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# **ESTATE, TRUST AND CAPACITY LAW BREAKFAST SERIES**

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## **Reform of Trust Law**

by Ian M. Hull & David Freedman

## **Form Over Substance – Allocating Dividends Between Income and Capital Beneficiaries**

by Jonathon Kappy

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## **Form Over Substance – Allocating Dividends Between Income and Capital Beneficiaries**

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## **Form Over Substance – Allocating Dividends Between Income and Capital Beneficiaries**

By: Jonathon Kappy<sup>1</sup>

While a trustee is charged with the duty to exercise authority over trust property with an even hand as between capital beneficiaries and income beneficiaries, the jurisprudence has removed much of the discretion granted to a trustee as it relates to the receipt of corporate dividends and their allocation between income of the trust and the capital of the trust.

### **The Even-Hand Rule**

Trustees are imposed with the duty of impartiality to carry out the terms of a trust and to ensure that, during the course of the administration of the trust, “they do not give advantage or impose burden when that advantage or burden is not to be found in the terms of the trust.” The Even-Hand Rule is rooted in a trustee’s fiduciary obligations requiring that an even hand be maintained as between income and capital beneficiaries when exercising discretionary powers, unless the trust instrument provides otherwise<sup>2</sup>.

The most prevalent example of a division between income and capital beneficiaries arises in the context of a spousal trust, in which the spouse is granted a life interest in the income with the capital assets passing to the children upon the death of the life tenant.

The life tenant of a trust is entitled to the income generated by the trust capital during his or her lifetime. A power of encroachment will often be included to bestow on the trustees the discretion to make capital advancements to the life tenant. The capital beneficiary is entitled to the capital of the trust upon the death of the life tenant.

The practical application of the Even-Hand Rule is twofold:

1. The trustees must administer the trust assets to provide fairly for both the life tenant and the remainderman. As it relates to balancing income generation versus capital growth, the Even-Hand Rule prevents trustees from seeking out investments geared disproportionately toward capital growth (which favours the capital beneficiaries) at the expense of income generating investments; and
2. The Even-Hand Rule requires that expenses incurred by the trust be allocated fairly between income and capital beneficiaries. The general common law rule dictates that expenses related to the income of the trust (for example, insurance, taxes, and regular repairs to property) are borne by income beneficiaries; and that expenses related to the

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<sup>1</sup> With much appreciation to David Smith for his insight into these issues

<sup>2</sup> *Ben & Quan Wong Joint Partner Trust (Trustees of) v. Wong*, 2010 CarswellBC 2519 (B.C.S.C.)

capital of the trust (for example, major improvements to trust property and administrative expenses) are borne by the capital beneficiaries.

### **Dividends as Income or Capital**

Maintaining an even hand amongst beneficiaries can become more complicated where the assets of the trust include shares in an active corporation. Where a corporation declares a dividend, it can be difficult for a trustee to ascertain whether such dividend should be allocated as income (for the benefit of the life tenant) or to capital (for the benefit of the capital beneficiaries). This is particularly so as the dividend may be the result of the corporation's distribution of profits to its shareholders or a distribution of the corporation's capital. Moreover, a dividend may be made in the form of a cash payment or other property, including additional shares.

Lloyd Raphael's Canadian Income Taxation of Trusts defines a "dividend" as follows:

"a share of the earnings of a corporation distributed pro rata to its shareholders whether the distributed earnings are, in terms of the source of the earnings, income or capital of the corporation or are paid in cash, shares, or other property (dividends in kind) of the corporation, except a distribution on a share redemption at par or other authorized reduction of paid-in or paid-up capital to the extent of the authorized and issued paid-up capital reduced in accordance with the definition of "paid-up capital" in paragraph 89(1)(c), or on the winding-up of all or part of the business or in the process of dissolution of the corporation to the extent of the paid-up capital returned to the shareholders under section 84."

Dividends can take on the following forms and may come from the following sources:

1. A Cash payment;
2. Distribution of stock of the paying company;
3. Distribution of property, such as stock of another company owned by the paying company (i.e. "a dividend in kind");
4. Distribution on a winding up of the company;
5. Distribution of a share redemption or on an authorized reduction of paid-up capital;
6. Dividends paid out of undistributed income on hand; and
7. Dividends paid out of undistributed surplus

As a result of the differing methods of payment and the differing sources for these funds in the hands of the corporation, the courts have had to consider whether the source of the dividend or the form of the dividend is determinative of its allocation between beneficiaries in the hands of the trustee.

## The Form Rule

The Privy Council in *Hill v. Permanent Trustee Co. of New South Wales Ltd.*<sup>3</sup> considered a circumstance in which a corporation declared a cash dividend to its shareholders, where the source of the dividend arose from a sale of substantially all of the assets of the corporation. In the context of its finding in this case, it is important to note that no resolution had been passed to wind up the corporation and a resolution for the voluntary liquidation of the company was defeated.

Upon finding that the dividend should be treated as income in the hands of the trust, and not capital, the court relied upon the form of the dividend declared by the company and disregarded the true nature of the assets being distributed to the shareholders. In particular, the court stated:

“From this it would appear that monies paid in respect of shares in a limited company may be income or corpus of a settled share according to the procedure adopted, i.e., according as the moneys are paid by way of dividend before liquidation or are paid by way of surplus assets in a winding up. Each process might appear to involve some injustice, the former to the remainderman, the latter to the tenant for life.”

Pursuant to the Form Rule, the form of the dividend, as opposed to its substance or source of funds, determines its classification as income or capital. The decision of the corporation as to the type of dividend to issue is determinative and the intentions of the directors of the company or the substance of the distribution is irrelevant. In doing so, the court relied upon the following principles:

1. A corporation is not concerned with the fate of the dividend in the hands of the shareholder. The corporation does not care if the dividend is treated as income or capital in the hands of the trust;
2. A corporation that is not in liquidation cannot make any payment by way of return of capital to its shareholders except as a step in an authorized reduction of capital. Any other payment of monies to the shareholders can only be made by way of dividing profits;
3. Monies paid to a shareholder who is a trust will, *prima facie*, be considered income of the trust. If the settlor or testator desires that monies paid be considered part of capital, there must be some provision in the trust deed or will which brings about this result; and
4. Other considerations apply when a corporation distributes profits by distributing additional shares of the corporation to its shareholders. In such a case, the distribution is considered capital in the hands of the trust.

In summary, unless the will or trust instrument states otherwise, the Form Rule dictates that:

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<sup>3</sup> [1930] A.C. 720, also see *Re Keating* [1934] S.C.R. 698

- A cash dividend by a corporation not in liquidation, including a capital dividend, is considered income; and
- A dividend is considered capital of the trust if it is distributed in the form of capitalized profit – that is, stock dividends, proceeds of redemption or purchase for cancellation, options to subscribe for new shares (including immediately redeemable preference shares), additions to paid up capital or property distributed on a winding up of a corporation.

The Form Rule has been accepted by the Supreme Court of Canada in *Re Waters*<sup>4</sup> wherein a corporation accumulated a significant amount of earnings. In order to distribute the earnings in a manner that would not be taxable in the hands of the shareholders, the corporation capitalized the earnings and distributed redeemable preference shares to the shareholders. In determining that such a dividend be considered capital in the hands of the estate, Justice Rand stated:

“...Here form is substance; and the moment form has changed the character of the earnings as assets, the intention follows that change.

In the absence of a statutory provision, a stock dividend, so-called, would not appear to be “income”: and the exemption from taxation provided for the shares here simply suspends the provision of the Income Tax Act imposing tax. From the standpoint of tax, it is indifferent to the company and the shareholder whether the ultimate receipt of money is capital or income: in neither case is it taxable. But its form is fixed and determined: and in the absence of special directions in the will, we are not at liberty to disregard what the testator is to be deemed to have foreseen as the possible action of the company.”

The court clarified that if a shareholder is given the option of accepting either cash or redeemable preference shares, such a distribution would be considered income. However, where no option is given to the shareholder, a distribution by way of stock dividend is categorized as capital in the hands of the estate.

### **Avoiding the Form Rule**

As set out in both *Hill v. Permanent Trustee Co. of New South Wales Ltd.*, and *Re Waters*, a settlor can exclude application of the Form Rule by providing his or her means of characterizing income and capital within the trust instrument itself.<sup>5</sup>

In *Smith Estate v. Smith Estate*<sup>6</sup>, the court held that a cash dividend declared upon the windup of the corporation following the sale of the assets of the corporation be considered capital of the estate. In disregarding the Form Rule, the court found it significant that:

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<sup>4</sup> [1956] S.C.R. 889 (S.C.C.)

<sup>5</sup> Also see *Canada Permanent Trust Co. v. McGregor* (1980), 7 E.T.R. 137 (Ont.C.A.)

1. The Will provided that all stock dividends should be treated as capital;
2. It was clear that the testator intended that the shares be considered capital, and thus, the proceeds replacing those shares also be considered capital; and
3. The dividend was declared in the course of a winding-up of the corporation and it was clear the dividend was a return of capital.

### **Distinguishing *Re Waters***

Courts have distinguished *Re Waters* in order to avoid its strict interpretation. In *Re Welsh*<sup>7</sup>, the shares in a closely held corporation represented substantially all of the testator's estate. The corporation sold all of its capital assets and declared a dividend out of the undistributed capital surplus.

Notwithstanding that the dividend was paid in the form of cash, and contrary to the Form Rule, the court held that such a dividend should be considered capital in the hands of the estate, and not income.

"I find that the intention of the testator as expressed in this will taken as a whole and in the circumstances which existed at the time when it was executed is quite clear. This testator intended that the value of his interest in Welsh Lumber Company Limited as represented by his shareholdings (to include the breakup value which such shares would attract) to be the capital of his estate, and to be held as part of the residue of his estate after payment of specific bequests. It was this on which income was to be derived which income he intended to be paid to his wife. Capital and income in this will had that special meaning to the testator. The source of the income to be paid to the widow was the interest earned from this capital sum and the limited power to encroach upon this sum for the benefit of the wife supports this interpretation. Indeed, that is what was done during the lifetime of Opal and she received some \$200,000 without it being necessary to encroach upon capital in any way. There is no suggestion that during her lifetime Opal asserted a claim to the moneys paid out as dividends.

I do not find cases such as *Re Waters* and *Re Hardy*, supra, of assistance in the present problem. Those cases clearly involve distribution of undistributed surplus income in a company. What we are concerned with in the present estate problem is distribution of surplus capital, really the entire capital of the company, and at a time when there was no undistributed income on hand. In fact there was a negative income balance according to the books of the company as of December 31, 1971. (See the statement as to capital surplus contained on pp. 392-3 of these reasons.)

While cases have spoken about questions of "form" and questions of "substance" as being determinative as to whether dividends are "income" or "capital", previously-decided cases do not really assist me here. It is clear that the Court may look at the form

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<sup>6</sup> 2000 CarswellBC 2628

<sup>7</sup> (1980) 28 O.R. (2d) 403 (H.C.J.)

of the transaction or at the substance, but that in any event the overriding consideration must be the intention of the testator as expressed by the words of his will and in the circumstances in which that will was executed.”

The court noted that at the time that the will was executed, capital surplus would likely have been distributed to beneficiaries by way of issuing redeemable preference shares (which would have been considered capital in the hands of the estate). Subsequent to the execution of the will, the *Income Tax Act* was amended such that the capital surplus was distributed by way of cash dividend. The court found that the testator intended, based on the language of the will and the surrounding circumstances, that the dividend be received as capital of the estate.

### **Where the Trustees Control the Corporation**

Where the trustees are also the directors or the controlling mind of the corporation, the trustees will be governed by the Even-Hand Rule, and not the Form Rule. It would be inequitable to permit trustees, in their capacity as directors, to transform income into capital or vice versa simply by the form of the dividend.<sup>8</sup>

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<sup>8</sup> *Re Fleming* (1973), 37 D.L.R. (3d) 512 (Ont. H.C.J.)





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## Reform of Trust Law

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## Reform of Trust Law

Outline by section of the Uniform Law Conference of Canada's *Uniform Trustee Act* (2012):

(Available at: <http://www.ulcc.ca/en/2012-whitehorse-yk/599-civil-section-documents-2012/1255-uniform-trustee-act>)

- Section 1
  - Definitions
- Section 2
  - Application of Act
- Section 3
  - Continuation of existing rules
- Section 4
  - Trust is not a person
- Section 5
  - Designated person
- Sections 6, 7
  - Appointment of substitute trustee
- Section 8
  - Temporary absence or incapacity of trustee
- Section 9
  - Power of court to appoint trustee
- Section 10
  - Person not qualified to be appointed trustee
- Section 11
  - Powers and duties of new trustees
- Sections 12-19
  - Resignation or removal of trustee
- Section 20
  - Joint tenants
- Sections 21-23
  - Vesting
- Section 24
  - Powers of trustee
- Section 25
  - Power of court to confer further powers on trustee

- Section 26
  - Duty of care
- Section 27
  - Conflicts of interest
- Section 28
  - Duty to report to qualified beneficiary
- Sections 32
  - Trustee not liable if overall investment strategy prudent
- Section 33
  - Abolition of common law rules – anti-netting rules
- Section 36
  - Duty to act impartially and prudently
- Section 37
  - Abolition of common law rules of apportionment
- Section 38
  - Apportionment of outgoings between income and capital
- Section 39
  - Discretionary allocation trusts of receipts and outgoings
- Section 40
  - Total return investment
- Sections 42-46
  - Distributive powers
- Sections 47-49
  - Agents – appointment, supervision, and trustee liability
  - Delegation of authority with respect to investment
- Section 50
  - Power to delegate by power of attorney
- Section 51
  - Liability for trust property
- Section 52
  - Powers conferred and duties imposed on trustees jointly
- Section 53
  - Trustees may act by majority
- Section 54
  - Trustee abstentions

- Section 55
  - Allocation of insurance proceeds
- Section 56
  - No notice from other trust
- Sections 57-58
  - Variation and termination of trusts
- Section 59
  - Arrangement effective on unanimous consent
- Section 60(7)
  - Court approval of arrangements with respect to charitable organizations or non-charitable purposes
- Section 60(5) and (6)
  - When court approval of arrangement on behalf of capable person refusing to consent may be granted
- Section 61
  - Notice to Public Guardian and Trustee and Attorney General
- Sections 64, 65
  - (Interim) compensation of trustee
- Section 66
  - Reimbursement of expenses
- Section 67
  - Passing of accounts
- Section 68
  - Repayment by trustee
- Section 70
  - Power of court to vary charitable gifts and charitable trusts
- Section 71
  - Surplus arising from public appeal
- Section 72
  - Power to order sale of property – charitable trust
- Section 73
  - Notice to Attorney General
- Section 74
  - Non-charitable purpose trust

- Section 75
  - Imperfect trust provisions – charitable and non-charitable purposes
- Section 76
  - Disposition purporting to create non-charitable purpose trust construed as power to appoint
- Section 77
  - Trust property held for charitable purposes not to be seized
- Sections 79, 80
  - Trustee applications to court for directions or order
- Section 81
  - Trustee may be relieved of liability for breach of trust
- Sections 82-86
  - Additional powers of the court
- Part 9
  - Perpetuities and Accumulations
- Part 10
  - General
- Part 11
  - Transitional Provisions, Repeals, and Consequential Amendments