INCOME TRUSTS: NOT JUST FOR BIG BUSINESS ANYMORE

By:  Paul R LeBreux, LLB, LLM, TEP
      Kim G C Moody, CA, TEP

Two months after tabling a consultation paper, “Tax and Other Issues Related to Publicly Listed Flow-Through Entities (Income Trusts and Limited Partnerships)”, Minister of Finance, Ralph Goodale announced on November 23, 2005 the Government’s proposal to reduce income tax rates on “eligible dividends” in an effort to level the playing field between corporations and income trusts. By increasing the available dividend tax credit, the Minister has partially reduced the well-documented discriminatory effect of dividend taxation (tax practitioners have been quite critical of Canada’s dividend taxation, given the double tax effect of taxing income earned by the corporate entity and subjecting that same taxed income to a second level of tax at the shareholder level). There is no disputing that the traditional income trust structure, so readily adopted by a number of Canadian publicly traded corporations, creates an effective and real tax arbitrage opportunity by significantly reducing or even eliminating completely corporate level tax, a key component in the surging popularity of income trusts in Canada. One need only look at the significant market capitalization of Canadian traded income trusts to gauge this popularity. This combined with the Government’s decision to sidestep (at least for now) any decision to directly tax income trusts has caused speculation that the queue of Canadian companies lining up to convert to the popular income trust model will grow exponentially.

Interestingly, what is lost in all of the income trust scuttlebutt, is the effect that such tax planning may have on private businesses. Now that the Government has shown its reluctance to do or say anything that may upset the income trust market, and are now seemingly prepared, at least for the short term, to address income tax inefficiencies by simply reducing ancillary levels of tax, the path now seems clear to consider a much broader application of the traditional income trust model. As tax practitioners, we are acutely aware of the proliferation of income trusts for large publicly traded companies; one need only open any financial newspaper as evidence of this. However, one must now question whether an opportunity presents itself for a potential trickle down effect to private companies. If the income trust model works so tax efficiently and effectively for publicly traded companies is there any reason to operate any business through a corporation any more?

Traditionally, the use of personal trusts has largely been restricted to personal planning initiatives. Although it has been commonplace to utilize trusts for the purposes of holding an interest in one or more businesses via the acquisition of shares in the capital of the corporate entity, it is only recently that tax practitioners have considered the merits of having the trust actually operate the business. The use of trusts as “business vehicles” can offer many advantages, predominantly from a tax arbitrage perspective. The use of “business trusts” in the context of private businesses now more than ever demands the attention of professional advisors.
To fully appreciate the tax effect of utilizing a Private Business Trust (a “PBT”), a basic understanding of Canadian tax law, as it relates to trusts, is necessary. The general principle being, any income earned in a trust is not subject to taxation within the Trust provided the Trust distributes the profits (income) to the beneficiaries (unit-holders) each year.

The main tax reason for considering the use of a PBT is to eliminate the incidence of double taxation associated with the generation of income at both the corporate and shareholder levels. Assuming a corporation is not a Canadian-controlled private corporation, the taxable income earned by the corporation will be subject to tax at a combined Federal and Provincial rate of approximately 35%. Once the corporation has paid corporate tax, it is now in a position to make a distribution to its shareholders by way of a dividend (a dividend by definition is a distribution of the retained earnings – or accumulated after tax earnings - to corporate shareholders). Dividends (assuming not inter-corporate dividends) are taxed at the personal shareholder level, however the dividend tax rate is lower than the tax rate on regular income as a result of the dividend tax credit. The Canadian tax system recognizes that dividends are distributed by a corporation from after tax income. Individuals receive a dividend tax credit to take into account tax paid by the corporation under a mechanism referred to as “tax integration”. The taxation of income at both the corporate and personal level effectively renders the tax rate higher than the tax that would be paid if the individual had earned the income directly.

Traditionally in Canada, a PBT has not been a vehicle of choice to carry out the business. Instead, personal trusts have often been utilized in the estate-planning for high net worth families to offer benefits in income splitting, capital gains splitting, asset protection, succession planning, probate avoidance and confidentiality protection. Many of the most effective and innovative techniques to maximize a family’s after tax income have utilized trusts as a key-planning component. A key element of such planning would be to ensure that the personal trust owned the shares of a private corporation that would carry out the underlying business. However, such a structure is subject to the double tax implications as explained previously.

Although the use of PBT’s has been far less prevalent than publicly traded Income Trusts, there have been recent examples of taxpayers utilizing PBT’s to carry out a business directly. The most recent example in Canadian jurisprudence is that of the case of Ferrel (Her Majesty the Queen v. Ferrel – 99 DTC 5111). The Ferrel case involved a situation of a personal inter-vivos trust that owned shares of a corporation. The corporation paid “management fees” to the trust pursuant to contractual arrangements between the trust, the corporation and Mr. Ferrel. The trust received such management fees and the trustees of the trust allocated such management fees to the beneficiaries of the trust who happened to be Mr. Ferrel’s children. Accordingly, the income was therefore taxed in the children’s hands as opposed to either the trust’s hands or the corporation’s. The CRA argued that the attribution rules applied to attribute such income back to Mr. Ferrel. Mr. Ferrel argued that the trust was a “business trust” in the sense that it was a trust carrying on a business. The Tax Court of Canada found that the attribution rules did not apply. Accordingly, the Minister appealed to the Federal Court of Appeal. At paragraph 2 of the decision of the Federal Court of Appeal, Justice Linden states:

...we have not been persuaded that the agreements between the trust and the taxpayer and the trust and the company were illegal for purposes of the Income
The decision rendered by the Federal Court of Appeal was welcomed by tax practitioners. Accordingly, to the extent that a personal trust could be utilized effectively in a Ferrel-type situation to carry out a business directly, the advantages would appear as follows:

1. The incidence of corporate taxation would be reduced or eliminated since the business income would be taxable either directly at the trust level or at the beneficiary level to the extent that the profits were paid or made payable to such beneficiaries.
2. The incidence of “kiddie tax” (a special tax levied on minor children to prohibit income splitting via the payment of dividends from a private corporation) would be eliminated since the criteria for the kiddie tax to apply would not be met to the extent that the business income of a trust would be generated from arm’s length sources and such business income allocated to minor beneficiaries.
3. Unlike that of a Canadian-controlled private corporation, there would be no need to “bonus down” profits in order to preserve integration. Accordingly, reasonableness issues and other risks associated with bonuses would be eliminated.
4. Capital gains splitting can occur on business asset sales unlike in a traditional corporate scenario, since a disposition of assets at the corporate level would result in corporate taxation with the only available income splitting being the payment of dividends to shareholders. However, to the extent that income is realized by the trust on an asset sale, such income can be allocated to the desired beneficiaries by the trustees of the trust.

There are some disadvantages for carrying out a business directly through a personal trust, which would need to be carefully considered:

1. A personal trust is not commonly thought of as a business vehicle. Given such, it may be difficult to explain to interested parties such as banks, secured creditors, shareholders, etc. It may be possible to simply address such concerns by having an agent corporation carry out the business activities on behalf of the trust. The use of an agent corporation may be a novel way to avoid some of the uncertainty inherent in the trust’s direct operation of a business.
2. The financial statements of a trust have a different equity section as opposed to a corporation. Accordingly, such equity section of the balance sheet may need to be explained to such interested parties.
3. If a business requires significant capital, the raising of capital would need to be planned out carefully so as to ensure that the trust would obtain such capital without causing the onerous application of certain attribution rules contained in the Act.
4. To the extent that available small business limits are available for a Canadian-controlled private corporation, it may be ideal to utilize such available small business limits given that the effective corporate taxation rate is very low as opposed to the highest taxation rate that is applicable to personal trusts.
5. The issue of whether or not beneficiaries of a personal trust are liable for the liabilities of the business activities of the trust would need to be addressed and appropriately dealt with by the trustees. The risk of a unit-holder’s liability of an income trust has been a
well-publicized concern, and has been put forward by a number of institutional investors (pension funds, for instance) as one of the main reasons for not investing in income trusts. To put this in context, the shareholders of a corporation usually have “limited liability,” in that, by law, a shareholder cannot be held personally liable for the actions and obligations of the corporation. The concept of “limited liability” has always been heralded as one of the lynch pins for operating a business through a corporate structure. Income trusts have tried to ring-fence this liability issue by having the Fund indemnify each unit holder or provide for limited liability in the Declaration of Trust itself. The limited liability issue is also being addressed from a legislative point of view (Ontario, “Trust Beneficiaries Liability Act (2004)” to provide Unit-holders in publicly traded trusts with limited liability”; Alberta “Income Trust Liability Act”; B.C., Nova Scotia and Manitoba are also reviewing potential draft legislation; and Quebec provides liability protection to Unit-holders of Quebec Trusts – 1994 Revised Civil Code of Quebec).

Utilizing PBT’s as business vehicles certainly makes business and economic sense in the right situation and should not be overlooked by professional advisors and investors. From a personal trust perspective, PBT’s as business vehicles are currently under utilized in Canada. With careful planning and the right circumstances, PBT’s as business vehicles can provide great flexibility.