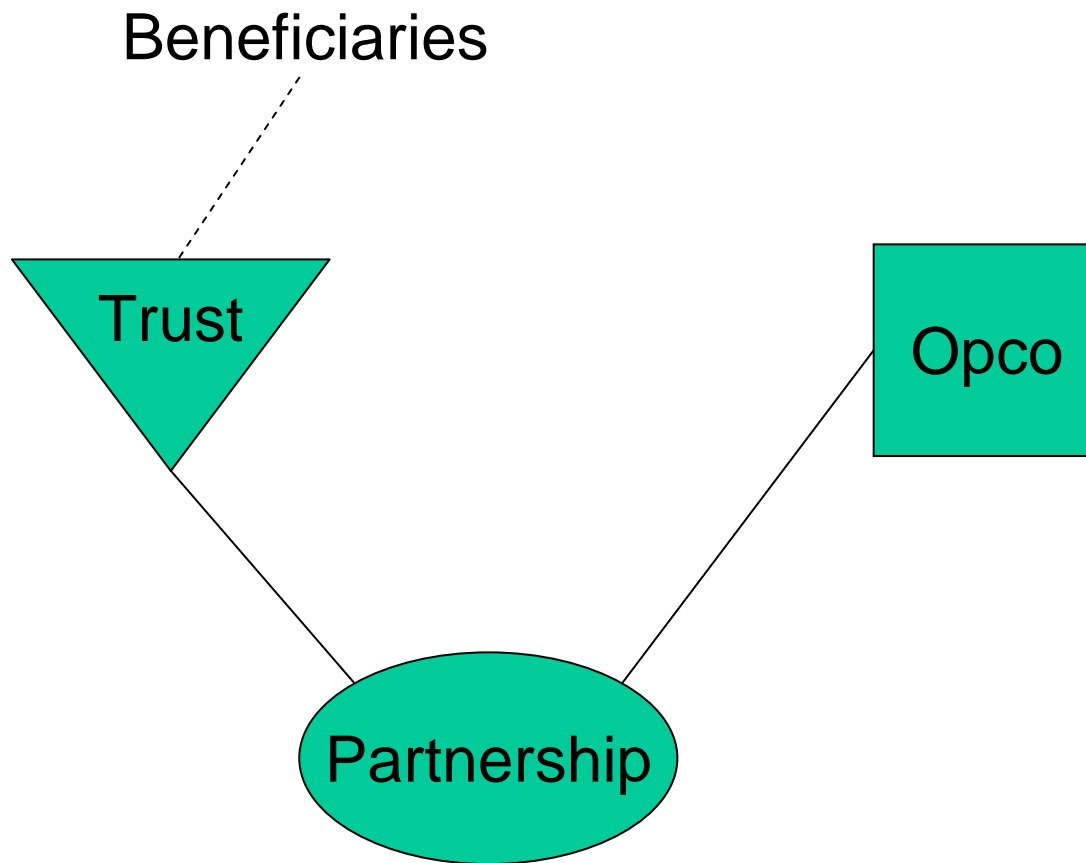
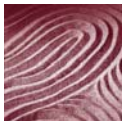
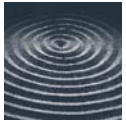


Disadvantages

- Corporate level of tax
- Tax rate limited by annual business limits and associated corporation rules
- Kiddie tax



2. Partnership Structure





Advantages

- Rollover of business assets to partnership is available
- Income allocated from partnership to trust and out to beneficiaries which avoids corporate level of tax
- Governance principles exist



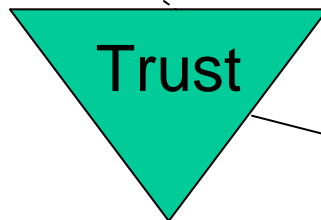
Disadvantages

- Lack of limited liability (other than for a limited partnership)
- Anti-avoidance rules regarding allocation of income
- Possible kiddie tax
- More cumbersome structure
- No Capital Gains Deduction available to beneficiaries of trust
- Adjusted cost base grinds and deemed capital gains for an inactive partner
 - Caution regarding timing of distributions

Alternate Partnership Structure



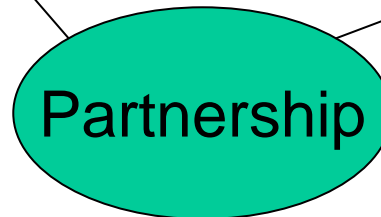
Beneficiaries



Common
Shares

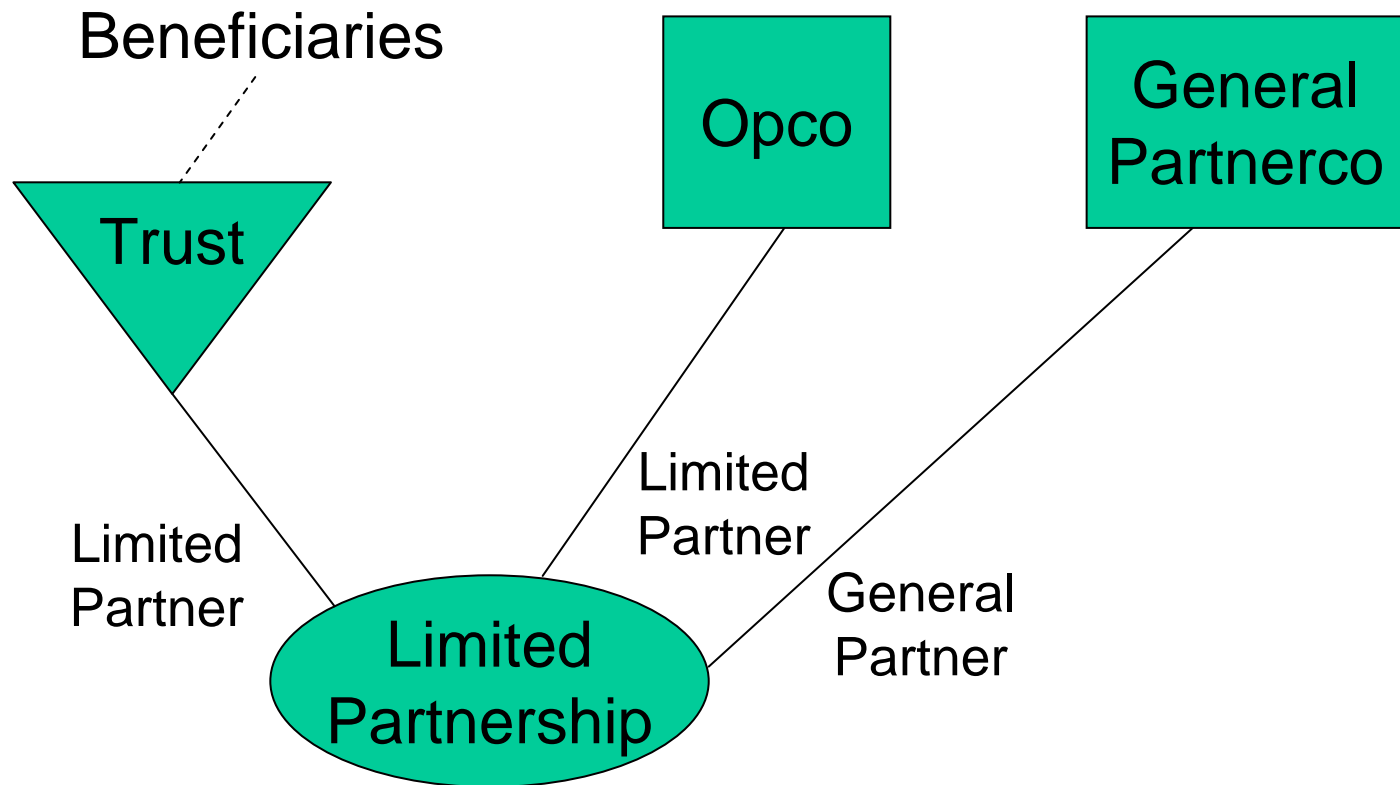
Parent

Preferred
Shares

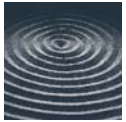


One advantage of this alternate structure is the availability of the capital gains deduction to the beneficiaries of the trust.

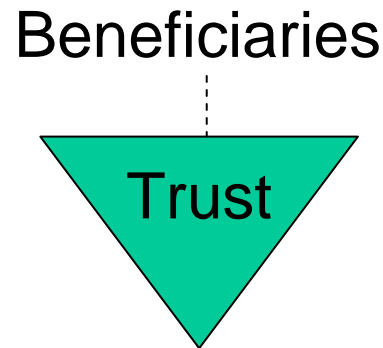
Alternate Partnership Structure Using a Limited Partnership



This structure attempts to isolate all business liabilities of the Limited Partnership to General Partnerco.

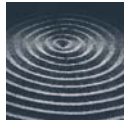


3. Trust Structure



- Trust carries on business directly (eg. Ferrel case)
 - Appellant was sole trustee and settlor of the Ferrel Family Trust (the “Trust”)
 - Trust held equity shares of a corporation
 - The corporation entered into an Agreement with Trust whereby management services of the appellant, in his capacity as trustee of trust, were provided to the corporation
 - Federal Court of Appeal held that the Agreement was not improper under trust law and that trust law now permits structures called “Business trusts”, which conduct business

Advantages



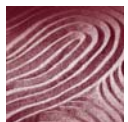
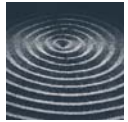
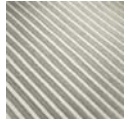
- Income can be allocated from trust to beneficiaries which avoids corporate level of tax
- Income taxable directly to the beneficiary
- Income that is earned by the trust is taxable where the trust is resident except for business income which is taxable in the province in which the business is carried on



Advantages (cont'd)

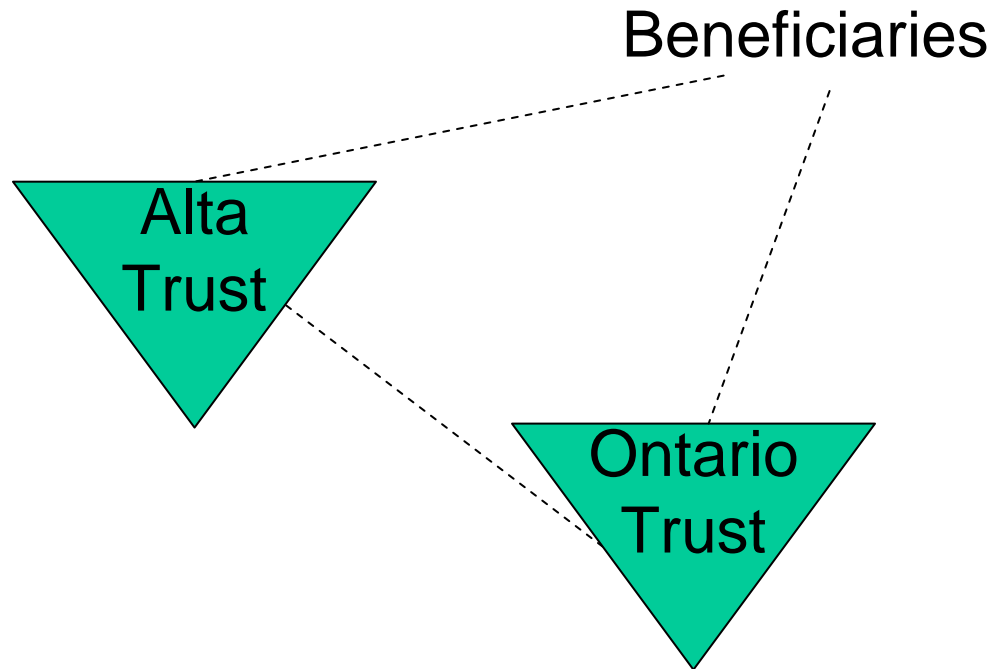
- Provincial rate shifting
- Mainly an income splitting advantage
- Where this structure is most useful:
 - Businesses with low risk of potential liability
 - Services or consulting
 - Businesses with little financing requirements
 - Businesses with few employees

Disadvantages



- No rollover available upon setup
- No Capital Gains Deduction
- Possible kiddie tax
- Liabilities of trustees
- Awkward manner to run a business

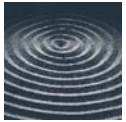
4. Use of Two Trusts for Provincial Rate Planning



- An advantage of this alternative structure is the limitation of liability for the trustees of the Alberta trust as they are not involved in the active business
- This structure can result in a shift in the Province in which the business income will be taxed



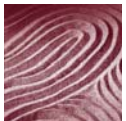
5. Use of an Agent Corporation



- Legal relationship of an agency

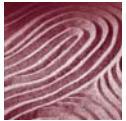
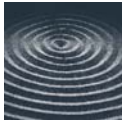


- Principal

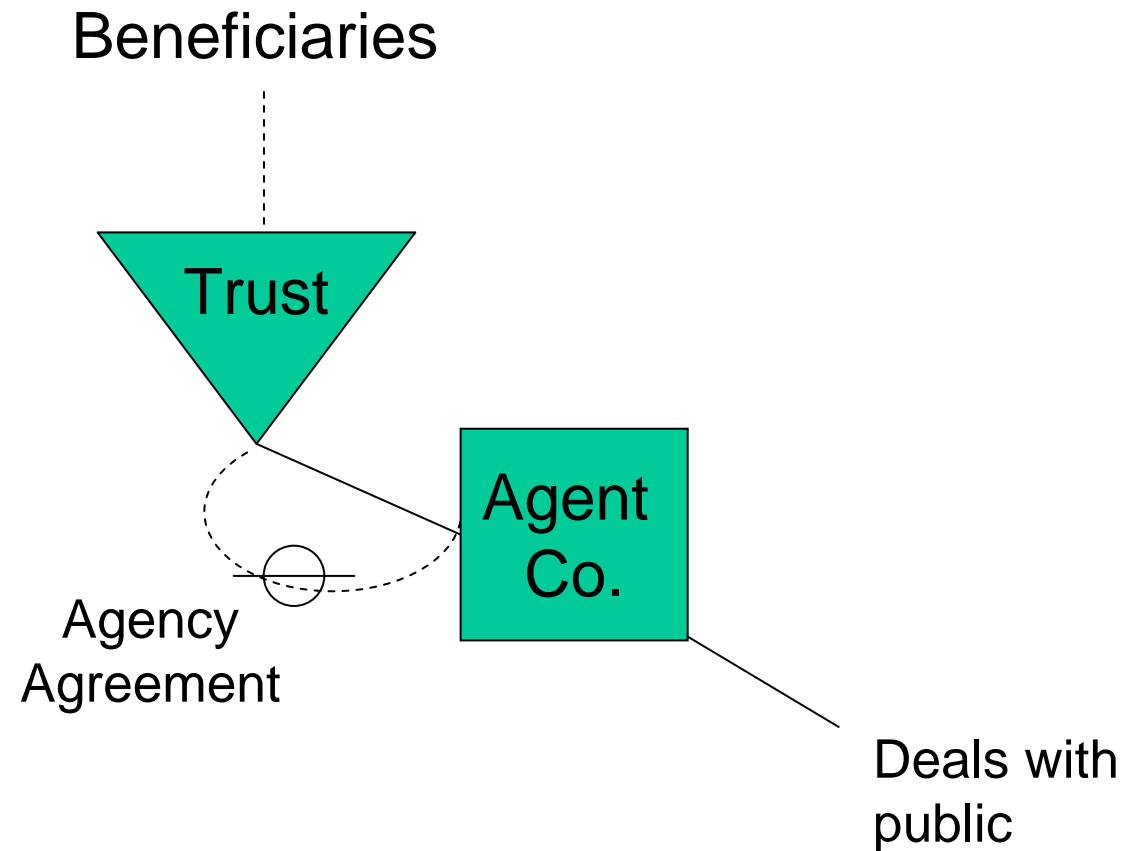


- Agent

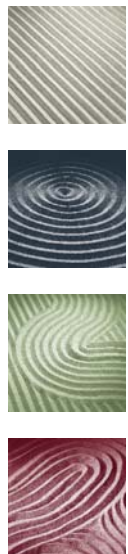
- Agent for an undisclosed principal



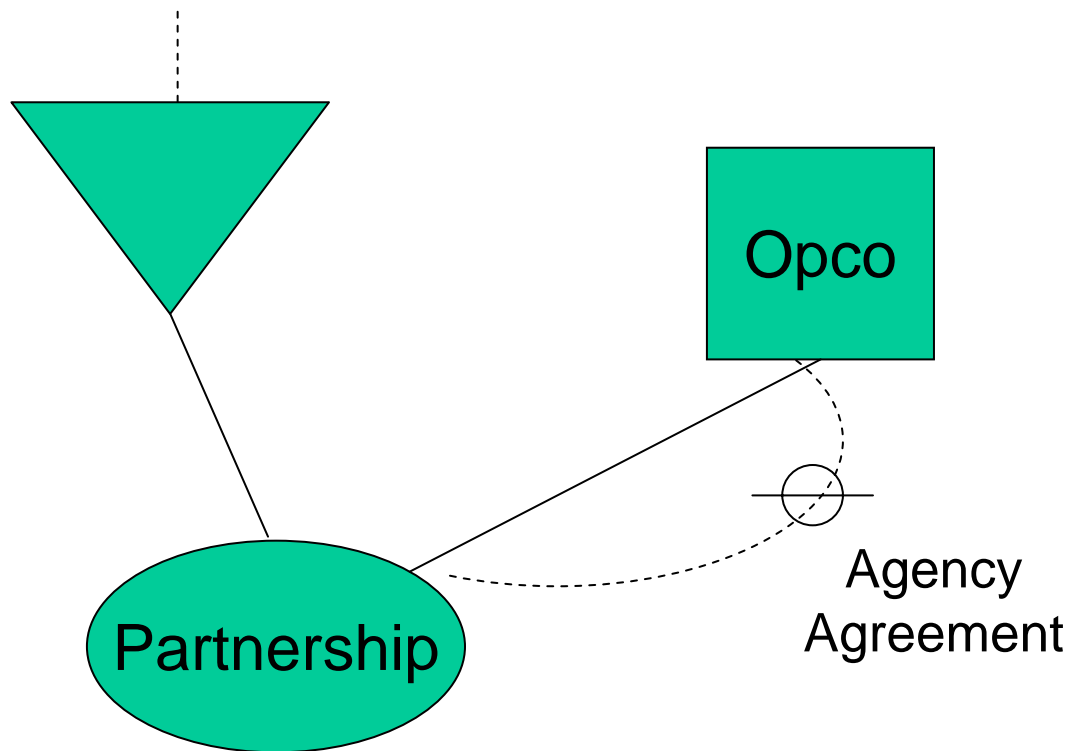
5. Use of an Agent Corporation (cont'd)



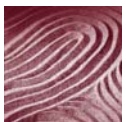
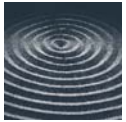
Alternate Use of an Agent Corporation



Beneficiaries



Advantages



- More seamless in dealing with business contacts eg. customers/clients, suppliers, banks



C. ALTERNATIVES TO LIMITING LIABILITY

- Use private corporation as trustee
 - *Loan and Trust Corporations Act*
 - Not offering services to public
- Consider situation where the Agent Corporation is also the trustee
- The limited partnership structure may be a good compromise



C. ALTERNATIVES TO LIMITING LIABILITY (cont'd)

- To protect themselves from future liability with respect to their exercise of discretionary powers, trustees can also rely on such devices as agreements and indemnities, court applications, advice from legal counsel and insurance



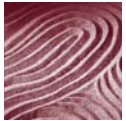
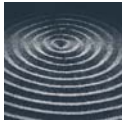
Use of an Indemnity

- Who should provide the indemnity?
 - Settlor
 - Beneficiary
 - Other
- Inconsistent with trustee's standard of care?



D. CONCLUSION

- The use of a trust in the context of a family business structure is a useful tool which can achieve numerous tax and other benefits
- Depending on the facts involved and the objectives to be achieved, a careful review of the advantages and disadvantages of each structure should be undertaken in order to implement the most appropriate corporate structure



E. The *Income Trusts Liability Act* (Alberta)



Situation Prior to the *Income Trusts Liability Act*

- Compare:
 - Corporation: liability of shareholders
 - Partnership: liability of partners
 - Trust: liability of beneficiaries or unitholders
- Issue: potential liability of beneficiaries in extreme circumstances
- Cited by some institutional investors as reason to avoid investing in income trusts



Growth of Income Trusts

- Popularity of income trusts continues to grow in Alberta
- Particular importance to the oil and gas sector
- As of July 2004, over 150 income trusts trading on Canadian stock exchanges, with an aggregate market capitalization of approx. \$90 billion



Alberta Government Response

- *Income Trusts Liability Act* Introduced on May 6, 2004
- Not retroactive - applies effective July 1, 2004
- Under *Income Trusts Liability Act*, the liability of Alberta unitholders of an income trust is now limited



Subsection 2(1)

- Principal section of the Act reads:
 - 2(1) Notwithstanding any express or implied indemnity of a trustee by a beneficiary of an Alberta Income trust, the beneficiary is not, as a beneficiary, liable for any act, default, obligation or liability of the trustee of the Alberta income trust



Definition “Income Trust”

- A publicly traded, unincorporated, open ended, limited purpose trust established by an underlying operating business. This includes royalty trusts, real estate investment trusts (REITs) and business trusts.



Definition

“Alberta Income Trust”

- A trust created under the laws of Alberta which is a reporting issuer in Alberta as defined in the *Securities Act* (Alberta)



Other Jurisdictions

- No similar law enacted in Canada to date
- Ontario has tabled legislation similar to the Act in the form of the *Trust Beneficiaries' Liability Act, 2004*

Limitation

- Liability of beneficiaries will not be limited under the *Income Trusts Liability Act* where beneficiary takes an active role in directing or administering the income trust



Outstanding Issues

- What constitutes taking an “active role”?
- Is it appropriate to exclude these actions from the limitation of liability?
- Submissions may result in further amendments