THE TAXATION OF TRUST INCOME:

SOME INHERENT PROBLEMS AND COMPARATIVE PERSPECTIVES

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Abstract

The taxation of trust income is subject to inherent problems due to the nature of the trust itself which allows the separation of the legal and equitable interests and the creation of differing equitable interests in income arising from property held in trust. Problematic areas include questions as to whom should be taxed on trust income, when and at what rate persons should be taxed, and on what they should be taxed.

Taxation of trust income under Canadian law depends on the nature of the income as currently distributable or as accumulating, and on the nature of the trust as testamentary or inter vivos. Provision is made for the taxation of the trust or of the beneficiary. Certain types of income are permitted to retain their character in the hands of the beneficiary.

An attempt to devise a logical system for the taxation of trust income reveals in detail the type of problems inherent in such a system. Conceptual and practical difficulties in determining the appropriate taxpayer, rate, and timing of taxation are considered as is the nature of the beneficial interest and its significance for tax purposes. The Canadian taxation of trust income does not completely resolve these problems.

The proposals of the Royal Commission and the current law in the United States and the United Kingdom are compared and contrasted with Canadian law. Differences among the rules of the various systems reflect differences in the way they deal with the problems inherent in the taxation of trust income.

The problems and their Canadian solutions are reviewed in comparison with methods adopted elsewhere. Any change to the existing rules would require a number of interrelated changes. It is not clear that improvements which might be effected are justifiable given the increased complexity attendant on their introduction.

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Introduction

It is the thesis of this work that any attempt to tax trust income will meet with certain general problems which may be incapable of perfect solution. By "general" problems are meant problems more basic than ones such as whether an *inter vivos* trust has a settlor for purposes of the preferred beneficiary election under the current Canadian legislation. What *is* meant are problems which underlie rules such as those alluded to above; problems which are both theoretical and practical and which are common to other systems of taxation as well as our own. These problems, while they can be simply posed, cannot be simply answered. They include interrelated problems as to whom should be subject to taxation on income arising from property held in trust; related questions as to the rates at which tax should be payable; problems of matching receipt of income with the imposition of tax liability; and problems as to the nature of the income taxed and the effect of its passage through the trust relationship.

That these problems are incapable of perfect solution is inherent in the nature of the trust relationship and in the differing, perhaps at times conflicting, objectives of taxation and trust law. They must be addressed, however, if only because they and the ways in which they are resolved provide the foundation for the complex systems of rules enacted to ensure taxation of trust income. It may well be the that the ways in which these problems are dealt with in Canadian law add further and unnecessary imperfections to an already inconsistent and at times illogical system. It must be remembered however, that no easy comparisons to an ideal system can be made; that, perhaps, no ideal system can be devised.

The subject of the taxation of trusts though perhaps not vast, is nevertheless wider than can be completely encompassed in this work. Certain limiting assumptions are therefore necessary. Questions of the residence of trusts for tax purposes are largely ignored. Likewise are questions as to the distinctions for tax purposes between income and capital interests and in particular, problems arising from the dispositions of such interest and from the distribution of capital in satisfaction of such interests. Consideration of attribution rules is also omitted: the focus here is on the taxation of trust income as it arises and is then distributed or accumulated. With these limits in mind, a brief comment on organization should be made.

In Chapter One, the relevant parts of the existing Canadian legislation are described. It should be noted here that although the rules of other jurisdictions are examined later, the primary focus of this work is on the Canadian rules and the way in which they resolve or fail to resolve the problems under discussion. In Chapter Two, the problems referred to above are further revealed. The course taken in this chapter is to attempt to determine a logical system for taxing trust income. In doing so, problems are of course encountered and it is the examination of these problems and of how the Canadian system described in Chapter One deals with these problems that form the body of this chapter. In Chapter Three, alternatives to the existing rules are considered. Under discussion are the proposals of the Royal Commission on Taxation, and the systems for taxing trust income currently in place both in the United States and in the United Kingdom. Finally, in Chapter Four the problems are summarized and their Canadian solution discussed in comparison with the solutions adopted in other jurisdictions.

Chapter One

Canadian Taxation of Trust Income

Under Canadian law a trust is treated as an individual for income tax purposes even though a trust is not, as a matter of law, an entity but rather an obligation.[1] A trust's income and taxable income are therefore calculated according to the rules applicable to individuals generally, subject to some exceptions.[2] One such exception is the determination of the residence of a trust.[3] Although the legislation contains no provision expressly governing trust residence, it has been generally accepted -- although not without criticism in some quarters -- that, by implication at least, a trust is resi-

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1 A trust is defined for the purpose of the subdivision of the Act dealing with trusts as "includ[ing] an _inter vivos_ trust and a testamentary trust": Income Tax Act, Stats. Can. 1952, c. 148, as amended, s. 108(1)(j). Further statutory references in this chapter are to this Act unless otherwise indicated. For commentary on the nature of the trust obligation, see chapter 2, _infra_.

2 One way in which the taxation of testamentary trusts differs from that of individuals generally is that a testamentary trust need not use the calendar year as its taxation year: s. 104 (23)(a).

3 A consideration of the special rules pertaining to non-resident trusts is beyond the scope of this work and it should be assumed unless otherwise stated that the discussion refers to resident trusts. With respect to non-resident trusts, reference should be made to the following material: Lloyd F. Raphael, _Canadian Income Taxation of Trusts_ (Don Mills, Ont.: CCH Canadian Ltd., 2nd ed., 1982), chapters 1 and 6; Cullity, "Non-Resident Trusts" (1981), 33 Can. Tax Fdn. Rept. Proc. Tax Conf. 646; Goldberg, "U.S. Trusts Cre-

dent where the trustee is resident.[4]

Certain deductions not applicable to individuals in their calculation of income are applicable to trusts. Chief among these are deductions for amounts payable in the year to the beneficiary[5] and for amounts which a beneficiary elects to have taxed as his income. A deduction for amounts paid for the upkeep of trust property used by a beneficiary is also available. The character of the income deducted may be designated by the trust as being of a certain type. To the extent such designations are made, amounts deducted from trust income and included in the income of a beneficiary are considered to be income from a source other than the beneficiary's interest in the trust. As a result, rules governing

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ated by and for Canadians Lose Treaty Exemption for Capital Gains" (1980), 28 Can. Tax J. 218; Noble, "Some Tax Avoidance Aspects of Non-Resident Trusts" (1979), 5 E.T.Q. 81; Maurice C. Cullity and Robert E. Forbes, Taxation and Estate Planning (Toronto: Richard De Boo Ltd., 1978), pp. 132-134, 526-530; R.A. Friesen and D.Y. Timbrell, Canadian Taxation of Income Arising in Non-Resident Corporations and Trusts (Toronto: CCH Canadian Ltd., 1975); Kellough, "Basic Tax Considerations of Trusts and an Examination of Some Particular Types of Trusts" (1975), 27 Can. Tax Fdn. Rept. Proc. Tax Conf. 478 at pp. 495-497; Bradley, "Shareholders of Foreign Affiliates and Beneficiaries of Non-Resident Inter Vivos Trusts" (1974), 26 Can. Tax Fdn. Rept. Proc. Tax Conf. 225; Sarkari, "Taxation of Non-Resident Trusts" (1974), 22 Can. Tax J. 584; Marshall A. Cohen, Income Taxation of Inter Vivos Trusts (Toronto: Canadian Tax Foundation, 1964), chapter 5.

4 The somewhat ludricrous result of a literal interpretation of subsection 104(1) which provides in part that "a reference to a trust ... shall be read as a reference to the trustee" is noted and criticized by Green, "The Residence of Trusts for Income Tax Purposes" (1973), 21 Can. Tax J.

particular types of income, for example, dividends, interest and taxable capital gains among others, will apply to trust income taxed in the hands of the beneficiary.

Certain deductions applicable to individuals in the calculation of taxable income are inapplicable to trusts, namely the personal exemption and deductions for dependants.[6] Also unavailable to an *inter vivos* trust is a deduction for the first $1000 of interest income.[7]

A trust with taxable income is subject to tax. For a testamentary trust, the rates are those applicable to individuals. An *inter vivos* trust, however, pays tax at a minimum rate of approximately 50%.

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217 at pp. 221-222 where he states that "[t]his provision is, to say the least, quite devastating, for if taken literally, it makes absolute nonsense of important parts of the Act." He suggests that in spite of the express provision to the contrary, a reference to the trust should be read as a reference to the trustee only where the context allows. He also points out that if an inference is to be drawn from the provision, the inference that the trust is resident where the trustee is resident is the wrong one, the appropriate result being that the trustee is the taxable entity and thus it is his residence that is important, it being incorrect to speak of resident and non-resident trusts (p. 222). Further discussion of the question of the residence of trusts can be found in Raphael, *supra*, note 3, at pp. 16-25; Morris, "Jurisdiction to Tax: An Update" (1979), 31 Can. Tax Fdn. Rept. Proc. Tax Conf. 414 at pp. 420-423; Amighetti, "Income Tax Events Triggered by Death: An Examination of Selected Problems" (1979), 31 Can. Tax Fdn. Rept. Proc. Tax Conf. 652 at pp. 657-659; Cohen, *supra*, note 3, at pp. 38-42; Scott-Harston, "Residence of Trusts" (1961), 15 Can. Tax Fdn. Rept. Proc. Tax Conf. 244. See also Interpretation Bulletin IT-447 "Residence of a Trust or Estate."

Although a trust is expressly treated as a individual for tax purposes,[8] certain provisions of the Act recognize the nature of a trust as essentially a conduit between the trustee and the beneficiary. Thus where income of the trust is currently distributable, the trust is treated as a conduit in that income is viewed for tax purposes as being income of the beneficiary, rather than of the trust. By virtue of a preferred beneficiary election, the same result can occur where income is accumulating for the benefit of certain known beneficiaries or of potential beneficiaries under a discretionary trust. Alternatively, where income is accumulating for beneficiaries other than those described above, the trust is treated as an individual with respect to that income and is taxed upon it. An examination of the differing rules applicable to income that is currently distributable and income that is accumulating follows. In the final pages of this chapter, rules applicable to specific types of income are considered.

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5 Defined as "includ[ing] a person beneficially interested [in the trust]": s. 108(1)(b).

6 Subsection 104(3).

7 Subsection 110.1(1).

8 Subsection 104(2).

I. Currently Distributable Income

Income referred to here as "currently distributable" includes both income which the trustee is required by the terms of the trust instrument to distribute in the year and income which is distributed in the year pursuant to a discretion exercised by the trustee.[9] For tax purposes, this income is treated as an amount payable to a beneficiary, a benefit received under a trust, or an amount paid for the upkeep of trust property used by the beneficiary. These categories are discussed below. The result of such treatment is that these amounts are included in the income of the beneficiary and may be deducted from the income of the trust. When all income of the trust is currently distributable to resident beneficiaries, the trust itself pays no income tax.

A. Amounts Payable to a Beneficiary

As indicated, an amount payable to a beneficiary may be deducted in computing trust income,[10] and must be included in

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9 Such income does not include amounts distributed as a result of the exercise of a power of encroachment on capital, such amounts probably being distributions in satisfaction of a capital interest and thus receivable by the beneficiary free of tax under subsection 107(2): see Fuke, "Tax Accounting Problems for Executors and Trustees" (1972), 20 Can. Tax J. 189 at pp. 197-198; Cullity and Forbes, supra, note 3, at p. 130.

10 Subsection 104(6).

computing the income of the beneficiary.[11] The inclusion, unlike the deduction, is mandatory, whether or not the trust takes the appropriate deduction. Failure of the trust to do so can result in double taxation.[12]

The mechanics of the deduction and inclusion provisions differ somewhat. The deduction, as a general rule, is made from the notional amount that would be the income of the trust if no deductions were taken for amounts payable to beneficiaries nor for amounts elected to be included in the income of a preferred beneficiary.[13] Where deductions are made from a spouse trust, the notional amount is calculated differently. A spouse trust, essentially, is a trust all the income of which is payable to a beneficiary who is, or was, in the case of a testamentary trust, the spouse of the settlor. If, during the lifetime of the spousal beneficiary, any other person is entitled to any of the income or capital of the trust, the trust does not qualify as a spouse trust.[14] If the spouse is a spouse trust, the deduction is taken from the

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11 Subsection 104(13).

12 An argument that the trust can elect not to deduct the income in which case it need not be included in the income of the beneficiaries failed in the case of Brown v. The Queen, [1980] F.C. 356, [1979] C.T.C. 476 (T.D. 1979). See also the comment on this case by McDonnell, (1979), 27 Can. Tax J. 344.

13 Subsection 104(6).

14 Paragraph 104(4)(a).

notional amount that would be income of the trust not only if no deductions were made for the amounts described above, but also as if amounts deemed to be proceeds of disposition of certain property of the trust[15] were not included in trust income.[16] The effect of this special rule is that the proceeds of disposition deemed to arise on the occurrence of certain dates or events cannot be passed to the beneficiary but must remain in the trust, subjecting the trust, rather than the beneficiary, to the taxable capital gains potentially arising from the deemed receipt of such proceeds.[17] Whether or not the trust is a spouse trust, however, the deduction is the amount payable to the beneficiary by virtue of the trust instrument to the extent of this notional income.

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15 "Capital property (other than depreciable property), property referred to in any of paragraphs 59(2)(a) to (e) or land included in the inventory of a business of the trust": s. 104(4); "depreciable property of a prescribed class of the trust": s. 104(5); "indexed securities owned under the [indexed security investment] plan": s. 104(5.1).

16 Subsection 104(6).

17 Property dispositions giving rise to the deemed receipt of proceeds by the trust are deemed to occur on the day on which the spouse who is the beneficiary under the spouse trust dies, on the day that is the twenty-first anniversary of that day, and at subsequent 21 year intervals: subsections 104(4), 104(5), and 104(5.1); and on the distribution during the lifetime of that spouse to a beneficiary other than the spouse, in satisfaction of his capital interest: s. 107(4).

The counterpart to this deduction provision is not its mirror image although it does provide for an inclusion in the income of the beneficiary.[18] The inclusion is again limited by a notional trust income. This notional amount is the amount that would be income of the trust if no deductions were made for amounts payable to beneficiaries, for amounts elected to be included in the income of a preferred beneficiary, nor for terminal losses or capital cost allowance claimed by the trust. As before, the amount of the inclusion is the amount payable to the beneficiary to the extent of this notional trust income.[19]

Although the quantum of the deduction and the inclusion may appear to differ because of the different notional amounts of trust income limiting each, this is not ultimately the case as claims for terminal loss and for capital cost allowance can be made by the beneficiary. The actual amount payable to the beneficiary is constant, regardless of whether a deduction or inclusion is being calculated.[20]

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18 Subsection 104(13).

19 Ibid.

20 It must be remembered that these subsections are dealing with two different matters. Involved in determining income for trust purposes and thus the amount payble to a beneficiary is the question of whether or not the trustees are entitled to set aside a reserve for depreciation. Involved in determining income for tax purposes and thus the appropriate deductions from and inclusions in income, is the question of the allocation of capital cost allow-

The deduction and the inclusion both apply to the year in which the income is payable. Whether payment is actually received by the beneficiary in that year is irrelevant. Where the years of reporting and receipt do not coincide, amounts earlier reported are excluded from income in the year of receipt.[21] Where the trust is a testamentary trust having a taxation year other than the calendar year,[22] the taxation year of the trust and of the beneficiary will not be the same. In order for the deduction and inclusion to coincide in such a case, benefits are included in the income of the beneficiary for the taxation year of the trust during which they are paid, even if this differs from the taxation year of

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ance. With respect to the first question it seems that whether a trustee may set aside an amount for depreciation is a matter for trust law and may depend in part on whether the trust is carrying on a business: see Williamson, "Capital Cost Allowances and Allocation Problems in an Estate or Trust" (1966), 16 U.T.L.J. 310; Raphael, supra, note 3 at pp. 217-224; Cohen, supra, note 3, at pp. 28-32. Where the trustee properly deducts an amount for depreciation, thus reducing the amount payable to a beneficiary, the beneficiary need include only that reduced amount in his income, having neither received nor been entitled to receive the amount properly set aside: Goldman v. Minister of National Revenue (1953), 9 Tax A.B.C. 251. A number of other cases have been decided, under earlier versions of the Act, on the ground that the trustee was not entitled, as a matter of trust law, to set aside amounts for depreciation. Such amounts were then included in the income of the beneficiaries for tax purposes, those beneficiaries being entitled to receive such amounts: Hebert v. Minister of National Revenue (1955), 13 Tax A.B.C. 65, 55 D.T.C. 305; No. 249 v. Minister of National Revenue (1955), 12 Tax A.B.C. 433, 55 D.T.C. 229. Cases decided in favour of the taxpayer, in that the

the beneficiary in which they are received.[23]

The rules discussed above establish a method of transferring income tax liability with respect to amounts payable to a beneficiary from the trust to that beneficiary. What is meant by "amounts payable," however, has given rise to some questions. The term includes not only amounts actually paid in the year, but also amounts the payment of which the beneficiary was entitled in the year to enforce.[24]

As a prerequisite to an amount being payable to a beneficiary, it seems that the trust must actually be in receipt of income; deemed receipt under the Act being insufficient. The point was determined in the case of Pichosky v. Minister

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deduction taken by the trustees was held to be proper, include Manning v. Minister of National Revenue, [1956] Ex. C.R. 350, [1956] C.T.C. 167, 56 D.T.C. 1099; No. 216 v. Minister of National Revenue (1954), 11 Tax A.B.C. 454, 55 D.T.C. 551.

With respect to the second question, the provisions of subsection 104(13) do not result in a greater amount being included in the income of the beneficiary than was deducted in computing the income of the trust. In both the deduction and inclusion provisions, the amount payable to a beneficiary which depends in part on whether a reserve for depreciation has been taken, is the same. What is precluded, in subsection 104(13), is a reduction for tax purposes of the income payable to the beneficiary by the use of capital cost allowance which may be taken by the trust irrespective of any amount set aside for depreciation. Thus the trust might, for tax purposes, be entitled to claim capital cost allowance in the amount of, for example, $20,000, yet not set aside any reserve for depreciation, instead distributing the entire trust income of, for example, $100,000 to the beneficiary so entitled. If the amount included in the income of the beneficiary was of National Revenue[25] when an unsuccessful attempt was made to apply the attribution rules to a dividend received by a personal corporation and thus deemed received by the trust which was a shareholder of that corporation.

Where income is not actually paid in the year to a beneficiary, in order for the amount to be considered payable, the beneficiary must be "entitled in that year to enforce payment." Questions have also arisen as to the nature of this right to enforce payment; the effect of non-exercise of the right; and the method, if any, by which the right can be barred.

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determined after the trust had taken capital cost allowance, that amount would be $80,000 whereas the beneficiary was actually entitled to and received the full $100,000. Since in such a case the trust would not need the allowance to set off against other income, in particular, amounts retained as a reserve for depreciation, subsection 104(16) provides for the flow through of such amounts to the beneficiary. In the result, capital cost allowance may be deducted by the beneficiary from the amount which would otherwise be his income from the trust, but capital cost allowance cannot, if deducted at the trust level, unduly enhance the position of the beneficiary.

21 Paragraph 104(13)(b).

22 See supra, note 2.

23 Paragraph 104(23)(c).

24 Subsection 104(24). The views of the Department of National Revenue may be found in Interpretation Bulletins IT-286R "Trusts--Amount Payable" and IT-342 "Trusts--Income Payable to Beneficiaries." Raphael, supra, note 3 at

With respect to the nature of the right required, the argument has been made that the right of a beneficiary having a vested interest in remainder to enforce due performance of the trust is sufficient to bring income accumulating in a trust within the definition of an amount payable. The argument failed.[26] The right of a beneficiary to ensure proper performance of the trust can thus not be equated with an entitlement to enforce payment unless perhaps such a right is exercised by a beneficiary whose interest is not only vested but is also not preceded by that of another beneficiary, nor is subject to defeasance.

The issue has also arisen in the context of a trust under which trustees were given a discretion to pay income or capital at any time for the "maintenance, support, education,

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p. 161 describes an amount as "payable at a date to a person if the person has on the date the right to demand payment thereof, sue therefor and the authority and capacity to give a valid binding receipt for payment received."

25 [1964] Ex. C.R. 946, [1964] C.T.C. 177. See also the comment on this case by McGregor, (1964), 12 Can. Tax J. 238. This principle has been expressly adopted with respect to the deemed receipt of proceeds of dispositions of property deemed to occur under subsections 104(4), 104(5), 104(5.1), and 107(4): see supra, note 17. With respect to the deemed income arising when the trust incurs recapture of capital cost allowance, see Williamson, supra, note 20 at p. 321 and see Cullity and Forbes, supra, note 3, at p. 111.

26 Ansell Estate v. Minister of National Revenue, [1967] 1 Ex. C.R. 518, [1966] C.T.C. 785. See also the comments on this case by McGregor, (1963), 11 Can. Tax J. 42 on the Tax Appeal Board decision and (1967), 15 Can. Tax J. 257 on the decision of the Exchequer Court.

advancement or benefit" of the beneficiary.[27] The trustees purported to make the amounts of income arising in each year payable to the beneficiary as and when requested by his parents. Such a request was never made and no amounts were paid in the years under consideration. The court found that under the trust instrument the authority given to the trustees was to pay, not to "make payable" but that even if, as suggested in the case of Sachs v. The Queen[28]

> [t]he authority to pay income to the beneficiaries... includes the authority to declare or designate income as held for them to the exclusion of the continuance of the trustee's authority to deprive them of it and to the exclusion of the possibility of their being deprived of it upon the happening of events referred to in the trust deed,[29]

this had not in fact occurred in the present case. It would seem, then, that amounts of income over which the trustee may exercise a discretion to pay, cannot be considered payable unless they are actually paid to the beneficiary or at the very least, unless they are irrevocably designated as being held for him subject only to his calling for them; the beneficiary not otherwise being entitled to enforce payment of such amounts.

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27 Cole Trusts v. Minister of National Revenue, [1980] C.T.C. 3027 (T.R.B.).

28 [1980] C.T.C. 358, 8 E.T.R. 39 (F.C.A.); aff'g [1980] C.T.C. 39 (F.C.T.D. 1979).

29 Per Thurlow C.J. at C.T.C. p. 362, E.T.R. p. 47.

The failure of the beneficiary to exercise his legal right to enforce payment will not relieve the beneficiary of his liability for tax on the income payable. In the case of Wood v. Minister of National Revenue[30] it was held that the taxpayer, not having exercised a valid disclaimer of his interest in the income, was properly taxed upon it.

In another case before the Tax Review Board[31] a taxpayer was entitled to an annuity but never received it as she entered into an agreement with other beneficiaries to receive a lump sum instead. She was taxed on the amount of the annuity to which she was entitled in the taxation year occurring before other, binding arrangements were made. These decisions make it clear that in order to preclude taxation of the beneficiary on amounts payable to him which he has not received and which, for whatever reason, he does not care to receive, a mere omission or refusal to exercise his right to enforce payment is insufficient. To prevent taxation, he must be legally barred from exercising that right. A disclaimer may serve this purpose.

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30 (1964), 37 Tax A.B.C. 37.

31 Johnson v. Minister of National Revenue (1958), 20 Tax A.B.C. 266.

A beneficiary may disclaim his interest by words or by conduct[32] but his disclaimer must be absolute. Thus the receipt of monies coupled with their assignment to a third party as occurred in the case of Plaxton v. Minister of National Revenue[33] where the beneficiary deposited amounts paid to him to his children's credit, does not constitute a disclaimer. The mere fact, however, that a disclaiming beneficiary can foresee the party to whom the disclaimed monies will go does not invalidate a disclaimer properly made.[34] In such a case, the person who becomes entitled to the money is so entitled under the terms of the original instrument, the disclaimer being merely the event triggering that entitlement. Where a beneficiary has disclaimed he is not liable

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32 Wood, supra, note 30.

33 (1959), 23 Tax A.B.C. 257, 60 D.T.C. 38, per Fordham at Tax A.B.C. p. 260, D.T.C. 40. See also the comment on this case by McGregor, (1960), 8 Can. Tax J. 96. For further discussion of the nature of a disclaimer see Cullity, "Will--Income Interests--Renunciation After Acceptance--Partial Renunciation--Taxation" (1978), 56 Can. B. Rev. 317 at pp. 318-319: "The fundamental distinction between the disclaimer which, for most purposes, avoids a gift of an interest ab initio and the various methods by which a person can divest himself of a proprietary interest which he has previously accepted has been recognized for centuries. After having accepted his interest, a life tenant under a trust might subsequently dispose of it by assigning it to another beneficiary or to a third party, by directing the trustee to hold it on trust for such a person, by declaring himself to be a trustee, by surrendering it to some other beneficiary or by releasing it to the trustees with the intention of extinguishing it. In some circumstances, significant consequences might follow from the choice of one or other of these methods. They share,

for tax.

1. Amounts Deemed to be Payable

The concept of an amount payable is somewhat broader when applied to an infant beneficiary whose interest is vested. Where the only reason that income is not payable to him in the year is that he was an infant, such income is considered to be payable for tax purposes.[35] Two questions arise therefore with respect to property held in trust for an infant beneficiary: firstly, whether his right to the income is vested, and secondly, if it is, whether the limitation on payment of the income arises only by virtue of his infancy.

Whether or not an interest is vested depends upon the terms of the settlement.[36] In discussing the question of

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however, the characteristic that they are essentially dispositions of subsisting interests, and that characteristic distinguishes each of them from a disclaimer. Where an interest is disclaimed, it is treated as if it had never been acquired by the disclaiming party"; and at p. 330; Bernstein, "Income Tax Consequences of Trust Distributions of Income and Capital" (1981), 33 Can. Tax Fdn. Rept. Proc. Tax Conf. 587 at pp. 592, 625-626; Amighetti, _supra_, note 4 at p. 654. See also Interpretation Bulletins IT-305R "Establishment of Testamentary Spouse Trusts," paragraph 5, and IT-385R "Disposition of an Income Interest in a Trust."

34 _Herman_ v. _Minister of National Revenue_ (1961), 28 Tax A.B.C. 145.

35 Subsection 104(18).

36 _Hashman Trustees_ v. _Minister of National Revenue_, [1972] C.T.C. 2227, (T.R.B.).

vesting, albeit with respect to the application of the attribution rules, Mr. Justice Heald stated in the Sachs case[37] that

> [a]n estate is contingent if the accrual of the owner's title depends upon the occurrence of some event ... Before it can be said that a beneficiary is entitled to a vested interest, two things must concur: (a) his identity must be established; (b) his right to the interest (as distinguished from his right to possession) must not depend upon the occurrence of some event.[38]

Thus where trustees were to keep trust money invested "until [each] child attains the age of 21 years" and were then to pay the trust monies to the children, their interests were held to be contingent and being contingent, not payable. In no way did the existence in that case of a power of encroachment for the maintenance of the children vest the gift.[39]

A distinction must therefore be drawn for tax purposes between gifts to infants contingent on their attaining the age of majority and gifts to infants which, although vested, are subject to a postponement of payment during infancy. A postponement for any other reason will preclude the income from being treated as payable to the beneficiary. In the case of Cole Trusts v. Minister of National Revenue[40] after

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37 Supra, note 28.

38 Ibid. at C.T.C. p. 365, E.T.R. pp. 50-51.

39 Supra, note 36.

40 Supra, note 27.

stating that to be vested an amount must meet the tests for its being payable, the Board goes on to state, with respect to the limitation on payment, that "the constraint [must] arise out of the terms of the trust deed" and not from any inherent right a trustee might have to withhold payment because of the minority of the beneficiary.[41]

2. Limitations on Amounts Payable

Although essentially beyond the scope of this discussion, brief mention should be made of limitations placed on the deduction of amounts payable to a beneficiary which result primarily from the non-resident status of either the trust or the beneficiary, or both.[42] Firstly, no deduction is permitted for amounts payable to a non-resident beneficiary unless the trust is resident in Canada.[43] If this was not the case, a distribution free of withholding tax could be made by a non-resident trust carrying on business in Canada.

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41 The last point was not strictly necessary to the decision since "the evidence was not that such payment was withheld because the beneficiary was an infant": supra, note 27, at p. 3033.

42 For discussion of the treatment of non-resident beneficiaries see: Raphael, supra, note 3, at pp. 224-238; Bernstein, supra, note 33, at pp. 634-638; Kellough, supra, note 3, at pp. 493-495; Cullity and Forbes, supra, note 3, at pp. 131-132; Cohen, supra, note 3, chapter 5.

43 Subsection 104(7).

Secondly, the deductibility of amounts payable to "designated beneficiaries" which include non-resident persons and resident trusts with non-resident beneficiaries among others is limited.[44] Simply put, no deduction can be taken for designated income payable to designated beneficiaries. The result is that designated income is taxed in the hands of the trust at the appropriate trust rate rather than in the hands of the beneficiary at the flat rate at which withholding tax is levied.

Designated income is defined as including income from real property in Canada, from timber resource properties, from Canadian resource properties, and from businesses carried on in Canada. It is further defined as including only taxable capital gains and allowable capital losses from property that would have been taxable Canadian property if the trust had not been resident, and as including only those non-capital losses arising from real property in Canada, from timber resource property, and from businesses carried on in

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44 Paragraph 104(8)(b). The deduction of amounts payable is limited to the amount by which the aggregate of all amounts payable to beneficiaries or included in their incomes under subsection 105(2) exceeds the proportion of the amount by which designated income of the trust exceeds trust income net of amounts payable, amounts included in computing the income of a preferred beneficiary and amounts included in the income of a beneficiary under subsection 105(2), that the aggregate of amounts payable to designated beneficiaries is of all amounts payable to all beneficiaries or included in their incomes pursuant to subsections 104(14) and 105(2).

Canada.[45] Double taxation of amounts not deductible by the trust yet payable to a designated beneficiary is precluded by deeming such amounts not payable and therefore not included in the income of the beneficiary where so designated by the trust.[46]

Thirdly, where all of the property of a trust is held for non-residents an additional deduction is provided. This allows for the deduction of any dividends or interest received by the trust from a non-resident-owned investment corporation to the extent that these amounts were not already deducted as being payable to a beneficiary.[47] The amount so deductible is deemed for the purposes of Part XIII of the Act to have been paid to a non-resident as income from the trust.[48]

The fourth limitation deals not with non-resident status but with deemed proceeds of disposition included in the income of the spouse trust where there has been an election by the trust and a preferred beneficiary.[49] The effect of

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45 Paragraph 108(1)(d.1).

46 Subsection 104(25.1). The same effect is achieved with respect to the application of withholding tax under paragraph 212(1)(c) by subsections 212(11.1) and 212(11.2).

47 Subsection 104(10).

48 Subsection 104(11). A "non-resident-owned investment corporation" is defined in subsections 248(1) and 133(8).

this limitation is that deemed proceeds are taxable only in the hands of the trust. Double taxation of amounts payable to a beneficiary but for which no deduction is permitted, is prevented by deeming such amounts not to be payable.[50]

In addition to "amounts payable" to a beneficiary, the following amounts are also included in his income: namely, "benefits" received from the trust and amounts spent on his behalf for the upkeep of trust property.

B. Benefits

The value of all "benefits" to a taxpayer from a trust must be included in his income.[51] Significantly, no provision is made for a corresponding deduction for the trust.[52] The provision is, of course, designed to counter tax avoidance.

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49 Subsection 104(8). The deduction applicable to the spouse trust in this case is limited to the amount by which the total of all amounts payable to beneficiaries or included in their incomes under subsection 105(2) exceeds the proportion of the amount by which the deemed proceeds exceed trust income net of amounts payable, amounts included in computing the income of a preferred beneficiary and amounts included in the income of a beneficiary under subsection 105(2) that the amount payable to beneficiaries is of the aggregate of all amounts payable to beneficiaries or included in their incomes by virtue of subsections 104(14) and 105(2).

50 Subsection 104(25).

51 Subsection 105(1).

52 Except to the extent that such amounts can be considered "payable" to a beneficiary or included in his income under subsection 105(2), assuming that subsection 105(1) has this wide a scope, see *infra*, note 53.

Although broadly worded, the scope may be somewhat illusory. Payments of capital are expressly excluded as are, at least by implication, payments of an income nature.[53] Benefits which may be caught include the sale of trust property to the taxpayer (note that the subsection is not restricted in its application to the beneficiaries) for less than fair market value, or alternatively, the sale of his property to the trust for greater than fair market value. The granting of a no or low interest loan by the trust to the taxpayer could also constitute a benefit.[54] Other suggested benefits include "the assumption by the trust of a beneficiary's personal and living expenses, or the rental of property to the beneficiary for an artificially low rent."[55]

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53 Even if the latter are not implicitly excluded by virtue of their being specifically dealt with under subsection 104(13), subsection 105(1) can presumably be read down to give such a limited effect, in accordance with subsection 4(4). In the Ansell Estate case, supra, note 26, Thurlow J. stated that "[t]o some extent the provision of this section may overlap that of 63(6) [now 104(13)] but their fields of operation are not co-extensive": C.T.C. at p. 799. See also Cullity and Forbes, supra, note 3 at p. 115.

54 Bernstein, supra, note 33.

55 Canada Tax Service, p. 105-101.

C. Upkeep or Maintenance of Trust Property

Where the terms of the trust instrument require trust income to be spent on the maintenance of property used by a life tenant or other beneficiary, such amounts must be included in the income of the appropriate beneficiary. Corresponding amounts can be deducted by the trust.[56] The amounts which must be so included and, therefore, which may be deducted, are limited by the test of what is "reasonable in the circumstances." Thus, presumably, a life tenant would not be required to include in his income amounts expended for capital rather than ongoing repairs and maintenance.[57]

II. Accumulating Income

Where income is accumulating, rather than currently distributable, different considerations apply. If the income is the subject of a preferred beneficiary election which allows the trustee and beneficiary to elect to have income accumulating for the benefit of the beneficiary taxed in his hands, it will be taxed at the rate applicable to the electing beneficiary. If not, the income will be taxed in the trust at the rate applicable to it depending on whether the trust is a

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56 Subsection 104(6).

57 The only reported decision on this subsection dealt with it only incidentally to another matter, see Molson v. Minister of National Revenue (1950), 20 Tax A.B.C. 67, 58 D.T.C. 476.

testamentary or inter vivos trust. Where no preferred beneficiary election is made and tax is levied on the trust rather than on the beneficiaries, the question of multiple trusts and their consolidation becomes important. The tax treatment of accumulating income depends then on whether a preferred beneficiary election, considered further below, is made.

A. The Preferred Beneficiary Election

As mentioned, where a preferred beneficiary election[58] is made, the amount of accumulating income subject to the election is included in computing the income of the beneficiary[59] and can be excluded in computing the income of the trust.[60] As a result, rather than being taxed in the trust, the income is taxed in the hands of the beneficiary, at the rate applicable to him, and in the year of election, not the later year of receipt.[61]

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58 For a more detailed discussion of the preferred beneficiary election than follows here, see Bernstein, *supra*, note 33 at pp. 595-615; Bernstein *et al.*, "The Taxation of Accumulating Income of Personal Trusts" (1980), 28 Can. Tax J. 715; Stringer, "Preferred Beneficiary Election in Testamentary Trusts" (1979), 5 E.T.Q. 160. See also Interpretation Bulletin IT-394 "Preferred Beneficiary Election."

59 Subsection 104(14).

60 Subsection 104(12).

61 Subsection 104(14).

Accumulating income is that income which the trustees are under an obligation to accumulate or with respect to which, they have a discretion to accumulate and do accumulate. Accumulating income is defined as the income of the trust calculated without deduction of amounts elected by a preferred beneficiary and without inclusion of certain deemed proceeds of disposition.[62] The existence of income actually received by the trust and not otherwise distributed to beneficiaries is thus a necessary prerequisite to the election by a beneficiary and the trust.

The election is limited to preferred beneficiaries. A preferred beneficiary is a beneficiary of the trust who is an individual resident in Canada and who is either the settlor of the trust or a person standing in a particular relationship to the settlor.[63] A "beneficiary" includes "a person beneficially interested in" a trust;[64] that is, a person who has either a "capital interest"[65] or an "income interest"[66]

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62 Paragraph 108(1)(a).

63 Paragraph 108(1)(g).

64 Paragraph 108(1)(b).

65 Defined as "a right (whether immediate or future and whether absolute or contingent) of the taxpayer as a beneficiary under the trust to, or to receive, all or any part of the capital of the trust": paragraph 108(1)(c).

66 Defined as "a right (whether immediate or future and whether absolute or contingent) of the taxpayer as a bene-

in the trust.[67]

The identity of the settlor of a trust is determined pursuant to the Act. If the trust is a testamentary trust, that is, one arising on and as a result of the death of an individual, and not created by someone other than that individual nor in receipt of property which has been contributed by anyone other than the individual,[68] the settlor is that individual.[69] Alternatively, if the trust is an inter vivos trust, that is "a trust other than a testamentary trust,"[70] the identity of the settlor depends upon whether the trust was created by the contribution[71] of property by one person or by the contribution of property jointly[72] by an individual and his spouse. In the first case, so long as the fair mar-

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ficiary under the trust to, or to receive, all or any part of the income of the trust": paragraph 108(1)(e).

67 IT-394, supra, note 58, paragraph 7.

68 Paragraph 108(1)(i).

69 Subparagraph 108(1)(h)(i). See also Interpretation Bulletin IT-374 "Meaning of Settlor."

70 Paragraph 108(1)(f).

71 According to IT-374, supra, note 69, paragraph 5, a contribution is essentially a transfer which vests title in the trustee without the person transferring the property receiving any value in return. Loaned property presumably does not therefore constitute a contribution, nor does a sale for fair market value.

72 What is meant by a "joint contribution" is somewhat unclear. Apparently, the contribution need not be of jointly held property nor need the contribution of each person be of equal value, although the contribution may

ket value[73] of the contributions made by the individual exceeds the fair market value of the total of all contributions made by other persons, that individual is the settlor. In the second case, and so long as the same condition is met with respect to the fair market value of the joint contributions, the settlors are the individual and his spouse.[74] As a result of this rule, an _inter vivos_ trust may never have a settlor, may only have a settlor from time to time[75] or may always have a settlor.[76] Where the trust has no settlor it has, by definition, no preferred beneficiary, and no reduction of income for tax purposes can be made by election.

A person may be a preferred beneficiary if he is the settlor of the trust, or if he is the spouse or former spouse of the settlor, or if he is the child, grandchild, or great grandchild, or a spouse of any of them, of the settlor.[77] The

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need to be made simultaneously, see IT-374, _supra_, note 69, paragraph 4. See also Raphael, _supra_, note 3, at p. 192.

73 At the time of the contribution, according to IT-374, _supra_, note 69, paragraph 6.

74 Clauses 108(1)(h)(ii)(A) and 108(1)(h)(ii)(B).

75 An individual's status as the settlor of an _inter vivos_ trust can be regained by subsequent contributions the value of which, coupled with the value of his previous contributions, exceeds the value of contributions by other parties.

76 IT-394, _supra_, note 58, paragraph 10.

77 Paragraph 108(1)(g).

extended definition of child[78] applies for this purpose, thus an illegitimate child, an infant dependant of whom the taxpayer has in law or in fact the custody and control, a son- or daughter-in-law, a stepchild, or an adopted child may all be preferred beneficiaries.

Where a preferred beneficiary exists, he and the trust may jointly elect that a designated part of the accumulating income, not exceeding his share, may be included in his income for tax purposes and excluded from that of the trust.[79] The share of a preferred beneficiary depends upon the nature of the trust as a spouse trust or otherwise and as a discretionary or non-discretionary trust.

Where the trust is a spouse trust[80] and the spouse is living at the end of the taxation year, no preferred beneficiary other than the spouse has a share in the accumulating income.[81] The share of the spouse is the entire amount of

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78 Subsection 252(1).

79 Bernstein, <u>supra</u>, note 33, raises the issue of whether or not the preferred beneficiary, to be entitled to elect, must have a capital interest, since accumulating income is added to trust corpus. He suggests that while a capital interest is not necessary where the trust is a spouse trust, at least a contingent capital interest may be necessary where the trust is discretionary, although the matter is not clear with respect to a non-discretionary trust (pp. 602-603). See also Raphael, <u>supra</u>, note 3, at pp. 193-202.

80 As defined in paragraph 104(4)(a).

that income. The accumulating income comprises capital gains on trust property, income for the purposes of a spouse trust not including capital gains.[82] This leads to the anomaly that a spouse who is entitled only to income can never receive the capital gains which accrue to the benefit of the capital beneficiary, yet only he or she can pay tax on those gains, rather than leaving them to be taxed at the trust rate. If by the terms of the trust instrument the spouse beneficiary is entitled to receive capital gains as well as income, the trust will have no accumulating income.

Where the trust is not a spouse trust the share of the preferred beneficiary is determined according to whether or not his interest depends upon the exercise of discretion by any person, or the failure to exercise such a discretion. Where the trust is not discretionary, the general rule is that a preferred beneficiary's share is the portion of accumulating income that may "reasonably be regarded as being earned for his benefit."[83]

An exception to this general rule provides that where the beneficiary is a member of a class of beneficiaries entitled to share equally in any income of the trust, his share

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81 Paragraph 104(15)(a).

82 Subsection 108(3).

83 Subparagraph 104(15)(b)(ii).

is calculated by dividing the amount of income to which the class is entitled by the number of members of the class, other than registered charities. The effect of this is to allow amounts accumulating for charities to be taxed in the hands of beneficiaries with lower marginal rates than are applicable to the trust, the charities themselves not being entitled to enter into an election.[84]

Where the interests of the beneficiaries depend upon the exercise by any person, or the failure to exercise, a discretionary power, a preferred beneficiary's share is governed by regulation. Under a discretionary trust, in order for any preferred beneficiary to elect, all beneficiaries whose interest depends upon the exercise or non-exercise of the discretion must be preferred beneficiaries, persons who would be preferred beneficiaries if they were resident in Canada, or registered charities.[85]

Here the general rule is that a preferred beneficiary's share is determined by dividing the accumulating income by the number of preferred beneficiaries entitled to share in

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84 See Cullity and Forbes, _supra_, note 3, at p. 114.

85 Paragraph 104(15)(c). With respect to the necessity for persons entitled on a gift over or in default of appointment to qualify as preferred beneficiaries, see Bernstein, _supra_, note 33, at p. 609 and Cullity, "Powers of Appointment" (1976), 28 Can. Tax Fdn. Rept. Proc. Tax Conf. 744 at p. 748, respectively.

the income.[86] A series of exceptions to this rule deal with situations where the settlor and his spouse or either of them are living and entitled to share in the accumulating income. Where this is so, the proportion of trust property contributed by the settlor is an additional factor relevant to the determination of a beneficiary's share.[87]

In any case not dealt with above, the share of the preferred beneficiary is nil, in effect precluding him from making the election.[88]

The effect of the election is two-fold. In the first place it allows a transfer of tax liability from the trust to a preferred beneficiary in a given year. In the second place, it allows a subsequent tax-free distribution of the income, whether or not to the beneficiary who earlier elected to pay tax on it.[89]

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86 Income Tax Regulations, Part XXVIII, paragraph 2800(3)(f).

87 Income Tax Regulations, Part XXVIII, subsections 2800(3) and 2800(4).

88 Paragraph 104 (15)(d).

89 Subsection 104(14). Such a result, for accumulating income generally, whether elected upon by a trust and preferred beneficiary or not would also seem to be reached by the decision in the Ansell Estate case, supra, note 26, see Ex. C.R. at pp. 533-534, and by a reading of subsection 107(2), assuming that accumulating income is added to corpus and is thus distributed tax-free to a beneficiary in satisfaction of his capital interest.

B. Income Accumulating and Not the Subject of a Preferred Beneficiary Election

Where no election is made by the trust and a preferred beneficiary to designate the accumulating income as that of the beneficiary for tax purposes, the trust remains liable for the payment of tax on that income. The rate at which the trust pays tax on its income depends upon its classification as a testamentary trust or as an *inter vivos* trust. A testamentary trust was described earlier as a trust arising on and as a consequence of the death of an individual and not created by a person other than that individual. The scope of this category of trusts has been narrowed by recent amendments to the Act. Trusts created after November 12, 1981 which would otherwise be considered to be testamentary trusts are classified as *inter vivos* trusts if, during the taxation year, "property has been contributed to the trust otherwise than by an individual on his death."[90] Trusts created before this date will be classed as *inter vivos* rather than testamentary in a taxation year if, after June 28, 1982 "property has been contributed to the trust otherwise than by an individual on his death"[91] or if the fair market value of property contributed otherwise than on the death of an individual exceeds the fair market value of property contributed on

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90 Subparagraph 108(1)(i)(ii).

91 Clause 108(1)(i)(ii)(A).

death.[92] Where, even with the more restrictive conditions now applicable, a trust can be classed as a testamentary trust, it is subject to tax on its taxable income at the rates applicable to individuals.[93]

An *inter vivos* trust pays tax at the greater of a federal rate of 34% of taxable income and the amount otherwise determined to be its tax payable.[94] As a result of the application of the provincial income tax rates to federal tax payable, an *inter vivos* trust subject to British Columbia income tax, for example, would pay tax at a combined minimum rate of approximately 50%.[95]

Transitional rules provide that this minimum rate does not apply to an *inter vivos* trust established before June 18, 1971: which was resident on that date and continuously thereafter until the end of the taxation year; which did not carry on any active business in the year nor receive property by way of gift since June 18, 1971; nor after that date, incur any debt or obligation to or guaranteed by a person with whom any beneficiary was not dealing at arms length.[96]

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92 Clause 108(1)(i)(ii)(B).

93 Section 117.

94 Subsection 122(1).

95 That is, 44% of 34%: Income Tax Act, R.S.B.C. 1979, c. 190, s. 3(1), (5).

C. Multiple Trusts

Although a trust is deemed to be an individual with respect to trust property, where several trusts exist and substantially all the trust property has been contributed by one person, and the income from all the trusts may ultimately accrue to the same beneficiaries or class of beneficiaries, the trusts may be treated as one.[97] Where all of the income of the trust is currently distributable or is subject to election by preferred beneficiaries, this provision is of little practical effect. Its significance has also been reduced by the replacement of individual tax rates with a high minimum rate applicable to inter vivos trusts. Testamentary trusts -- and those inter vivos trusts not caught by the minimum rate rule -- which are subject to tax do benefit from separate status since each trust, being treated as a separate individual, is subject to its own marginal rate of taxation.

In the case of Mitchell v. Minister of National Revenue[98] it was held that four separate trusts, one created for each of the taxpayer's four children, did not constitute a

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96 Subsection 122(2).

97 Subsection 104(2).

98 (1956), 16 Tax A.B.C. 99.

single individual. It does not appear from the report whether the trust instruments made provision for cross-remainders over; if so, it seems likely that the decision would have been otherwise.

III. The Nature of the Income Allocated Between Trust and Beneficiary -- The Flow-Through Rules

Recognizing, in spite of the express provision to the contrary, that a trust is not an entity or individual but rather is a relationship or a "conduit" between the trustee and the beneficiary, the Act provides for a number of types of income, allowances and credits to be treated as those of the beneficiary rather than the trust. The effect of these provisions is that instead of passing through the trust to become simply income received from the trust, these types of income allowances and credits retain their different characters when received by the beneficiary. Thus for example taxable dividends received by the trust can be designated as being received by the beneficiary with the result that the beneficiary is entitled to apply the dividend gross up and credit provisions to them.

The mechanics of the rules are fairly straightforward. The types of income, allowances and credits subject to flow through treatment are set out in the Act as are the limitations on the amounts which may be designated. The argument that all types of income received by the trust as well as allowances and credit should be permitted to retain their character in the hands of the beneficiary[99] has been put to rest by a recent addition to the Act. That amendment states that except as otherwise provided, amounts included in a beneficiary's income shall be deemed to be income from an interest in a trust.[100] Deductions by a beneficiary of amounts otherwise deductible by the trust are correspondingly limited.[101]

The types of income, allowances, and credits for which this treatment is provided in the Act, are primarily the following: dividends, both taxable and nontaxable; interest; taxable capital gains; capital cost allowance, recapture and terminal loss; depletion allowance; foreign taxes; pension benefits; and death benefits.[102]

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99 See also, Bernstein, supra, note 33, at p. 616; Kellough, supra, note 3, at p. 491. See also Minister of National Revenue v. Trans-Canada Investment Corporation, [1956] S.C.R. 49, [1955] C.T.C. 275; aff'g [1953] Ex. C.R. 292, [1953] C.T.C. 353.

100 Subsection 108(5).

101 Paragraph (108)(5)(b).

102 Although not discussed here, similar treatment is extended to the investment tax credit (subsection 127(7)) and to amounts received as a refund of premiums under an RRSP (subsection 146(8.1)).

A. Dividends

1. Taxable Dividends

Taxable dividends received by a trust on shares of the capital stock of a taxable Canadian corporation[103] may be designated by the trust as, and therefore be deemed to be, taxable dividends received by the beneficiary rather than by the trust. An exception to this treatment is provided with respect to non-resident withholding tax under Part XIII: non-resident beneficiaries are treated as receiving taxable dividends as income from the trust, rather than dividends per se.

The amount which can be designated received by any particular beneficiary is subject to three limitations: firstly, it "must reasonably be considered" to be part of the amount included in the income of the beneficiary; secondly, it cannot exceed the amount so included, whether as income payable, amounts elected by a preferred beneficiary, or benefits or upkeep; and thirdly, it must not be an amount designated as taxable dividends with respect to another beneficiary.

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103 Subsection 104(19). See also Interpretation Bulletin IT-372 "Trusts--Flow-through of Taxable Dividends to a Beneficiary."

The effect of such a designation is that the beneficiary is entitled to apply the dividend gross-up and credit provisions[104] to such income. If no designation is made, the trust is entitled to apply these provisions to the extent that it has not distributed all of its income. If it has, and if no designation has been made, the operation of the gross-up and credit rules is lost to both the trust and the beneficiary.[105]

2. Non-taxable Dividends

Non-taxable dividends received by the trust, if designated by the trust, are not included in computing the income of the beneficiary.[106] The limitations on the amounts which may be designated with respect to a particular beneficiary differ somewhat from those applicable to taxable dividends. A designation can be made only when an amount is payable to a beneficiary. In addition, the "reasonably considered" limitation referred to above, although present, applies not to the share of the beneficiary, but instead to the nature of the dividends. The amount is again limited to the extent that it has not been designated with respect to another bene-

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104 Subsection 82(1) and section 121.

105 See Bernstein, _supra_, note 33, at p. 617.

106 Subsection 104(20). Non-taxable dividends are primarily dividends paid out of a corporation's capital dividend account: subsection 83(2).

ficiary.

B. Interest Income

The portion of interest income designated by the trust is deemed to be interest of the beneficiary, and not of the trust.[107] The limitations on the amount which can be designated are the same as those applicable to taxable dividends.

Each beneficiary receiving amounts designated is entitled to deduct up to $1000 of interest income in computing his taxable income.[108] As a result of the flow-through of interest, the deduction is multiplied by the number of beneficiaries receiving interest income. Furthermore, where the trust is an _inter vivos_ trust, if it were not for the operation of this provision, no deduction for interest income would be permitted, such a trust being precluded from taking the deduction itself.[109]

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107 Subsection 104(26).

108 Section 110.1.

109 Subsection 110.1(1). For further discussion of the treatment of interest income see Raphael, _supra_, note 3, at pp. 212-215 and pp. 216-217.

C. Taxable Capital Gains

A flow-through of taxable capital gains net of allowable capital losses and net capital losses carried forward is permitted, although only to a beneficiary resident in Canada.[110] Amounts designated by the trust are deemed[111] to be taxable capital gains of the beneficiary from the disposition of capital property. The limitations on the amount which can be designated are essentially the same as those applicable to taxable dividends and to interest income. Amounts deemed received as proceeds of deemed dispositions are neither deductible as amounts payable nor as amounts with respect to which a preferred beneficiary election has been made, and thus no flow-through of these amounts is permitted.[112]

No provision is made for the flow-through of losses.[113]

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110 Subsection 104(21). See also Interpretation Bulletin IT-381 "Trusts--Taxable Capital Gains and Allowable Capital Losses."

111 For the purposes of sections 3 and 111.

112 Subsection 108(6) and paragraph 108(1)(a), respectively.

113 This may cause a problem where the trust has loss carry forwards--deductible in computing taxable income rather than income--yet is required to distribute all its income, thus leaving it with a taxable income of zero. As a result, the benefit of the deduction is lost.

D. Capital Cost Allowance, Recapture and Terminal Loss

A beneficiary may deduct from the amount that would be his income from the trust either as being payable to him or as a result of election, the amount of capital cost allowance and terminal loss otherwise deductible by the trust that the trust determines.[114] Amounts then deductible by the trust are correspondingly reduced. For the purpose of calculating recapture of capital cost, however, amounts of capital cost allowance deducted by beneficiaries are deemed to have been allowed to the trust. The amount deductible by a particular beneficiary is limited to his proportionate share of trust income.[115]

E. Depletion Allowance

The flow-through of a depletion allowance is limited to amounts payable to a beneficiary to the extent that those amounts are designated by the trust as being payable "out of an amount deductible in computing the income of the trust for the year under regulations made under subsection 65(1)."[116] As is the case with the designation of capital cost allowance

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114 Subsection 104(16). Some question exists as to whether the beneficiary entitled to take capital cost allowance must be a capital beneficiary, see Raphael, _supra_, note 3, at pp. 219-220.

115 Subsection 104(17.1).

116 Subsection 104(17).

and terminal loss, the amount deductible by a beneficiary is limited to his proportionate share of trust income.

The effect of the designation is that the beneficiary receives the income tax-free.[117]

F. Foreign Taxes

A beneficiary is deemed to have received foreign source income to the extent such income is designated by the trust.[118] The amount that may be designated is limited to the amount that may "reasonably be considered" to be part of the income included in computing the income of the beneficiary -- as being payable to him or as the result of election -- and that is not designated by the trust with respect to another beneficiary. A beneficiary is also deemed to have paid that proportion of the foreign tax paid by the trust on its foreign income, that the proportion of foreign income included in computing his income is of the total foreign income of the trust.[119] The income of the trust from foreign sources is deemed to be its actual income therefrom less any amounts deemed to be foreign source income of the beneficiary.[120]

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117 See Bernstein, supra, note 33, at p. 622.

118 Subsection 104(22). See also Interpretation Bulletin IT-201 "Foreign Tax Credit--Trust and Beneficiaries."

119 Paragraph 104(22)(b).

120 Paragraph 104(22)(c).

Foreign taxes paid are deemed, essentially, to be those paid by the trust less those deemed paid by the beneficiary.[121]

The effect of these designations is that the beneficiary receiving such income is entitled to apply the foreign tax credit provisions against his income tax otherwise payable.[122]

G. Pension Benefits

The provisions dealing with the flow-through of pension benefits apply only to testamentary trusts. Pension benefits which would otherwise be included in the income of the trust, if designated by the trust, are deemed to be included in computing the income of the beneficiary instead.[123] Amounts which may be designated are limited to those which may reasonably be considered to be part of the amounts payable to the beneficiary and which are not designated in respect of any other beneficiary.

As a result of designation, the amounts in question may be eligible for transfer to a deferred tax arrangement[124] and, where the beneficiary is the spouse of the deceased tes-

121 Paragraph 104(22)(d).

122 Section 126.

123 Subsection 104(27).

124 Paragraph 60(j).

tator, for the pension income exemption of $1000 in computing taxable income.[125]

H. Death Benefits

Finally, that part of any amount received by a testamentary trust as a death benefit that may reasonably be considered "to be paid or payable at a particular time to a particular beneficiary" is deemed to be received by that beneficiary as a death benefit and not to have been received by the trust.[126] By retaining its character, such income is eligible for at least partial exemption in computing income where the beneficiary is the spouse of the person as a result of whose death the benefit was paid, or a child of that person where the spouse is deceased.[127]

In conclusion, the rules governing the taxation of trust income provide for taxation in the hands of the beneficiary or in the trust, but not both. Allocation of tax liability depends upon the nature of the income, that is, whether it is currently distributable or accumulating, and on the source of the income. Trusts are taxed at a minimum rate of approxi-

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125 Subsection 110.2(1).

126 Subsection 104(28).

127 Subsection 248(1) "death benefit" and subparagraph 56(1)(a)(iii).

mately 50% -- unless they are testamentary trusts -- a rate higher in most cases than would be paid by a beneficiary receiving the income directly. This inequity can be removed to some extent by the use of the preferred beneficiary election.

Chapter Two

Problems Inherent in Taxing Trust Income

Having set forth in Chapter One the existing Canadian rules pertaining to the taxation of trust income, an attempt will be made in this chapter to present a logical argument as to the way in which such income should be taxed. The focus here will be not so much on technical points such as when an amount can be considered payable -- matters which were discussed in Chapter One as part of the description of the existing rules -- as on more general questions such as on whom and on what tax should be imposed, when, and at what rate. In the course of argument certain problems will become apparent. These problems and the way in which the existing rules solve or avoid them, or fail to do so, will also be discussed.

Starting from the position that an income tax system is a more or less permanent feature in the policy of governments and in the lives of taxpayers, it is clear that income arising from property held in trust must equally be subject to income tax as is that arising from property otherwise held. Such a result is appropriate both in principle[128] and at a

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128 The principle of neutrality in a taxing system suggests that taxpayers should pay the same amount of tax on a given amount of income whether it is received directly or through an intermediary such as a trust or a corporation.

pragmatic level since if this was not the case the avoidance of tax would be a simple matter indeed. It is also clear that so far as possible the method chosen to tax trust income should conform to general principles of taxation[129] and should not unnecessarily disregard trust concepts.[130] Balanced against this latter objective, however, is the necessity to prevent undue reduction of taxes through the use of the additional taxpayer created when property is placed in trust.[131] Given that trust income must be taxed, liability for the payment of tax must be imposed in some quarter.

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129 For example, principles of equity and neutrality and the need for simplicity.

130 For example, the recognition that a trust is an obligation not an entity.

131 It was doubtless this concern which prompted the inclusion of the following provision in the November, 1981 Notice of Ways and Means Motion to Amend the Act: "(73) That... (e) effective after November 12, 1981, a provision be introduced to counter tax avoidance where in a taxation year a trust distributes an amount to or designates an amount in respect of a beneficiary and one of the results thereof is an undue reduction or postponement of the tax otherwise payable under the Act." The provision did not ultimately appear in the legislation although more precise amendments were made to limit the advantages which could be derived from the operation of the rules as they then stood; including a more restrictive definition of "testamentary trust"; the restriction on the conduit nature of the trust (now s. 108(5)); and limitations with regard to the shares of dividends and

I. Determining the Appropriate Taxpayer

As a general rule, the owner of property is subject to tax on income arising from that property, an appropriate result since he is entitled to the use and benefit of that income. An exception to this general rule is made in circumstances to which the attribution rules apply. The basis for this exception is that although property has been transferred, thus relieving the transferor of ownership, the relationship between the transferor and the transferee, or the conditions under which transfer to the trust was made, is such that the transferor may well retain control over the property and receive the benefit of the income arising therefrom.[132]

Assuming, however, that the transfer of property is not such that it will attract application of the attribution rules, the question arises as to the correct choice of the tax unit: the trust, the trustee, or the beneficiary.

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credits which could be allocated among beneficiaries (e.g. s. 104(17.1)).

132 Income Tax Act, Stats. Can. 1952, c. 148, as amended, ss. 74-75. Further statutory references in this chapter are to this Act unless otherwise indicated.

A. Trust or Trustee?

A trust, unlike a corporation, does not constitute a legal entity. As a result, it cannot own property, nor be made liable for the payment of tax on income arising from that property, nor make payment of that tax through an agent since a trust not being an entity can hardly be a principal. A trust has been defined as

> an equitable obligation binding a person (who is called a trustee) to deal with property over which he has control (which is called the trust property), for the benefit of persons (who are called the beneficiaries or cestuis que trust), of whom he may himself be one and anyone of whom may enforce the obligation.[133]

Notwithstanding the nature of a trust as a relationship between two parties vis-a-vis certain property, the existing rules deem the trust to be an entity separate from both beneficiary and trustee, for the purposes of the Act. While this position is stated clearly and expressly in one part of the Act,[134] the directive included in another casts some confusion on the matter.[135] The confusion perhaps reflects an unease with adopting so basic a diversion from trust law and

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133 Underhill's Law Relating to Trusts and Trustees (London: Butterworths, 13th ed., David J. Hayton ed., 1979) p. 1.

134 Subsection 104(2).

135 Subsection 104(1) which provides that a reference to a trust is to be read as a reference to a trustee. See also, Chapter 1, supra, at p. 5, n. 4.

is not, as might be suspected, confusion as to the nature of the trust under trust law, but rather as to the nature of the trust for purposes of the Act. Two views are apparent: one, that the trust is a separate entity discharging its tax liability through its agent, the trustee; and another, that the trustee, being owner of the trust property and acting vis-a-vis that property in a capacity distinct from that of his individual capacity, is liable for tax on income arising from that property.

Reading the two provisions of the Act together, that is, that a trust is a separate entity or individual, and that a reference to a trust is to be taken as a reference to a trustee -- which on the face of it appears to be directed toward the agency question -- the result is, appropriately, that it is the trustee who is considered to be the separate entity. In such a context, the reference to the trustee's personal tax liability remaining unchanged[136] makes perfect, if redundant, sense. One cannot be totally satisfied with this reading however since a literal application of the provision that a reference to a trust is a reference to a trustee, produces nonsensical results among some of the other provisions.[137] If its meaning is questionable there, it must also be question-

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136 Subsection 104(2).

137 For example, paragraph 104(2)(b), subsection 104(15).

able when applied to the issue of the nature of the trust as an entity or otherwise.

Treating the trust as the taxable entity is a misleading shorthand for so treating the trustee. Although it might be argued that, for the sake of simplicity, the trust ought to be considered an entity, surely the distinction between the individual as trustee and the individual in his personal capacity is scarcely if at all more complex than the notion of an artificial person. In addition, such "simplicity" can be achieved only by distortion of the nature of the trust; unnecessary distortion, although admittedly only "for tax purposes."

B. Trustee or Beneficiary?

Assuming that it is neither necessary nor desirable to treat the trust as a taxable entity and that, as between the trust and the trustee, it is more appropriate to so treat the latter, a further question arises. Should the trustee, as legal owner of trust property, or the beneficiary as the person entitled to the benefit of the income arising from the trust property, be the party subject to tax?

Several arguments in favour of imposing tax on the trustee spring to mind immediately. He is the legal owner of the trust property and as such, income arising from that property is generally receivable by him. Having the control and management of the trust property he is in the position best suited to reporting income and determining tax payable. In addition, tax can be paid out of trust monies in his hands, thus matching liability with the means of discharging it.

The primary difficulty in imposing tax on the trustee is directly attributable to the nature of the trust relationship. Although he is the legal owner of the trust property he is not, as trustee, entitled to any benefit arising therefrom. The problem is not of course that the trustee to his detriment pays tax on money he never receives. The separation of his liability as an individual from his liability as trustee achieves this result. The difficulty is that, given a system of taxation which employs progressive marginal rates and which gives some recognition to the attributes of the taxpayer by virtue of deductions and exemptions for example, where the taxpayer receives but does not benefit from income, his personal circumstances ought not to be relevant. As a result, the question arises as to the rate of tax which ought to be applicable to trust income in the hands of the trustee.

Two alternatives are possible, given the absence of relevant personal and financial circumstances. The trustee may simply be subjected to the same set of marginal taxation rates as are other individuals, with no allowance for the exemptions applicable to such taxpayers. Alternatively, he may be subjected to a flat rate of tax on trust income, such a rate by definition ignoring the circumstances of the taxpayer. Bearing in mind earlier comments on the desirability of the taxation of trust income conforming to general principles of taxation, it appears that neither choice is particularly appropriate since in either case any correlation between the rate imposed on the trustee and the rate at which the beneficiary would pay tax, is merely coincidental. Applying the first alternative, while the income from a trust under which only one beneficiary was entitled to income might well be taxed at a lesser rate than if it had been taxed in the hands of the beneficiary,[138] where more than one beneficiary exists, the aggregation of income in the hands of a single taxpayer, the trustee, could well result in higher rates.

While the adoption of a flat rate would eliminate the anomaly of the appropriateness of the rate varying with the number of beneficiaries with interests in the trust income, such a rate would not necessarily be the equivalent of the rate which would be payable by the beneficiary. The adoption of a flat rate gives rise to a further question as to where on the scale of progressive marginal rates, such a rate

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138 Due to the application of two sets of graduated marginal rates on taxation of the same aggregate amount of income.

should fall. Since a flat rate ignores the economic circumstances of the taxpayer, other factors would presumably influence the choice of rate. Considerations of tax avoidance validly being among them, such a rate might well need to be set closer to the upper end of the scale than to the lower end.

As has been illustrated, neither alternative is without its difficulties. The existing rules reveal a compromise on the issue: testamentary trusts are subject to the individual marginal rates; *inter vivos* trusts are not.[139] The basis of the distinction appears quite simply to be the prevention of tax avoidance, especially when one considers the further restrictions placed on trusts in order to qualify as testamentary in nature[140] and the quantum of the flat rate applicable to *inter vivos* trusts.[141] Such distinctions, however, are illogical and add to an increasingly complex and sometimes ill-thought out collection of anti-avoidance rules, each of which builds on the preceding rule and each of which introduces further distinctions of its own.[142]

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139 Sections 117, 122.

140 See the definition of testamentary trust: s. 108(1)(i).

141 A minimum *federal* rate of 34%: s. 122(1).

142 Interestingly, in none of the other three systems for the taxation of trust income discussed in Chapter 3, is a distinction drawn between testamentary and *inter vivos* trusts.

Since the reasons initially advanced in favour of taxation of the trustee, essentially administrative and expedient in nature, seem outweighed by the difficulty in determining an appropriate rate at which the trustee could be taxed, it may well be that the beneficiary is the more appropriate tax unit. Trust income to which the beneficiary is entitled can be aggregated with his other income the total of which, subject to the appropriate exemptions, deductions, allowances and credits, determines his taxable income and thus tax payable at the appropriate rates.

The conceptual difficulty in taxing the beneficiary is that while he is entitled to the benefit of income arising from property held in trust, he is not, at least in classical trust theory viewed as the owner of that property. In other words, he does not have rights in that property but rather, has a right against the trustee to compel the proper administration of the trust. He owns not the property of the trust, that is, the assets giving rise to the income, but instead owns his interest in the trust. The contrary view was of course adopted in the case of Baker v. Archer-Shee.[143] In practice, the distinction may not matter. Viewed from the

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143 [1927] A.C. 844 (H.L.). See also, Waters, "The Nature of the Trust Beneficiary's Interest" (1961), 45 Can. B. Rev. 219.

perspective of taxation, the beneficiary ought to be subject to tax for the same reason that an owner was said earlier to be subject to tax, namely because he is entitled to the use and benefit of the income. The issue is not legal ownership per se, but possession of a right of enjoyment in property.[144] Arguably, the criterion that the owner be the person taxed can be met by the view that the beneficiary owns his interest in the trust and that income received by the beneficiary arises not from the specific trust assets but from that interest, which itself constitutes property.[145]

While at this point it may seem that despite the potential for conceptual difficulties regarding the nature of ownership, the beneficiary is the person on whom tax liability should logically be imposed, the matter is not that simple. Given the nature of the trust relationship which separates ownership of the legal and equitable estates and thus allows for successive equitable interests and interests of varying natures, one cannot posit one solution applicable in all cases. Instead one must examine the various positions in which a beneficiary might find himself, both from the point

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144 This view is reflected in other parts of the Act, eg. s. 54(c)(v) change of legal ownership without a change in beneficial ownership; s. 56(2) indirect payments; ss. 74 and 75 attribution rules.

145 The nature of the beneficiary's interest and its significance for tax purposes is discussed further below, at pp. 65-68.

of view of general principles as well as with an eye to practicality.

II. Imposing Tax Liability: Difficulties of Timing and Rate

Beneficiaries in a given year may be ascertained -- whether their entitlement to income is vested or merely contingent -- or unascertained, and may or may not be in receipt of income arising under the trust. Three positions will be considered: the beneficiary who is ascertained and who is in receipt of income; the beneficiary who, although ascertained is not in receipt of income, either because his interest is contingent or because although it is vested, payment is postponed; and the beneficiary who is not yet ascertained, or more properly the situation existing where income is accumulating for eventual distribution to beneficiaries to be determined by the exercise of the trustee's discretion. In the first case, obviously, income will be currently distributable; in the latter two it will be accumulating in the hands of the trustee.

A. The Beneficiary who is Ascertained and in Receipt of Income

Where a beneficiary is in receipt of income (a circumstance under which he must both be ascertained and have a vested interest in that income) clearly he rather than the trustee can and should be taxed. By taxing the beneficiary the objective of taxing the person entitled to the benefit of income arising from property is met. In addition, the beneficiary can be taxed at the rate appropriate for him in the year in which the income arises and is received by him. As well, tax liability and the means with which to discharge it merge in the same taxpayer.

The existing rules achieve this result by the mechanism of including in the income of the beneficiary amounts payable to him and by deducting from trust income the corresponding amount.[146] The same result should and does occur under the existing rules when although income has not actually been paid to the beneficiary, he could, if he wished, enforce payment.[147]

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146 Subsections 104(6),(13). The same effect would be achieved, although at the expense of added complexity, by a gross-up and credit system under which tax was paid by both the trustee and the beneficiary.

147 See the definition of "amounts payable": s. 104(24).

B. The Beneficiary who is Ascertained but not in Receipt of Income

Somewhat more difficult questions arise where the beneficiary, although ascertained, is not in receipt of income. This may occur either because his interest is as yet contingent or because, although his interest is vested, payment is postponed. The difficulty with taxing the beneficiary under these circumstances is that he has not yet and in fact may never receive the income to which he is at least contingently entitled. Even if he does ultimately receive the income, he will have been called upon to pay tax upon it for the year in which it arose, a year in which not having received the income, he may have difficulty making payment.[148] A further inequity arising from the disparity between the year in which the income arises and that in which it is received or receivable by the beneficiary is that the rate at which he would pay the tax would be the rate appropriate for him in the year in which income arose. This rate could well differ from that applicable to him in the year income is received or receivable either because there had been a change in the rates prescribed or because there had been a change in his financial position.

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148 Practically, of course, this problem may be solved by a direction in the trust instrument that the trustees are to pay all taxes or by the exercise by trustees of a broadly drawn power of encroachment.

Assuming for the moment that the timing disparity between the years of taxation and receipt ought not necessarily to be a bar to the taxation of the beneficiary, such a solution, at least in the case of the beneficiary who's interest is vested, may be appropriate particularly if the alternative is to tax the income in the hands of the trustee without regard to the position of the beneficiary. The second timing problem, disparity of rates still remains. If, alternatively, recognition could be given to the position of the beneficiary, taxation of the trustee might be a desirable result. This possibility is discussed further below. Where the interest of a beneficiary is only contingent, however, in no way ought he to be compelled to pay tax on income he may never receive.

The existing rules provide with respect to income vested in an infant but with payment postponed, for taxation of the beneficiary at the rate then applicable to him.[149] While the rate at which tax is paid thus more closely approximates the appropriate rate than would taxation of the trustee under the existing rules, the problems of matching receipt of income with the imposition of tax liability and disparate rates in the years income arises and is later received, remain.

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149 Subsection s. 104(18).

As for the taxation of income accumulating for a beneficiary whose interest is as yet contingent, the existing rules provide that where the beneficiary is a preferred beneficiary, he and the trustee may elect that he will pay the tax applicable in a year on an amount of accumulating income of the trust not exceeding his share.[150] If the beneficiary is not a preferred beneficiary, or if he chooses not to make the election, the income is taxed at the rate applicable to the trustee.

The fact that such treatment must be elected no doubt reflects the fact that unlike the case of the postponement of payment to an infant whose right to the income has vested, in this case the beneficiary may never receive the income. Although in theory the problem of disparity between taxation and receipt of income still exists, under these circumstances it is less problematic. The election of course need not be made if the beneficiary has insufficient funds to discharge the tax. As for the potential disparity in rates referred to above -- the disparity between the rate applicable to the beneficiary in the year he pays the tax and the year in which he receives the income -- a third factor must now be added. In addition to disparities arising from a change in the prescribed rates from year to year or a change in the position

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150 Subsection s. 104(14).

of the beneficiary is the potential disparity arising from the fact that once the beneficiary has elected and paid tax on certain income, it may subsequently be distributed tax-free to another beneficiary notwithstanding a divergence in the applicable rates.[151] There is, under the existing rules, no scope for correcting this problem since the distribution of such income is considered to be a distribution in satisfaction of a capital interest, an event which is not taxable.[152]

What has not been done directly however may have been done indirectly. The Sachs case[153] provided that the election by a preferred beneficiary with a contingent income was sufficient to vest interest in the beneficiary. While the attentions of the Court were directed to the question of the applicability of the attribution rules, it would seem as well that such a result would preclude the subsequent distribution to a different beneficiary.

If one does not accept the view that it is appropriate to tax a beneficiary with respect to income he has not yet received, either in a mandatory fashion or through an

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151 Ibid.

152 Subsection 107(2).

153 Sachs v. The Queen, [1980] C.T.C. 358 (F.C.A.), aff'g [1980] C.T.C. 39 (F.C.T.D.).

election mechanism, one must fall back on the taxation of the trustee. The major objection to such a course, that the rate imposed on the trustee would be one determined arbitrarily and without reference to the position of the beneficiary can be met, where the beneficiary is ascertained, by applying to the trustee the rate applicable to the beneficiary. In this way, tax could be paid out of the income upon which it was levied and could be paid at the appropriate rate for that year. The problem of the beneficiary's rate being different in the year of distribution could be solved by an adjustment made by the trustees in the case of a further deduction if necessary or by the beneficiary in the case of an application for a partial refund of taxes paid earlier by the trustees vis-a-vis income ultimately received by him.

While such a proposition may have a certain logical and equitable appeal, pursuing it further reveals certain administrative problems. For example, which portion of the beneficiary's income should the trust income be considered since a notional inclusion at the top end of the beneficiary's income might well lead to his being subject to a higher rate of tax; such a higher rate therefore being applicable to the trustee with regard to that income.

Further, in order to calculate his tax payable as trustee, the trustee must have knowledge of the taxable income of the beneficiary, indeed, perhaps of his entire tax return given that were the trust income received by the beneficiary in the year, he might have been entitled to additional credits or allowances, thus reducing the amount by which his income would be increased by receipt of the trust income. This need for information on the part of the trustee thus leads to further difficulties. Firstly, the beneficiary is compelled to disclose his otherwise confidential tax return. Secondly, either the trustee is put under substantial pressure to get and make use of the necessary information from the beneficiary in order to file returns in the same year as the beneficiary or else, if this is impossible, the trustee must pay tax on income arising in a year, based on the position of the relevant beneficiary in the preceding year. Thirdly, and most significantly, where there are a number of beneficiaries, the trustee must in effect calculate separate returns for shares of income proportionate to the interest of the beneficiary,[154] determine the rate applicable and thus tax payable in each case, and then aggregate the latter to determine his tax payable; a procedure somewhat more complex than that under the existing rules.

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154 Assuming that not only the beneficiaries but also their shares are ascertained, subject to their meeting any contingencies imposed on their entitlement.

These problems, it should be noted, assume that the income is ultimately received by the beneficiary whose rate has been applied to it. In the case of the contingent beneficiary whose interest does not eventually vest and who therefore never receives that income, a further problem arises in that adjustments to the amounts of tax previously paid would need to be made, given that the income will now be received by another beneficiary. Under the existing rules, the failure of the interest of a contingent beneficiary to vest is disregarded.

It should be clear that the difficulties involved in taxing trust income where beneficiaries are ascertained but not in receipt of income, are not wholly resolvable. The choice to be made is a choice between a number of imperfect solutions.

C. The Unascertained Beneficiary

Beneficiaries under a trust will be unascertained in any given year where the trust instrument provides that the entitlement, if any, of a beneficiary, depends on a discretionary power held by the trustee. What is meant here by discretionary power is not a discretion as to whether to pay income to X in a given year or whether to accumulate it, but rather, a discretion as to whether to ultimately pay accumulated income to X or to Y. Under these circumstances it seems clear that tax must be payable by the trustee and at some standard rate since there are no beneficiaries whose positions would as yet be relevant.

In such a case it would seem that there is no reason why a payment on the part of the trustee could not be considered a pre-payment by the beneficiary. If so, the amount paid could be subject to adjustment at the point at which the beneficiary was ascertained. This could be simply done by the use of a gross-up and credit system. In other words, the beneficiary could include in income for tax purposes both income received and tax paid by the trustee. He would then receive credit for the latter amount in determining what further tax or refund was applicable in respect of the income. Rules would of course be necessary to determine the amount of credit applicable to a particular beneficiary.

The existing rules do not, however, use such a system. Instead, where all potential beneficiaries are preferred beneficiaries, and only then,[155] the beneficiaries may elect to pay tax on the trust income at their own rates. The rules as presently constituted make no provision for situations in which not all beneficiaries are qualified to elect, or for situations in which the trustees do not ultimately exercise

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155 Or where, if not preferred beneficiaries, the beneficiaries would be preferred were they resident in Canada, or else were registered charities: s. 104(j).

their discretion in favour of a potential beneficiary who has previously elected. The <u>Sachs</u> case may, however, preclude the development of such a situation although it does so on the basis of a somewhat shaky foundation.

III. <u>The Nature of the Income</u>

The nature and thus the treatment of income arising from property held in trust depends essentially on the view one takes as to the nature of the beneficiary's interest. If he is regarded as having rights in specific trust assets then clearly the trust ought to be seen as a mere conduit, with income passing through the trust retaining its character. As a result, the beneficiary's entitlement to the operation of all tax rules pertinent to that type of income ought to be preserved. Alternatively, if he is regarded as owning not specific assets but instead, his interest in the trust, then income received by him is income from a source that is property, that property being his interest in the trust. In this latter case, the nature of income arising in the trust is not preserved when it passes through the hands of the trustee to be received by the beneficiary.

Applied against these two views as to the nature of the beneficiary's interest is the taxation principle of neutrality, essentially, that the substance of the income, rather than the form in which it is received, ought to govern its tax treatment.

The same issue arose earlier in this chapter with regard to the question as to whether or not the beneficiary ought to be the party taxed. In that context, a decision as to the nature of the beneficiary's interest was unnecessary since one could argue for taxation of a beneficiary under either theory. Likewise in the discussion imposing tax on the beneficiary at the rate appropriate to him, the nature of the beneficial interest could be simply assumed without being decided, thus allowing for a focus on the question of neutrality of rates. In considering the effect on income of passing through the trust, however, the matter can no longer be ignored.

Arguably, treating the trust as a conduit is the better view. Although earlier in this chapter an argument was made against departing from trust theory so far as the nature of the trust as an entity or otherwise was concerned, different considerations are present here. Taking the position that the taxable entity ought to be the trustee rather than the beneficiary in no way impinged on tax theory or principle. Regardless of whether the trust or the trustee was considered the tax unit, there was still a person on whom tax liability could be imposed. Thus one could argue in favour of preserving trust principles. With respect to this question, however, the classical view of the beneficiary's interest conflicts directly with the tax notion of neutrality. Given the desirability of achieving consistent treatment across the wide spectrum of incomes and taxpayers, it may be justifiable to depart from trust theory in this context.

Whether one agrees or disagrees with the above conclusion it would seem logical that a consistent pattern be followed. In other words, that the trust in all tax matters be viewed as a conduit or alternatively, that all income received by the beneficiary be viewed as income from property, that is, the beneficiary's interest in the trust.

The existing rules do not adopt this logical approach. With the advent of recent amendments to the Act, the conduit principle is now preserved only in a limited number of specific situations, as expressly provided by statute. In all other cases, income is considered to be income from property as described above.[156]

IV. The Problems in Summary

The foregoing discussion should have highlighted several areas which are problematic in any attempt to develop a logical system of rules for the taxation of trust income. The first of the areas focusses on the nature and identity of the taxpayer: the trust, although it is not an entity; the trus-

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156 Subsection 108(5).

tee who has legal but not beneficial ownership of the trust property; or the beneficiary, regardless of how his interest is viewed conceptually. The second area, that of the imposition of tax, considers three situations depending on whether or not the beneficiary is ascertained and is in receipt of income. This area reveals further problems in determining the person on whom tax liability should be imposed; problems not originally apparent in a more generalized discussion of the nature of the interest held by the trustee and by the beneficiary. Such problems include the determination of the appropriate rate of tax, timing difficulties and administrative problems, as well as the difficulty which arises from taxing a person who may never receive the income which has been subjected to tax in his hands. The third area of difficulty deals with the treatment of income passing through the trust. That treatment depends on one's view of the nature of the beneficial interest and thus of the trust.

The existing rules reflect these problems. Some confusion exists as to whether it is the trust or the trustee who is subject to tax. Further, depending on the nature of the trust provisions, it is sometimes the beneficiary and sometimes the trust(ee) who is subject to tax. In the latter case, the rate of taxation depends on the classification of the trust as testamentary or *inter vivos*.[157]

With respect to the question of the imposition of tax liability, either no attempt is made, other than in the case of a beneficiary who is both ascertained and in receipt of income, to achieve an appropriate rate of taxation, or if it is, it is at the expense of other factors which themselves lead to difficulties.[158]

As for the matter of the nature of trust income, inconsistent treatment under the existing rules is only too apparent.

In examining and criticizing any set of legal rules one must be aware that the nature of the subject matter may be such as to preclude the development of a system of rules that is in all cases both logical and consistent. This is particularly so when one attempts to lay the rules of one area of law, taxation, over those of another area, trusts. Inconsistencies between the rules of the two systems are bound to occur and reflect the differing objectives of the respective

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157 Paragraphs 108(1)(f), (i), sections 117, 122.

158 For example, where no preferred beneficiary election is made, an _inter vivos_ trust is taxed at a 50% rate and accumulated income is ultimately distributed as capital with no adjustment made as to the amount of tax previously paid. Alternatively, if an election is made, although the initial rate of tax paid is appropriate to the electing beneficiary he has paid tax on income he may never receive and at a rate which may not even approximate that applicable in the year in which trust money is eventually received.

areas of law. Inconsistencies within a system, however, ought to be minimal. The existing rules governing the taxation of trust income may in some respects be more inconsistent than is required by their subject matter.

Chapter Three

Alternatives to the Canadian System

Problems in the taxation of trusts are not limited to the current Canadian system of taxing trust income. Problems such as those illustrated in Chapter Two are inherent in the nature of the trust and must be grappled with by the implementers of any scheme of rules. In this chapter, some of the proposals of the Royal Commission on Taxation regarding the taxation of trusts are described, as are the methods for taxing trust income under American and British law. Aspects of these three sets of rules are compared and contrasted with current Canadian law.

I. Proposals of the Royal Commission

Before commencing an examination of the proposals put forward by the Commission regarding the taxation of trust income, two matters of an introductory nature should be mentioned. The first of these can perhaps be termed the philosophy of the Commission. In general, this consisted of a focus on the principles of equity and neutrality in taxation.[159] In particular, this focus led the Commission to attempt to devise principles for a system which would tax

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159 Report of the Royal Commission on Taxation (Ottawa: Queen's Printer, 1966). See, for example, volume 4, p. 150.

trusts fairly vis-a-vis income passing through other intermediaries and vis-a-vis direct transfers to a beneficiary.[160] The results of this governing philosophy can be seen in the Commission's advocacy of a gross-up and credit system similar to that applied to corporations and their shareholders, and in their recommendation that a "prospective beneficiary" be allowed to elect that a trust be taxed at his "additional rate," respectively.[161]

The second introductory matter is that of the scope of the Commission's report and the exclusions from it which it is necessary to make here. Matters which are not dealt with in this work include some concepts which are common to the Report as a whole and some recommendations specifically pertaining to trusts. The Commission recommended the inclusion of gifts within the tax base and the expansion of the tax unit from the individual to the family. The trust recommendations contained in the Report reflect these general principles in the special rules devised both for the treatment of trust income that constitutes a gift or bequest, and for the treatment of intra-family transfers. Neither type of rule is discussed here since the premise which underlies each does not form part of the general income tax law presently appli-

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160 See Report, supra, note 159, volume 4, p. 149.

161 These terms are defined, infra, at pp. 83-84.

cable to Canada.[162]

Also excluded from consideration are certain recommendations which although specific to trusts, are beyond the scope of this work. This is so either because they deal with specific areas which are not discussed here, such as distributions from trust corpus[163] or the residence of a trust,[164] for example, or because they are provisions which are merely transitional in nature.[165]

A. The General Rule: Taxation of the Trust

Despite some apparent confusion in the wording of the Report[166] it seems clear that the Commission adopted the view of the trust as conduit rather than as entity. Where it does treat the trust as an entity it does so for purposes of administrative convenience only, regarding tax levied on the

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162 These rules are elaborated in Chapter 21 of the Report, supra, note 159.

163 See Report, supra, note 159, volume 4, pp. 157-158.

164 See Report, supra, note 159, volume 4, pp. 195-198.

165 See Report, supra, note 159, volume 4, pp. 164-165.

166 For example, the Commissioners state, at volume 4, p. 150 of the Report, supra, note 159: "[a] trust is an intermediary, much like a corporation or a co-operative, and, as such, is a conduit through which income passes on the way to the beneficiaries"; and at p. 155: "[a] trust is an entity which acquires property by way of gift, or bequest, or for a consideration, and earns income from the holding or disposal of property, from business, or otherwise."

trust as a prepayment of tax owed by the beneficiary rather than as an amount properly imposed on the trust as an entity in its own right.[167] To the extent that the Commissioners lean toward an analogy between the corporation and its director and the trust and it trustee they reflect their view that all intermediaries be taxed, to the extent possible, in the same manner. This analogy perhaps explains the focus on the trust as tax unit, rather than the trustee.

The Commission proposed that, as a general rule, the trust be subject to an initial tax on trust income at the top individual rate; 50% in their scheme of things.[168] This rule would be subject to a number of exceptions including one applicable to distributable income and one applicable to accumulated income. These exceptions are discussed further below.

Comparing this general rule with the existing system of Canadian rules, one sees a similarity of form but differences of substance. Firstly, in both cases, at least in some respects, the trust is considered to be a taxable entity,[169]

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167 See Report, supra, note 159, volume 4, p. 150.

168 See Report, supra, note 159, volume 4, pp. 157, 159, 163-164, 203.

169 Income Tax Act, Stats. Can. 1952, c. 148 as amended, s. 104(2). Further statutory references in this Chapter are to this Act unless otherwise indicated.

presumably the primary taxable entity with respect to trust income. The existing rule reflects this position in its inclusion and then deduction of amounts payable to the beneficiary.[170] By contrast, the proposal made by the Commission has no provision for deduction of this amount. Instead income is taxed either in the trust -- with the beneficiary receiving a credit for taxes paid --[171] or in the hands of the beneficiary provided he makes the first election described below.

Secondly, no distinction is drawn between testamentary and <u>inter vivos</u> trusts in the Commission's proposals and consequently no rate differential exists between the two. Thirdly, a further distinction is eliminated, at least at this level. The rule that trusts be taxed at a 50% rate applies both to distributable income and to accumulated income. The current rule which provides for taxation of the trust, allows a deduction for income payable and thus in practice applies only to income accumulating in the trust and not the subject of a preferred beneficiary election.[172]

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170 Income Tax Act, s. 104(6), (13).

171 <u>Report</u>, <u>supra</u>, note 159, volume 4, pp. 159, 161.

172 Income Tax Act, s. 104(2), (6), (12).

Finally, and most significantly, the tax paid by the trust under the proposed rule is considered to be a prepayment by the beneficiary for which he receives credit and for which he must account by grossing-up the amount received by the amount of tax paid by the trust.[173] Under the existing rules, the beneficiary pays tax directly on income payable to him or receives accumulated income tax-free.[174] In neither case is payment of tax by the trust the first tier in a two-tier system of taxation.

B. Exceptions to the General Rule: Elections by the Beneficiary

Leaving aside elections which could be made by the beneficiary where trust income arises from a gift or where a beneficiary is a non-resident,[175] the beneficiary could elect for different tax treatment than that described above, the nature and effect of the election depending on whether income is distributable or accumulated.

With respect to distributable income, essentially "amounts payable" to the beneficiary under the existing

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173 Supra, note 171.

174 Income Tax Act, s. 104(13), (14), and see Ansell Estate v. Minister of National Revenue, [1967] 1 Ex. C.R. 518.

175 See Report, supra, note 159, volume 4, at pp. 157, 160, 162-164, 199-202, 203, 209.

rules,[176] a resident beneficiary entitled to such income could, under the proposed rule, elect to have that income taxed to him at his rate of tax. As a result, he would receive from the trust the full amount of income to which he was entitled,[177] rather than receiving a reduced amount, credit, and a possible refund. This election differs from the existing rules in two ways. Firstly, the concept of distributable income differs from that of payable income in the case of minors. Secondly, payment of tax by the beneficiary is optional rather than mandatory.

The proposal with respect to minor beneficiaries was that only income actually used for their benefit be treated as part of their incomes and therefore subject to election.[178] Under the existing rules, all income which would otherwise be payable to a minor beneficiary but is not, due to his infancy, is treated as part of his income and is therefore subject to taxation in his hands.[179] The result of the proposed rule would be to subject such income to tax at the top individual rate, unless the second election, dis-

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176 Report, supra, note 159, volume 4, p. 153; Income Tax Act, s. 104(24).

177 Report, supra, note 159, volume 4, pp. 159, 163-164, 168-169.

178 Report, supra, note 159, volume 4, p. 169.

179 Income Tax Act, s. 104(18).

cussed below, was applicable. While this could well be disadvantageous, given the rate of tax applicable to the minor beneficiary, it does avoid the problem of tax liability without income being received or receivable, both for minors and for adults who for whatever reasons have not received income to which they are entitled.

Turning now to the question of accumulated income, the rule proposed by the Commission would allow a resident beneficiary who fits within the definition of "prospective beneficiary" to elect to have the trust pay tax on income accumulating for his benefit, at his "additional" rate rather than at the usual trust rate.[180] Under the proposed system, a "prospective beneficiary" is either a beneficiary whose interest is indefeasibly vested or who is likely to eventually receive trust income and capital or either of them. A person would be considered likely to receive trust monies if he would become entitled to do so either on the death of an income beneficiary who is at least ten years older than he is, or on his attaining the age -- not greater than 40 -- set out in the trust instrument.[181] Where an election was made by such a beneficiary, the trust would pay tax on its income at the beneficiary's "additional rate," that is, the trust would

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180 Report, supra, note 159, volume 4, pp. 159-160, 163-164, 169-172.

181 Report, supra, note 159, volume 4, pp. 159-160, 170.

pay an amount of tax equal to that which would have been paid by the beneficiary had he received the income.[182]

This election differs substantially from the one currently embodied in the legislation as the preferred beneficiary election.[183] The scope of the category of prospective beneficiary is in some ways wider than that of the preferred beneficiary category. As an illustration of this, one notes that although to be a member of the latter class, a beneficiary must stand in a certain familial relationship to the settlor,[184] such is not the case with respect to the former class. Conversely, while a person may have only a discretionary interest under a trust and yet be a preferred beneficiary; this is not generally true of a person meeting the definition of prospective beneficiary. To qualify under the proposed rule, the beneficiary whose interest is not vested must have a contingent interest which will be satisfied on the occurrence of one of two proposed events.[185] Although the phrasing used in the Report suggests that the vesting of such

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182 Report, supra, note 159, volume 4, pp. 160, 171.

183 Income Tax Act, s. 104(14).

184 Income Tax Act, s. 108(1)(g), and see supra, Chapter 1, p. 30.

185 That is, on the death of an income beneficiary who was at least 10 years older than the beneficiary or on attaining an age not greater than 40 years specified in the trust instrument.

interests would not depend on the exercise of a discretion by the trustee, examination of the rules proposed in the case of the existence of two or more beneficiaries reveals provisions applicable to discretionary beneficiaries.[186] Since this is the case, the discretion of the trustee is presumably limited to naming the beneficiary whose entitlement would arise on the occurrence of one of the prescribed events.

As alluded to in the preceding paragraph, certain limitations are placed on the effect of the election where two or more prospective beneficiaries are involved. Where each interest can be determined, separate additional rates of tax are to be calculated and paid with respect to the portions of income attributable to each interest.[187] With respect to the determination of shares at least, this rule is similar to that applicable to preferred beneficiaries having ascertainable interests.[188] Where potential beneficiaries have only a discretionary interest under a trust and thus the share of each cannot be determined, the rules governing election are somewhat different. The proposed rule would have all beneficiaries make the election and the rate at which the trust paid tax would be the additional rate of the beneficiary hav-

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186 Report, supra, note 159, volume 4, pp. 171-172.

187 Report, supra, note 159, volume 4, p. 171.

188 Income Tax Act, s. 104(15)(b).

ing the highest marginal rate, determined on the assumption that all of the income was received by that beneficiary.[189] This proposal differs from the current rule both in the necessity of election by all beneficiaries, not the case at present, and in the failure to postulate shares as is done currently.[190] A final limitation is proposed for cases in which not all of the beneficiaries are prospective beneficiaries. Under such circumstances, only that amount of trust income attributable to the shares of prospective beneficiaries can be elected upon and taxed at additional rates, the remainder being taxed at the usual 50% rate.

The Commission proposals not only differ from the current rules in the definition of prospective or preferred beneficiary and in the calculation of the share of each beneficiary, they also differ in that tax on the amount elected, while in both cases calculated with the position of the beneficiary in mind, would under the proposals be paid by the trust rather than by the beneficiary. As would be the case with respect to distributable income bearing tax initially in the hands of the trustee, the beneficiary of accumulated income would ultimately receive an amount on which tax had initially been paid by the trust, either at his additional

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189 Report, supra, note 159, volume 4, pp. 171-172.

190 Income Tax Act, s. 104(15)(c).

rate or at 50%, and would receive credit for that amount. This of course differs from the tax-free distribution of accumulated income under the present rules, whether or not it has been the subject of a preferred beneficiary election.[191]

Where an election is unavailable or is simply not made, the trust would remain subject to tax at the 50% rate.

C. Calculation of the Tax Credit

The Commission recognized and sought to deal with the problem raised by the fact that the initial tax -- for which the beneficiary was to receive credit -- might have been paid by the trust at different rates. The reason for this could be any one of several: the trust might have paid tax at the 50% rate or at a lesser additional rate where an election had been made; the additional rate tax might have varied over the years either because of changes in the prescribed rates of tax or because of changes in the position of the beneficiary; or the prospective beneficiary might have changed.

The solution proposed was the adoption of a formula, the results of which were to be calculated yearly, which could be used to determine the rate of tax for which the beneficiary would receive credit; the "cumulative average rate." In the words of the Commission, the rate was to be

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191 Supra, note 174.

> determined by calculating the total income of the trust, other than currently distributable income, which had been subject to initial tax, and dividing this amount by the total initial tax paid thereon.[192]

One should note that this rate is applicable only to accumulated income, the credit applicable to the beneficiary receiving distributable income being the 50% rate paid by the trust. For ease of calculation, the Commission proposed that separate funds within one trust be treated as separate trusts.[193]

A calculation such as the one described above is not, of course, necessary under the existing rules, since tax is paid only once, whether by the trust or by the electing beneficiary, in the year in which the income arises.

D. Multiple Trusts

Provisions dealing with the consolidation of multiple trusts as are found in the current legislation were considered unnecessary by the Commission for a combination of reasons, some reflecting general principles adopted by them, some specific to trusts.[194] Reasons of a general nature included the treatment of the family as the tax unit, and the

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192 Report, supra, note 159, volume 4, p. 176.

193 Report, supra, note 159, volume 4, pp. 158-159.

194 Multiple trusts are discussed at volume 4, pp. 190-191 of the Report, supra, note 159.

inclusion of gifts within the tax base. With respect to trusts in particular, since income under the proposals would be taxed at either 50% or at the beneficiary's personal rate -- and since if one person was the beneficiary under several trusts his income from each would be aggregated when received by him -- no reduction in tax rates would be possible. To result in a reduction of taxes through the use of multiple trusts, each trust must have separate marginal rates.

E. The Nature of the Income Taxed: Flow-Through Rules

The types of income for which flow-through treatment was proposed by the Commission were dividends, interest and foreign income.[195] No provision was made for the flow-through of losses, the reduced tax payable as a result of reduced income being considered sufficient relief for the beneficiary.[196] The existing rules differ from these proposals in the greater number of types of income, allowances and credits which may flow-through to the beneficiary and in the preclusion of such treatment for amounts not specifically dealt with.[197]

Both the discussion of the mechanics of the treatment and the extent to which the beneficiary could treat income as being of a certain nature were inconclusive in the Report,

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195 Report, supra, note 159, volume 4, pp. 177-178.

196 Report, supra, note 159, volume 4, pp. 178-179.

197 Income Tax Act, ss. 104(16)-(22), (26)-(28), 108(5).

the latter in fact, virtually non-existent. By contrast, the existing rules are fairly detailed and growing more so each year.

In summary then, one can note several major differences between the proposals of the Royal Commission and the existing rules. Although a two-tier gross-up and credit system was suggested it has not been adopted. Elections with respect to accumulating income currently result in payment of tax by the beneficiary rather than the trust, thus avoiding the necessity for the complex calculations required under the proposals. Finally, the current rules reflect a disparate treatment of *inter vivos* and testamentary trusts not found in the *Report*.

II. American Taxation of Trust Income

A. General Rules

Inevitably, perhaps, given its nature, a trust is regarded as both an entity and a conduit for tax purposes under American law. The conduit principle is reflected in both the deduction granted the trust for amounts of income currently distributed to beneficiaries,[198] and in the rules which provide that various types of income retain their char-

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198 See *Statler Trust* v. *Commissioner of Internal Revenue*, 361 F. 2d 128 (2d Cir. 1966).

acter whether taxed in the hands of the trust or of the beneficiary.[199] The trust is regarded as an entity, though, in that it must calculate taxable income and pay tax -- by its fiduciary -- in much the same way as does an individual.[200] Simple comparisons with Canadian law as to the dominant trait in each system are difficult. On the one hand, it might appear that the trust is less an entity under American law since its accumulation distributions are ultimately taxed to the beneficiary, not necessarily the case in Canada. On the other hand, a trust under American law is allowed an exemption similar to the personal exemption, not the case here. Nor does an examination of the rules governing the nature of the income distributed, the character rules of American law,[201] point clearly in favour of the conduit nature of the trust in either system. At best, each is a hybrid, albeit with differing characteristics.

As mentioned, a trust calculates gross income and then taxable income in essentially the same manner as does an

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199 Internal Revenue Code s. 652(b) and s. 661(b), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, s. 1906(b)(13)(A), 90 Stat. 1520. References to the I.R.C. are references to this Code (1954).

200 I.R.C. s. 641(b); see also Maximov v. United States, 209 F. 2d 565 (2d Cir. 1962), aff'd. 373 U.S. 49, 10 L. Ed. 2d 184, 83 S. Ct. 1054.

201 Supra, note 199.

individual, subject to some exceptions.[202] Capital gains on trust property for example are in some instances dealt with under a separate rule[203] and to that extent are excluded from taxable income.[204] The Internal Revenue Code includes a number of rules specifically applicable to trusts with respect to credits and deductions. Among these are the allowance of the foreign tax credit (to the extent that it is not allowed to beneficiaries) and the disallowance of the political contributions credit.[205] In lieu of the personal exemption allowed to individuals, trusts are allowed exemptions of $300 or $100 depending on their classification as simple or complex trusts.[206] A deduction is also allowed for charitable contributions, and is not subject to the limitation applicable to individuals generally.[207] Trusts are also allowed

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202 I.R.C. s. 641(b).

203 I.R.C. s. 644, as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, s. 701(e), 90 Stat. 1520; Revenue Act of 1978, Pub. L. No. 95-600, s. 701(p)(3), 42 Stat. 2763; Instalment Sales Revision Act of 1980, Pub. L. No. 96-471, s. 2(b)(4), 94 Stat. 2247, applicable to gains on property transferred to the trust at less than fair market value.

204 I.R.C. s. 641(c).

205 I.R.C. s. 642(a)(1), (2).

206 I.R.C. s. 642(b).

207 I.R.C. s. 642(c), as amended by Tax Reform Act of 1969, Pub. L. No. 91-172, s. 201(b), 83 Stat. 487; Tax Reform Act of 1976, Pub. L. No. 94-455, ss. 1402(b)(1)(J), 1402(b)(2), 1906(b)(13)(A), 90 Stat. 1520.

deductions for depreciation and depletion as well as for amortization to the extent such deductions are not allowed to the beneficiaries.[208] With respect to net operating losses, these are deductible by the trust[209] and both net operating loss carryovers and capital loss carryovers as well as excess deductions are allowed to the beneficiaries on termination of the trust.[210] Of greatest importance however is the deduction allowed to the trust for income currently distributed to a beneficiary to the extent of distributable net income.[211]

To this point, at least, the Canadian and American rules are more similar than different. A trust under Canadian law also calculates income and taxable income as though it were an individual[212] and is entitled to essentially similar credits and deductions. Neither the allowance of an amount in

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208 I.R.C. s. 642(e), as amended by Revenue Act of 1962, Pub. L. No. 87-834, s. 13(c)(2), 76 Stat. 960; I.R.C. s. 642(f), as amended by Tax Reform Act of 1969, Pub. L. No. 91-172, s. 704(b)(2), 83 Stat. 487; Revenue Act of 1971, Pub. L. No. 92-178, s. 303(c)(4), 85 Stat. 497; Tax Reform Act of 1976, Pub. L. No. 94-455, ss. 1906(b)(13)(A), 1951(c)(2)(B), 2124(a)(3)(B), 90 Stat. 1520; Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, s. 212(d)(2)(D), 95 Stat. 172; Technical Corrections Act of 1982, Pub. L. No. 97-448, s. 102(f)(1).

209 I.R.C. s. 642(d).

210 I.R.C. s. 642(h), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, s. 1906(b)(13)(A), 90 Stat. 1520.

211 I.R.C. ss. 651(a), (b), 661(a).

212 Income Tax Act, s. 104(2).

lieu of the personal exemption nor the deduction of trust loss carryovers by beneficiaries on termination of the trust are permissible under Canadian law however.[213]

The American rules applicable to current distributions of income differ somewhat, depending on the classification of the trust as simple or complex, a distinction one author views as essentially descriptive rather than substantive.[214] A simple trust is one which is required to distribute its income currently and does not make distributions of corpus, nor have charitable beneficiaries.[215] All other trusts are complex.[216] Although such a distinction is not found in Canadian law, the two systems are not as different as might be thought, taxation in each case depending more on the nature of the distribution than on the classification of the trust by which it is made.

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213 Income Tax Act, s. 104(3).

214 Michaelson, "Distributable Net Income, The Tier System, and the Throwback Rule" (1969), 4 Real Prop. Prob. & Tr. J. 634 at 635, states that the rules, so far as applicable to each type of trust, are essentially the same.

215 The specific rules applicable to simple trusts are contained in I.R.C. Subtitle A, Chapter 1J, Part IB.

216 The specific rules applicable to complex trusts are contained in I.R.C. Subtitle A, Chapter 1J, Part IC.

While current distributions of income are, under American law, taxed only once, in the hands of the beneficiary, accumulation distributions are otherwise dealt with. Taxation of the beneficiary in the former case is accomplished by deduction and inclusion provisions similar to those found in Canadian law.[217] Accumulation distributions are taxed on two occasions: first when earned, in the trust, and subsequently when distributed, in the beneficiary's hands.[218] This differs from Canadian law which provides only for taxation when the income is earned, and only for taxation of the trust unless the beneficiary elects to be taxed in its stead.[219]

A trust under American law is subject to marginal rates of taxation.[220] This differs from Canadian practice where only testamentary trusts are permitted to pay tax at the graduated marginal rates applicable to individuals; *inter vivos* trusts being subject to a minimum flat rate of tax of approximately 50%.[221]

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217 I.R.C. ss 651(a), (b), 652(a); Income Tax Act, ss. 104(6), (8), (13).

218 I.R.C. ss. 641(b), 661(a), 662(a), 667.

219 Income Tax Act, s. 104(12), (14).

220 I.R.C. s. 1(e). Note that trusts are also subject to the alternative minimum tax imposed under I.R.C. s. 55 as amended, subject to an initial exemption of $20,000.

221 Income Tax Act, ss. 117, 122(1), (2).

The issue of multiple trusts has caused greater difficulty in the United States than in Canada, no doubt because of the greater tax reductions which can be effected under American law. These resulted from the $1,000 exemption allowed each trust in lieu of the personal exemption -- since reduced to $100[222] -- and from the application of separate rates of taxation to each trust. Although intention of the grantor is important in determining whether one or several trusts have been created, multiple trusts are presently subject to consolidation under Treasury Regulations if they serve no substantially independent purpose, have the same grantor and substantially the same beneficiaries, and have tax reduction as their principal purpose.[223] Multiple trusts are also subject to penalty under the provisions of the Code dealing with the throwback rule.[224] Under the consolidation approach the increased tax is paid immediately by the trust; under the throwback rule the increased tax is ultimately paid by the beneficiary. The problem is dealt with under Canadian law by a discretionary power held by the Minister of National Revenue to consolidate trusts essentially for having the same

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222 Revenue Act of 1938, c. 289, 52 Stat. 477, s. 163(a) (U.S.).

223 Treas. Reg. s. 1.641(a)-0 (1956), paragraph (c) added by T.D. 7204, 8-24-72.

224 I.R.C. s. 667(c), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, s. 701(a)(1), 90 Stat. 1520.

settlor and beneficiaries. No purpose test is required.[225]

B. Distributable Net Income

Distributable net income[226] was mentioned earlier in the context of current distributions of income. It is a tax concept unique to the taxation of trusts and estates and applicable to distributions from both simple and complex trusts. Its purpose is twofold. Firstly, it provides a ceiling on the amount of income that can be deducted from trust income and correspondingly included in the income of a beneficiary.[227] That is, it limits the amount taxable to the beneficiary. Secondly, it allows for the allocation of various types of income between the trust and the beneficiary and among the various beneficiaries.

Distributable net income is essentially taxable income of the trust with certain modifications; modifications which are necessary as one of the functions of distributable net

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225 Income Tax Act, s. 104(2).

226 Defined in I.R.C. s. 643(a), as amended by Revenue Act of 1962, Pub. L. No. 87-834, s. 7, 76 Stat. 960; Tax Reform Act of 1976, Pub. L. No. 94-455, ss. 1013(c)(1), 1013(c)(2), 90 Stat. 1520; Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, s. 404(b)(4), 94 Stat. 229; Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, ss. 301(b)(4), 301(b)(6)(B), 302(b)(1), 95 Stat. 172; Technical Corrections Act of 1982, Pub. L. No. 97-948, s. 103(a)(3).

227 See Mott v. United States, 462 F. 2d 512 (Ct. Cl.); cert. denied 409 U.S. 1108, 34 L. Ed. 2d 688, S. Ct. 902.

income is to determine the character of income distributed. It is taxable income as determined _before_ deductions for distributions to beneficiaries[228] and for the amount allowed in lieu of the personal exemption;[229] with the _exclusion_ of capital gains to the extent that they are allocated to corpus and likewise capital losses except to the extent used in determining net capital gains distributed to the beneficiary;[230] and with the _inclusion_ of amounts normally excluded from taxable income, namely tax-exempt interest,[231] income of a foreign trust,[232] and excluded dividends or interest.[233]

The notion of distributable net income is similar to although more complex than the Canadian concept of a notional trust income determined before deductions for amounts payable to beneficiaries, amounts included in the incomes of pre-

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228 I.R.C. s. 643(a)(1).

229 I.R.C. s. 643(a)(2).

230 I.R.C. s. 643(a)(3).

231 I.R.C. s. 643(a)(5).

232 I.R.C. s. 643(a)(6), as amended by Revenue Act of 1962, Pub. L. No. 87-834, s. 7, 76 Stat. 960; Tax Reform Act of 1976, Pub. L. No. 94-455, ss. 1013(c)(1), 1013(c)(2), 90 Stat. 1520.

233 I.R.C. s. 643(a)(7), as amended by Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, s. 404(b)(4), 94 Stat. 229; Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, ss. 301(b)(4), 301(b)(6)(B), 95 Stat. 172; Technical Corrections Act of 1982, Pub. L. No. 97-448, s. 103(a)(3).

ferred beneficiaries, and with respect to spouse trusts, without inclusion of capital gains arising from certain deemed dispositions.[234] With the exception of the capital gains exclusion, however, the primary function of this trust income concept in Canadian law is to provide a ceiling on amounts deductible to the trust and included in the beneficiary's income. The allocation of amounts of particular types of income is covered under separate provisions although trust income, like distributable net income, does provide a quantitative limitation on these amounts.[235]

C. Simple Trusts

A simple trust, as mentioned above, is one under which the trustee is required to distribute current income, whether he does so or not,[236] which makes no distributions from corpus, and which has no charitable beneficiaries.[237] Note that a trust which is discretionary not as to distribution but as to shares is a simple trust. All other trusts are complex

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234 Income Tax Act, ss. 104(6), (8), (13).

235 Income Tax Act, ss. 104(16)-(22), (26)-(28).

236 Whether trust income is distributable depends upon the terms of the trust instrument: Frick v. Driscoll, 129 F. 2d 148 (3d Cir. 1942); income is currently distributable when the terms of the trust instrument direct the trustees to periodically pay or credit income to the beneficiaries: United States v. Higginson, 238 F. 2d 439 (1st Cir. 1956).

237 I.R.C. s. 651(a).

trusts. An otherwise simple trust will not be so in its termination year since on termination it will make distributions of corpus. For that year the trust is treated as complex, the trust's classification being made on a yearly basis.

A simple trust is allowed a deduction from trust income for amounts of current income distributable to a beneficiary.[238] The deduction is limited to the amount of the trust's distributable net income. No deduction may be taken for amounts not included in the gross income of the trust, for example, tax exempt interest.[239]

The beneficiary must include the corresponding amount in his income, that is, the amount required to be distributed currently.[240] He must include the income whether distributed or not,[241] the test not being actual receipt but the existence of a present right to receive the income.[242] The amount included is the beneficiary's share of distributable net income. If distributions exceed distributable net income, a proportionate amount of each beneficiary's distribution is

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238 Ibid.

239 I.R.C. s. 651(b).

240 I.R.C. s. 652(a).

241 Ibid.

242 Higginson v. United States, 137 F. Supp. 240 (D. Mass. 1956), aff'd 238 F. 2d 439 (1st Cir. 1956).

included in his income.[243]

The components of income making up this amount retain their character in the hands of the beneficiary, as do deductions applicable to them. They are allocated proportionately among the beneficiaries unless the trust instrument specifically provides otherwise.[244]

No comparison of the Canadian and American treatment of current distributions appears here since that subject is dealt with in more detail under the following heading.

D. Complex Trusts

Trusts which are not simple trusts are complex trusts. Complex trusts may accumulate income, may make distributions from corpus, or may have charitable beneficiaries. The complex trust rules serve two purposes. First, since the Code provides that although gross income does not include the value of a gift, bequest or devise of property,[245] it does include income arising from such a gift and a gift of income from property,[246] the (taxable) income component must be sep-

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243 I.R.C. s. 652(a).

244 I.R.C. s. 652(b), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, s. 1906(b)(13)(A), 90 Stat. 1520.

245 I.R.C. s. 102(a).

246 I.R.C. s. 102(b). Note that amounts included in the gross income of a beneficiary under the trust provisions

arated from the (non-taxable) property component of a gift. The manner in which this is done is considered further below. The second purpose of the complex trust rules is to counter the tax avoidance resulting from the shifting or postponement of tax. The rules governing distributions from complex trusts vary depending on whether the distribution is current in nature, is an accumulation distribution, or is a distribution from corpus; the latter being received tax-free as would have been a direct gift of the corpus.[247]

Current distributions may be either first tier or second tier in nature. First tier distributions, also made by simple trusts, are those amounts of income arising in a year which are required to be distributed currently. Second tier distributions are other amounts properly paid, credited or required to be distributed, and may consist of discretionary distributions of current income, distributions of accumulated income, or distributions from corpus. The distinction is important from the viewpoint of taxing the income component of distributions. Second tier distributions will be considered current -- and therefore taxable as such in the hands of the beneficiary -- only to the extent of distributable net income remaining after deductions have been taken for first

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of the Code are treated as gifts of income from property.

247 The expression "tax-free" is used here to mean free of income tax consequences.

tier distributions.[248] In other words, the tier system prevents a taxpayer from claiming that a distribution is from corpus and therefore non-taxable notwithstanding the fact that all current income has not been exhausted. It is, in essence, an ordering rule, and precludes the need to trace the source of each distribution.

The hardship which might be caused by the tier system where a complex trust is for two or more beneficiaries is alleviated by the separate share rule.[249] This rule allows "substantially separate and independent shares" of the beneficiaries to be treated as separate trusts for the purpose of calculating distributable net income. As a result, therefore, a beneficiary in receipt of a corpus distribution will not be subject to tax on it simply because income is being accumulated for another beneficiary.

The tier system has no equivalent in Canadian law nor is it required. In the first place there is no need to separate accumulated income from corpus since for tax purposes as well as under trust law accumulated income is an accretion to capital. In the second place, an alleged distribution from corpus in a year where not all income was distributed would not

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248 I.R.C. s. 662(a)(1).

249 I.R.C. s. 663(c), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, s. 1906(b)(13)(A).

give rise to tax avoidance for two reasons. Firstly, the undistributed income would, at least in an inter vivos trust, be subject to taxation at a rate of approximately 50%, equivalent at present to the highest individual rate. Secondly, and this point relates to the conceptual difference in the treatment of accumulated income, the alleged corpus distribution would not have avoided a tax subsequently levied on an accumulation distribution, since such a tax is not imposed in Canada.

Returning to the mechanics of the complex trust provisions governing current distributions, one can see similarities to the treatment of simple trusts. Like them, complex trusts are allowed a deduction for amounts of income required to be distributed currently, first tier distributions. In addition, complex trusts are allowed a deduction for amounts properly paid, credited, or required to be distributed, second tier distributions. Both are limited by distributable net income.[250] No deduction is allowed for amounts not included in gross income of the trust.[251] Thus where first tier distributions equal distributable net income, any second tier distributions must be from accumulated income or corpus

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250 I.R.C. ss. 661(a)(1), 661(a)(2), as amended by Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, s. 302(b)(2).

251 I.R.C. s. 661(c).

and are dealt with accordingly. Where first tier distributions are insufficient to exhaust distributable income, the beneficiaries of second tier distributions are taxed on them as current distributions. Where second tier distributions exceed the limit of the remaining distributable net income, the beneficiaries of such distributions are taxed proportionately, up to the limit.[252] Second tier distributions in excess of that limit are taxed as accumulation distributions.[253]

As indicated in the previous paragraph, beneficiaries include in their incomes amounts required to be distributed currently or otherwise properly paid, up to distributable net income. As is the case with simple trusts, the income comprising current distributions from complex trusts retains its character in the hands of the beneficiary.[254] Gifts or bequests of a specific sum of money or of specific property which are paid all at once or in no more than three installments are neither required to be deducted by the trust nor

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252 I.R.C. s. 662(a)(2).

253 I.R.C. s. 665(b), as amended by Revenue Act of 1962, Pub. L. No. 87-834, s. 7, 76 Stat. 960; Tax Reform Act of 1969, Pub. L. No. 91-172, s. 331(a), (d)(2)(A), 83 Stat. 487; Tax Reform Act of 1976, Pub. L. No. 94-455, s. 701(b), (c), 90 Stat. 1520.

254 I.R.C. s. 661(b), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, s. 1906(b)(13)(A), 90 Stat. 1520.

included in the beneficiary's income.[255]

With the exception of the tier system, American and Canadian treatment of current distributions is essentially similar. A deduction is made from trust income, and an inclusion made in the income of the beneficiary entitled to the income whether he is in receipt of it or not. The American character rules are broader than the Canadian, however, in that they apply to all types of income included in the distribution, not merely those specifically dealt with in the legislation as is the case in Canada. The major difference between the two systems is, of course, in their treatment of accumulated income.

Accumulation distributions are subject to a separate set of provisions under American law, provisions which collectively make up what is commonly called the "throwback" rule. Accumulation distributions can be defined as second tier distributions in excess of distributable net income less first tier distributions in a given year.[256] An exception to this is that amounts in excess of distributable net income but less than the trust accounting income are not considered to

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255 I.R.C. s. 663(a)(1).

256 I.R.C. s. 665(b), as amended by Revenue Act of 1962, Pub. L. No. 87-834, s. 7, 76 Stat. 960; Tax Reform Act of 1969, Pub. L. No. 91-172, s. 331(a), (d)(2)(A), 83 Stat. 487; Tax Reform Act of 1976, Pub. L. No. 94-455, s. 701(b),(c), 90 Stat. 1520.

be accumulation distributions.[257]

E. **Excess Distributions: The Throwback Rule**

The purpose of the throwback rule is to prevent the tax avoidance resulting from the accumulation of income at trust rates and its subsequent distribution to a beneficiary in a low income year.[258] The rule is applicable to any trust making an accumulation distribution and its effect, in general terms, is to treat the beneficiary as though the distribution had been made in the year in which it was accumulated. That this is not strictly the case, however, is apparent both from the fact that liability for payment of tax arises in the year of distribution, not accumulation,[259] and from the fact that tax payable on distribution is determined by an averaging method.[260] It also appears as if, with the exception of tax-

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257 I.R.C. s. 665(b).

258 Stevens, "Accumulation Trusts and the Throwback Rule" (1971), 49 Taxes 876, states at p. 878 that "What started out as a proposal to deal with the multiple trust problem, a problem which needed a legislative solution, developed into a comprehensive new system for taxing trusts and their beneficiaries which involves great complexity."

259 I.R.C. s. 667(a), as amended by Tax Reform Act of 1969, Pub. L. No. 91-172, s. 331(a), 83 Stat. 487; Tax Reform Act of 1976, Pub. L. No. 94-455, ss. 701(a)(1), 1014(a), 90 Stat. 1520.

260 I.R.C. s. 667(b)(1), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, s. 701(a)(1), 90 Stat. 1520; Revenue Act of 1978, Pub. L. No. 95-600, s. 701(q)(1)(C), 92 Stat. 2763.

exempt interest, the character rules do not apply to an accumulation distribution.[261]

The application of the rule depends upon the existence of two things: firstly, an accumulation distribution, and secondly, undistributed income for preceding years. Undistributed income is the excess of distributable net income over first and second tier distributions and taxes paid by the trust with respect to distributable net income in a year.[262] Where these factors are present, an accumulation distribution is "thrown back" to the earliest preceding taxable year in which the trust had undistributed income, and is deemed to have been a second tier distribution in that year to the extent of undistributed income. If the accumulation distribution exeeds undistributed income of that earliest preceding year, the remainder is set against undistributed income of subsequent preceding years in the same manner.[263] An accumulation distribution, to the extent that it exceeds undistributed income of all preceding taxable years, is a

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261 I.R.C. s. 667(a), as amended by Tax Reform Act of 1969, Pub. L. No. 91-172, s. 331(a), 83 Stat. 487; Tax Reform Act of 1976, Pub. L. No. 94-455, ss. 701(a)(1), 1014(a), 90 Stat. 1520.

262 I.R.C. s. 665(a), as amended by Tax Reform Act of 1969, Pub. L. No. 91-172, s. 331(a), 83 Stat. 487.

263 I.R.C. s. 666(a), as amended by Revenue Act of 1962, Pub. L. No. 87-834, s. 7, 76 Stat. 960; Tax Reform Act of 1969, Pub. L. No. 91-172, s. 331(a),(d)(2)(B), 83 Stat. 487.

non-taxable corpus distribution. Taxes paid by the trust on income in the year in which it was accumulated are also deemed distributed by the trust to the beneficiary for the purpose of offsetting the tax assessed against the beneficiary on distribution.[264]

The calculation of the tax payable by the beneficiary on distribution is somewhat complex. The following sequence of steps describes its operation. Firstly, the beneficiary determines the number of preceding taxable years against which the distribution is to be applied[265] and divides the amount of the distribution (plus taxes deemed distributed) by that number of years. This gives him an average increase of income for those years. Secondly, in order to determine the applicable tax rate, he takes the five years immediately prior to the year in which the distribution is made and eliminates the years of highest and lowest taxable income.

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264 I.R.C. 666(b),(c) as amended by Tax Reform Act of 1969, Pub. L. No. 91-172, s. 331(a), 83 Stat. 487; Revenue Act of 1978, Pub. L. No. 95-600, s. 421(d), 92 Stat. 2763; Technical Corrections Act of 1979, Pub. L. No. 96-222, s. 104(a)(4)(H)(vi), 94 Stat. 194.

265 I.R.C. s. 667(b)(3) provides that: "if the amount of the undistributed net income deemed distributed in any preceding taxable year of the trust is less than 25 per cent of the amount of the accumulation distribution divided by the number of preceding taxable years to which the accumulation distribution is allocated under section 666(a), the number of preceding taxable years of the trust with respect to which an amount is deemed distributed to a beneficiary under section 666(a) shall be determined without regard to such year."

Thirdly, he adds to taxable income for each of the remaining three years the average yearly increase in income as determined in Step One. Once this is done, he calculates the increased tax attributable to the additional income in each of the three years. Fourthly, he then determines the average increase in tax per year. Fifthly, and finally, he multiplies the average amount of tax by the number of preceding years determined in Step One. This total amount of tax is then reduced by the amount of tax paid by the trust with respect to the income now distributed.[266] This offsetting of tax paid and tax owing is limited to the tax payable on trust income; in other words, if the amount paid by the trust exceeds the amount owing from the beneficiary, the beneficiary does not receive a credit which could be applied against income generally.[267]

A number of special rules apply to accumulation distributions, the following among them. The distribution of income accumulated for a beneficiary before birth and while he is under twenty-one years of age is not considered to be an accumulation distribution. Instead, it is treated as a

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266 I.R.C. s. 667(b)(1), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, s. 701(a)(1), 90 Stat. 1520; Revenue Act of 1978, Pub. L. No. 95-600, s. 701(q)(1)(C), 92 Stat. 2763.

267 I.R.C. s. 666(e), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, s. 701(a)(2), 90 Stat. 1520.

non-taxable distribution of corpus.[268] Another rule deals with the ordering of multiple distributions.[269] A third rule penalizes beneficiaries of multiple trusts in that where a beneficiary receives accumulation distributions from three or more such trusts in one year, the amount of tax paid by the third and any additional trusts is not permitted to be offset against the tax owing by the beneficiary. In effect, such income is subject to double taxation. A de minimus rule provides an exception where the aggregate of all distributions does not exceed $1000.[270]

The American treatment of accumulated income differs substantially from the Canadian in a number of ways. Under American law tax is imposed on both the trust and the beneficiary and to the extent that there is overpayment by the trust, the income is doubly taxed. Under Canadian law taxation occurs only once, at the time the income is earned, and income is taxed either in the trust or in the beneficiary's hands. The beneficiary is taxed on his election and without receipt of the income. In the case of the preferred benefi-

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268 I.R.C. s. 665(b) as amended by Revenue Act of 1962, Pub. L. No. 87-834, s. 7, 76 Stat. 960; Tax Reform Act of 1969, Pub. L. No. 91-172, s. 331(a),(d)(2)(A), 83 Stat. 487; Tax Reform Act 1976, Pub. L. No. 94-455, s. 701(b), (c), 90 Stat. 1520.

269 I.R.C. s. 667(b)(5).

270 I.R.C. s. 667(c), as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, s. 701(a)(1), 90 Stat. 1520.

ciary election under Canadian law, the beneficiary's liability is determined with respect to and is discharged in the current taxable year. Under American law, liability is to some extent determined with respect to preceding years during which the income was accumulated, but discharging that liability is not required until the year of distribution.

In conclusion, there are a number of substantial differences between the two systems of taxation, the treatment of accumulated income both practically and conceptually being the most apparent. Other differences include the wider scope of the character rules under American law, at least with respect to current distributions, and the application of graduated marginal rates of taxation to all trusts, not just testamentary ones. Finally, the approach taken with respect to multiple trusts differs in the two jurisdictions. In the United States in addition to a more narrowly defined consolidation test, such trusts may incur the penalty of double taxation.

III. British Taxation of Trust Income

Unlike the case in Canada and in the United States, the law governing the taxation of trusts in the United Kingdom is not to be found collected in one part of the income tax legislation.[271] Its piecemeal nature and its heavy reliance on judicial decisions have led one writer to describe it as a "common law" area of taxation.[272] It is by nature a two-tier system; a system which imposes some tax on the trustee and some on the beneficiary. In this it differs from the Canadian method of taxing either the trust or the beneficiary.

A. Taxation of the Trustee

The trustee is liable for tax not as an agent for the beneficiary as a general rule but simply because he is the person entitled to and in receipt of income.[273] Thus he receives income from the various sources enumerated in the Schedules and Cases of the Income and Corporate Taxes Act and is taxed either by deduction at source or by direct assessment.[274]

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271 Although Part XVI of the Income and Corporation Taxes Act 1970, 1970, c. 10 (U.K.), is entitled "Settlements" it deals not with the taxation of trusts per se but with the operation of attribution rules applicable to trusts and to settlements of all kinds.

272 Patrick C. Soares, Trusts and Tax Planning, (London: Oyez Publishing Ltd. 1979), p. 16.

273 *Williams* v. *Singer*, [1921] 1 A.C. 65 (H.L.).

274 Re Schedule A income tax see Income and Corporate Taxes Act 1970, 1970, c. 10, s. 68(1); re Schedule B see s. 92(1); re Schedule C see 94(1); re Schedule D see s. 114; and re Schedule F see Finance Act 1972, 1972, c. 41, s. 86.

Under certain circumstances the trustee will not be subject to tax but these are exceptions to the general rule. One such exception exists when, on the authorization of the trustee, income is paid directly to the beneficiary and never passes through the hands of the trustee. In such a case, the trustee is not taxed, never having received the income.[275] The second circumstance under which the trustee may not be held liable for the payment of tax exists where the beneficiary himself is not liable for tax.[276] This exception applies only where the beneficiary is by nature exempt from tax, for example, where he is a non-resident, not merely where his financial circumstances preclude his assessment.

In practice, the levying of tax on the trustees as the persons receiving income may well have the same effect as levying tax on the trust as a separate individual, particularly since the trustees' personal circumstances are ignored. The latter course, followed in Canada, differs conceptually from British tax law, which does not recognize the trust as an entity even for tax purposes. A further distinction between the two systems is that although under Canadian law a trust is to some extent taxed as an individual, a deduction

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275 Taxes Management Act 1970, 1970, c. 9, ss. 13, 76 (U.K.); Williams v. Singer, supra, note 273.

276 Inland Revenue Commissioners v. Reid's Trustees, [1929] S.C. 439.

is permitted for amounts of income payable to a beneficiary. No deduction is afforded under British law; instead, the beneficiary receives some credit for the tax paid by the trustee.

Under British income tax law, three rates of tax may be applied: basic rate, higher rate, and additional rate or investment income surcharge. The applicability of these rates to trust income in the hands of the trustee is discussed below.

1. The General Rule: Liability for Basic Rate Tax

A trustee is not considered to be an individual for tax purposes[277] although he is considered to be a person. Certain consequences follow from this. Although the trustee is liable for basic rate tax on the income arising from various sources, he is not subject to higher rate tax on that income nor, as a general rule, is he subject to additional rate tax. The applicability of additional rate tax to trustees is discussed further below. Basic rate tax is set at 30% for the 1983-84 taxation year and applies to income not in excess of L14,600.[278] Higher rate tax constitutes a set of increasing

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277 Although there is no express authority for this point, it appears to be generally accepted, see: Farrand, "Conveyancer's Notebook" (1977), 41 Convey. 4.

278 Finance (No. 2) Act 1983, 1983, c. 49, s. 1 (U.K.).

rates of tax corresponding to increasing bands of income; in effect, a graduated marginal rate system.[279] Not being an individual disentitles the trustee to any personal reliefs with respect to trust income.

The separate status of the trustee for tax purposes is reflected in the fact that neither the beneficiary's personal circumstances nor the trustee's are relevant in assessing the tax payable by the trustee on trust income. Additionally, the personal tax liability of the trustee is unaffected.

Canada, of course, has no investment income surcharge (additional rate tax) nor does it distinguish between basic and higher rates of tax. A distinction not found in British tax law is made in Canadian tax law, however, the distinction between testamentary and inter vivos trusts. The latter are taxed in a manner more similar to British trusts, on a flat rate basis.[280]

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279 For the 1983-84 year, higher rate tax is set as follows:

part of excess over L14,600	higher rate
- the first L2600	40%
- the next L4600	45%
- the next L7100	50%
- the next L7100	55%
- the remainder	60%

280 Although it should be noted that the Canadian flat rate of approximately 50% is a minimum and is not applicable if the income of the trust is such that the trust's marginal rate exceeds 50%: Income Tax Act, s. 122.

2. Accumulation and Discretionary Trusts: Liability for Additional Rate Tax

Not being an individual, a trustee was not originally liable for additional rate tax, nor for higher rate tax. As a result, a trust for accumulation or a discretionary trust with or without a power of accumulation provided a useful vehicle for tax avoidance in that such income was subject only to basic rate tax in the trustee's hands. Where income was accumulated and ultimately distributed as capital, further tax could be completely avoided. The Finance Act of 1973 remedied this situation somewhat by providing that additional rate tax of 15% applied to both these types of trusts.[281] The combined basic and additional rate tax is thus assessed against income of such trusts whether that income is accumulated or is distributed pursuant to a discretionary power. Not being an individual, the trustee is precluded from claiming the surcharge-free band of income available to individuals.[282] For this reason, the overall amount of tax paid during the period of accumulation may exceed that which would have been paid by a beneficiary had he received the income directly.

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281 Finance Act 1973, 1973, c. 51, s. 16 (U.K.).

282 For the 1983-84 year, there is no additional rate tax (that is, investment income surcharge) on investment income not exceeding L7100: Finance (No. 2) Act 1983, 1983, c. 49, s. 1 (U.K.).

The addition of the 15% investment income surcharge is complicated by the fact that it is not necessarily applicable to the same income as is the basic rate tax. Income which is treated as the settlor's under the attribution rules of Part XVI of the Act is not subject to additional rate tax in the hands of the trustee.[283] Income which when it arises -- that is, before distribution -- is treated as the income of a beneficiary is also excluded.[284] The income to which an infant beneficiary has a vested and indefeasible right falls within this exclusion, being treated as that of the beneficiary whether he receives it or not. Other exceptions deal with the income of charitable trusts and pension trusts.[285]

A further limitation is that additional rate tax is charged on investment income net of expenses, not the case with basic rate tax.[286] The resultant complications for the beneficiary's credit for tax paid by the trustee are discussed below.

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283 Finance Act 1973, 1973, c. 51, s. 16(2)(b).

284 Ibid.

285 Finance Act 1973, 1973, c. 51, s. 16(2)(c) (U.K.).

286 Finance Act 1973, 1973, c. 51, s. 16(2)(d) (U.K.).

As mentioned above, discretionary and accumulation trusts are not singled out for additional taxation under Canadian law. Income which is accumulating and not the subject of a preferred beneficiary election is taxed in the trust at a minimum rate of 50%.

3. Combined Rate Adjustments On Discretionary Distributions

To this point discussion has been limited to the tax levied on the trustee for the year during which the income arose. Further tax may be assessed where the trustee makes a payment to a beneficiary; a payment which is income of the beneficiary but which would not be so if the payment had not been made.[287] This further tax arises if the combined rate of tax[288] in the year of distribution exceeds the combined rate applicable to the year in which the income arose.

The amount distributed to the beneficiary is treated as the net amount remaining after the deduction of tax from an appropriately grossed-up amount.[289] In other words, assuming a combined rate of 45%, a distribution of L550 is treated as a distribution of L1000. The sum deducted is both treated as

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287 Finance Act 1973, 1973, c. 51, s. 17 (U.K.). In other words, this further tax is not applicable to a payment which is received by a beneficiary as capital, nor to an income payment which was not discretionary.

288 That is, basic and additional rate tax.

289 Finance Act 1973, 1973, c. 51, s. 17(1), (2) (U.K.).

paid by the beneficiary[290] and as owing by the trustee.[291] The trustee may set off against this amount, taxes already paid on the income when it arose.[292] No provision is made for a refund of tax where the tax originally paid exceeds that assessed in the year of distribution, however.

Under Canadian law, no provision is made for reassessment of the trustee in the year of distribution. A discretionary payment made in the year in which the income arises, is "payable" to the beneficiary and therefore taxable in his hands rather than in the trust. A discretionary payment made out of accumulated income is presumably received by the beneficiary as capital.[293]

B. Taxation of the Beneficiary

Subject to the exceptions referred to above, namely where the trustee never receives the income and where the beneficiary is exempt from tax, income is taxed not only in the hands of the trustee but also in the hands of the benefi-

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290 Finance Act 1973, 1973, c. 51, s. 17(2)(a) (U.K.).

291 Finance Act 1973, 1973, c. 51, s. 17(2)(b) (U.K.).

292 Finance Act 1973, 1973, c. 51, s. 17(2)(b), (3) (U.K.).

293 While on first consideration it would seem that this should also be the case under British law, the controlling factor there is not the source of the payment but the interest of the beneficiary, that is, in income or capital. See further, *infra*, pp. 124-125.

ciary.

The tax liability of a beneficiary depends upon his entitlement to income. Where he is currently entitled to income, he is taxable upon it whether or not it is received by him.[294] He is taxable on the income under the Schedule applicable to that income. A beneficiary is currently entitled when the trustee is under a duty to pay income to him and he is then absolutely entitled to it.[295] As a result, when a beneficiary's interest is merely contingent or is vested subject to divestment, trust income is not taxed in his hands. This result is modified under Canadian law through the use of the preferred beneficiary election.

Trust income to which the beneficiary is entitled[296] is included in his total income and is subject to tax at the rates applicable to him. Such income has already borne tax at the basic rate in the hands of the trustees and in some cases, at the additional rate as well. The amount included

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294 Baker v. Archer-Shee, [1927] A.C. 844 (H.L.); Hamilton-Russell's Executors v. Commissioners of Inland Revenue (1942), 25 T.C. 200 (K.B.D.).

295 Tollemache v. Inland Revenue Commissioners (1926), 11 T.C. 277; Miller v. Inland Revenue Commissioners, [1930] A.C. 222. This accords with the Canadian concept of "amount payable" to a beneficiary. The difference, of course, is that such amounts are deductible from trust income under Canadian law.

296 Or which he is entitled to have applied for his benefit, including benefits in kind.

in the beneficiary's income is the net amount to which he is entitled, grossed-up by the rate of tax deducted by the trustee. The beneficiary is entitled to a credit which takes into account the amount of tax paid by the trustee.

The position is not, however, as simple as it might appear, since the beneficiary does not receive a full credit. This results from the decision in Macfarlane v. Inland Revenue Commissioners[297] which held that trust expenses, while not deductible in computing trust income, are deductible in computing the income of the beneficiary for the purposes of determining his entitlement to reliefs and his liability to higher rate tax. While the case of Baker v. Archer-Shee suggests that the beneficiary must include gross income to which he is entitled, for example L100, the Macfarlane case suggests that this is not so. Assuming trust expenses of L10 and tax (payable at the basic rate) of L30, the result under the latter case might suggest the inclusion of L90. Instead, the beneficiary includes in his income the amount obtained by grossing-up the amount actually received from the trust (that is, net of taxes paid and expenses) by the rate of tax paid by the trustee. Using the figures given above, the beneficiary would include the sum of L85.71[298] and would receive a

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297 [1929] S.C. 453; 14 T.C. 532.

298 That is, $\frac{L60 \times 100}{100 - 30}$ = L85.71.

credit for taxes paid of L25.71 rather than the full L30.[299]

As with other aspects of the British system for taxing trusts, there is again no parallel in Canadian law dealing with a credit for the beneficiary. Instead of a credit being granted to the beneficiary, a deduction is allowed to the trust.

1. Accumulation Trusts and Discretionary Trusts

Whether a beneficiary is taxed on income accumulating in a trust depends on whether or not his interest in that income is vested indefeasibly. If so, the income is treated as his as it arises and will be taxed in his hands.[300] Where his interest is merely contingent, however, the income is not the beneficiary's as it arises and indeed is never received by him as such. Such income bears tax in the hands of the trustee at the basic and additional rates and not in the hands of the beneficiary either when it arises, or on its ultimate distribution since it reaches him as capital.[301] Although

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299 See also, John Tiley, Revenue Law (London: Butterworths, 2nd ed. 1978) p. 485.

300 Hamilton-Russell's Executors, supra, note 137. Having already borne tax at the basic rate, such income will be liable only for higher or additional rate tax if that. Remember that trustees are not liable for additional rate tax on income which when it arises is treated as that of the beneficiary.

301 Stanley v. Inland Revenue Commissioners, [1944] K.B. 255; Inland Revenue Commissioners v. Blackwell, [1924] 2

higher rate tax is thus avoided, since no income is received, the converse is also true: a beneficiary in a position to claim a repayment of tax paid by the trustee is precluded from doing so since tax was deducted not from his income but from an amount received by him as capital.

A beneficiary under a discretionary trust has no entitlement to income until the discretion is exercised in his favour and income is distributed to him. Prior to that event, therefore, he is not subject to tax.

The position of the beneficiary with a vested interest in accumulating income is similar under Canadian law. Such a beneficiary is entitled to enforce payment of trust income[302] and that income is treated as payable to him and is accordingly taxed in his hands. Where the beneficiary is a minor, the income is deemed to be payable to him.

2. Capital Payments as Income

One further point should be noted. Payments which are made out of capital may be treated as income if the beneficiary's right is to income, that is, to an "annual payment."[303] Being treated as income, such amounts are subject to the same

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K.B. 351.

302 Saunders v. Vautier (1841), Cr. & Ph. 140, 41 E.R. 482.

303 Brodie's Will Trustees v. Inland Revenue Commissioners (1933), 17 T.C. 432.

rate of tax as is actual income.

Presumably this situation does not arise under Canadian law. The nature of a payment appears to be governed by its source, thus an amount distributed in a year in excess of trust income would be recognized as an accretion to capital.

In summary, several notable differences between the Canadian and British methods of taxing trust income can be mentioned. Firstly, and most obviously, under Canadian law only one of the trust and beneficiary is subject to tax on trust income, not both as occurs in the British system. Secondly, under our system, the tax paid on income for the year it arises is all the tax to be paid on that income. Thus an alteration in rates between the time income arises and the time it is distributed is irrelevant. Thirdly, the credit system in place in Britain currently has no counterpart in Canada. As for the question of tax avoidance through the use and application of trust rates, income of as trust subject to a discretion is perhaps more fully taxed in Canada: where higher rate tax is avoided in Britain, income at comparable levels would be taxed at the appropriate marginal rate in the case of a testamentary trust or at 50% in the case of an <u>inter vivos</u> trust. Finally, it follows clearly from the fact that both trustee and beneficiary in Britain are taxed, that the British system has no need of the preferred beneficiary election concept, a method whereby tax liability is shifted from the trust to the beneficiary.

IV. A Comparative Summary

Before proceeding to the concluding chapter of this work, a brief summary of some of the similarities and differences among the various sytems of taxing trust income may be in order. The current Canadian legislation provides for the taxation of the trust or the beneficiary, but not both. While nominally, at least, the trust is a taxable entity, it may deduct from its income amounts payable to a beneficiary thus shifting liability for currently distributable income to him. A similar result is obtained by the operation of the American rules. The Royal Commission proposals and United Kingdom law provide instead for taxation of both trustee and beneficiary. Conceptually the two systems may differ, the Commissioners regarding payment by the trust as prepayment by the beneficiary, the British holding the view that the trustee as owner of property is taxed on income arising from it. In practice, the results are similar, the beneficiary being entitled to a credit for at least part of the taxes already paid. Whether the method is one of deduction and inclusion or one of credit and gross-up, essentially similar results are reached. Tax is levied for the year the income is earned and distributed and is assessed at rates appropriate to the circumstances of the beneficiary.

The principal divergence among the four systems occurs, not surprisingly, in the taxation of accumulating income. It is here that the problems inherent in trust taxation are most apparent. Income is held by persons who receive no benefit from it and whose personal circumstances are therefore irrelevant to its taxation, there is disparity between the year in which income is earned and that in which it is distributed, this in turn giving rise to changing rates of taxation; and finally, income which is received as such by the trustee may ultimately be received by the beneficiary as capital.

The methods of resolving these difficulties vary. In Canada and the United Kingdom accumulating income is taxed in the trust when earned and is ultimately distributed as capital. Under British law there is no provision for taxation at the beneficiaries' rates; under Canadian law a beneficiary may elect to pay tax now and receive the income later. The proposals at the Royal Commission would have resulted in a system where tax was initially paid by the trust, either at full trust rates or else at the additional rate of tax which would have been payable had he received the income in that year. The American rules also provide for taxation in the trust, and for a credit for taxes paid. Both systems, being two-tier in the sense of extracting tax at both the trust and beneficiary levels require greater complexity. Under the Royal Commission rules, adjustments of tax could be made in the year taxes were initially paid. The reverse is true of the American system which determines the amount of tax to be paid in the year of distribution although based on the beneficiary's previous income. Both systems adopt averaging methods: the Royal Commission vis-a-vis the appropriate credit which should be received by the beneficiary over the years, the American vis-a-vis the appropriate amount of tax ultimately to be paid, the credit remaining constant over the years. Both systems, taxing both the distribution of current and accumulated income, require sets of ordering rules as well.

The foregoing discussion reveals, perhaps, that the further one attempts to go in resolving problems due to timing and appropriate rates of taxation, the further one is drawn into complexity.

Chapter Four

Conflicting Objectives and the Difficulties of Change

It was suggested in the Introduction to this work that the taxation of trust income is subject to certain inherent problems arising out of the nature of the trust relationship. It has been further suggested that while the existing Canadian rules governing this matter may fairly be criticized, the difficulty with them is not so much that they fail to meet an ideal standard but in fact, that no ideal standard can be set.

Having described the existing rules in Chapter One and having attempted to establish a logical system in Chapter Two against which the Canadian rules could be measured, it should now be clear that certain problems are incapable of perfect solution; problems applicable not just to the Canadian rules but to any attempt to tax trust income. In Chapter Three certain rules proposed or utilized under other circumstances or in other jurisdictions were considered.

In order to bring the discussion to a conclusion this Chapter will comprise a review of questions raised earlier: in brief, questions such as who should be taxed; how much he should be taxed; when he should be taxed; and on what he should be taxed. Each question will be considered here in light of the Canadian answer, the problems it gives rise to, and the possible alternatives as revealed in Chapter Three. The competing objectives referred to in the Introduction and again in Chapter Two should be borne in mind here also, as should the interrelated nature of these questions.

I. The Taxpayer

The Canadian answer to the question of who should be taxed, assuming that the attribution rules are inapplicable, is to tax either the trust or the beneficiary. For convenience, and because it is arguably more correct to do so, we will refer to taxation of the trustee rather than of the trust in the discussion to follow.

Clearly, there is no quarrel with taxing the trustee per se. Holding the trustee liable is necessary in order to prevent massive tax avoidance or at least postponement through the device of a discretionary trust under which no potential beneficiary has a vested interest. Such action is also clearly defensible in that the trustee is in law the owner of the property giving rise to the income.

Likewise, the taxation of the beneficiary per se does not cause problems, at least not where the beneficiary is subject to tax on income currently arising and distributable.

The difficulty posed by the Canadian position is a result of the interrelated nature of taxing the trustee and the beneficiary or, more accurately, the lack of any such interrelationship. Excluding income currently arising and distributable (since it is treated in essentially the same manner as it would have been had it been received directly) the fact remains that accumulated income cannot be taxed in a neutral fashion unless there is taxation at more than one time or of more than one party, in order that certain adjustments may be made.

Adjustments are necessary for several reasons. Firstly, an adjustment is necessary because where tax on accumulating income is paid by the trustee, the rate at which that tax is paid corresponds only coincidentally, if at all, to the rate to which the beneficiary would be subject if he were taxed for that year on that income.

Secondly, and this difficulty exists whether tax is paid by the trustee or by the beneficiary pursuant to a preferred beneficiary election, the amount of tax paid for the year in which income arises may bear very little relation to the amount which would be assessed were the income taxed in the year of distribution. This may result from, among other things, changes in the prescribed rates or changes in the financial position of the beneficiary ultimately receiving the distribution.

Given that this difficulty exists, what are the possible alternatives? All three systems examined in Chapter Three assess tax liability in a manner which recognizes the interrelationship between trustee and beneficiary. The Royal Commission proposed a straight gross-up and credit system in conjunction with a tax of 50% initially levied on the trustee.[304] The American rule is similar in the sense that the beneficiary receives a credit for taxes paid by the trust up to the extent of trust income.[305] It differs in that the tax originally paid by the trustee is assessed according to marginal rates of taxation,[306] and in its determination of the amount of income properly considered accumulated and therefore subject to tax when received by the beneficiary.[307]

The British system is also characterized by taxation of both trustee and beneficiary. In fact, due to an anomaly in the calculation of the credit to which the beneficiary is entitled, trust income may on occasion be subjected to double taxation.[308] Taxation of accumulated income is however, more

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304 See Chapter 3, supra, at p. 79, n. 168.

305 See Chapter 3, supra, at p. 110, n. 266, 267.

306 See Chapter 3, supra, at p. 95, n. 220.

307 See the discussion with respect to the throwback rule, Chapter 3, supra, at p. 107 ff.

308 See Chapter 3, supra, at p. 123, n. 299.

similar to the current Canadian position.

Looking at the question of who should be taxed in isolation, it appears that an interrelated system of taxing both trustee and beneficiary[309] would be preferable to the current system. In this way, adjustments could be made to the original amount of tax paid by the trustee in a way which would reflect the economic position of the beneficiary at the time when the income was received or receivable by him.

It must be remembered that these questions are not entirely separable. Any proposal whereby both trustee and beneficiary are taxed raises the question as to what should be taxed. In the case of income received by the trustee, the answer is simple. When it comes to amounts distributed to the beneficiary, the answer is less so. Before, however, dealing with this point the question of the appropriate rate of taxation ought to be considered, since alterations to rate may to some extent render a gross-up and credit system, for example, unnecessary.

II. The Rate of Taxation

The Canadian answer to the question of the appropriate rate of taxation clearly depends on whom the taxpayer is. Where tax is levied on the beneficiary either because income

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309 For example, a gross-up and credit system.

is payable to him or because he elects, as a preferred beneficiary, to pay tax on it, he is taxed at the rate appropriate to him, trust income being aggregated with his income from other sources. While in the latter case a question arises as to the propriety of timing, in the former, taxation of the beneficiary at his rates on income he receives is clearly appropriate.

The rate currently imposed on the trustee is less so. An inconsistency exists between the treatment of inter vivos trusts and those which are testamentary. Trustees of the former pay a flat rate of approximately 50%, those of the latter are subjected to the marginal rates applicable to individuals generally. The difficulty is that neither rate coincides with that of the beneficiary and given that income is taxed only once, this lack of correlation cannot be subsequently corrected. The only way to resolve this difficulty[310] is to impose tax at rates appropriate to the beneficiary. This was, in fact, suggested by the Royal Commission. It was their proposal that a beneficiary for whom income was accumulating, could elect to have the trust pay tax on his "share" of the income at his "additional rate" that is, pay the additional amount of tax that the beneficiary would have been required to pay had he received the income in the year

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310 Assuming that tax is levied on only one occasion as it is under the present system.

in which it arose.[311] Neither the United States nor the United Kingdom attempts to operate a system completely along these lines, although the United States' separate share rule is somewhat similar.[312] The drafters of the current Canadian legislation also rejected it in favour of a system essentially similar as to rate, but under which, the beneficiary pays the tax, thus not involving the trustee in numerous and possibly complex calculations.

It should be remembered that even if it is possible to tax income as it arises according to the rate applicable to the apparent beneficiary, the difficulty that when the income is received or receivable the beneficiary's rate may be different is still not solved. This problem leads to a consideration of the question of timing.

III. The Timing of Taxation

The Canadian answer to the question of timing is that income is taxed only once, when it arises. Again, where income is distributed to the beneficiary in the year in which it arises no problem exists. Where this is not so, several problems are apparent. For example, circumstances may exist where the beneficiary is called upon to pay tax for that year

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311 See Chapter 3, *supra*, at p. 83, n. 180.

312 See Chapter 3, *supra*, at p. 103, n. 249.

without income being received or receivable by him.[313] This is the result of providing an infant with a vested interest although with payment postponed. A similar result, although one which is chosen by the beneficiary rather than imposed upon him, occurs where he makes a preferred beneficiary election.

The second problem of course is that by taxing income only when it arises and not also when it is distributed, there is no mechanism whereby earlier underpayments or overpayments can be corrected. Even if there were such a mechanism, there remains the further problem as to whether it is more appropriate to impose tax initially at a high rate or at a lower one.

Canada, which makes no subsequent adjustment, does both. The United States which does make such an adjustment has provisions only for additional payment of tax by the beneficiary, not for receipt of a refund.[314] Balanced against the desire for neutrality which suggests that income should be taxed twice in order to allow an adjustment are two factors: one, the need for simplicity in tax law; and two, the fact

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313 Although this problem may be avoided in practice by including a broad encroachment power in the trust instrument or by providing that all taxes are to be paid out of trust funds.

314 Supra, note 305.

that under trust law, and apparently Canadian tax law, accumulated income is an accretion to capital and a distribution of capital is a tax-free distribution.

Both the Royal Commission proposals and the United States rules contain detailed provisions for determining the amount of tax which should be paid by the beneficiary to whom accumulated income is finally distributed.[315] The question does not arise under the United Kingdom rules since income accumulated for a person entitled to it is taxed to him as it arises and income accumulated subject to a discretion is received as capital.

The Royal Commission proposed the adoption of a formula whereby an average tax credit could be calculated for a beneficiary.[316] The United States throwback rule is somewhat more complex, being specifically directed not just to the tax payable but to the source of the income.[317] The matter of source leads to the final question, what should be subject to tax?

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315 See Chapter 3, supra, at pp. 83-84 and 108-109, respectively.

316 See Chapter 3, supra, at pp. 87-88.

317 See Chapter 3, supra, at pp. 107-108, 101-102.

IV. The Subject of Taxation

At present in Canada, the trustee is taxed on income received by him, subject to the deduction allowed for income payable to a beneficiary. The latter is taxed on income distributed to him for the year in which it arises and on income which he elects to pay tax on in the year in which it arises. Income which is accumulated for him (unless he is a minor with a vested interest in the income) is received by him as capital and therefore is not subject to tax on distribution.[318]

This is also the case in Britain with respect to accumulations in a discretionary trust. The trustee paying tax only at the basic rate of 30% and the additional rate of 15%, higher rate tax is avoided. This anomaly is roughly and perhaps inequitably balanced by the fact that although some income tax is avoided, so are some income tax refunds.[319] The inequity appears to be that for those in higher income brackets there is a saving and for those in lower brackets a loss.

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318 Where the trust is an *inter vivos* trust, this may result in an overpayment of tax; where the trust is testamentary, an underpayment, depending on the beneficiary's marginal rate.

319 See Chapter 3, *supra*, pp. 123-124.

Of more concern perhaps is the fact that in the United Kingdom, distributions of capital made to persons having income interests may well be subject to tax.[320] This latter problem does not arise in Canada, deductions from trust income and inclusions in the income of the beneficiary being of amounts payable to the beneficiary under the trust instrument and limited by the trust's income for the year. This is a simpler -- and properly so since accumulating income is not tracked -- version of the United States system for separating the income from the capital component. It should be apparent that only if a two-tier system of taxation of trust income were adopted would the separation of trust funds into the components of current income, accumulated income, and capital be required.

In conclusion, it is clear that any change to the rules governing the taxation of trust income requires a considerable number of related changes. It also seems that any attempt to resolve the problems discussed earlier will lead to the introduction of further complexities into the system. For example, if a gross-up and credit system were introduced to deal with the problem of the rate paid by the trustee differing from that which would be payble by the beneficiary,

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320 See Chapter 3, <u>supra</u>, p. 124.

rules for determing the amount of credit to which a beneficiary was entitled would be required. Such rules would have to make provision for allocating the credit among various beneficiaries. The complexities involved might dictate that some sort of averaging system be adopted. The achievement of absolute neutrality would thus have been compromised by the need to avoid excessive complexity. Likewise, the introduction of a two-tier system would create a need to further distinguish between income and corpus distributions than is done presently. The increased neutrality and equity in the taxation of trust income which might be gained through alteration of the existing rules are perhaps not justified by the introduction of the complexity required to achieve them.

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