

Planning for Trusts Faced With The 21-Year Deemed Disposition Rule

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Overview of Issues Reviewed

- 21-Year Deemed Disposition Rule
- Typical Use of Trust
- Allowing Deemed Disposition
- Rollout to Canadian Resident Beneficiaries
- Limitations on Rollout Approach
 - Non-Resident Beneficiary
 - 75(2) Problem
- Vested Indefeasibly Approach

Overview of Issues Reviewed

- Pros and Cons Between Vested Approach and Rollout Approach
- Non-Tax Considerations
- Key Takeaway Points

The 21-Year Deemed Disposition Rule

- The 21-year deemed disposition rule (“**DDR**”) is one of the significant limitations that applies to the use of trusts
- The DDR is provided for in subsections 104(4), 104(5) (depreciable property) and 104(5.2) (resource property) of the Income Tax Act (“**ITA**”)
- Most trusts are deemed to dispose of their assets at fair market value on each 21st anniversary of the trust for proceeds equal to fair market value

The 21-Year Deemed Disposition Rule

- 21 years can pass more quickly than you can expect
- Assuming fair market value exceeds tax cost, this results in a capital gain and income tax
- Often large income tax exposure with no liquidity to pay
- The purpose of DDR is to avoid being able to have unlimited deferral of capital gains tax

The 21-Year Deemed Disposition Rule

- Limited exceptions to DDR include qualifying spouse and common-law partner trusts, alter ego trust, joint spouse trusts, all interests vested indefeasibly (discussed below), eligible capital property and inventory that is not land
- Because of limited time, presentation will address a few selected issues

Typical Use of Trust

- Many different possible uses for a trust in tax and estate planning (beyond scope of presentation)
- Common use is for trust to own shares in a private corporation
- Trust often introduced in the context of an estate freeze in situation where common shares owned by a parent are exchanged for frozen value shares with new growth shares issued to trust so increase in value of corporation accrues to trust (with various family members as beneficiaries) to limit capital gains tax of parent

Typical Use of Trust

- Recent tax changes reduce some tax advantages for use of a trust, such as income splitting but still useful reasons for a trust
- Many advantages to have growth shares owned by a trust rather than children directly, including more flexibility, more control for parent, creditor protection, etc.
- Trustees have ability to decide later how growth shares allocated among family members
- Parent can be among the discretionary beneficiaries for commercial protection, if needed (subject to careful set-up to avoid subsection 75(2), as per below)

Allowing Deemed Disposition

- Non-tax reasons for assets to remain in Trust vs transfer to beneficiaries
- Assets without significant unrealized gains
- Liquid assets to sell to pay tax
- Reduce value of shares by pay dividends from CDA and RDTOH
- Retain some assets and roll out other assets
- Trust can elect 159(6.1) to pay tax in 10 annual instalments subject to interest and provide security

Rollout to Canadian Resident Beneficiaries

- Most common approach to dealing with DDR is to distribute assets from the trust to Canadian resident beneficiaries on a tax-deferred basis, pursuant to subsection 107(2) of the ITA in satisfaction of capital interest (the “**Rollout Approach**”)
- Various planning required in connection with use of Rollout Approach
- Non-tax commercial consideration to place restrictions on family members receiving shares from the trust (dealt with below)

Rollout to Canadian Resident Beneficiaries

Reorganization Prior to Rollout

- Often desirable to reorganize shares prior to rollout
- May be desirable for parent to retain voting control
- May be desirable for parent to subscribe for class of shares with discretionary dividend rights if not a beneficiary.
- May be desirable to freeze existing growth shares so parent can gift new growth shares to married children for Family Law Act protection

Rollout to Canadian Resident Beneficiaries

Reorganization Prior to Rollout

- Alternate for new growth shares owned by new Trust so 21 years to allocate
- Concern with frozen shares to children re retraction right (may split into voting shares and non-voting common shares if not do freeze)
- Interpose holdco (with voting shares owned by parent and equity shares owned by children) to own retractable frozen shares
- Can't rollout to another trust - 104(5.8)



Rollout to Canadian Resident Beneficiaries

Reorganization Prior to Rollout

- Technical Interpretation indicates CRA will apply GAAR if roll to a corporation wholly-owned by another trust (high risk)
- Tailor details to the situation
- In some circumstances, Rollout Approach not available

Limitations on Rollout Approach

Non-Resident Beneficiary

- Rollout not available to non-resident beneficiary per subsection 107(5) and trust deemed to dispose at fair market value pursuant to subsection 107(2.1)
- This will trigger capital gains tax to trust
- Rollout involves disposition by Beneficiary of Capital Interest in Trust
- For non-resident beneficiary may trigger section 116 compliance if at any time during past five years more than 50% of the value of the trust is attributable to Canadian real estate (usually tax-free but compliance burden)



Limitations on Rollout Approach

Non-Resident Beneficiary

- Alternative for non-resident beneficiary is to use Rollout Approach to a Canadian resident corporation owned by the non-resident individual
- Recent Technical Interpretation says CRA may apply GAAR
- Issue of whether trust deed allows for such a transfer (care required in drafting)
- If corporation isn't a beneficiary, complications for individual beneficiary to transfer capital interest to a corporation
- US beneficiary may prefer to use ULC

Limitations on Rollout Approach

75(2) Problem

- Key exception to Rollout Approach is if subsection 75(2) of the ITA applied to the trust at any time (cannot cure)
- Negative impact of 75(2) is more often loss of rollout rather than attribution
- During lifetime of settlor or other transferor, Rollout Approach available only to settlor or settlor's spouse

Limitations on Rollout Approach

75(2) Problem

- If transferred to other beneficiaries subsection 107(4.1) prevents a rollout under section 107(2), with trust deemed to dispose of assets at fair market value triggering capital gains tax per subsection 107(2.1)
- 75(2) problem and loss of Rollout Approach ends upon death of settlor/transferor so the problem may be eliminated
- Loss of Rollout Approach even if transferred property does not generate income (e.g. settlement of trust with a coin)

Limitations on Rollout Approach

When Does 75(2) Apply

- Some uncertainty as to proper interpretation and application of 75(2)
- Many Technical Interpretations from CRA over the years with changes to position
- Number of Tax Court cases, some of which disagreed with CRA's position
- To avoid 75(2), great care must be taken at time of settlement in preparing trust deed and also subsequent transfers to the trust
- Dangerous trap if trust deed not prepared by tax specialist



Limitations on Rollout Approach

Choice of Settlor and Trustees

- Problem if settlor is a beneficiary, even if only remote possibility
- Be careful with contingent/default beneficiaries
- Problem if settlor has certain powers as trustee or otherwise
- Problem if settlor is sole trustee (even if settlor is not a beneficiary)

Limitations on Rollout Approach

Choice of Settlor and Trustees

- If settlor is one of two trustees (but not a beneficiary) 75(2) wording could apply since settlor has a veto, but CRA has provided some comfort in Technical Interpretations, subject to certain qualifications
- Safest if settlor is not a trustee or a beneficiary
- Inconvenient if settlor is a trustee with minimum of 3 trustees

Limitations on Rollout Approach

Other Transfers

- 75(2) not limited to transfer of property to trust by settlor, but can apply to any transfer of property to the trust
- Possible trap if parent has paid expenses of the trust (can be viewed by CRA as a transfer of property from parent to trust)
- Any expenses paid by parent should be documented as a loan
- Despite prior positions of CRA, Courts have held that bona fide loan to a trust is not considered a transfer of property and does not cause 75(2) to apply



Vested Indefeasibly Approach

- If Rollout Approach is not available, alternative approach is to rely on paragraph (g) of the definition of “trust” in subsection 108(1) of the ITA, such that if all interests in the trust have vested indefeasibly, the trust is not considered a trust for purposes of the DDR (the “**Vested Approach**”)

Vested Indefeasibly Approach

How to Cause Vested Indefeasibly

- Some uncertainty as not defined in ITA
- Limited guidance from CRA as question of law
- Archived IT-449R – unassailable right to ownership of a particular property
- Interests of beneficiary must be totally fixed without any type of condition
- Beneficiary is entitled to interest in trust even if beneficiary does not survive to the date of distribution

Vested Indefeasibly Approach

How to Cause Vested Indefeasibly

- If beneficiary with vested interest does not survive to date of distribution, then the vested interest passes as per the beneficiary's will
- Upon death of beneficiary, there would be deemed disposition of vested interest pursuant to subsection 70(5) of ITA for proceeds equal to fair market value triggering capital gain

Vested Indefeasibly Approach

Deed of Trust

- Issue of whether Deed of Trust itself allows for causing vesting indefeasibly
- Not necessary that interests are vested from the outset so long as trustees have power to vest before 21st anniversary
- Issue of whether trust deed has power to amend to deal with causing vesting indefeasibly

Vested Indefeasibly Approach

Court Variation

- If trust deed does not allow for vesting indefeasibly, it may be necessary to apply to Court for variation of the trust
- Messy and lengthy procedure involving Office of the Children's Lawyer if there are any minor beneficiaries or unborn beneficiaries, even if only contingent or discretionary beneficiaries
- Likely necessary to set aside some assets for minor beneficiaries and unborn children

Pros and Cons Between Vested Approach and Rollout Approach

- If Rollout Approach is available it is most commonly used and likely subject to less scrutiny by CRA (subject to possible 75(2) problem)
- Advantage of Vested Approach that no red-flag on trust's tax return as nothing to report versus Rollout Approach requires reporting disposition of assets to beneficiaries

Pros and Cons Between Vested Approach and Rollout Approach

- Possible advantage of Vested Approach allows shares to continue to be owned by the Trust so need not deal with children directly owning shares (subject to rule in *Saunders v. Vautier*)
- Rollout Approach has advantage to obtain restrictions in advance from beneficiaries, such as shareholders' agreement, but with Vested Approach, it is risky to have beneficiaries agree to restrictions in advance, as such restrictions could jeopardize vesting

Non-Tax Considerations

- While avoiding capital gains tax from DDR is a priority, there are also non-tax considerations
- Want beneficiaries to agree to restrictions as to how to deal with shares or vested interest
- Under Rollout Approach, prudent to have beneficiaries sign shareholders' agreement in advance
- Restrictions for encumbering and transferring shares both while alive and upon death

Non-Tax Considerations

- Parent typically wants shares to be transferred to lineal descendants (rather than spouse of child)
- Parent wants to retain complete control of corporation during lifetime
- Variety of issues can be dealt with in Shareholders' Agreement depending on the situation
- Under Vested Approach, risk to causing vesting indefeasibly if restrictions agreed to in advance
- Need lead time to get shareholders' agreement signed in advance

Non-Tax Considerations

- Issues of possible independent legal advice for children
- Disadvantages of Vested Approach that beneficiaries may refuse to agree to restrictions after the vesting
- Under Vested Approach, want beneficiaries to agree not to force wind-up of trust under *Saunders v. Vautier*

Family Law Act Considerations

- Consider steps to protect shares or vested interests from spousal claim
- Prior to rollout, consider freeze of growth shares with gift of new growth shares from parent to married child
- Best protection may be in limited purpose marriage contract
- Depending on circumstances, interest in trust and assets distributed from trust may qualify for exclusion from net family property based on gift during marriage if married at time trust settled

Key Takeaway Points

- Often large income tax exposure with no liquidity to pay
- Care needed at time of set-up of trust to avoid subsection 75(2)
- Care needed in connection with all subsequent transfers of property to trust (including payment of expenses) to avoid 75(2)
- Care required in drafting trust deed for various issues, including allowing rollout to corporation for non-resident beneficiary, allowing for vested indefeasibly

Key Takeaway Points

- Significant lead time required prior to 21st anniversary for proper planning and implementation with shareholders' agreement and possible marriage contract
- Best approach must be tailored to the situation

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