OVERVIEW OF THE TWENTY ONE YEAR RULE
A TRUST LAWYER'S PERSPECTIVE

By: M. Elena Hoffstein & Corina S. Weigl

TABLE OF CONTENTS

Introduction 1
Part I – Overview of the Trust as a Vehicle for Property Ownership 2
1. What is the Nature of a Trust 2
(a) General Overview 2
(b) What is a Discretionary Trust? 2
(c) What Does it Mean to Establish a Trust? 3
2. Purposes of a Trust as Part of an Estate Plan 3
(a) Tax Purposes 3
(i) Income Splitting 3
(ii) Multiplying the Capital Gains Exemption 4
(iii) Freeze of the Owner/Manager's Future Gain 4
(b) Non-Tax Purposes 5
(i) Asset Protection - General 5
(ii) Trusts and the *Family Law Act* 5
(iii) Trusts for Disabled Children 6
(iv) Trusts to Avoid Probate Taxes and the Probate Process 6
Part II –Trust Law Considerations Applicable to Planning Options 7
1. Is there a Distinction Between Powers and Duties 7
2. What are the Core Duties of a Trustee 7
(a) Duty of Loyalty 7
(b) Duty of Care 7
(c) Duty to Maintain an Even-Hand 8
3. When Will a Court Interfere with a Trustee's Exercise of an "Absolute" Discretion 9
4. When is there a Right to Trust Information - When is there a Duty to Disclose 11
(a) Can the Right of Access to Information be Excluded or Restricted 12
(b) When are Trustee Communications Privileged? 13
(c) Personal Liability of Trustees 14
5. Trustee's Ability to be Exonerated from Breaches of Their Duties 15
(a) What Are the Different Types of Exculpatory Clauses 15
(b) What Are the Limitations of Exculpatory Clauses 16
6. Considerations Where Beneficiaries Include Minor Beneficiaries 17
7. Ability to Amend Trust Terms 18
(a) Express Power 18
(b) *Saunders v. Vautier* 18
(c) Disclaimers, Releases, Surrenders 18

(d) *Variation of Trusts Act* 19
(e) Income Tax Consequences of Amending Trust Terms 20
(i) Consent of Beneficiaries 20
(ii) Creating a New Trust 21
(iii) CRA Position 21
8. Characterization of Corporate Distributions for Trust Law Purposes 22
(a) What Determines Whether Corporate Distributions Constitute Income or Capital 23
(b) Alternatives to the "Form Rule" for Characterizing Corporate Distributions 24
(c) Restrictions on the Settlor's Ability to Provide an Alternative to the "Form Rule" 25
(d) Impact of the "Form Rule" on Duty to Maintain an Even-Hand 26
9. Allocation of Burdens Among Successive Beneficiaries 27
(a) Overview 27
(b) Jurisprudence on the Obligations of the Life Tenant 28
(c) Jurisprudence on the 21 Year Deemed Disposition 31
(d) Comparison to Tax Law 35
(e) Summary 36
Part III - Historical Background of the 21 Year Tax Rule 37
Part IV - The 21 Year Tax Rule - Some Particular Issues 38
1. When is a Trust Created? 38
2. What Time of the Day on the 21st Anniversary does the Rule Apply 39
3. What Property is Subject to the Rule 39
4. What Trusts are Exceptions to the Rule 40
5. What's the Problem for the Taxpayer 40
6. Are there any Anti-Avoidance Rules 41
Part V – Summary of Planning Options 41
1. Determining the Scope of the Problem 42
2. Considering the Options to Manage the Problem 42
(a) Do Nothing and Pay the Tax 42
(b) Managing the Value of Private Company Shares 43
(i) Reducing the Value of the Company 43
(ii) Managing the Value Accruing to the Trust 45
(c) Distribution Option 45
(ii) Terms of the Trust 46
(iii) Non-Resident Beneficiaries 47
(iv) Subsection 75(2) 48
(v) Trustees Intend to Discriminate 55
(vi) Successive Beneficiaries 56

(d) Indefeasible Vesting 56
Part VI - Process Trustees Should Follow When Considering Planning 58
1. Obtain Advice 59
2. Trustee Resolution 60
3. Implementation 61
4. Protect the Trustees 61
Part VII - Drafting Tips to Follow to Allow for Planning 61
1. Include a Statement Expressing the Purpose of the Trust, ... 61
2. Include Provisions to Allow for Indefeasible Vesting, ... 61
3. Include a Capital Encroachment Power Together with a Discretion to Terminate, ... 61
4. Allow an Ability to Allocate Phantom Income and Expressly Refer to subsection 104(21) of the Act, ... 61
5. Consider Including a Power to Vary or Amend the Terms of the Trust, ... 61
6. Consider Including a Mandated Distribution on the 21st Anniversary, ... 61
7. Include Powers to Implement Corporate Re-Organizations, ... 61
8. Include Corporations and Trusts Within Class of Beneficiaries, ... 61
9. Ensure Discretionary Powers Allow for Distributions “to or for the benefit of”, ... 61
10. Consider Including a Provision that Allows for “Laddered Freezes”, ... 62
11. Include a Provision that Allows the Income Tax Consequences of Distributions to be Allocated to Beneficiaries, and 62
12. Include Appropriate Exculpatory Clauses. 62
Conclusion 62

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M. ELENA HOFFSTEIN[1]
FASKEN MARTINEAU DUMOULIN LLP
416-865-4388
ehoffstein@fasken.com

AND

CORINA S. WEIGL[2]
FASKEN MARTINEAU DUMOULIN LLP
416-865-4549
cweigl@fasken.com

OVERVIEW OF THE TWENTY ONE YEAR RULE – A TRUST LAWYER'S PERSPECTIVE[3]

Introduction

For practitioners specializing in the area of estate planning, particularly those with a focus in the area of business succession, trusts are a key tool in the advisor's toolbox. Whether the objectives to be achieved are tax driven or non-tax driven, it is the benefit of being able to separate control and management of property from enjoyment of property, and, in the context of a discretionary trust, the flexibility it offers, that have ensured the trust plays a key feature in virtually every client's estate plan.

Despite this clear rationale for considering a trust when developing a client's estate plan, there are limitations that flow from the use of a trust. Those limitations are the perpetuity period, the accumulation period and the 21 year deemed disposition rule under the *Income Tax Act* (Canada)[4] (the "21 Year Tax Rules"). It is the latter rule that is the focus of this paper.

Our paper will begin by setting the stage with a background discussion of the nature of a trust, as well as considering the purposes for using a trust in a client's estate plan. Then we will consider various trust law considerations that have to be addressed when planning to address the 21 Year Tax Rule. Thereafter we will provide some historical background for the introduction of the 21 Year Tax Rule. This will be followed by a description of the Rule itself and a discussion of the problems that the Rule imposes on clients (and their advisors).

We then turn to the various planning options that are available to address the implications of the Rule. In doing so, we refer to relevant trust law considerations. Inevitably the particular facts and circumstances at issue will play a key role in the manner in which the trust law considerations are addressed. As a result, our discussion is, by necessity, general in nature.

The message we hope to impart is that trust and tax law are slow to change – the perpetuity period, the accumulation period and the 21 Year Tax Rule have been around for a long time and will likely continue to be around. Thus, 21 years in the development of law is a very short period of time, where change is highly unlikely. This is not the case for a family where 21 years can truly be a lifetime. Circumstances that exist at the start of a trust will – without fail – be very different than what will exist 21 years later. Whether changes are due to births, deaths, marriages, divorces, remarriages, personal, educational and professional opportunities taking someone outside Canada, or health related issues, family circumstances are dynamic, while the law remains virtually static. Recognizing the dynamic nature of family circumstances at the time a trust is established is key to creating an estate plan that will continue to be relevant to a client, despite the potential impact of the 21 Year Tax Rule.

Part I – Overview of the Trust as a Vehicle for Property Ownership

1. *What is the Nature of a Trust*

(a) General Overview

A trust is not a legal entity. It is a relationship which arises whenever a person called the settlor, transfers property, whether real or personal, to another person called the trustee, who then has the fiduciary obligation to hold and manage the property, for the benefit of other persons called beneficiaries. It is the beneficiaries who are entitled to the use and enjoyment of the trust property - not the trustee.

Since a trust is not a legal entity, it cannot enter into contracts, own property or incur liabilities. Rather the trustees engage in all transactions in respect of the trust property in their capacity as trustees; it is the trustees who "own" the trust property but in that capacity.

Trustees act as principals; they are not agents of the beneficiaries.[5] Trustees are, however, accountable to the beneficiaries. They must act in accordance with the fiduciary obligations imposed on trustees at law, while also being bound by the terms of the trust instrument.

When a trust is used as part of an estate plan, there will generally be a document outlining the terms of the trust relationship. The trust instrument will not create a contractual relationship between any of the relevant parties of the trust relationship. Rather, the trust instrument will generally: (i) express the intention of the settlor,[6] (ii) identify the property used by the settlor to create the trust relationship, (iii) identify the beneficiaries and articulate the beneficial rights of the beneficiaries, and (iv) provide for the powers of the trustees to manage the trust property and the duties the trustees have to the beneficiaries when managing the trust property. In addition, the common law will impose duties on the trustees which may be modified by the terms of the trust document.

Trusts can either be *inter vivos* – established by an individual during his/her lifetime – or testamentary. Where a trust is established by an individual during his/her lifetime, s/he is referred to as the "settlor", whereas the creator of a testamentary trust is referred to as the "testator" or "testatrix". A testamentary trust is defined in subsection 108(1) of the Act to be: "in a taxation year…a trust that arose on and as a consequence of the death of an individual (including a trust referred to in subsection 248(9.1))". The 21 Year Tax Rule applies equally to both.

(b) What is a Discretionary Trust?

A discretionary trust is a trust for the potential benefit of a class of beneficiaries, as described in the trust instrument, e.g. "all of the children of Mr. A, together with all of the issue of the children of Mr. A". The terms of the trust may bifurcate the beneficiaries between those entitled to the income earned on the trust property and those entitled to the trust property itself, being the capital of the trust.[7]

A discretionary trust allows the trustees to postpone to a future date both:

(i) the decision as to which beneficiaries should be benefitted, and

(ii) the decision as to when to transfer the assets of the trust to those beneficiaries.

This flexibility arises because a discretionary trust provides the trustees with the discretion to determine:

(iii) which beneficiaries of the trust will receive capital (i.e. the assets of the trust), and income distributions, and

(iv) when distributions of capital and income are to be made to the beneficiaries.

In the context of an estate plan, a trust is unlike a corporate structure which would require a determination at the date of incorporation of (i) which family members should benefit from the future value of the underlying assets of the corporation by becoming shareholders, and (ii) the extent to which those family members should benefit in terms of their shareholdings.

Pending distributions of the capital of a discretionary trust, the trustees control and make all decisions in respect of the trust's assets. It is the trustees who exercise all property rights with respect to the assets of the trust, such as the voting rights attached to shares of a family corporation. It is the trustees who ultimately decide whether income earned on the assets of the trust, such as dividends, is distributed to the beneficiaries and to which beneficiaries. It is also the trustees who ultimately decide who will benefit from the assets of the trust, that is to say to whom the assets of the trust, or the proceeds of sale therefrom, will be distributed.

It is important to note that the assets of the trust are **not** the personal property of the trustees. Ultimately the benefit of the assets of the trust "belongs" (beneficially) to the beneficiaries for whose benefit those assets are being administered. Trustees are fiduciaries. When making decisions, the trustees owe a fiduciary obligation to the beneficiaries to act reasonably and not arbitrarily and to consider the interests of all potential beneficiaries when exercising their discretion.

(c) What Does it Mean to Establish a Trust?

When a trust is established as a component of a client's estate plan, it is important to have an appreciation of what it means to establish a trust by transferring property to a trustee, as well as the duties imposed on a trustee. Far too often individuals establish family trusts naively believing that they are free to control and deal with the property of the trust in the same manner they could if the property was still theirs beneficially. While the trustees do control how the property is dealt with and, in the context of a discretionary trust, to whom income and capital are ultimately distributed, they do so subject to a number of fiduciary obligations. The primary duties imposed on trustees by the common law will be discussed in greater detail below.

2. *Purposes of a Trust as Part of an Estate Plan*

The reasons for using a trust as part of an individual's estate plan generally fall into two categories - tax reasons and non-tax reasons. Trustees ought to understand the potential tax and non-tax purposes to be achieved with a trust relationship, both generally and from the perspective of the settlor's particular purposes for establishing the trust. Recognizing the general and, more importantly, the specific purposes, is a key to what a trustee should consider when making decisions in respect of the trust property, such as planning for the 21 Year Tax Rule. Immediately below we consider some, although not all, of the more common purposes for establishing a trust. The purposes we focus on are those that are more relevant to planning for the 21 Year Tax Rule.

(a) Tax Purposes

<u>(i)</u> <u>Income Splitting</u>

Income splitting is the term used to describe arrangements aimed at saving tax by shifting income from a high income earner to a family member who is in a lower tax bracket. While the Act has many rules in place to prevent income splitting, it is still possible to achieve income splitting, particularly *via* a discretionary family trust, if properly structured.

For the business owner, the relevance of income splitting will depend on whether the business is in the start-up phase or is a fully mature business. Where a discretionary family trust acquires shares in the early stages of a business which has the potential for growth, the increased value of the shares held by the trust can be taxed in the hands of the beneficiaries, who may pay less tax and can benefit from the capital gain exemption (see below). It may also allow for income splitting through the payment of dividends on the shares owned by the family trust. Where the business is a mature one, an "estate freeze" is often employed to provide some certainty as to the deemed capital gain which will arise on the owner's death, while passing the future growth of the business on to other family members through the vehicle of a discretionary family trust.

(ii) Multiplying the Capital Gains Exemption

The $800,000 capital gains exemption under subsection 110.6(2.1) of the Act, for qualifying small business corporations ("QSBC") provides a significant exemption from capital gains tax on the disposition of shares of a Canadian controlled private corporation, as defined in the Act, which carries on an active business in Canada and which meets additional tests. Assuming that the business meets the test for the exemption, the use of a discretionary family trust to own equity shares of a QSBC can dramatically increase the amount of capital gains that can be exempted from tax on the sale of the business by using the exemptions available to each of the beneficiaries of the trust to whom either shares of the business or the proceeds of sale therefrom are allocated.

There is one caveat to note in respect of using the exemption available to a minor beneficiary. In order to utilize the $800,000 capital gains exemption of a beneficiary who is a minor, that amount must be designated as a capital gain of the minor from a disposition of property qualifying for the $800,000 capital gains exemption. Once the minor beneficiary reaches the age of majority, s/he can require payment of the amount and therefore the minor beneficiary's enjoyment of the income cannot be further deferred. Parents may be concerned about allocating significant funds to a beneficiary who is under the age of majority. A similar concern may arise when considering the planning options to address the 21 Year Tax Rule. The challenges presented to the trustees where there are minor beneficiaries is discussed under the heading "*Trustee Considerations Where the Beneficiaries Include Minors.*"[8]

(iii) Freeze of the Owner/Manager's Future Gain

An "estate freeze" involves the reorganization of an individual's assets so that any future increase in value of those assets accrues to other persons. This type of transaction is often used to fix the value of the individual's interest in the assets for purposes of the deemed disposition on death by the individual of those assets pursuant to subsection 70(5) of the Act. By fixing the value of the individual's interest in the frozen assets, the tax liability which will arise on his or her death will be known and thus the payment of this liability can be planned for.

The most common asset to "freeze" is the shareholding interest of a business owner. Often the owner will want to "freeze" his or her equity interest in the corporation, while allowing the future growth to accrue to the benefit of other family members, often children and grandchildren, through a discretionary family trust. The result of this transaction is that any increase in value of the owner's interest in the corporation after the freeze is not subject to tax on the owner's death. Rather, it will be subject to tax in the hands of the family members, usually children, to whom equity shares have been allocated from the discretionary family trust either on a later disposition by them or on their death.

The introduction of a discretionary *inter vivos* family trust to hold the new growth shares of the business following the freeze provides the freezor flexibility to determine at some future date which family members should receive the shares and/or other trust property. This will allow the freezer to take into account the differing capabilities, needs and personal and economic circumstances of the beneficiaries, as well as the needs and interests of the business. For example, a child active in the family business can be treated differently than an inactive child.

(b) Non-Tax Purposes

It is the separation of legal title from beneficial enjoyment, as well as the ability to ascribe beneficial enjoyment for different periods of time and in differing interests, that makes a trust an extremely useful vehicle for the ownership of property. Understanding the non-tax benefits that flow from the trust vehicle is an important consideration for trustees to bear in mind when engaging in planning to address the 21 Year Tax Rule. Examples of non-tax benefits:

- to create a structure for the management of property in the event of the owner's incapacity;
- to provide creditor protection;
- to protect property from *Family Law Act* claims of spouses of children;
- to maintain control of property, such as a family corporation, while allowing others to have the enjoyment (or "fruits") of the property;
- to provide for disabled beneficiaries while protecting entitlement to social assistance;
- to defer decision-making about who is to benefit from property;
- to provide for an individual who lacks capacity to manage property because of age, immaturity, disability or other inability;
- to provide a life interest to one or more individuals while ultimately benefiting other individual(s) - common in a second marriage situation; and
- to avoid the probate process and/or the application of probate tax.

Some of these reasons will be discussed briefly below.

(i) Asset Protection - General

Where an individual is concerned about personal liability, for example because s/he is a director of a public company, s/he may want to utilize a trust to protect against the claims of creditors. The use of a discretionary trust is a measure which may reduce the exposure to such liability, if properly structured. If an individual goes bankrupt and holds property in trust for others, unless the transfer of the property into the trust can be attacked,[9] the property ought not be subject to the claims of creditors.[10] A full consideration of the many factors which must be considered to determine whether a trust settlement will be effective to avoid the claims of creditors is beyond the scope of this paper.[11]

(ii) Trusts and the *Family Law Act*

Pursuant to the *Family Law Act*,[12] provision is made for the equalization of "net family property" between spouses in the event of marriage breakdown and in the event of the death of a spouse. Specifically, the

Family Law Act entitles the spouse whose net family property is the lesser of the two spouses' net family properties, to a payment (called an "equalization payment") equal to one-half of the difference. Pursuant to the provisions of the Ontario legislation, one of the key points from a property law perspective is that neither spouse has a proprietary interest in a particular property of the other spouse but rather has a right to an "equalization payment".

It is not uncommon for wealthy parents to be concerned with protecting their wealth from the claims of their children's spouses. One solution to this problem is to establish a purely discretionary trust of which their children are discretionary beneficiaries. Since the child's interest in the trust is subject to the discretion of the trustees, the argument is that it will have negligible value in the event of a marriage breakdown of the child occurring before significant income or capital had been transferred to the child from the trust.[13]

(iii) Trusts for Disabled Children

Parents who have a child with a disability will want to ensure the needs of their disabled child are fully met in the event the parents are incapable or are no longer alive to provide for those needs. This is the case whether the child is in receipt of benefits under the *Ontario Disability Support Program Act*[14] or not. In either case, a fully discretionary trust is a very good vehicle to make provision for such a child.

(iv) Trusts to Avoid Probate Taxes and the Probate Process

Probate is simply judicial evidence of the authority of the executors to deal with the assets of a deceased individual. The source of the authority of the executors is the Will itself, not the letters probate the court issues to the executors. Probate, however, provides comfort to financial institutions and others that there is not a later Will in existence, that the Will is not being contested and that they are dealing with the authorized executors.

The necessity for probate is generally determined by the nature of the assets held by the deceased, statutory requirements for the sale or transfer of certain assets and the state of the deceased's financial affairs.

If probate is required by the executors to deal with the assets of the deceased, a tax is imposed pursuant to the *Estates Administration Tax Act, 1998*.[15] Further, the Will governing the disposition of those assets must be submitted to the court and thereby becomes a public document. Where privacy is a goal, avoiding the probate process will be key to maintaining privacy.

One means to avoid or reduce the tax or avoid the probate process, is the use of a trust to hold assets. Provided the terms of the trust are structured appropriately, generally assets transferred to a trust during the settlor's lifetime will be removed from an estate's value for probate purposes. This is because those assets will pass to beneficiaries outside the settlor's Will and therefore probate taxes will not be exigible in respect of those assets. While there are other probate tax planning techniques available, it is beyond the scope of this paper to discuss them.

Care should be taken, however, as the settlor will, to a degree, lose control over the assets transferred. In addition, there may be adverse income tax consequences from the application, under the Act, of the attribution rules and the rules relating to the disposition of capital property. These adverse tax consequences may be mitigated if the settlor is 65 years old and the trust qualifies as an "alter ego trust", "spousal trust" or "joint partner trust" for purposes of the Act. In addition, these trusts are an exception to the 21 Year Tax Rule.

Part II –Trust Law Considerations Applicable to Planning Options

The following Part will review the trust law concepts relevant to planning for the 21 Year Tax Rule. The concepts will have relevance to some or all of the planning strategies. As a result, having an understanding of these concepts will assist the reader in better advising trustees when engaging in particular planning strategies to address the 21 Year Tax Rule.

1. *Is there a Distinction Between Powers and Duties*

Trustees have both "powers" and "duties". These are easily distinguishable from one another. As Waters notes:

> *A duty is an obligation; a power is an authority to act. A duty of the trustee compels him to act, or prohibits him from acting, in a certain way. A power of the trustee enables him to act in a certain way, but leaves him with the discretion as to whether or not he should so act.*[16]

In other words, powers are permissive. They give trustees the discretion to take (or not take) certain actions. Duties, on the other hand, are restrictive. They restrict trustees' discretion by either mandating or prohibiting actions. It is duties with which we are concerned here. Both powers and duties are granted by legislation (as in the *Trustee Act*), by jurisprudence and by the trust instrument itself. So, while the basic framework of a trustee's rights, duties and powers is rooted in statute and equity, the settlor or testator may modify those same rights, duties and powers in the trust instrument. While many of our modern trusts and Wills contain many additional powers and intend to remove many of the more troublesome duties, the modern trust document may not be sufficiently explicit to fully oust the application of all the duties that will become crucial in the context of planning for the 21 Year Tax Rule.

The first duty of a trustee is to adhere to the terms of the trust instrument. However, the trust instrument may not be determinative of the trustee's duties. This is because a trust instrument cannot alter the duties of a trustee in a manner that is inimical to the nature of a trust. Moreover, as will be discussed further below, adjectives such as "absolute", "uncontrolled" or "unfettered" may suggest a discretion that is beyond judicial review. This, however, is not the case. Ultimately, all exercise of discretionary power is subject to judicial review.

2. *What are the Core Duties of a Trustee*

An individual who takes on the responsibility of being a trustee assumes the highest fiduciary duties recognized at law. The hallmarks of the trustees' duties are honesty, objectivity and care, and a duty to act impartially by maintaining an even-hand among beneficiaries. These fiduciary duties are described as the duty of loyalty, the duty of care and the duty of impartiality. Each of these is briefly described below.

(a) Duty of Loyalty

Trustees must avoid conflicts between their own interests and those of the beneficiaries. They must not profit from their position. If there is a breach of trust that arises from a breach of this duty, a trustee can be compelled to hand over any and all profit derived from the transaction.

(b) Duty of Care

The trustee must act in a manner consistent with the standard of care expected of the reasonable and prudent business person who is administering assets of another person. This duty is described as imposing on a trustee the duty of "vigilance, prudence and sagacity".

(c) Duty to Maintain an Even-Hand

This duty is also referred to as the duty of impartiality. When there are beneficiaries with competing, for example, successive interests, trustees are required to act impartially in the administration of trust property. While this duty is perhaps best understood in the context of trustees exercising their power to make investments, the rule imbues the exercise of all powers of a trustee.

The duty of impartiality also applies to the exercise of trustees' discretionary powers. When exercising their discretions, trustees are obliged to comply first with the terms set out in the trust document, and second with the intentions of the settlor of the trust, to the extent that such intentions can be determined.[17] Sometimes the settlor's intentions are contained explicitly in the trust document and sometimes they are contained in a separate, contemporary document. However, the intentions of the settlor are the intentions of the settlor at the time that the trust was created, and trustees cannot properly take intentions contained in a "letter of wishes" or other document made subsequently to the establishment of the trust into account when exercising their discretion.

The imposition of trustees' duties does not deny the trustees their right to exercise discretion where granted by the trust instrument, but rather provides a context for the execution of those powers. Trustees must adhere to the fundamental purpose of a trust, discerned through the trust document – often not an easy task. If they wish to deviate from an equal treatment of all beneficiaries, trustees must do so based upon rational principles and must not exercise their judgment arbitrarily or capriciously. This is the case notwithstanding that a discretion may be described as "absolute". The meaning that may be given to this term, as well as the process trustees should engage in when exercising their discretionary powers, particularly when the goal may be to disentitle a beneficiary, are further discussed below.

As we consider particular planning strategies available to address the 21 Year Tax Rule deemed disposition rule, it will become apparent that many of the planning strategies available require trustees to carefully consider the implications of this duty. The practical import of this duty has been described as two-fold:

- The even-hand rule requires that trustees administer trust assets such that they provide fairly for both the life tenant and the remainderman. It therefore proscribes actions by trustees that favour life tenants by generating high income at the expense of capital appreciation. Conversely, the even-hand rule bars trustees from taking steps that are geared disproportionately toward capital growth at the expense of income generation and therefore favour the remainderman. This duty raises unique considerations in the context of trusts owning business assets. For example, decisions related to corporate distributions can be structured in a manner that favours one category of beneficiary over another. While the form of corporate distributions does not often have relevance to the planning strategies to address the 21 Year Tax Rule, it is raised here for context.[18]

- The even-hand rule requires that expenses incurred by the trust be allocated fairly between income and capital beneficiaries. The general common law rule is 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 capital of the trust (for example, major improvements to trust property and administrative expenses) are borne by the capital beneficiaries. The allocation of financial burdens will be given further consideration below.

3. *When Will a Court Interfere with a Trustee's Exercise of an "Absolute" Discretion*[19]

The general rule is that courts will not interfere with a trustee's exercise of an absolute discretion unless it was exercised with mala fides.[20] The case that promulgated this general rule is *Gisborne v. Gisborne*, a 19th-century decision of the House of Lords.[21]

The *Gisborne* rule demonstrates that there is in fact an exculpatory effect obtained when trustees are granted an absolute discretion — that is, pursuant to *Gisborne*, trustees exercising such a discretion are insulated from judicial review so long as they have not acted mala fides. The courts' expansive treatment of the concept of mala fides, however, signals the need for caution in the degree of reliance that is placed upon the general rule articulated in *Gisborne*.

When exercising their discretion, trustees are bound to adhere to certain fiduciary obligations imposed by law; the breach of which enables judicial intervention and the potential awarding of equitable remedies to objecting beneficiaries. These include the duty to:

(i) consider the exercise of their discretion;

(ii) act in accordance with the terms and purposes of the discretionary power;

(iii) consider the potential beneficiaries of the discretionary power;

(iv) act reasonably and not perversely or capriciously;

(v) take into account relevant considerations and to refrain from considering extraneous considerations; and

(vi) at all times to act in good faith.

The ability of the courts to review an exercise of trustee discretion cannot be displaced by even the broadest language (such as the term "absolute discretion") in the instrument creating the discretion. The jurisprudence in this area remains fluid, and can be extremely elastic depending on the fact situation involved. Recent case law in Ontario suggests that judicial deference to the exercise of discretionary powers by trustees remains the norm.[22]

In any action to challenge a trustee's discretionary power, the burden is on the challenger to prove that the trustee exercised the discretionary power improperly, and in general, a court will not substitute its decision for the trustee's simply because it disagrees with the decision reached by the trustee. However, it should also be noted that courts have never interpreted "absolute discretion" in the trust context as the equivalent to the free exercise of discretion by trustees. In struggling with broad discretionary powers granted to trustees, the courts have developed the following restraints:

(a) a trustee cannot fail to consider the exercise of discretion; the trustee must turn his or her mind to the discretionary power granted to him or her;

(b) a trustee cannot, in exercising the power, be attempting to achieve a purpose or act in a manner not authorized by the terms for which the discretion was given;

(c) a trustee cannot be unthinkably unreasonable, perverse or capricious;

(d) a trustee cannot be motivated by bad faith or other improper purposes;

(e) a trustee shall not take into account extraneous considerations or irrelevant considerations; and

(f) a trustee cannot be motivated by matters that the court considers to be against public policy such as the religious background of a particular beneficiary's intended spouse.

Although not exhaustive, the following is a categorization of the general circumstances in which courts are likely to interfere with a trustee's exercise of discretion, irrespective of whether it has been characterized in the trust instrument as being "absolute", "unfettered" or "uncontrolled".[23]

1. *Improper purpose*: A court will strike down a trustee's exercise of discretion if it was exercised for a purpose alien to that for which it was given to the trustee.[24] It is not enough if an extraneous purpose was achieved by the decision. The extraneous purpose must have actually formed a part of the basis upon which the trustee based his or her decision.[25] This principle was applied by Galligan JA of the Ontario Court of Appeal in *Fox v. Fox Estate*.[26] In that case, the executrix, who was also the primary income beneficiary, had been given an absolute discretion to make capital advancements to the testator's grandchildren. She exercised that discretion so as to give the entire capital to the testator's grandchildren. One of her motivations for doing so was to express her disapproval of the decision of the capital beneficiary, her son, who also had a 25 percent life interest in the estate, to marry a gentile. By advancing the entire capital to the grandchildren, she basically disinherited her son from the estate. The court set aside her exercise of discretion on the ground that it had been exercised for an improper purpose. She was also removed as the executrix of the estate.

2. *Failure to consider*: Courts will intervene where a trustee has failed to consider whether he or she should exercise the discretion, including situations in which the trustee erroneously denies that the discretion exists or that it is applicable in the circumstances. It is important to distinguish such situations from those in which the trustee is cognizant of the discretion but exercises it in favour of the status quo — that is, consciously makes the discretionary decision to do nothing.[27]

3. *Unreasonable decisions*: If a trustee exercises his or her discretion in an unreasonable, arbitrary, or capricious manner, then a court may intervene. It is important to distinguish this standard of review from a "correctness" standard of review. Courts will not necessarily intervene simply because the trustee's decision was in their view incorrect. To justify the intervention of the court, the decision must be not only incorrect, but also unreasonable in the view of the court. An example of such a decision is the case in which a trustee refuses to exercise his or her power to advance income for maintenance despite the fact that the beneficiary is in need.[28]

In general, prior to exercising any discretionary power, the trustees should ensure that the following due diligence and administrative technicalities are complied with:

(a) the trustees must turn their mind to the exercise of the discretionary power and consider all of the circumstances that are relevant to the power being exercised;

(b) in the abstract, the trustees' starting point will ordinarily be to look for a broadly equal division among the beneficiaries; if the basic principle of equality is deliberately to be departed from, the trustees will ordinarily require cogent reasons for doing so;

(c) the execution by the trustees of written resolutions detailing such reasons contemporaneous with the decision, while unnecessary at law, would be prudent to forestall certain potential objections to the exercise of the discretionary power;

(d) the trustees should inform themselves of the situation of all the potential beneficiaries of the discretionary power; this may require obtaining information from the beneficiaries that is relevant to the exercise of the discretionary power;

(e) prior to exercising their discretion the trustees should obtain complete information pertaining to the assets of the trust and the anticipated tax liabilities of distributions made from the trust, as well as all necessary fiscal and other relevant professional advice pertaining to these issues.

4. *When is there a Right to Trust Information*[29] *- When is there a Duty to Disclose*

The duty of trustees to account to beneficiaries is at the heart of the trust relationship. That duty extends to the provision of information relating to the administration of the trust, what the trust property consists of and how it is invested and administered.

A number of authors have attempted to clarify the essence of a trust. For example, Professor Hayton states that "the core element of a trust, for its existence reflecting the irreducible minimum of obligation on trustees, is the right of a beneficiary to enforce the trusteeship, in default of which, the beneficial ownership remains with the Settlor."[30]

In another article "The Irreducible Core Content of Trusteeship,[31] he observes: "Knowledge of the trust is necessary to make the trust effectual with the trustees being accountable to the beneficiaries for their stewardship of the property." Put another way, if the beneficiaries have no rights enforceable against the trustees, there are no trusts.

The case of *Vadim Schmidt* v. *Rosewood Trust Limited*[32] a decision of the Privy Council on appeal from the courts of the Isle of Man, is of great interest to trust practitioners in that it considers and restates the approach to be taken to the question of disclosure of information by trustees to beneficiaries.

In this case the son of a settlor of an offshore trust sought disclosure of the trust's account and information about the trust assets to address alleged deficiencies and inconsistencies in the material provided by the Trustees.

The Privy Council engaged in an extensive review of the law relating to disclosure of information by trustees to beneficiaries.[33]

The Privy Council reviewed the case of *O'Rourke* v. *Darbishire*[34] wherein the court found that the trustees of a trust have a duty to provide documents and that beneficiaries are entitled to be informed about matters affecting the trust and its beneficiaries. It also reviewed the case of *Re Londonderry's Settlements*[35] wherein the court struggled with whether documents in dispute were trust documents. In that case the court determined that agenda of meetings, minutes of meetings, correspondence of trustees and information about the basis on which trustees exercised their discretion were not trust documents and therefore not producible, but had difficulty determining what was a trust document.

The Privy Council chose not to follow those cases but found instead that no beneficiary has a proprietary or other form of absolute right to information concerning a trust and that the above cases did not support such a view. Instead the Privy Council restated the basis for disclosure as follows:

> *… the more principled and correct approach is to regard the right to seek disclosure of documents as one aspect of the court's inherent jurisdiction to supervise, and if necessary to intervene in, the administration of trusts. The right to seek the court's intervention does not depend on entitlement to a fixed and transmissible beneficial interest. The object of the discretion (including a mere power) may also be entitled to protection from*

a court of equity, although the circumstances in which he may seek protection and the nature of the protection he may expect to obtain, will depend on the Court's discretion.[36]

The courts and trustees faced with a request for information will now have to weigh all relevant factors in determining how to respond to such a request. As noted by the Privy Council:

> *There are three such areas in which the court may have to form a discretionary judgment whether a discretionary object (or some other beneficiary with only a remote or wholly defeasible interest) should be granted relief at all; what classes of documents should be disclosed, either completely or in a redacted form; and what safeguards should be imposed (whether by undertakings to the court, arrangements for professional inspection, or otherwise) to limit the use which may be made of documents or information disclosed under the order of the court.*[37]
>
> *Especially when there are issues as to personal or commercial confidentiality, the court may have to balance the competing interests of different beneficiaries, the trustees themselves, and third parties such as a family business. Disclosure may have to be limited and safeguards may have to be put in place. Evaluation of the claims of a beneficiary (and especially of a discretionary object) may be an important part of the balancing exercise, which the court has to perform on the materials placed before it. In many cases the court may have no difficulty in concluding that an applicant with no more than a theoretical possibility of benefit ought not to be granted any relief*[38].

In the view of the Privy Council, the right of a beneficiary is not a right to trust documents or information, but an equitable right incident to his beneficial interest entitling him to invoke the jurisdiction of the court to compel the trustee to make disclosure.

(a) Can the Right of Access to Information be Excluded or Restricted

A question which arises is to what extent a settlor can expressly or by implication confer or exclude a right of access to trust documents or information. Are such provisions legally effective or can access remain a matter of discretion for the court? David Steele in his article "The Beneficiary's Right to Know"[39] notes that while there is little law directly on point, there is considerable consensus among commentators that while a trust instrument may limit the trustee's usual duties to account and disclose, it may not eliminate these duties altogether. This is in line with the *Schmidt* decision.[40]

What then should trustees do in light of the *Schmidt* decision? The following suggestions are made:[41]

(1) Each request for information will need to be considered individually in light of the underlying principle that any right to disclosure is based on the fundamental obligation of trustees to act in the interests of the beneficiaries as a whole, and the overriding jurisdiction of the court to ensure that the terms of any trust can be enforced.

(2) Trustees may need to consider whether there are any factors which might weigh against the provision of disclosure to a particular beneficiary, in particular the interests of other beneficiaries.

(3) The nature of the interest of the beneficiary in the trust and the realistic expectation of benefit being conferred on that beneficiary may also be relevant.

(4) Arguments based on what may or may not be trust documents will no longer be material as to the right of any given beneficiary to disclosure. Rather the nature of any given document will be one

factor to be weighed, in order to determine whether it is appropriate for particular information to be given to a particular beneficiary.

(5) Trustees will need to consider whether to require that limitations be imposed on the manner in which information is disclosed or on the uses to which information disclosed can be put if this could protect trust property or the interests of other beneficiaries.

(6) While Trustees still have no legal obligation to explain their reasons for the exercise of their discretion, it would be prudent for them to record their reasons in the event of litigation arising out of a failure to disclose. Based on the decision in *Edell v. Sitzer*,[42] the onus is on the beneficiary to prove an abuse of the exercise of its discretion.

(7) While, as noted above, an attempt by settlors of trusts to completely oust the jurisdiction of the court in this area will not be countenanced, modification of a beneficiary's right to seek disclosure may be valid in certain circumstances.

(b) When are Trustee Communications Privileged?

In general, as discussed above, trustees have a fiduciary duty to provide beneficiaries with accurate information and trust documents regarding the state of the trust and its administration. Trustees must therefore make these documents available to the beneficiaries for inspection. As noted, it is important for a trustee to understand what constitutes a trust document and under what circumstances must this information be disclosed to the beneficiary. Similarly, to the extent a trustee obtains legal advice, to what extent is the advice privileged vis a vis claims brought by the beneficiaries against the trustees, for example, breach of their duties. As will be discussed below, not all advice received by a trustee is privileged.

Canadian case law provides little guidance in determining what a trust document is, aside from the trust instrument itself and accounting information such as a statement of assets. Additionally, it is not clear what kind of documents beneficiaries can ask trustees for outside of what is set out in the trust terms, although it has been concluded that trust documents have the following characteristics: 1) they are documents in the possession of the trustees as trustees; 2) they contain information about the trust which the beneficiaries are entitled to know; and 3) the beneficiaries have a proprietary interest in the documents and are entitled to see them.[43] According to Waters,[44] what is clear, however, is that a beneficiary who issues a statement of claim against a trustee alleging breach of trust may obtain at least some of the trust documents under litigation disclosure rules. However, no court is likely to let a beneficiary go on a "fishing expedition" to look for evidence of trustee bad faith or acts that are ultra vires the trustee's exercise of discretion. A prima facie case must be shown before pre-litigation disclosure can occur.

It is well settled that communications between trustee and a solicitor for the purpose of obtaining advice concerning the administration of the trust are not privileged as against the beneficiaries, and the beneficiaries are presumptively entitled to have access to those communications.[45] The leading case in Ontario on this point of "proprietary right" is *Ontario (Attorney General) v. Ballard Estate*,[46] where it was concluded that trust documents belong to the beneficiary, either with a present or contingent interest, not because he or she has an ownership interest in them, but because the very reason that the solicitor was engaged and advice taken by the trustees was for the administration of the estate and for the benefit of all beneficiaries who take or may take under the trust.[47] Essentially, beneficiaries are the owners of the property and as such, should be entitled to access information relating to their property.

In the *Schmidt*[48] decision, the Privy Council rejected the proprietary test in favour of a balancing of interests test where the trustee's fiduciary duty to keep the beneficiary informed and to render accounts should be more closely considered by the court, as part of its inherent jurisdiction to supervise the administration of trusts. Although the proprietary right analysis has not been wholly abandoned, Canadian courts that have considered or followed Schmidt generally support the view that a balancing approach by the court is required and that the nature of a beneficiary's interest, along with any arising conflicts, is a factor to consider when deciding whether or not disclosure of trust documents to a beneficiary is appropriate. Considering a beneficiary's entitlement to the information is not enough.

At least two Canadian cases have followed or considered *Schmidt. In MacPherson*,[49] the Court held that a beneficiary, simply by asserting a claim, did not have an entitlement as of right to disclosure. Instead, the strength of the claim should be assessed and balanced against competing interests such as personal or commercial confidentiality. Ultimately, disclosure of the document, a legal opinion, was disclosed to the plaintiff. In *Martin Estate, Re*,[50] the issue centered around a request for disclosure of commercially sensitive information which came into possession of trustees in their capacity as directors. Here, the court recognized that questions of disclosure were to be answered by balancing the interests of the various parties involved, and disclosure of information was ultimately allowed.

However, there have been exceptions to the general principle of disclosure. For example, in *Re Londonderry's Settlement*,[51] the court found that it was more important to preserve the confidentiality of the trustee's deliberations with respect to their exercise of discretion in certain matters including a beneficiary's merits and rights to benefit under a trust. In such cases, trustees may be entitled to invoke a right of confidentiality because deliberative secrecy is a necessary factor for the proper administration of the trust.

Another circumstance in which a beneficiary may be denied access to legal advice provided to the trustee is in the context of litigation, specifically when a beneficiary commences legal proceedings against the trustee(s) arising out of the administration of the estate. Under this circumstance, legal advice obtained for the purposes of defending that litigation will be protected by litigation privilege. The leading authority on this point is *Talbot v. Marshfield*;[52] in *Cooke v. The Canada Trust Company.*[53] Ultimately, a conflict of interest will exist between the trustee and the beneficiary once litigation is contemplated or has been commenced. In particular, where the trustee obtains a legal opinion from a lawyer for his or her own protection, the beneficiary is not entitled to access or inspect the opinion.[54]

To conclude, the communications between the trustee and beneficiary of a trust with respect to legal advice obtained in connection with the administration of the trust is not privileged and will generally be disclosed to beneficiaries. However, there are situations where a court may deny a beneficiary's request for disclosure of trust documents if there are independent grounds for doing so. This includes the need for confidentiality in the trustees' deliberations and invoking litigation privilege if the parties are adverse in interest. Regardless of the approach to disclosing trustee documents, trustees who are concerned as to whether access should be given to beneficiaries should continue to abide with their basic duty to act in the best interests of the beneficiaries.

(c) Personal Liability of Trustees

As noted above, trustees hold legal title in a fiduciary capacity for the benefit of the beneficiaries of the trust they are administering. The duties incident to that office, bring with them risk of liability While in many cases the trustees can be indemnified out of the trust assets, there is also possible exposure to personal liability. If a trustee administers a trust or estate and distributes the assets without first obtaining a clearance certificate under the *Income Tax Act*, the trustees may incur personal liability for any subsequent tax liability imposed on the trust. Personal liability is also possible for a breach of trust occasioned by the exercise of discretion in a manner that the court identifies as having been exercised "mala fides". Finally, there is potential liability to trustees under the *Trustee Act* (Ontario). That Act was amended in 1999 to introduce the prudent investors rule. That rule provides *inter alia* that a trustee ought not to be relieved from investments that result in a loss unless a trustee has followed a "prudent investor" investment plan that includes a reasonable assessment of risk and returns. If a trustee has no such investment plan or fails to follow the plan, the trustee's only recourse is to persuade the court to reduce the assessment of damages by virtue of the portfolio's "overall performance" over the relevant period.

In the case of *Fox v. Fox Estate,*[55] for example, a trustee had exercised her discretion to distribute a trust fund to grandchildren, thereby bypassing her son because he had married outside the faith. In finding that she had taken extraneous factors into consideration in exercising her discretion, which demonstrated mala fides, the court ordered a repayment of any funds improperly removed from the trust, plus interest thereon from funds into which these funds could be traced or from the trustee personally where tracing was not possible. In addition, the court ordered costs in favour of the son to be paid by the trustee personally.

5. *Trustee's Ability to be Exonerated from Breaches of Their Duties*

In planning to address the 21 Year Tax Rule, do trustees need to be concerned about being exposed to a claim from one or more of the beneficiaries and thereby be exposed to personal liability as discussed above? Whether this is the case will depend not only on the nature of and manner in which they have exercised their powers but also on whether they have the benefit of any exculpatory provisions. This will be further considered below.

The fiduciary duties of trustees arise through the operation of both common law and statute law, namely, the *Trustee Act*. These duties are perhaps best described as the default obligations of trustees. This is because the common law and statutory duties are the default duties that apply only if the trust instrument is silent in this regard. If the settlor includes clauses in the trust instrument that alter or negate the common law and statutory duties, then these duties generally will not apply. Such clauses are variously known as exculpatory clauses, immunity clauses, exemption clauses, exclusion clauses, indemnity clauses, and excusing clauses. They are referred to here simply as exculpatory clauses.

(a) What Are the Different Types of Exculpatory Clauses

There are basically two fundamental types of exculpatory clauses. These two types of exculpatory clauses parallel the two distinct functions that exculpatory clauses serve.

The first type of exculpatory clause excuses trustees from liability arising from their failure to adhere to their common law and statutory duties. The intended function of this type of exculpatory clause is not to alter the duties of the trustees. It is instead simply to protect trustees from the consequences flowing from a breach of trust (read a breach of their duties). A standard form of such a clause is:

> *No Trustee acting in good faith shall be held liable for any loss occasioned to the trust fund except for loss caused by his or her own dishonesty, gross negligence or wilful breach of trust.*[56]

A subset of this type of exculpatory clause protects trustees not against liability arising from their own conduct, but instead against liability arising from the conduct of their co-trustees.[57]

The second type of exculpatory clause negates or alters the duties of trustees. The intended function of this type of exculpatory clause is not to excuse trustees from liability. It is instead simply to prevent the question of liability from ever arising in respect of certain duties by relieving the trustees from having to adhere to them in the first place. This type of exculpatory clause has been described as having the effect of expanding "the range of the fiduciary's acceptable actions."[58] An example of such a clause is: "Trustees are not required to maintain an even-hand between the income and capital beneficiaries."[59]

Clauses that purport to bestow upon trustees an absolute and unfettered discretion constitute less obvious examples of this type of exculpatory clause — for example, "My trustees shall exercise the following powers as they see fit in their absolute and unfettered discretion." Although such clauses do not explicitly excuse a trustee from the usual duties imposed by trust law, they do so implicitly by describing the trustee's discretion as "absolute" and "unfettered."[60]

Scott on Trusts lucidly describes the distinction between the two types of exculpatory clauses as follows:

> *The effect of a provision enlarging the power of the trustees is to prevent acts from constituting a breach of trust that would otherwise be in breach of trust. The effect of a provision relieving the trustee of liability for breach of trust, however, is not to extend his powers but to restrict his liabilities.*[61]

(b) What Are the Limitations of Exculpatory Clauses

Waters has observed that "in England and Canada [exculpatory clauses] are valid almost without doubt."[62] The strength of this observation should not, however, be interpreted as meaning that settlors have a carte blanche autonomy to exculpate their trustees from all liability flowing from their failure to discharge their duties. Nor should it be construed as meaning that settlors may fundamentally vary the constraints imposed upon trustees by virtue of their fiduciary status. Indeed, despite their validity, exculpatory clauses are subject to important restrictions. In some cases courts have construed exculpatory clauses narrowly. In other cases courts have not enforced exculpatory clauses that are contrary to public policy, such as where the clause is completely inimical to the fiduciary status of a trustee. Thus, although an exculpatory provision may relieve a trustee from certain of the duties imposed upon him or her by trust law, it cannot remove the essential fiduciary character of a trustee.

The inclusion of an exculpatory clause in a trust instrument can to a degree alter the duties of trustees and to a degree insulate them from judicial review. There are nevertheless limitations of exculpatory clauses in this regard. Notwithstanding such limitations, it is good practice, however, to consider providing some guidelines for trustees to assist them in their decision-making and provide them some protection in the event that their decisions are challenged by a disgruntled beneficiary.

Some of the more frequent areas of concern, which should be addressed in a trust document, to avoid friction and possible litigation, include the following:

(1) The even-hand rule – adding a provision that trustees need not have regard to the even-hand rule in making decisions relating to distribution of income or capital among beneficiaries or in making investment decisions.

In addition the even-hand rule should be ousted if it is intended that the shares of a company be held indefinitely even if not producing income or could be modified to take into account judicial positions with respect to corporate distributions and whether they constitute income or capital in the hands of the trustees

(2) Guidelines as to whether, in making decisions as to whether to distribute income or capital, Trustees can consider the independent means of a beneficiary;

(3) Question of compensation – often a source of friction between trustees and beneficiaries. Setting the amount or a formula for determining compensation, providing guidelines as to whether remuneration received in other capacities (lawyer, accountant, director) is to be taken into account would go a long way to alleviate friction; and

(4) Making provisions as to whether a trustee may buy estate assets and a methodology for doing so may avoid court costs of an application to court.

6. *Considerations Where Beneficiaries Include Minor Beneficiaries*

Whenever dealing with the 21 Year Tax Rule in the context of a discretionary family trust, consideration must always be given to the interests of minor beneficiaries as well as those beneficiaries who are unborn or unascertained.

There is nothing in law that prevents a child from owning land or personal property. The problem, however, is that a child lacks the legal capacity (18 years of age in Ontario) to contract as an adult. More specifically, it is not that minors cannot contract, but rather that they have the ability to abandon or set aside the contract upon attaining the age of 18, which poses a risk to any third party who enters into the contract with the minor. However, if the third party is prepared to assume this risk, then the parties can contract. To become a party to the contract, a guardian, such as the minor child's parent, can be appointed to do anything in which the child has the power to do in his or her own right.

It should be noted that parents are not automatically deemed in law to be the guardian of their child's property. This is also the case for adults with legal custody of a child. Pursuant to the *Children's Law Reform Act*,[63] upon application by a child's parent or by any other person and on notice to the Children's Lawyer,[64] a court may appoint a guardian of the child's property. A guardian of a child's property has charge of and is responsible for the care and management of the property of the child. It is important that the order of guardianship be precise and refer specifically to guardianship of the child's property, and not simply guardianship of the child's person, which generally refers to the care and control of the child in all other respects (education, religion upbringing, etc.).

Given the risk to a third party who enters into the contract with a minor, the third party will want to ensure s/he has some protection against the risk that the minor child will walk away from the contract upon attaining the age of 18. There are two ways to achieve this protection when a guardian is appointed to enter into a contract for the minor. The first is to seek an indemnity from the guardian, to protect against the possible default of the minor, whereby the guardian undertakes to indemnify the third party against a liability or loss caused by the minor, who upon reaching the age of 18 may abandon or set aside the contract. The second, is that the third party would make the adult a principal contracting party, where the adult is responsible for fulfilling the terms of the contract.

As a result of the legal incapacity of a minor to own property and the fact that parents do not have the legal right to deal with the property interests of their minor children unless they are a court-appointed guardian of property, a trustee who allocates trust property to a minor faces certain risks.[65] Those risks include future complaints by the minor child about how the property was managed. More importantly though, if the trustees continue to hold property allocated to a minor, such as where trust property is allocated to a vested indefeasible trust (see below for discussion of these trusts), and subsequently engages in transactions related to that property, it is open to the minor to set aside those transactions upon attaining the age of majority. This can present a significant hurdle when trustees need to be in a position to give good title to such property to a third party. As a result, caution needs to be exercised when allocating trust property to a minor.

7. *Ability to Amend Trust Terms*

(a) Express Power

The ability of trustees to amend the terms of a trust depend upon:

(i) whether the trust document provides the trustees with the authority to amend the terms of the trust; and

(ii) if yes, the scope of the authority granted to the trustees.

Where there is an express amending power granted to the trustees in the trust document, it will be necessary to consider the scope of the power. In particular, what aspects of the trust relationship (as stipulated in the trust document) can the trustees amend. It may be the case that even with an express amending power, the scope of the power does not permit the amendment intended to be implemented.

Once an assessment of the scope of the amending authority has been made, the trustees will need to consider the nature of the proposed amendment they wish to make, in order to determine whether it is within the scope of the express amending power.

In this regard, it is fairly common for a trust document to include an amending power that permits amendments to the administrative powers of the trustees but does not permit amendments to the classes of beneficiaries or the provisions related to the distribution of income or capital. The obvious rationale for not including an ability to amend the beneficiaries and the distribution provisions is because the settlor intended to benefit the beneficiaries that were originally provided for such that s/he did not wish the trustees to have the authority to make amendments of this nature. In addition, there is a concern expressed among academics that allowing the trustees the power to amend the beneficiaries may result in a determination that a valid trust was not created because there lacked certainty of beneficiary. Finally, there are potential income tax consequences that may arise in the event amendments to the beneficial interests of a trust are of a substantive nature.

(b) *Saunders v. Vautier*

If there is no express amending power then a consideration should be made as to whether the decision of *Saunders v. Vautier*[66] can be relied upon. The principle established by this case provides that where all the beneficiaries of a trust are *sui juris* (i.e., under no legal incapacity) and they constitute all of the persons entitled to the trust property, then together they can compel the trustees to make a distribution of the trust property to them.[67]

There is some debate within the academic community as to whether this principle can be relied upon to effect amendments to the terms of the trust without compelling a distribution of the trust property. As the factual context within which the principle is available does not often arise – or at least does not often arise in the context of a fully discretionary trust that has been appropriately drafted – we do not intend to address this debate in more detail. We merely raise the issue in the event readers find themselves in a situation where the facts fit the basis of the decision and an amendment is desired but there is no express amending power and a court application is not desired.

(c) Disclaimers, Releases, Surrenders

Another means to vary or terminate a trust includes the use of disclaimers, releases and surrenders effected by the beneficiaries. In simple terms, a disclaimer is a refusal by the disclaiming party to accept a gift or an interest that has been offered to that party, whereas a release or surrender is a disposition or transfer of a property interest previously accepted by the party. A more comprehensive overview of disclaimers, releases and surrenders has been published elsewhere.[68]

(d) *Variation of Trusts Act*

In the event there is no express amending power, an inability of the beneficiaries to effect a variation through a disclaimer, release or surrender, and *Saunders v. Vautier* cannot be relied upon, the trustees can consider bringing a court application to amend the terms of the trust document. Such an application would be brought pursuant to the *Variation of Trusts Act*.[69]

In general, the approval of the court will only be granted if it can be demonstrated that the variation of trust is for the benefit of those persons on whose behalf the court is being asked to give approval.

The jurisdiction of the court under the *Variation of Trusts Act* is set out in section 1 which provides that the court has power *if it thinks fit* to approve an arrangement varying or revoking all or any part of the trusts or enlarging the powers of the trustees. There is no actual power in the court to make or direct any variation. However, the arrangement can be proposed by any person whether or not there is any other person beneficially interested. Generally, however, the beneficiaries who make the proposal, should be the adult capacitated beneficiaries who, having consented to the approval, now ask the court to approve on behalf of those beneficiaries who cannot.[70] Those persons include:

(a) infants or those who are otherwise incapable of consenting;

(b) any person who may in the future become a person of a particular description or class entitled to an interest;

(c) certain persons, including the unborn, who may become beneficiaries, and

(d) persons who may benefit by reason of a discretionary power given to anyone and exercisable after an existing interest terminates.[71]

In general, courts do not approve an arrangement on behalf of any person coming within section 1, subsection (1)(a) to (c) of the *Variation of Trusts Act* (as listed above), unless the arrangement appears to be for the benefit of that person. In the case of a beneficiary who wishes to vary a trust, he/she may make an application to the Superior Court of Justice once the consent of all beneficiaries is obtained. Where there are minor or unborn beneficiaries, the Children's Lawyer is appointed to represent their interests and to provide any consent, and a benefit for this class of beneficiaries must be shown.

The test for varying a trust, in respect of persons in categories section 1, subsection (1)(a) to (c), is twofold: it must be for the "benefit" of those on whose behalf the court is being asked to approve and the court must consider the variation to be "fit".

The courts have considered a number of factors in considering the "fitness" of the proposed variation. These include the purpose of the variation, the views of the trustees, and the intention of the founder of the trust.[72] In particular, and as noted by Pennell J. in *Irving (Re)*, the intention of the founder of the trust and deciding whether the proposed arrangement remains within the ambit of the intention is important to consider,[73] as courts have been reluctant to approve a variation which has the effect of creating a new trust. In an attempt to further clarify, Pennell J. in *Irving (Re)* has stated "the spirit of the Act ... permits pruning of the trust in order to promote fruitfulness but the root is to be preserved".[74] Thus, the overall arrangement of the variation cannot be such as to revoke and resettle a trust. However, despite this limitation, courts have strained to find wherever possible that revocation and resettlement merely constitutes a variation of the original trust and is therefore within the court's power.[75]

With respect to the persons in categories section 1, subsection (1)(a) to (c) of the Act, the variation must also be for the "benefit" of those on whose behalf the court is being asked to approve. The onus of proving there is a benefit and the sufficiency of the benefit is on the applicants[76] and it must be shown that the benefit is for every member of the class as an individual, on whose behalf approval of the court is sought.[77] It would therefore not be sufficient to show that the proposed variation would benefit a class of beneficiaries as a whole.

It has also been held that the term "benefit" is to be liberally interpreted and is not just confined to financial benefit.[78] Examples of non-financial benefits may include removing conditions precedent to the taking of a share of an estate, removing a power of appointment or changing dispositive provisions to enlarge the benefits available to incapacitated individuals.[79] The elimination or avoidance of family friction may also be a benefit under the *Variation of Trusts Act*.[80]

The presence of non-financial benefits, however, will not, in most cases, outweigh the necessity of proving that the incapacitated beneficiaries will be receiving some financial benefit and that this financial benefit is adequate.[81]

Conversely, the courts have in some cases taken the position that while there may be financial benefits, non-financial considerations or disadvantages must be taken into account in refusing to approve a variation, even where financial benefits may have been demonstrated.

(e) Income Tax Consequences of Amending Trust Terms

When varying the terms of the trust, it is important to understand that there are possible tax implications that might be triggered. The implications that will be briefly discussed include the consent of beneficiaries, whether the variation establishes a new trust, and the general position taken by the CRA.

<u>(i) Consent of Beneficiaries</u>

Whether varying the terms of the trust follows from an express amending power, an application of the role in *Saunders v. Vautier* or by court order, it is achieved through agreement of the beneficiaries. Consent of a beneficiary raises the issue of whether the variation constitutes a disposition of the beneficiary's interest. While this issue does not appear to have been directly considered by a Canadian tax court, the reasoning in the English case of *Thorne v. Inland Revenue Comrs*.[82] may provide guidance as to how a Canadian court might address the issue.

The *Thorne* case involved a dispute over stamp duty assessments. The trustees were directed to hold income from the settled property in trust for the settlor's wife and, after her death, to pay the income to the settlor's son and daughter. The value of the trust fund grew so significantly that there was a real concern about the amount of death duty that would be payable on the wife's death. In light of this concern, an order was obtained to vary the trust so as to eliminate the life interest of the settlor's wife and to divide the daughter's interest, to be held for her children and others. The question was whether the variation of the interests under the original settlement amounted to a voluntary disposition of property for stamp duty purposes. The court held that the variation order, obtained on the consent of the beneficiaries, had given rise to a voluntary disposition by both the settlor's wife and his daughter. The stamp duty assessments were confirmed.

If *Thorne* had occurred in Canada, both the widow and the daughter would presumably have realized an income inclusion equal to the fair market value of their respective income interests.[83] Additionally, since the variation was in favour of the daughter's children, among others, any distribution of income to such children while they were minors might also trigger attribution rules.

Indirect support for triggering and applying the attribution rules with respect to the variation of trusts was discussed in the case of *Murphy v. The Queen*.[84] This case involved the effect of obtaining an order under Ontario's *Variation of Trusts Act*, where the taxpayer's wife, who had not been a beneficiary, became an income beneficiary following the variation. The court concluded that there had been a transfer of property by the taxpayer to his wife, the property being a right to income. Attribution was found applicable, with the result that the income was deemed to be the income of the taxpayer and not the spouse.

It should be noted that the *Murphy* decision focused on the transfer of property for the purposes of the attribution rules. It did not, however, consider whether there were immediate tax consequences to the beneficiary who had consented to the variation and in effect had assigned his vested rights to the income of the trust to his wife. In light of this situation, it would be presumably open to the Minister of Revenue to assess the beneficiary of a vested income interest as having disposed of the interest for proceeds equal to fair market value.

Where a beneficiary consents to a trust variation that effects a disposition of a vested capital interest in the trust, the disposition will give rise to a capital gain only in the event that the proceeds of disposition, deemed or actual, exceed the cost amount of the interest.

If a trust variation effects a disposition of an interest in a fully discretionary trust, it may be reasonable to assume that the beneficiary should realize no adverse tax consequences. However, a beneficial interest of this nature may be recognized as entitling the beneficiaries to the protection of the court, but may be unquantifiable for tax purposes.[85]

As the trust variation may involve dispositions of income and capital interests in the trust, the attribution rules, and perhaps the indirect payments rule, may apply. The *Murphy* decision exemplifies the scope of the attribution rule where the trust variation affected a beneficiary's income interest. In principle, a similar result could be obtained where the variation affected a beneficiary's capital interest and resulted in income to the beneficiary's spouse or minor child.

(ii) Creating a New Trust

Another consideration regarding the variation of a trust is whether it has the effect of creating a new trust, also known as a resettlement of the trust. The consequences of a new trust would include a disposition by the old trust of its assets as well as a disposition by the beneficiaries of their interests in the old trust. In addition, the creation of a new trust might affect the tax status of the old trust.

Unfortunately, there is very little Canadian case law that considers whether varying a trust results in a disposition of trust interests or results in a resettlement of the trust. As described by Jason Stephan,[86] the court concluded in *Murphy* that a variation of trust resulted in a disposition of property because the variation effected a change in pre-existing beneficial interests under the trust. Additionally, in *Re Irving*,[87] the reconstruction of the trust’s terms were inconsistent with the original intentions of the settlor as expressed by the trust’s initial terms, and the court concluded that the variation was a resettlement of the trust.

Therefore, when applying to vary the terms of a trust, attention must be paid to the settlor’s original intention and terms in order to avoid creating a new trust.

(iii) CRA Position

The CRA has considered several types of trust variations. Its general position seems to be that where the variation does not change the trust materially, and in particular does not change the beneficiaries or their entitlements, the variation will not constitute a resettlement of the trust and there will be no disposition by the trust of its property and no disposition of income or capital interests by any beneficiary. In short, where a varied trust does not result in a significant change to the entitlements of the beneficiaries, there is unlikely to be any adverse tax consequences. The CRA has ruled to this effect where the proposal was to vary the terms of a testamentary trust to permit the trustee's discretion to allocate different types of income to each beneficiary without changing the sharing ratio among the beneficiaries.[88] The tax purpose for the variation was to allow the trustees to allocate Canadian-source income, particularly dividends from taxable Canadian corporations, to the Canadian-resident beneficiaries.

On the other hand, the CRA has expressed the view that varying the terms of a testamentary trust to add beneficiaries, thus modifying the residuary beneficiary's interest in the trust, would be substantial enough to result in the creation of a new trust.[89] In that case, the trust created under the will would no longer qualify as a "testamentary trust." Unfortunately, the loss of status as a testamentary trust would mean that the trust would no longer benefit from graduated rates, but would instead be taxed as an inter vivos trust, meaning at a flat rate equal to the top marginal rate applicable to an individual taxpayer.[90]

While a variation to the terms of a trust may be substantial enough to result in the creation of a new trust, it should be noted that the 21-year deemed disposition date under the "old" trust cannot be extended on the basis that there has been a transfer of property from the "old" trust to the "new" trust. The first deemed disposition date for the transferee trust after the transfer is generally advanced to the first such date that would have been the deemed disposition date of the transferor trust.[91]

Additionally, where a new trust results from the variation, careful consideration must be given to whether the "transfer" of property from the "old" trust to the "new" trust would trigger a taxable disposition of such property (eg. capital gains). Although there would be a disposition, subsection 107.4(3) of the *Income Tax Act* generally provides for a rollover of property to a trust where the property is transferred to the trust by way of a "qualifying disposition."[92] A basic requirement is that the disposition of property to the transferee trust not result in any change in beneficial ownership of the property. For example, if a case like *Murphy* were to be assessed today, given the change in beneficiaries, the CRA might assess the trust on the basis that the variation created a new trust, resulting in a disposition of property to the new trust that was not a qualifying disposition.

Therefore, understanding potential tax consequences is an important consideration prior to making an application to vary the terms of a trust. It may be advisable for a trustee to consider applying for an advance tax ruling from the CRA, confirming that a proposed variation does not result in a disposition of trust interests nor give rise to a newly created trust.

8. *Characterization of Corporate Distributions for Trust Law Purposes*[93]

As already noted, due to their status as fiduciaries, trustees are subject to a duty of impartiality. This duty requires that trustees not afford preferential treatment to any single beneficiary or group of beneficiaries. The duty of impartiality applies where (1) there is more than one beneficiary of the trust and (2) the trust instrument does not authorize disparate treatment of beneficiaries. Waters has succinctly formulated the duty of impartiality as follows: "[T]he duty of the trustees [is] to carry out the terms of the trust as they find them, and to ensure that in 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."[94]

The duty to act impartially requires that receipts coming into the trust be allocated fairly between income and capital beneficiaries. Where the trustees hold shares of a family business, the duty of the fiduciary, while easy to articulate, takes on additional complexities in its implementation. The allocation of corporate distributions is a case in point.

It is not uncommon to find situations, where the trust comprises shares of an operating company and the terms provide for a life interest to one beneficiary, with a gift over to the children and other issue on their death. The terms of the trust may also provide the power to encroach for the benefit of the life tenant in the discretion of the trustees.

The trustees in such a case have a number of difficult issues to face; if they also serve as directors of the company, the issues are compounded. In particular, the application of the even-hand rule to a trust that holds shares in a company raises the following four key issues, each of which will be addressed below:

1. How do trustees determine whether corporate distributions constitute income or capital to the trust?

2. How can a settlor provide for an alternative to the "form rule" for characterizing corporate distributions as income or capital of the trust?

3. What are the restrictions on the ability of a settlor to provide an alternative to the "form rule"?

4. What are the implications of the form rule with respect to a trustee's duty to maintain an even-hand between income and capital beneficiaries?

(a) What Determines Whether Corporate Distributions Constitute Income or Capital

Why is it relevant to the even-hand rule for trustees to determine whether corporate distributions constitute income or capital to the trust? As indicated above, the distinction between income and capital beneficiaries, and by extension income and capital, is fundamental to the even-hand rule. It is axiomatic that maintaining an even-hand between income and capital beneficiaries requires that trustees be able to distinguish income and capital. The challenge of applying the even-hand rule to a trust holding business assets for successive beneficiaries — namely, shares in a small business corporation — lies in determining what implications the interposition of a corporation holds for delineating between income and capital.[95]

Consider a trust that directly holds title to real estate for a life tenant and a remainderman. The delineation of income and capital in this simple example is straightforward. If the trustees were to lease this real estate, then the resultant proceeds would constitute rental "income" payable to the life tenant. If the trustees were to sell the real estate for an amount in excess of its cost base, the gain would constitute "capital" that would ultimately be payable to the remainderman.[96]

Assume now that instead of holding the real estate directly, the trust holds it indirectly. Specifically, assume that the trust holds shares in a small business corporation whose sole asset is the real estate. If the corporation decides to lease the real estate, it will earn rental income and may flow this income to the trustee-shareholder via a corporate distribution. Would such a distribution be properly conceptualized as "income" in the hands of the trustee payable to the life tenant as was the rental income in the above example? If the corporation decides to sell the real estate for a gain, it may flow this gain to the trustee-shareholder via a corporate distribution. Is this distribution properly conceptualized as "capital" in the hands of the trustee payable to the remainderman as was the gain in the above example? The answers to these questions hinge on the characterization of the corporate distributions in question as "income" or "capital."

Corporate distributions are the means by which corporations make payments to their shareholders. Generally speaking, such payments take the form of dividends.

Dividends can take on many forms: (1) 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 (read a dividend in kind); (4) distribution on a winding up of the company; (5) distribution on 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 matter of company law, if there is a distribution by a corporation to its shareholders *prior to a winding up*, it must be a payment of profits. Nevertheless, trust law does not allow trustees to automatically assume that since corporate distributions are payments of profit they constitute trust income to which life tenants are necessarily entitled. Instead, trustees are bound by the "form rule" as the general rule for classifying dividends as being either income or capital of a trust.[97]

The form rule provides that the form of the dividend (as opposed to its substance) determines its classification as income or capital. Pursuant to the form rule, the decision of the corporation as to what type of dividend to declare (cash dividend, stock dividend, etc.) is determinative of whether the dividend should be conceptualized as either income or capital of the trust.[98] Since form settles the issue, the intentions of the directors of the company or the substance of the distribution are not relevant.[99]

What, then, are the distributions that are regarded as having the form of income and those that are regarded as having the form of capital? The general rule is that, unless the will or trust instrument provides otherwise, corporate dividends should be classified as follows:

- A dividend is considered income of the trust and therefore a part of the life tenant's entitlement only if it is in the form of a "payment out" — that is, a cash dividend including a capital dividend.

- A dividend will be considered capital of the trust and therefore a part of the remainderman's entitlement 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.

In short, pursuant to the form rule, dividends in the form of cash are considered to be income in the hands of trustee-shareholders and, by extension, dividends not in the form of cash are considered to be capital in the hands of trustee-shareholders.

The form rule is good law in Canada. While Ontario courts were at one time reluctant to strictly apply the form rule, the Supreme Court of Canada has long since ruled in favour of a strict application of it.

(b) Alternatives to the "Form Rule" for Characterizing Corporate Distributions

As noted above, the form rule is for the most part applied strictly by courts. It has even been applied, for example, where its practical effect has been to convert a capital gain of the underlying corporation into an income receipt for the trust. Courts simply assume that the form rule is consistent with the intentions of the settlor. To exclude the form rule the settlor need merely articulate a contrary intention in the trust instrument. This can be done in two ways, explicitly and implicitly.

The least ambiguous method of excluding the form rule is to expressly provide for this in the trust instrument. It is not absolutely necessary, however, to expressly exclude the form rule in order for it not to apply. It may in limited circumstances be sufficient if the trust instrument merely implicitly discloses a contrary intention.[100]

(c) Restrictions on the Settlor's Ability to Provide an Alternative to the "Form Rule"

There are restrictions on the ability of a settlor to provide an alternative to the form rule for characterizing corporate distributions as between income and capital. In particular, there are practical, jurisdictional, and public policy restrictions in this regard. It should be emphasized that if a settlor is unhappy with the practical consequences of the form rule, then an alternative means of *characterizing* dividends is not the only solution. A settlor may, for example, specify how dividends are to be *allocated* irrespective of their characterization under the form rule.

The most effective means of providing an alternative to the form rule is to expressly enumerate in the trust instrument how the trustees are to characterize each form of dividend that the trust is likely to receive. This method, however, is hampered by significant practical considerations. It has been observed, for example, that it is "no mean task" for a settlor to foresee in advance the various ways that the companies in which the trust will hold shares will handle distributions.[101] Given the prominence of tax considerations to this issue and the fact that the specifics of such considerations evolve over time in response to amendments to the Act, it will in fact be nearly impossible to enumerate in the trust instrument how each form of corporate distribution that the trust is likely to receive should be characterized. One solution is for the settlor to employ language in the trust instrument that is broad enough to encompass unforeseen forms of corporate distributions. Even here, however, it appears that "the more novel the mode of distribution, the less likely it is that the language used in the will or settlement will readily cover that mode of distribution."[102]

There is an important jurisdictional restriction on the ability of a settlor to oust the form rule. Since it is not practical to enumerate in the trust instrument how every corporate distribution is to be characterized as between income and capital, the question has arisen as to whether trustees may be empowered in the trust instrument to make a final and conclusive characterization as the need arises. Courts have held that they cannot. The jurisdiction to characterize corporate distributions as income or capital ultimately lies with the court. It is an impermissible diminution of this jurisdiction for trustees to be granted the discretion to make binding characterizations of corporate distributions.[103]

In addition to trust law concerns as to whether Trustees can be authorized to characterize corporate distribution as income on capital share are also tax law concerns. *Terrill Estate v M.N.R.*[104] is a decision of the Tax Court of Canada dealing with whether a testamentary trust qualified for the favourable tax treatment afforded to spousal trusts. It stands for the proposition that trustees may not be authorized to characterize at their whim incoming moneys as income or capital, and that provisions that authorize trustees to determine whether incoming moneys are income or capital merely authorize them to employ accepted practices in this regard.[105]

At issue in *Terrill* was, inter alia, whether a clause in the will providing that the executors had the discretion to determine whether incoming moneys were income or capital of the trust disqualified the trust as a valid spousal trust. The will contained the following provision:

> *In addition to all powers conferred by law, I give my Executors and Trustees the right and power, without the intervention or consent of the beneficiaries herein named:...*
>
> *(g) To determine and distinguish capital from revenue and to credit or charge receipts and disbursements to capital or revenue of my Estate in such proportions and amounts as they may think proper.*[106]

The minister argued that this clause disqualified the trust as a spousal trust. The rationale of this argument was that giving the executors authority to determine what constitutes income and capital raised the possibility that the executors would determine that a particular sum that would ordinarily be considered income should nevertheless be treated as capital. The net effect of this, argued the minister, was that the trust was not a valid spousal trust since the spouse, the income beneficiary, was not necessarily going to receive all the income as required under paragraph 70(b) of the Act.

Tremblay TCJ rejected the minister's argument. In particular, Tremblay TCJ rejected the implication of the minister's argument that the decision to regard a particular sum as income or capital would be an "arbitrary decision made at the whim of the executors."[107] It was instead held that the executors were bound to adhere to accepted practice in determining which sums constituted income and which constituted capital.[108] Since the clause did not expressly empower the executors to deem a sum capital that would ordinarily be regarded as income, reasoned the court, it did not taint the spousal trust. Notwithstanding the results in this case, it stands as a warning that tax considerations cannot be ignored.

(d) Impact of the "Form Rule" on Duty to Maintain an Even-Hand

Strictly speaking, the form rule and the even-hand rule are two distinct rules that speak to two distinct issues. The form rule speaks to the characterization of incoming moneys to the trust. The even-hand rule speaks to the duty of trustees to treat beneficiaries with impartiality. How, then, can the form rule possibly have implications for the trustee's duty to keep an even-hand?

As indicated above, the ability to distinguish between income and capital is a prerequisite to the application of the even-hand rule. The form rule is therefore *ipso facto* relevant to the even-hand rule. Nevertheless, in many instances, such as where trustees do not control the corporation in which the trust holds shares, the form rule will not significantly affect the trustee's duty to maintain an even-hand. In such instances, the trustees simply passively receive dividends in whatever form the corporation decides to give them, and then allocate them to the appropriate class of beneficiary as per the form rule.

But what if the trustees are the directors of the corporation in which the trust holds shares? Here the trustees do not passively receive dividends. In their capacity as directors, they actually determine the form that dividends will take. This is significant because, as indicated above, the form of a dividend, as per the form rule, determines its characterization as income or capital, and by extension whether it belongs to income or capital beneficiaries. The duty to maintain an even-hand therefore seems to require that trustees in their capacity as directors establish a corporate distribution policy with the form rule in mind. In this regard, cognizance of the form rule is of critical relevance to the ability of trustees who serve as directors to maintain an even-hand.

The preceding discussion is, of course, true only if it may be validly assumed that trustees, when acting in their capacity as directors, are obliged to adhere to the duties imposed by trust law, such as the duty to maintain an even-hand. To what extent is there a carryover of duties between the respective roles of a trustee-director? Must a trustee-director conduct himself in his role as a director in a manner consistent with the duties placed upon him in his role as a trustee? Early case law on this issue suggested that there was no such obligation. More recent case law suggests otherwise.[109]

The significance of the form rule to the duty to maintain an even-hand turns ultimately on whether there is a carryover of duties between the dual roles of "trustee" on the one hand and "director" on the other. While early case law suggested that there was no such carryover, more recent case law suggests otherwise.[110] While there is still some confusion as to the precise state of the law on this issue in Canada, the fact that there are cases suggesting that trustee-directors continue to be subject to their duties as trustees even when acting in their capacity as directors underscores that trustees remain subject to a duty of impartiality when they are acting as directors. In order to discharge this duty, they should be intimately familiar with both the form rule and the circumstances in which a settlor may exclude it.

9. *Allocation of Burdens Among Successive Beneficiaries*

Whenever trustees are faced with a financial burden, such as income taxes or financing costs, they must consider the manner in which to allocate the burden. In particular, whether the burden should be allocated on income account or capital account or apportioned. Like other aspects of trust law, the rules which may be applicable from an income tax perspective are not necessarily coincident with those applicable from a trust law perspective.

Where the trustees determine it is in the best interests of the beneficiaries to retain the assets of the trust, they may be required to incur financing costs to satisfy the tax liability that will arise as a result of the 21 Year Tax Rule.[111] What follows is a discussion of trust law considerations that may apply with respect to the allocation of the various burdens associated with such financing costs, as well as the income tax liability. In particular, where the trustees engage in borrowing to pay the tax liability (and/or other expenses that they may incur), how should the trustees allocate the interest and principal portions of the proposed borrowing, as well as the income tax liability. It seems reasonable to assume that the principal amount of the loan should be borne by capital, but what of the interest on the loan? In *Re Vair*[112] it is noted that, when money is borrowed to protect the fund as a whole, the interest is generally borne by the income.

While this issue has particular relevance in the context of a trust where there is a life tenant entitled to income and other beneficiaries entitled to capital after the death of the life tenant, it is also relevant where beneficiaries entitled to income differ, either directly or indirectly, from those entitled to capital. This may be the case because of the express terms of the trust defining the two classes of beneficiaries. It may, however, also be the case because from a trust administration perspective it is anticipated (or intended based upon the settlor's purposes) that the beneficiaries ultimately entitled to the capital (i.e. grandchildren) will differ from those currently entitled to income (i.e. children).

(a) Overview[113]

Donovan Waters succinctly summarizes the law related to the responsibility as between successive beneficiaries for financial burdens imposed on trust property.[114]

> *The general rule adopted by the Court of Chancery and followed today is that the nature of the burden will determine whether it is borne by life tenant or remainderman. For example, day to day expenditures are naturally associated with income, and major occasional improvements or expenditures are similarly associated with capital. If the trust property includes a house, the discharge of annual municipal and school taxes upon that house and the cost of regular painting, decorating and maintenance falls upon the life tenant. Occasional substantial repairs are the responsibility of the capital, and hence are borne by the remainderman.*
>
> *Similarly, the costs and expenses of the trustees in administering the trust have been regarded by the courts as sufficiently fundamental and long-term that capital should bear those items. But this is only a prima facie determination. If it can be shown that the costs in question were exclusively concerned with the administration of the life tenant's interest, then income must bear the costs. Where the acts of administration in question benefit both life tenant and remainderman, the courts have sometimes been prepared to say that both income and capital must contribute to the costs but, in general, acts done for the benefit of the trust as a whole are regarded as a burden on the capital. After all, even if capital meets these costs, the life tenant loses the future income on the capital paid out, and in this way he is associated with the burden.*[115]

Accordingly, the general principle with respect to the allocation of financial burdens between successive beneficiaries, is that the beneficiary who reaps the benefit must bear the burden. There are, however, circumstances where the application of the general principle may not ensure the successive beneficiaries are treated impartially. In this context, the even-hand principle may overlay an obligation to apportion the burden between the two categories of beneficiaries.

(b) Jurisprudence on the Obligations of the Life Tenant[116]

There appears to be no direct judicial authority considering:

(i) the manner in which the capital gains tax liability arising due to the 21 Year Tax Rule

or

(ii) how any related financing costs,

are allocated. Accordingly, in the absence of specific jurisprudence on point, the allocation of capital gains tax and interest between the life tenants and remainderman of a trust would be determined according to the general even-hand principle in trust law.[117]

It is a long-established principle of trust law that in the absence of specific directions in the instrument creating a trust, the life tenant must "keep down the interest" on any mortgage or other debt encumbering the trust *corpus*. *Halsbury's*[118] summarizes the law as follows:

> ***961. Outgoings payable out of income***. *<u>In the absence of an express direction by a settlor to the contrary, it is presumed that the settled property is intended to descend intact. Income must, therefore, bear all ordinary outgoings of a recurrent nature in respect of the property</u>, such as rates and taxes, the interest on charges and incumbrances on the property, and fee farm rents and quit rents to which the property is subject, rents reserved by the leases under which settled leaseholds are held, and the expense of performing and observing all continuing obligations, covenants and conditions on the part of the lessee, the cost of insurance effected by trustees, and the costs of ordinary repairs. <u>The tenant for life must bear the costs of legal proceedings for his sole benefit in respect of his life interest</u>, such as … the costs of an application in an administrative action for payment of income, … the costs of rendering an income account unnecessarily demanded by a tenant for life in an administration action, ….*

Ontario jurisprudence has followed these general principles, particularly with respect to the payment of municipal taxes by the life tenant.[119]

Where the trust document makes no express direction in respect of who should bear the burden of capital gains tax as a result of the 21 Year Tax Rule, consideration must be given to whether the trust has been in existence since the introduction of the Rule in 1972. If this is the case, then the drafter of the trust document must be presumed to have been aware of its potential application. In the absence of express direction, the venerable rule that the life tenant must keep down the interest must be presumed to have been intended.[120]

The rule that the life tenant pays interest on debts encumbering the trust *corpus* is ancient and unqualified. *Halsbury's* summarizes the law on apportionment of interest on encumbrances as follows:[121]

> ***966. Liability for incumbrances and interest on them.*** *Apart from any question arising on the special terms of the instrument creating the settlement, a tenant for life is*

under no obligation to discharge any portion of the principal of paramount incumbrances, but he is bound as between himself and the remainderman to keep down the interest accruing during his lifetime to the extent of, and out of, the rents and profits received by him. If the rents are at any time insufficient to keep down the interest, subsequent rents arising during his lifetime are applicable to liquidate arrears accruing during his own life tenancy and, if part of the property is sold, principal, interest and costs due on the mortgage being then paid off out of the proceeds, the rents of the unsold portion subsequently received by the tenant for life remain liable as between himself and the remainderman to recoup amounts paid out of capital in satisfaction of arrears of interest.

967. Extent of obligation of tenant for life. *The obligation of the tenant for life to keep down interest applies even if there is an ultimate limitation to the tenant for life in fee, or if he has an absolute power of appointment, by reason of which he might make the estate his own. A purchaser of his estate, although himself the mortgageee, is bound to discharge the obligations.*

If real estate is charged by will with payment of debts, and subject to that is settled, every tenant for life must keep down all the interest upon all the debts bearing interest which are ascertained to be a charge upon the estate from the day of the testator's death, and also pay all interest payable on any legacies charged on the estate.

The liability of the tenant for life is not personal, but is a charge on his life estate, and if he fails to keep down interest, future rents and profits payable during his tenancy for life are liable to recoup to the remainderman the full amount of his default, and he is not entitled to have any portion of the settled estates sold for the purposes of paying off interest and arrears. However, he may have an incumbrance paid off by sale if the rents are insufficient to keep down the interest.

968. Remainderman's rights. *The remainderman is entitled to be repaid arrears of interest out of the assets of a deceased tenant for life to the extent of the rents received during the life tenancy, subject to any set-off there may be in respect of capital charges paid by the tenant for life. …*

. . .

[footnotes omitted]

In 1786, in *Tracy v. Lady Hereford*[122], Lord Chancellor Thurlow, on appeal affirming the decision of the Master of Rolls (Sir Kenyon, later Lord Kenyon), held that the tenant for life is responsible for keeping down interest accruing on any encumbrances to the estate, even if this should entirely consume the life interest.

This approach—to avoid using hindsight, in the form of apportionment of a burden, to correct contingencies implicit in the testator's directions concerning the gift—was adopted by the majority of the Ontario Court of Appeal in slightly different circumstances in *Re Robertson*.[123] There the trustees had deducted large annual expenses for depreciation, which had reduced income to the life interest. The life tenant sought an adjustment after a sale of the business that yielded substantial capital gains. The majority held that the expense had been a proper expense estimating depreciation. The actual capital value could be subject to contingencies, such as demand or inflation, and so the court would not use hindsight to adjust the depreciation expenses.

The majority in *Re Robertson* also held that the testator intended the net income to be calculated annually subject to the contingencies inherent in estimating depreciation expense.[124] As to the intent argument in *Tracy v. Lady Hereford*, the Lord Chancellor held that the settlor is presumed to grant the life interest subject to contingencies inherent in the gift and that no allocation should be made in an attempt to account for such contingencies.[125]

Accordingly, applying *Tracy v. Lady Hereford*, the life interest is immune from potential *personal* liability for any shortfall in the estate to meet interest payments. Conversely, there is no adjustment to the obligation to pay interest fully to account for contingencies that affect how the benefit of capital growth falls to the benefit of either income or capital due to the nature of the underlying assets.

This decision specifically dismisses the potential argument that the remainderman should bear a proportion of the interest expense on the basis that the remainderman has a contingent benefit of increased capital gains because borrowing enables retention of the trust property, such as shares of a private company. The settlor, having transferred specific property to a trust, is presumed to have intended such contingencies inherent in the nature of the assets to fall where they fall. Where the trust document was drafted when the 21 Year Tax Rule was known, then by the lack of any express directions there is no reason to suppose the testator (or settlor) intends any departure from this ancient rule. The Lord Chancellor in *Tracy v. Lady Hereford* specifically held that the remedy of the disgruntled life tenant is to apply for liquidation of the assets and thereby remove exposure to such contingencies and receive certain interest on the net principal after conversion. Another option available to the life tenant is to pay off the charge and assume the benefits of the charge.[126]

The rule that was affirmed in *Tracy v. Lady Hereford* has remained the law in England and Canada since, and has been applied in numerous analogous situations.[127]

Since at least 1851, Ontario courts have followed the principle that the life tenant pays the interest on encumbrances.[128]

This was the result in *Todd v. Moorhouse*[129]. In that case, a settlement included shares of two corporations that later made calls on the shares. To avoid having to liquidate the shares, the life tenant, at the request of the trustees, lent her own money to satisfy the calls. The life tenant continued to receive dividends. Upon her death, her executor sought repayment of the loan plus interest from the date of her death. Sir Jessel M.R. held that is was a clear case.

> *Then it was said she never made this claim in her lifetime; but why should she make a claim? She was receiving the dividends on the shares; she did not want them to be sold; the very object she had in advancing the money was to prevent the shares being sold. Both she and the trustees thought that a sale would be an injury to everybody; and so it has turned out, for the shares, as I have been informed at the Bar, have risen very much in value. But after her death, when her interest has ceased, her administrator requires to be repaid the money: and I must say I never saw a clearer case.*

Although not put directly in issue, the court implicitly sanctioned the apportionment of burden that the dividend income received by the life tenant was burdened by the interest costs during the life tenancy (i.e., she was not entitled to interest for her loan to the estate until her death, when the life interest and her right to dividends ended). Therefore, interest was only payable by the remainderman from the date of the life tenant's death.

Similarly, Middleton J.A. in *Re Campbell*,[130] applied the rule that the life tenant keeps down the interest in respect of a debt in respect of shares the testator had purchased in a corporation but not fully paid for. As of the date of death, the testator owned 153 shares, which were held for the benefit of the life tenant.

The life tenant also otherwise owned 154 shares. The dividends paid on all 307 shares had been applied to pay the blended principal and interest payments due under the share purchase agreement. The life tenant complained that her dividend income should not have been diverted to pay the debts of the testator. The court held that the capital must pay the principal but that the life tenant must pay the interest on the debt. Specifically, to the extent the trust borrowed (from her) to pay off the original debt, the life tenant would be responsible for the interest accruing on that new charge.

> *The rights of the parties must be determined having regard to the situation at the testator's death. Testator owned this stock subject to the payment of the balance of this purchase money. He directed the payment of the debts out of his estate other than the insurance money and it appears that the rights of the parties were then crystallized and that the principal money due upon the purchase must be paid out of the capital of the estate and that the interest must be paid by the life tenant. The life tenant would then be entitled as between herself and the remaindermen to the income, including all the dividends upon this stock, and she would have to bear the interest outgoings.* ***The income which she would have received and which has been applied in payment of the capital debt will itself now constitute a charge upon the capital and in respect of this she must, of course, bear the burden of interest until it can be realized and paid off.*** *She is only, of course, entitled as life tenant to the net income and this is merely another way of stating the same proposition—if there is a debt she must bear the interest charges on that debt.*
>
> (emphasis added)

(c) Jurisprudence on the 21 Year Deemed Disposition

There appears to be only one decision expressly dealing with the tax liability arising due to the 21 Year Tax Rule. This is the decision in *Ontario (Public Guardian) v. Hodgins Estate*.[131] Prior to considering the specifics of this decision, we consider the manner in which the capital gains tax liability due to the 21 Year Tax Rule may be allocated based upon general trust law principles.

Absent directions otherwise to the contrary in the trust instrument, capital gains taxes are generally chargeable to capital (i.e. the remainderman on the basis that they are extraordinary expenses). *Scott* and *Fratcher* usefully describe the difference between current expenses, which are chargeable to income and extraordinary expenses, which are chargeable to capital as follows:

> *233.2.* ***Current Expenses****. …Ordinary current expenses are, of course, chargeable to income. Thus interest paid by the trustee upon mortgages and other indebtedness [including Matter of Smith, 82 N.Y.S.2d 468 (1948) (interest on estate tax liability)], expenditures for repairs, regular recurring taxes and water rates, premiums on trustee's bond, are payable out of income. In general whatever regularly recurring or ordinary expenses are necessary to preserve the trust property or its value are payable out of income. …*
>
> *233.3.* ***Extraordinary Expenses****. …Although current expenses are payable out of income, extraordinary expenses are usually payable out of principal, even though they are incurred for the benefit not only of the principle, but also of the beneficiary entitled to income. The reason is that a payment out of principal not only diminishes the principal but also diminishes the income that would otherwise have been earned on the principal, with the result that each of the beneficiaries in effect bears the expense proportionately to his interest.*

> *Although regularly recurring taxes, such as an annual tax on land or tax on income, are, as we have seen, payable out of income, a tax on capital gains is normally chargeable against principal.* [132]

The foregoing is consistent with the principles quoted from *Halsbury's*, *supra*, that the life interest is generally liable to pay all regular recurring taxes arising after the settlement.

Where, however, the capital gains tax liability is imposed on a deemed, as opposed to realized basis, an issue to consider is whether there is an argument that the general principles should be augmented or that the liability should be apportioned in some manner.

The capital gains tax that arises due to the 21 Year Tax Rule is arguably analogous to a property tax on land, for which the life tenant is plainly responsible in trust law. A tax on a deemed disposition every 21 years is no different in principle from an annual property tax, except that it is paid every 21 years rather than annually. The life tenant presumably enjoys increased income on untaxed capital base for each of the first 20 years of the trust and so some portion of the tax on the increase in capital base could be fairly allocated to the life interest.

A capital gains tax would *normally* be borne by the remainderman because, as noted, the burden of tax should fall on the interest that reaps the benefit. However, in the case of a "deemed" disposition, the remainderman does not derive any present benefit—making it analogous to a property tax.[133] This is often more so the case where the imputed gain is based on a business valuation done using a multiple of earnings approach. This is particularly the case where established practice is to distribute a large portion of the earnings to the life tenants through dividends. Accordingly, it is not the case that the entire value of the capital gain has vested in the remainderman and, arguably, some portion of the capital gains tax should be allocated to the life interests based on their life expectancy.

The point can be illustrated by an example. Suppose the trust held a treasury bill that paid 10% annual interest for 31 years. Suppose, after 21 years, the market interest rate on a 10-year treasury bill was 5%. The capital value of the treasury bill (P+x) would exceed the principal amount (P) and result in a capital gains tax (cgt). However, if the life tenant lived 10 years, the remainderman would have received none of the benefit of the deemed capital gain yet would have been burdened with the entire tax. If there had been an actual disposition at year 21, the capital would have been reinvested at 5% on (P+x-cgt), which would have been less than 10% on either P or (P-cgt). Without any allocation of part of the tax burden to income, the remainderman would receive just (P-cgt) with all of the notional gain (x) going to the life tenant.

A trust that owns shares of a private corporation is similar but differs from the treasury bill example in three important ways. First, the duration of the life tenancy is contingent on the life of the life tenant. Second, the interest earned on a treasury bill is an enforceable legal obligation, whereas corporate dividend declarations are discretionary and cannot be compelled by shareholders. Third, the business uncertainties of the corporation add far greater degrees of contingency than the payment of interest on a bond. Nonetheless, despite the contingencies, a material portion of the deemed capital gain could still be attributed to the net present value of the expected stream of dividends accruing to the benefit of the life tenants. Accordingly, it *could be argued* in principle that some portion of the capital gains tax should be allocated to the life tenants.

A somewhat (but not perfectly) analogous situation in older cases was where a trust became burdened with the fine for the renewal of a lease. This is like a capital gains tax, in that it is a lump sum expense covering a time-span that might be longer or shorter than the duration of the life tenancy. This case law was discussed by Lord Chancellor Eldon in *White v. White*.[134]

Early cases appeared to have fashioned a rule that one-third of the renewal would be borne by the life tenant and two-thirds by the remainderman. The Lord Chancellor observed that this rule would be unfair to apply equally to a tenant for life at age 99, who might enjoy the land for only 10 days, as to a man of 25, and that this old rule had already been "exploded" with respect to apportionment of mortgages. On the other hand, Lord Eldon was not able to accept that the life tenant was only to keep down the interest on money borrowed to pay the renewal fine:[135]

> *In the case of a tenant for life of an equity of redemption and the remainderman in tail or in fee the whole inheritance being charged with the mortgage, it is fair, that the tenant for life shall only keep down the interest; for the whole charge is upon the whole inheritance; and the natural division is, that he, who has the corpus, shall take the burden; and he, who has only the fruit, shall pay to the extent of the fruit of that debt. But these interests, whether for lives or years, are in their nature temporary. I cannot therefore apply to them that rule, as to another species of estate, distinct in the very point, that is to furnish the rule. Therefore that position, that the tenant for life is bound to pay the interest, must be understood with this allowance; that he is farther bound to have charged upon him a due proportion of the benefit he takes in the estate by the application of the principal paid for the purchase of the renewed interest in the estate.*

However, on the construction of the will, the court found that the testator had intended a sufficient fund would have been reserved for the renewal, apart from the life interest. Therefore, the tenant for life was to permit the remaindermen to mortgage the estate to the extent of the renewal charge, with the life tenant to keep down the interest on the mortgage.

The case is analogous to the 21 Year Tax Rule as applied to trusts. A tax based on a deemed capital gain is like the fine for the renewal of a lease. The tax must be paid in order to retain and not have to sell the trust property, such as shares of a private corporation. The court in *White v. White* recognized that an equitable apportionment of the expense to retain the asset would depend on the contingency of life expectancy. Further, in the context of a private corporation, the contingencies of the business would be not unlike the contingencies of the value of leased land, considered in *White v. White*. However, although the income on leased land would be contingent, it would not be subject to the discretion of corporate directors, as would be the case with the trusts that hold shares of a private corporation. Nonetheless, the principle discussed in *White v. White* could reasonably apply to apportion the capital gains tax either one-third life tenant and two-thirds remainderman, or along some more reliable estimate of life expectancy, as suggested in the *dicta* of the case.

In the absence of authority on point, the neatest solution to this dilemma is to either (1) liquidate the capital investment, so that the remainderman does not pay capital gains tax on the present value of future income stream to be paid to the life tenant, or (2) finance the tax through borrowing, so that the current interest obligation offsets the portion of the tax on the increased value that is attributable to capitalized earnings that will be paid to the life tenant. Again, this second option is the situation where a trusts borrows to pay the tax liability - capital bears the principal and income bears the interest.

Although deciding a slightly different issue, in *Re Schippmann Estate*,[136] the court allocated the benefit of a deferred capital gains tax between beneficiaries by using as a "benchmark" of even-handedness the result as if the property had been liquidated, taxes paid and a distribution had been made.[137] The court, in effect, used the first option as a benchmark to measure the even-handedness of the allocation.

This "benchmark" approach can be used to graphically illustrate the reasonableness of having the life tenants keep down the interest on the principal amount borrowed to pay the capital gains tax. Ignoring capital appreciation or depreciation over time, consider the benchmark situation of liquidating the capital asset to pay the tax, as compared to borrowing to pay the tax.

(a) Property value = $100,000

Rate of return = 10%

Capital gains tax liability = $20,000

Remaining capital after sale to pay tax = $80,000

Annual return to life tenant (10% of $80,000) = <u>$8,000</u>

(b) Property value = $100,000

Rate of return = 10%

Annual return (10% of $100,000) = $10,000

Amount borrowed to pay tax = $20,000

Rate of borrowing = 10%

Cost of borrowing (10% of $20,000) = $2,000

Net return to life tenant if charged interest ($10,000 - $2,000) = <u>$8,000</u>

The scenario (a) benchmark shows plainly that the life tenants would be treated equitably by the established common-law rule that the life tenant keep down the interest. A trust with shares of a private corporation may differ slightly in that the rates of interest on borrowed funds and the future dividend rates may differ. What the foregoing demonstrates is that if trustees consider financing to pay the tax liability arising because of the 21 Year Tax Rule, it will be important that an appropriate level of dividends is paid to the life tenant. In this regard, it will be important for the trustees to be aware that if the life tenants were to pay interest expenses out of the dividends and there was a significant decline in the dividend rate, the life tenants could protect their position by forcing a sale of the shares. Accordingly, the life tenants are best maintained in a position comparable to the benchmark (scenario (a)) by having them pay the interest on the funds borrowed to pay the capital gains tax (scenario (b)).

The problem with attempting to attribute part of the capital gains tax to the life estate is that the calculation is difficult and there are too many contingencies, such as the life expectancy of the life interest, the performance of the underlying business, and the future dividend pattern of the corporation. A converse set of difficult contingencies applies to any attempt to allocate a portion of the ongoing interest expense to the remainderman. In essence, trying to apportion capital gains tax between income and capital is, in general, too difficult to administer. Accordingly, established jurisprudence allocates interest to income where the trust borrows to pay an expense.

The only Canadian authority on which a beneficiary bears the burden of the capital gains tax on the 21-year deemed disposition is *Ontario (Public Guardian) v. Hodgins Estate*.[138] However, in that case the court did not apportion as between life and capital interests. The testator had left a farm to Henry McNaughton for life, then to the sons of the testator's nephew then alive. Harry McNaughton was (at the time of the case) 74. Because the remainder interest of the nephew's sons had not yet vested, there would be a deemed disposition on the earlier of McNaughton's death or the 21st anniversary of the testator's death. The executors withheld distribution of the residue of the estate because it might become chargeable with tax payable on capital gains accruing after the testator's death. The court rejected this position and held that once the asset had become segregated (from the residue), it would be unfair to impose the burden on the residue where the will was silent on the issue of capital gains tax. The court went on to hold that since the life tenant enjoyed possession of the property, the life tenant should shoulder the burden of the capital gains tax. The court did not advert to the allocation of burden between the life tenant (McNaughton) and the remainderman and, presumably, by "life tenant" actually meant the life interest and remainderman jointly, as distinct from the residue of the estate, without speaking to the allocation between life tenant and remaindermen.

(d) Comparison to Tax Law

To fully appreciate the foregoing we consider the position where life tenants might draw an analogy from the non-deductibility of interest under the Act. A position may be advanced by life tenants of a trust that because the test for interest deductibility under the Act is whether the borrowed money is used to earn income, interest should be chargeable to the life tenancy only if the interest expense is directly attributable to increased income; this would clearly not be the case in the context of the 21 Year Tax Rule. This, however, is not borne out by the jurisprudence.

The leading case in this regard is *Bronfman Trust v. The Queen*.[139] Under the trust in that case, the beneficiary had the right to receive 50% of the revenue from the trust property and the trustees had discretion to make an allocation from capital to the beneficiary. The *corpus* of the trust, apart from a Rodin sculpture, was stocks and bonds. The market value of the portfolio was about $70,000,000, much in excess of the $15,000,000 cost base. The annual revenue was only in the range of $200,000-$300,000, which was less than one percent on the market value. Evidently, the portfolio's value was principally in capital gains. The trustees of the trust made discretionary distributions of capital to the beneficiary totaling $2,500,000. There was no suggestion that the discretionary distribution was in any way made for the purpose of enhancing income-earning potential. On the contrary, the inevitable result was to reduce the trust's net income-earning prospects both in the short-term and in the long run owing to the depletion of the trust capital.[140] The trust then borrowed $2,300,000 to finance the capital allocation to the beneficiary, which was distributed to the beneficiary and not used to acquire income-earning property. Within two years, shares had been sold and the loan had been paid off. Thus the loans postponed but did not obviate the need for an eventual reduction in the trust's capital assets.

The trust argued that the loan postponed liquidation of income-earning property until the time was ripe to dispose of them. The trust argued this was the same outcome as if the trust had sold the assets to make the distribution and then borrowed money to reacquire them. The Supreme Court of Canada rejected this characterization. Chief Justice Dickson, writing for the court, observed that the discretionary allocation of capital to the beneficiary could not be characterized as having been done to earn income. The court distinguished *Trans-Prairie Pipelines Ltd. v. Minister of National Revenue*,[141] which had upheld the deductibility of interest on $700,000 borrowed to expand a business, where $400,000 was applied to redeem preferred shares that contained sinking fund covenants that made it impractical to finance an expansion. Dickson C.J. agreed with Pratte J.A. (in dissent in the F.C.A) that the preferred shares in *Trans-Prairie* had been issued to raise money for income-earning capacity and so the new borrowing, in effect, inherited the purpose of the original borrowing it replaced.

With respect to a trust facing the 21 Year Tax Rule, in this context the borrowing will not be discretionary for another purpose, such as making a discretionary distribution. The triggering motivation (payment of tax on deemed capital gains) is not an income-producing purpose, as in *Trans-Prairie Pipelines*. Nonetheless, the payment would be a non-discretionary expense, analogous to the restoration of capital in the event of an involuntary loss such as fire damage. Accordingly, *Bronfman Trust* is distinguishable on its facts.

This distinction is supported by the outcome and reasoning of the Supreme Court of Canada in the later decision *Tennant v. M.N.R.*[142] In that case, the taxpayer borrowed $1,000,000 to capitalize a corporation.

Later, he disposed of the shares to a holding corporation he owned, using a section 85 rollover at a cost base of $1,000. At issue was the continuing deductibility of the full amount of interest on the outstanding loan after the rollover. The court held that the replacement property fulfilled the same purpose as the original loan and, therefore, the interest accruing on the original loan continued to be deductible, notwithstanding the drop in value of the replacement property—the first source continued in a new form.

Bronfman Trust is also distinguishable from the context of a trust facing the 21 Year Tax Rule because of the differences between tax law and trust law. Dickson C.J. observed that in tax law, interest is presumed non-deductible except as expressly permitted under section 20 of the Act. This, as shown above, is the opposite of the law pertaining to settlements—the life tenant is presumed to be responsible for interest as a matter of the settlor's intent and is protected by being able to apply for liquidation (conversion) of the assets into income-bearing investments. Dickson C.J. noted that the tax policy is to encourage investment in capital that would produce income, so the ultimate motivation for the borrowing must be to produce income before the government intends to forego tax revenue. Under trust law, the underlying encumbrance need not have been for the purpose of generating income. The principle applies, for example, to the costs of paying annuities to legacies or to discharge mortgages or other debts existing at the time of settlement (for whatever purpose). The trust principle is one of dividing the benefits and burdens of the pool of assets and liabilities, and is not restricted to encourage the accumulation of capital that generates additional marginal income.

There is a further distinction between the context of a trust facing the 21 Year Tax Rule and *Bronfman Trust*. The *corpus* of a trust would be enhanced by the borrowing (both life tenants and remainderman), whereas the *Bronfman Trust* borrowing did nothing to advance tax policy—it postponed tax that would have been generated from capital gains and failed to generate sufficient additional income to cover the interest expense. Nonetheless, the *Bronfman Trust* borrowing did promote the interests of the trust, and so there is no inconsistency in the interest being non-deductible for tax purposes (there being no tax policy being advanced) but still being chargeable to the life interest in the trust.

Based on the foregoing, the jurisprudence on the deductibility of interest under the Act is distinguishable both on the facts—because the outlay by a trust in the context of facing the 21 Year Tax Rule is non-discretionary—and because of the different policies involved. Accordingly, reliance on this argument would be detrimental to the trustees of a trust facing the 21 Year Tax Rule.

(e) Summary

For over 200 years, Anglo-Canadian jurisprudence has held that the account of the life tenant must bear the interest on any encumbrance on the *corpus* of the trust. Accordingly, where a trust holds property such as dividend-producing shares of a corporation, absent any express direction in the trust instrument, the life tenant's entitlement to dividends would be net of any interest on money borrowed to pay capital gains taxes in respect of the shares.

Although there appears to be no direct judicial authority on point, having regard to the general principle that he who reaps the benefit ought to bear the burden, the better view is that capital gains tax liability arising due to the 21 Year Tax Rule would be allocable to the remainderman and not the life tenant.

In response to an argument that the context of the 21 Year Tax Rule supports a departure from the general rule that the life tenant must "keep down the interest" because the remainderman benefits from the interest through potential capital gains, it could be argued that the life tenant should bear a portion of the capital gains tax liability. The capital gains tax at issue is being imposed on a notional and not a realized capital gain. In the context of the trust property being shares of a private corporation, the appraised value will often be based on an earnings approach that calculates the value of the corporation as an industry-appropriate earnings multiple of the projected cash flow of the business in future years. If, based on historical dividends, a substantial portion of those earnings will be distributed to the life tenants as dividends in the years subsequent to the 21 Year Tax Rule, it is arguably inequitable for the remainderman to pay capital gains tax on the present value of earnings to be received by the life tenant.

However, because of the numerous contingencies that would apply in attempting to fine tune apportionment in either case—apportionment of interest, apportionment of tax—the jurisprudence supports the more simple-to-administer rules that the life tenant keeps down the interest (of financing incurred to pay the capital gains tax liability) and the remainderman takes the burden of the principal (of such financing). The life tenants are protected by way of dividends. If there were historically no dividends being paid, then the trustees may need to take steps to see to the payment of dividends to ensure the life tenant is provided with an income stream. If the dividend policy were to change or if no dividends were historically paid, the life tenants could force a sale of the capital to be converted into investments with a more even-handed rate of income.

Part III - Historical Background of the 21 Year Tax Rule

The establishment of trusts has long been burdened with limitations. From a trust law perspective those limitations flow from the rule against perpetuities and the rule that limits the accumulation of income. As noted by R. Daren Baxter, "the common law Rule Against Perpetuities is useful context for understanding the 21-Year Rule in Canadian tax law."[143] Mr. Baxter goes on to offer the following useful explanation:

> *First, readers should understand that the duration of a trust arrangement has been limited by law for a long time, albeit differently and for different reasons Second, one should appreciate that where the Rule Against Perpetuities remains part of the law of a Canadian province or territory, the tax rules do not create but rather accelerate a tax event. Since property cannot be held upon a trust in perpetuity, some future disposition that would be recognized for tax purposes is likely to occur, but not necessarily as early as is deemed to occur under the current tax rules. By contrast, where the Rule Against Perpetuities no longer applies (i.e. Nova Scotia), the tax rule creates a tax event that might otherwise be avoided in perpetuity. Third, the otherwise seemingly arbitrary timeline of 21 years in modern tax law is seemingly a nod to the decision in the House of Lords that finally determined the period of an impermissible perpetuity after 150 years of judicial deliberation. Fourth, someone reading a deed of settlement should appreciate that dual references to 21 years have separate but overlapping purposes.*

Following the 1966 report of the Royal Commission on taxation, Canadian tax law went through significant reform in 1971-72.[144] The 1966 reports underlying principles were to ensure taxpayer equity while maintaining administrative convenience. With the recommendation of periodic taxation of wealth, the report generally recommended that wealth should be taxed when realized as opposed to on an accrual basis. However, recognizing that taxpayer equity could be challenged given strategies could be implemented that avoided taxation on a disposition basis, several accrual based tax events were introduced as part of the 1971-72 reform.

One accrual based tax event introduced is the rule in subsection 70(5) of the Act which provides what when a natural person dies, he or she is deemed to dispose of his or her capital properties, eligible capital properties, land inventories and resource properties immediately before death and receive proceeds of disposition therefore equal to the fair market value of such properties. The realized income in respect of such property will be included in the deceased taxpayer's income in their terminal year. Given there are legal entities[145] that either do not "die", such as a corporation or a partnership, or can exist for a relatively long period of time, such as a trust,[146] the foregoing rule will not apply to properties owned by such entities. Accordingly, to ensure the tax liability stemming from subsection 70(5) of the Act is not avoided for an indefinite period of time, an additional accrual based tax event was introduced – the 21 Year Tax Rule.

One might posit that it is not necessary to have the 21 Year Tax Rule because subsection 70(5) applies to a taxpayer's capital interest in a trust. Unfortunately, there are, in general, two practical limitations with this position.

First, it is difficult to ascribe a value to a beneficial interest in a discretionary trust. Beneficiaries of a discretionary trust do not have an interest in the trust property. Rather, they have a right to be considered by the trustee as a recipient of a distribution of trust property.[147] Consistent with this, jurisprudence in the tax context has held that such interests have an indeterminate value. For instance, the House of Lords in *Gardside et al v. IRC* considered the nature of the rights of a beneficiary under a discretionary trust as follows:

> *No doubt in a certain sense a beneficiary under a discretionary trust has an "interest"; the nature of it may, sufficiently for the purpose, be spelt out by saying that he has a right to be considered as a potential recipient of benefit by the trustees and a right to have his interest protected by a court of equity.*[148]

Similarly, in *Leedale (Inspector of Taxes) v. Lewis*, the House of Lords held that an interest in a discretionary trust had an indeterminable value.[149] Revenue Canada has also made a similar statement in Technical Interpretation No. 9213470 (September 1, 1992).[150]

Second, leaving aside interests that are vested indefeasibly, it is generally the case that an interest in a trust ceases upon the beneficiary's death. For these reasons, relying upon an interest in a trust to maintain the integrity of the tax system is not practical.

Part IV - The 21 Year Tax Rule - Some Particular Issues

Subsection 104(4) of the Act provides that a personal trust, subject to certain exceptions, is deemed to dispose of certain types of property at the:

- end of the day that is 21 years after the day the trust was created, and
- every 21 years thereafter,

for proceeds equal to the fair market value of such properties at that time and to reacquire such properties at that fair market value.[151] With the exception of certain trusts where the deemed realization is specified to occur on another date, the 21 Year Tax Rule applies equally to *inter vivos* and testamentary personal trusts.

Several questions stem from the parameters of the Rule. These will be explored further below.

1. *When is a Trust Created?*

One might assume that the date of the trust agreement is the relevant date. This assumption is, however, incorrect. The date when the trust was created is the date when the trust has been validly established. To ascertain that date one must go back to the requirements for the establishment of a trust.

In order for a valid trust to be created the relationship created must satisfy the three certainties. The three certainties are:

(i) certainty of intention on the part of the settlor to create a trust relationship in respect of property,

(ii) certainty of objects in the sense that it must be possible for the trustees, or a court, if necessary, to be able to identify who is to benefit from the trust property, and

(iii) certainty of subject matter – the trustee must be able to identify the property to which his or her fiduciary obligations apply.

Furthermore, there must be a transfer of property from the settlor to the trustees in order to "constitute" or establish the trust relationship. As a result, it is possible for a trust agreement to, on its face, appear to satisfy the three certainties without there, in fact, being a valid trust relationship. Until there is a transfer of property from the settlor to the trustee, such that the trust relationship is established, there is no valid trust. It is for this reason that trust lawyers pay keen attention to ensuring that there is property used to settle the trust.

But for CRA's policy regarding the date a testamentary trust is established, the foregoing ought to apply equally to testamentary trusts. In particular, generally speaking, a transfer of property from the executor to the trustees would occur once the executor has completed the administration of a deceased taxpayer's estate, in the sense of having satisfied all debts and specific gifts and then being in a position to fund any trusts directed to be created under the taxpayer's will. However, applying such a rule in the testamentary context could make administration of the 21 Year Tax Rule challenging.[152] Accordingly, a bright line rule is applied. For taxpayers who have died after February 11, 1991, the starting date for the creation of a testamentary trust is the date of death regardless of when the trust actually receives property from the estate.[153]

2. *What Time of the Day on the 21st Anniversary does the Rule Apply*

Another question that arises is the time of the day that is relevant. The answer to this question can be found in subsection 27(4) of the *Interpretation Act*, R.S.C. 1985, c. I-21. In particular, the application of this statutory provision means that the deemed disposition day occurs at the end of the day that is 21 years after the specified day but not including the specified day. For a trust created on October 29, 2014, the first deemed disposition will occur on October 29, 2035.[154] While the timing of the application of the 21 Year Tax Rule may seem to be an inconsequential matter, in a stock market of some volatility the implications of the foregoing rule may have a profound impact on a trust.

3. *What Property is Subject to the Rule*

While colloquially we refer to the 21 Year Tax Rule as being applicable to trusts, this is technically incorrect for two reasons. First, the rule does not apply to all trusts in that certain trusts are excluded from its application. More importantly though, to the extent the rule has application to a trust, it applies to certain property only. In particular, generally trusts are deemed to dispose of non-depreciable capital property, land inventory, depreciable property, Canadian and foreign resource properties and NISA Fund No. 2. Life insurance is property that is not subject to the 21 Year Tax Rule.[155]

It is important to note that the 21 Year Tax Rule also applies to non-resident trusts to the extent they own "taxable Canadian property" where the gain is not subject to treaty protection.[156] However, the 21 Year Tax Rule will not apply to "exempt property" held by a non-resident trust. This is to avoid non-resident trusts from using the rule to their advantage.[157]

4. *What Trusts are Exceptions to the Rule*

Subsection 108(1) of the Act excludes certain types of trusts from the application of the 21 Year Tax Rule. One exception presents a planning opportunity for purposes of addressing the implications of the 21 Year Tax Rule. This is the exception for trusts in which all interests have vested indefeasibly.[158]

5. *What's the Problem for the Taxpayer*

The fundamental problem created by the 21 Year Tax Rule is that it imposes a tax liability when there has been no transaction. As a result, funding the tax liability becomes a concern. Where assets of the trust are illiquid, such as with shares of a private company, this unfunded tax liability can pose a challenge.

Funding of the tax liability in the context of illiquid assets, such as private company shares, can be accomplished in one of four ways, all of which have their challenges. They are as follows:

1. An additional settlement of property on the trustees sufficient to pay the tax liability, could be made. Careful consideration of the implications of subsection 75(2) of the Act will need to be made. Even if it is possible to find an individual who is willing to make a contribution to the trust, given the parameters of subsection 75(2), it is often unlikely that this individual could make a contribution to the trust.[159]

2. The trustees could sell some of the assets of the trust. This may be possible (and preferable) in the context of a portfolio of marketable securities. Where, however, the trust assets are limited to illiquid assets, such as shares of a private company, this approach is often not practical.

3. The trustees can anticipate the 21 Year Tax Rule by beginning to create a reserve of funds sufficient to satisfy the tax liability. This could be accomplished by not distributing all of the annual income earned by the trust, for instance dividends paid on shares of a private company, for a number of years leading up to the 21st year of the trust.[160]

4. The trustees could borrow funds using the trust assets as security.

With the exception of receiving an additional contribution of property, each of the other options raises issues from the perspective of the trustees' duties to the beneficiaries of the trust. For example, if the trustees engage in a borrowing, how are the financing costs to be allocated. If the trustees intend to create a reserve derived from current income, in the context of a trust where there is a life tenant entitled to income followed by remainder beneficiaries entitled to capital, how is the interest of the life tenant to be protected. This can be particularly acute when it is not anticipated that the assets of the trust will be sold after the death of the life tenant such that imposing a charge on the capital to "reimburse" the life tenant for lost income may not be an equitable solution.[161] Further consideration of this issue is given above under the heading "*Allocation of Burdens Among Successive Beneficiaries*".

As noted by David G. Thompson:

> *…it is essential to keep in mind that the interests of the beneficiaries must be served and that the trustees of a trust cannot focus on tax issues to the exclusion of non-tax issues. Strategies to defer or reduce tax are not always in the interests of all of the beneficiaries, particularly where there are multiple classes of beneficiaries. For instance, assume a trust with income and capital beneficiaries borrows money to pay the tax arising from the deemed disposition of the trust's assets. Is the interest expense a charge against income or capital? What about the repayment of principal? Such issues must be considered.*[162]

The other point to bear in mind with borrowing to fund the tax liability is that it is only after-tax income to the trust that can finance the borrowing. Interest payments payable on the borrowing are not tax deductible. As a result, this is an additional cost that must be considered.

The challenges posed by the 21 Year Tax Rule, however, go beyond that of an unfunded tax liability. In particular, the lack of proper integration in the context of private company shares means the specter of double taxation is real. A deemed realization by a trust of private company shares will not result in an increase in the cost base of the underlying capital property of the private company. As a result, the same economic gain will be taxed again upon a later sale by the private company of its capital property.

6. *Are there any Anti-Avoidance Rules*

Prior to February 1990, it may have been possible to defer the 21 Year Tax Rule by engaging in a trust-to-trust transfer.[163] However, since February 1990, subsection 104(5.8) of the Act essentially provides that where there has been a trust-to-trust transfer of property, the 21-year deemed disposition date for the transferee trust will be that which applied to the transferor trust. While there are certain limited exceptions for transfers that involve no change in beneficial ownership, by and large the ability to use successive trusts as a means to defer the impact of the Rule has been eliminated.

Other anti-avoidance measures exist. For instance, there are rules designed to prevent a non-resident trust from distributing stepped-up property to Canadian resident beneficiaries.[164] Similarly, subsection 104(4)(a.3) and subsection 73(1) of the Act prevent an individual avoiding a deemed disposition on an intended departure from Canada. Attempting to vary the terms of a trust may result in subsection 108(6) deeming the "new" trust to be a continuation of the varied trust. Subsection 104(4)(a.2) is another anti-avoidance measure designed to avoid strategies that involve leveraging trust assets with accrued capital gains, in combination with satisfying a beneficiary's income interest and distributing the trust assets and financing obligations to capital beneficiaries. Finally, with the underlying purpose of the 21 Year Tax Rule being certain, the GAAR must always be considered.

Part V – Summary of Planning Options

In this section we provide an overview of the common planning strategies available to address the implications of the 21 Year Tax Rule. In doing so, we also note the hurdles that may arise within the context of those planning options. It is not the purpose of this paper to provide a detailed analysis of the income tax considerations applicable to each of the planning options. Rather, our purpose in providing the following summary is to raise the trust law considerations that apply to the planning considerations.

While there are combinations and permutations, in general, the planning options available to address the implications of the 21 Year Tax Rule fall into one of four differing forms. First, after determining the scope of the problem, the trustees can determine to do nothing (the "Do Nothing Option"). In combination with the Do Nothing Option, the trustees can take steps to reduce the impact of the deemed disposition of trust assets (the "Reduction Option"). Second, and perhaps the option that is considered the solution of first choice, the trustees may determine to make a distribution of appreciated assets to one or more of the beneficiaries (the "Distribution Option"). A third solution, albeit also a Distribution Option, is that the trustees can cause appreciated trust property to be distributed in a manner that all of the interests in the trust have vested indefeasibly, such that the exception in paragraph (g) of the definition of "trust" in subsection 108(1) of the Act can be relied upon (the "Vested Option"). What follows is a consideration of each of the foregoing, together with a consideration of the hurdles that may arise. Reference will be made to the trust law considerations that are relevant to each of the options.

1. *Determining the Scope of the Problem*

It goes without saying that upon accepting a trusteeship, trustees ought to determine when the 21 Year Tax Rule will apply. Trustees ought to know what is the applicable deemed disposition date. Once charged with this knowledge, trustees ought to create a "tickler" at least two years in advance of the deemed disposition date. The reason for doing so is because hurdles may arise with the various planning options available. In that event, the trustees will require time to address those hurdles.

Once aware of the applicable deemed disposition date, as the "tickler" arises, the next matter for the trustees to address is to determine the scope of the income tax problem. In our view, this is critical. Before even considering whether other actions should be taken, including ways to reduce the impact of the 21 Year Tax Rule, it is incumbent on the trustees to know the extent of the liability. This need not necessarily be a specific determination, as opposed to an overall assessment having regard to the nature of the assets.[165]

Once the trustees have determined the potential income tax consequences, it may be the case that the pending capital gains and resulting tax liability is manageable. For example, the trust assets may be a portfolio of marketable securities with a high (or relatively high) cost base. In this context, the trustees might determine it is in the best interest of the beneficiaries to continue to hold the trust assets.[166]

2. *Considering the Options to Manage the Problem*

(a) Do Nothing and Pay the Tax

It is important to remember that the 21 Year Tax Rule is an acceleration of the income tax liability. The result of allowing the deemed disposition to apply to some or all of the trust assets is an increase in the adjusted cost base to their fair market value on the 21st anniversary of the trust. If a sale of the trust assets is anticipated in the near future, given the impact of the 21 Year Tax Rule is an acceleration of the tax liability, the trustees might appropriately determine that allowing the Rule to apply is acceptable.

Subsection 159(6.1) of the Act allows the trust to elect to pay the tax in equal installments over a ten year period. Other complexities exist with relying upon this option including: the need to post security acceptable to CRA and the fact that this deferral option is only available in respect of capital property. Further, and perhaps most significant, an interest liability is applied to the outstanding payments. The interest rate that is applicable pursuant to the Act may exceed what could be available through an alternative source of borrowing. This is a matter the trustees will need to consider. In addition, the interest is not deductible. Notwithstanding, should it be determined appropriate to allow the 21 Year Tax Rule to apply, this election will allow the trustees an ability to spread satisfaction of the liability over a period of time. It will be incumbent on the trustees to determine the manner in which to allocate the burdens associated with the borrowing, whether from CRA or a third party source. This is discussed in greater detail above under the heading "*Allocation of Burdens Among Successive Beneficiaries*".

The Do Nothing Option is an option trustees would consider engaging in, if they have determined it is appropriate that the trust relationship continue. In coming to that determination, the trustees will need to understand the settlor's purposes for using the trust vehicle when the trust was originally established. Trustees will also need to understand the personal and economic circumstances of the beneficiaries and in particular, whether there are risks associated with the personal and economic circumstances of the beneficiaries.

Where the terms of the trust provide for a life interest to one beneficiary, with a remainder interest to another beneficiary, the Do Nothing Option will likely be the option that is chosen. This would particularly be the case where the economic interests of the life tenant and the remainder beneficiaries differ. Often this is the situation in a second marriage. It may, however, also be the situation because of the nature of the relationships, or lack of relationships, among the various interested beneficiaries.

When considering the potential economic impact of the 21 Year Tax Rule and relying upon the Do Nothing Option, the trustees ought to have regard to any tax losses that may be available which will serve to reduce the tax impact.

The application of any potential exemptions available under the Act to shelter the tax liability ought to also be considered.[167] This will require a consideration of which beneficiaries have the applicable exemption available. In the context of shares of a private company the relevant exemption is that which applies to "qualified small business corporation shares".[168]

The trustees could take steps to allocate the deemed capital gains to one or more of the beneficiaries. Whether this is possible will depend upon whether the trustees have the authority to allocate income of this nature, often referred to as "phantom income". Ideally the terms of the trust will give the trustees this authority.[169]

It is important to note that CRA's view is that a capital encroachment power alone may not be sufficient to allocate deemed capital gains. Rather, it is CRA's view that the terms of the trust should allow the allocation of amounts that are considered to be income under the Act.[170]

Assuming this authority exists, the trustees must ensure they take the appropriate steps to make the income "paid or payable" to a beneficiary. Where this is done the beneficiary will be required to include the amount in their income, and the trust would be entitled to a corresponding deduction.[171] If the trust assets qualify as property to which one of the lifetime capital gains exemptions applies, the beneficiary would then shelter some or all of the income tax liability.[172]

Given CRA's policy, albeit perhaps misapplied, if the terms of the trust do not allow allocating amounts that are considered income under the Act, it may be the case that terms of the trust need to be varied. The concept of a trust variation is considered in further detail above under the heading "*Ability to Amend Trust Terms*".

(b) Managing the Value of Private Company Shares

A variation of the Do Nothing Option is to take steps to manage the value of the trust assets. The concept of managing the value of the trust assets has two strategies embedded within it. The first is to take steps to reduce the value of the trust assets. The second is to take steps to manage the value accruing to a trust over a period of time, to an amount that can then be extracted from the company prior to the next applicable 21st anniversary. The former involves a number of different actions related to making corporate distributions. The latter involves implementing a strategy of "laddered freezes" over time. Each of these, as it relates to private company shares, will be briefly discussed below.

(i) Reducing the Value of the Company

Practically speaking this may only be available where the assets of the trust are shares of a private company controlled by the trustees.[173] This can be accomplished by the payment of dividends and the distribution of tax accounts, such as the capital dividend account and use of the refundable dividend tax on hand ("RDTOH") account. As Wolfe Goodman outlined in the context of a trust with an income beneficiary but no power to distribute trust assets and no ability to vary its terms:

> *In the case, we concluded that we would simply have to face deemed realization of the trust during the lifetime of the original income beneficiary. We had to concentrate on*

reducing the potential tax liability. The trust held all the shares of an investment company which owned various securities, some of which were highly appreciated. It also had a substantial capital dividend account and a large amount of refundable dividend tax on hand. In these circumstances, it clearly made sense for the company to pay out its whole capital dividend account to the trust, since this would reduce the value of the shares but without creating any tax liability for the trust. In addition, since payment of taxable dividends would result in refund of the company's RDTOH, it also made sense for it to pay sufficient dividends to exhaust its RDTOH, giving the company a large tax refund. Even though the trust would have to pay tax on this dividend, this would not involve any significant net tax liability. Because we did not want these large distributions by the company to be treated as income payable to the income beneficiary, the company was advised to issue stock dividends for these distributions, which would be treated as capital receipts under trust law and therefore would be retained in the trust.

The really difficult problem concerned the large amount of unrealized appreciation on the securities portfolio of the company, which obviously increased the value of the shares in the hands of the trust and affected their tax liability. We therefore recommended that the trustees form a new company to which they would transfer all of the present company's portfolio at fair market values, and that the present company would then be wound up. This would, of course, accelerate the company's tax liability in respect of these appreciated securities. The resulting addition to the company's capital dividend account could be distributed as a tax-free capital dividend, and while the taxable portion of the capital gains could be distributed as a taxable dividend[,] this would reduce the total tax liability only slightly. The main reason for transferring these securities to a new company at their fair market value was to ensure that they would have a stepped-up adjusted cost base in its hands. If the trustees did not make this transfer, the adjusted cost base of the securities would be unaffected by the fact that the shares had been revalued to their fair market value, which would have been a very serious situation.[174]

The foregoing strategy essentially involves reducing the value of the shares of a corporation held in a trust. This can be accomplished by causing the corporation to:

1. pay tax-free capital dividends which can then be distributed or used to finance the tax liability that continues to exist, or

2. if the corporation has an RDTOH balance, causing the corporation to pay taxable dividends, which, depending on the terms of the trust, may be allocated to beneficiaries, either by requirement or discretion, or used to finance the tax liability, or

3. where capital gains tax rates are higher than eligible dividend rates, if the corporation has a GRIP balance, have the corporation declare eligible dividends, to reduce the value of the trust.

Each of these strategies raises the issue of how the duty to maintain an even-hand is applied in the context of corporate distributions, particularly whether a distribution constitutes income or capital. This is discussed in greater detail above under the heading "*Characterization of Corporate Distributions for Trust Law Purposes*".

Another option to reduce the value of the private company shares is to create a payable owing to the trust. This can be accomplished by having the company create a corporate liability by declaring but not paying a dividend. The trust ought to be taxable only upon receipt of the dividend. The actual payment of the dividend can then be managed over time.

(ii) Managing the Value Accruing to the Trust

The underlying premise of this strategy is that as value accrues to the trust, which we will call Trust 1 trust, the trustees engage in a re-freeze for the benefit of a new trust Trust 2 at a point in time when it is determined that sufficient value has accrued to the current trust. The frozen value that has then accrued to the current trust would then be realized, by way of share redemptions, over a period of time prior to Trust 1 being subject to the 21 Year Tax Rule, the intention being that by the time the 21 Year Tax Rule applies to Trust 1, the accrued value will have been extracted.

This strategy is suitable where it is intended that a trust continue to benefit from accumulating value of the company for a period longer than 21 years. This may be the case where the intention is to benefit multiple generations. For example, the strategy may be that as Trust 1 hits its tenth anniversary an assessment is made that a sufficient quantum of value has accrued to the current trust. The trustees would then engage in a refreeze and with future value accruing to the benefit of Trust 2. After the tenth anniversary of Trust 1 until its 21st anniversary, the frozen value would be realized by Trust 1 such that by the 21st anniversary of Trust 1, it no longer has a significant embedded tax liability.

For this strategy to be entered into will depend upon whether the company has sufficient liquidity to redeem the frozen value accrued to the current trust. It will also depend upon the terms of the Trust 1 (and each subsequent new trust created) being sufficiently flexible, such that the fiduciary issues related to freezing the value accruing to the benefit of the beneficiaries of the current trust, who may be different from the new trust, do not pose a challenge to the trustees. For the trust law considerations reference should be had to the section above under the heading "*When Will a Court Interfere with a Trustee's Exercise of an "Absolute" Discretion*".

(c) Distribution Option

The strategy that is perhaps most commonly looked to as a means to manage the 21 Year Tax Rule – at least initially – is for the trustees to distribute all of the assets with accumulated capital gains to one or more of the capital beneficiaries. While a distribution of capital property results in a disposition of the distributed property by the trust, as well as a disposition by the beneficiary of his or her capital interest in the trust, provided the distribution meets the provisions of subsection 107(2) of the Act, the distribution will qualify for a tax-deferred "roll out". It is the simplicity of the Distribution Option that is its greatest advantage thereby making this option, the option of choice.[175]

Notwithstanding its simplicity, it is important to be aware that the Distribution Option does not eliminate the tax liability. Rather, the Distribution Option simply defers the realization of the liability until the distributed property is either disposed of by the recipient beneficiary, for example, s/he sells or gifts the property, or s/he passes away.[176] In addition, it is incumbent on the trustees not to lose sight of either the settlor's purposes for creating the trust relationship over the trust property or the benefits of having a trust relationship over the trust property.[177] Where:

1. the beneficiary has creditor related risks,

2. the beneficiary's personal circumstances make a distribution challenging, for example, they lack capacity due to age or mental abilities, or their life style raises concerns,[178] or

3. ongoing control of the trust property with the trustees is considered necessary,[179] for instance because the trustees determine that the settlor would not have intended for the property to be distributed,

a distribution of trust property to one or more beneficiaries may not be appropriate.

There are a number of hurdles that can present themselves when considering the Distribution Option. The most common hurdles are as follows:

1. the terms of the trust document do not permit a capital encroachment;

2. the beneficiaries include non-resident beneficiaries;

3. subsection 75(2) of the Act applies to the trust; or

4. the trustees intend to discriminate among the beneficiaries; or

5. the trust provides for income to be paid to one person during his or her lifetime and for the capital to be distributed to someone else on the first persons death (e.g. income to child for life and then capital to his or her children).

Each of these will be discussed in greater detail below.[180]

(ii) Terms of the Trust

In order for the trustees to be able to rely upon subsection 107(2) of the Act, the trustees must have the legal authority to make a distribution of capital to the intended beneficiary, in satisfaction of their capital interest in the trust.[181] The substance of this requirement is that the distribution must be legally effective. From a trust law perspective, there are two aspects to ensuring the distribution is legally effective.

First, the terms of the trust must allow the trustees to make a capital distribution. Assuming the terms of the trust do allow a capital distribution, the intended recipient (or recipients) of property must be entitled to receive a distribution of capital. In other words, the intended recipients must be within the class of capital beneficiaries.

In the event that either one of the foregoing conditions is not fulfilled, the distribution will not be legally effective. This is because it is outside the scope of the trustees' authority, as provided for in the trust document. The implication of this is that the distribution is void and could be set aside. [182]

In the event the terms of the trust do not allow for capital distributions to be made or the intended recipient(s) are not entitled to receive capital of the trust, the trustees could consider amending the terms of the trust. The ability of the trustees to amend the terms of the trust are discussed in greater detail above under the heading "*Ability to Amend Trust Terms*". For purposes of providing context, we refer to comments provided by Wolfe Goodman on point:

> *"In some cases this solution can be applied very simply. If a trust holds property which must be distributed to a beneficiary at age 30, but the beneficiary will not reach this age until, say, 1995, it will probably be feasible to advance the distribution date to 1992. If the trust instrument presently permits the trustees to do this, nothing more will be required. If it does not, an application will have to be made to court to permit them to make such a distribution. In the typical case, this will mean cutting out some contingent beneficiaries who would be entitled to receive the property if the primary beneficiary failed to attain age 30. If so, the official guardian or similar official of the province, representing unborn and minor contingent beneficiaries, and all the adult contingent beneficiaries will have to join in the application. The official guardian will likely insist on getting something for the unborn and minor contingent beneficiaries. He may be satisfied with a term insurance policy on the life of the primary beneficiary with all premiums*

prepaid until the primary beneficiary reaches age 30. Alternatively, a portion of the trust estate may have to be set aside for the unborn and contingent beneficiaries."[183]

(iii) Non-Resident Beneficiaries

Where there are non-resident beneficiaries, further hurdles exist. Subsection 107(2) of the Act does not allow property of a trust to be distributed to a beneficiary, who is a non-resident of Canada, on a tax-deferred basis. Rather, subsection 107(2.1) provides that a distribution to a non-resident beneficiary will be treated as a disposition by the trust, of the distributed property, at its fair market value. As a result, a tax liability will arise at the trust level. This may indirectly impose an unfair burden on those beneficiaries who are resident of Canada.

There are a few planning options available to address the implications of a non-resident beneficiary. One planning option is to distribute trust property to a Canadian resident corporation, of which the non-resident individual beneficiary is directly or indirectly a shareholder.[184] Subsection 107(2) of the Act is only available if the trust property is "distributed by the trust to a taxpayer who was a beneficiary under the trust". Accordingly, for this option to be available to the trustees, the class of beneficiaries to which capital can be distributed must include corporations that are owned or controlled by one or more of the individual beneficiaries that are also within the class of capital beneficiaries (often respectively referred to as "Corporate Beneficiaries" and "Individual Beneficiaries").

A benefit of distributing trust assets to a Corporate Beneficiary is that control over the assets can continue to be retained while deferring the income tax on the accrued gains on the trust property until the Corporate Beneficiary sells the property or the shareholders dispose of their shares, on a deemed or real basis. For this reason, the use of a Corporate Beneficiary may have appeal even when dealing with a distribution to an Individual Beneficiary who is a Canadian resident.

If the terms of the trust do not expressly include the concept of Corporate Beneficiaries within the class of capital beneficiaries, an issue arises as to whether subsection 107(2) will be satisfied. The trustees will need to consider whether the language of the dispositive provisions allow for a distribution to a corporation that is owned or controlled by an Individual Beneficiary. An option, suggested by Tim Youdan, is to consider whether the trust contains general language within the capital distribution provisions, such as a power to distribute "to or for the benefit of" an Individual Beneficiary.[185] To reach a conclusion that a corporation is itself a beneficiary on the basis that the distribution is "for the benefit" of the individual beneficiary, the trustees would need to rely upon the extended meaning of "beneficially interested" provided in subsection 248(25), which applies to the definition of "beneficiary" in subsection 108(1).

In the absence of clear language permitting distribution to a corporation, it would be prudent to obtain an advance tax ruling prior to making any distribution to a corporate beneficiary. However, whether CRA would be prepared to grant a ruling confirming that such a distribution is within subsection 107(2) is unclear. In particular, if CRA's position is that relying upon the power to distribute "to or for the benefit of" an Individual Beneficiary, by paying an amount to a Canadian resident corporation of which the Individual Beneficiary is a shareholder, does not make the corporation a beneficiary of the trust, then subsection 107(2) will not be available.

In the event comfort cannot be obtained that a distribution to a corporation "for the benefit" of a beneficiary would constitute a distribution to the corporation as a beneficiary, the trustees could amend the terms of the trust. The ability of the trustees to amend the terms of the trust are discussed in greater detail under the heading "*Ability to Amend Trust Terms*."

Finally, the authors of *Taxation and Estate Planning* put forward the strategy of having a non-resident beneficiary assigning his or her interest to a Canadian resident corporation. The following is offered as an explanation:

> *Any non-resident beneficiaries would transfer to a newly formed Canadian corporation ("New Can Co") their entitlement to receive capital distributions from the trust in return for shares in New Can Co; this transfer can occur under subsection 85(1). The trust would distribute the appreciated property to New Can Co before the deemed disposition date. When the non-resident beneficiary later disposes of their shares of New Can Co, they will be taxable in Canada and section 116 certificates will be required.*

The authors go on to offer the following description of the disadvantages:

- *Would require the co-operation of non-resident beneficiaries;*
- *More complicated;*
- *The general anti-avoidance rule must be considered;*
- *An advance tax ruling is recommended which is expensive, time consuming and may give rise to other concerns; and*
- *Tax implications in the non-resident jurisdictions must be considered*.[186]

Prior to February 11, 1991 it was possible to avoid the implications of the 21 Year Tax Rule by transferring appreciated trust property from a current trust to a newly established trust, so long as there was no change in the beneficial ownership such that there was no disposition realized by the current trust. However, since that date this is no longer possible. In particular, subsection 104(5.8) of the Act provides that where capital property is transferred from one trust (called the "transferor trust") to another trust (called the "transferee trust"), "in circumstances in which subsection 107(2) or 107.4(3) or paragraph (f) of the definition of "disposition" in subsection 248(1) apply", then the deemed disposition date applicable to the transferee trust will be no later than the date that would have applied to the transferor trust. These sections are those to which a rollover would otherwise apply on a distribution of appreciated trust property.

As a result of the foregoing, there remains some uncertainty about whether it is possible to distribute appreciated trust property to a Canadian resident corporation, the shares of which are owned by a new trust established in anticipation of the 21 Year Tax Rule applicable to an already existing trust. It is clear that a distribution of appreciated trust property from a current trust to a newly established trust would be caught by the rule in subsection 104(5.8). Whether this rule would also apply in the proposed context is uncertain. This planning strategy may be appropriate where it is intended to continue to manage the appreciated trust property within the parameters of a trust relationship.

(iv) Subsection 75(2)

In any deliberation to distribute of trust assets to Canada resident beneficiaries, an important attribution rule which requires careful consideration is the rule in subsection 75(2) of the Act.[187] Of particular importance is, the interplay between subsections 75(2) and 107(4.1) which makes it imperative that these sections be carefully considered whenever a decision is made to effect an *in specie* distribution of assets to a beneficiary in satisfaction of such beneficiary's capital interest such as, for example, where the trustees intend to rely upon the Distribution Option to address the 21 Year Tax Rule.[188]

It is because of these provisions 75(2) and 107(4.1) that in all cases where an *in specie* distribution is contemplated, it will be imperative to review the history of the trust, including:

- how the trust has been funded,
- the identity of the settlor and other contributor,
- the identity of the trustees and the beneficiaries,
- the property contributed to the trust and the manner of such contributions (sale, gift), and
- the terms of the trust with respect to how trustees make decisions,

to satisfy oneself that subsection 75(2) never applied. What follows is a consideration of the relevant aspects of subsection 75(2) and its companion provision, subsection 107(4.1).

Overview of Subsection 75(2)

Subsection 75(2) will apply where property of a trust is held on any of the following conditions: (i) that the property (or property substituted therefor) may revert to the person from whom the property was directly or indirectly received (ii) that the property (or property substituted therefor) may pass to persons to be determined by such person at a time subsequent to the creation of the trust, or (iii) that, during the lifetime or existence of such person, the property shall not be disposed of except with the consent of or in accordance with the direction of that person. It should be noted that the provisions may apply not only to a contributor[189] who is an individual but also a contributor which is a corporation and includes not only the person who settled the trust but any contributor.[190]

If the section applies, then any income or loss from the property contributed by the settlor or property substituted therefor and taxable capital gain or allowable capital loss resulting from the disposition of such property will be attributed to the person from whom the property or substituted property was received during the lifetime of such person while such person is resident in Canada. This will be the case whether the income is retained in the trust or paid to its beneficiaries. The CRA has confirmed that double tax will not arise in respect of income earned by a personal trust as the amount subject to attribution pursuant to subsection 75(2) is not considered to be income of the trust nor is it considered to be income of the beneficiaries where it is paid or made payable to them or deemed payable under subsection 104(13.1) or subsection 104(13.2).[191]

CRA has for some time taken the position that subsection 75(2) applies even if property is transferred to the trust at fair market value by a person who is a capital beneficiary on the basis that it does not seem to matter how the property comes into the trust (even if the transferor may have received consideration equal to the fair market value of the property so transferred) but rather whether the terms of the trust are such that the person who transferred the property to the trust may re-acquire it or property substituted therefor. This contrasts with other attribution rules which are deemed not to apply to fair market value transactions.[192]

However, in the recent case of *Her Majesty the Queen v Sommerer*,[193] the Federal Court of Appeal held that subsection 75(2) does not apply to a beneficiary who transfers property to a trust at fair market value.

The terms of subsection 75(2) are not precise and the limits of the provision are far from certain. There has been little, if any, jurisprudence which would assist in interpreting the provisions of the section and CRA has adopted administrative provisions that are broad and at times contradictory. The concern about subsection 75(2), however, goes beyond the attribution of income on property held by the trust on certain conditions. Even if the amount of the attributed income may be zero or nominal (such as for example, where the "property" in question is a coin which does not generate income), the provision may lead to potentially harsh results as a result of the possible application of subsection 107(4.1). That section of the Act provides that if subsection 75(2) was applicable at any time in respect of <u>any</u> property of the trust then the distribution of any property of the trust to beneficiaries on a rollover basis would, subject to certain exceptions, be denied. Thus it is important to understand the scope of subsection 75(2) and to take steps to avoid it wherever possible, not only to avoid the attribution rule of subsection 75(2) itself but also so as not to invoke the application of subsection 107(4.1).

The most often asked questions with respect to subsection 75(2) relate to: (i) what is a "condition" that creates a "reversion," and (ii) what constitutes a "determination", "consent" or "direction" by the settlor or contributor.[194]

<u>Subparagraph 75(2)(a)(i)</u>

a) *Reversion*

With respect to what constitutes a reversion of property for purposes of subsection 75(2)(a)(i), the provision will presumably cover revocable trusts notwithstanding that the term "reversion" is used to refer to a future interest in land (or property) arising by operation of law whenever an estate owner grants to another a particular estate, such as a life estate or a term of years, but does not dispose of the entire interest.".[195]

Where the trust indenture contains a provision that would allow the settlor or other person who contributed property to a trust to reacquire the property, (as for example if the settlor was a potential capital beneficiary), even if the ability to reacquire the property were remote, subsection 75(2) would apply. This is so even if the event which leads to the application of subsection 75(2) was not in existence at the time the trust was established nor in existence at the time the property was transferred to the trust.[196]

However, where the contributor could reacquire the property by operation of law, such as the total failure of the trust for lack of beneficiaries or impossibility of purpose, and not pursuant to any condition under the trust indenture, subsection 75(2) would not apply.[197]

Accordingly, a contributor of property to the trust, whether as settlor or otherwise, should not be a capital beneficiary. If a settlor/contributor is an income beneficiary, subsection 75(2) does not appear to have application.[198]

It appears that subsection 75(2)(a)(i) will not apply where property is loaned to a trust since, in these circumstances, the transfer of property back to the person from whom it was received would not be a reversion of the property pursuant to the terms of the trust.[199] CRA has indicated, however, that the loan must be a genuine loan made to the trust outside and independent of the terms of the trust.[200]

It is clear, therefore, that to avoid the application of subsection 75(2)(a)(i), the trust should be irrevocable and under no circumstances should it be possible for the property to revert to the settlor or other contributor of property to the trust other than by operation of law on the failure of the trust.

b) *Directly or Indirectly*

Subparagraph 75(2)(a)(i) provides that the attribution rule will apply where property is held by the trust "on condition that it may revert to the person from whom the property was directly or indirectly received". CRA's administrative position suggests that transfers must occur in the course of the same series of transactions in order for an indirect receipt of property to potentially attract the application of subsection 75(2)(a)(i).[201]

c) *Property Held by Trust on "Condition": Options; Powers of Appointment*

CRA has considered the possible application of subsection 75(2) in the context of powers of appointment.[202] In the situation where a person settles a trust for the benefit of his/her spouse and the spouse is given a general power of appointment exercisable by will over the property of the trust or a special power of appointment, CRA's position is that subsection 75(2) will apply. This is because CRA takes the position that the settlor may be appointed as a capital beneficiary under the power of appointment and thus the contributed property can be returned to him/her. Additionally, if the terms of the trust provide that on a failure of beneficiaries the trust assets are to be distributed in accordance with the terms of the will of the settlor, CRA has taken the position that it would apply subsection 75(2) on the basis that by retaining that power the settlor has effectively retained a power to determine to whom the property will pass after the creation of the trust.[203]

CRA distinguishes this from the situation where the terms of the trust provide that the trust property may devolve to the estate of the settlor's spouse even though there is a possibility that the settlor may be named as the beneficiary under the spouse's will.[204] In this situation CRA has indicated that it would not apply subsection 75(2) because the property would devolve to the settlor not by virtue of the terms of the trust but rather by virtue of the terms of the will.

The CRA takes the position that the words "held on condition" are broad enough to cover an option to reacquire property contributed to a trust by a person who is not a beneficiary. This position has been criticized,[205] as is noted that the property under option is not to revert to the option holder pursuant to the terms of the trust but rather pursuant to the terms of the option (a contractual right).

<u>Subparagraph 75(2)(a)(ii) - "determination"</u>

Subsection 75(2)(a)(ii) provides that where property is held on condition that it or property substituted therefor can pass to persons to be determined by the person at a time subsequent to the creation of the trust, subsection 75(2) will apply.

In a number of CRA interpretations, CRA has clarified that this subparagraph will apply if the contributor can select beneficiaries from a group of beneficiaries or can select the percentage of the trust fund. However the subparagraph will not apply, according to CRA, if the beneficiaries are named or predetermined and the contributor only retains the power to determine the quantum.[206] However if the possibility of being able to determine the quantum of trust property is seen that the contributor can determine the beneficiaries to when property can be distributed, then subsection 75(2) may apply.

These interpretations are confusing and seem to draw distinctions that are difficult to comprehend. It has been noted that where "beneficiaries are named or are identified as an ascertainable class under the trust deed and cannot be modified by the settlor subsequent to the creation of the trust, subsection 75(2)(a)(ii) should not have application."[207] This should also be the case, even where the power to distribute the property is fully discretionary such that one beneficiary may receive property to the exclusion of the others. The reasoning is that this does not result in the possibility to determine beneficiaries as the beneficiaries have already been set out in the trust deed.

<u>Paragraph 75(2)(b) - Consent; Direction</u>

Paragraph 75(2)(b) provides that subsection 75(2) will apply where property is held on condition that during the existence of the person, the property or property substituted therefor shall not be disposed of except with the person's consent or in accordance with the person's direction. This provision would appear to apply to both dispositive and administrative powers (such as the power to make investment decisions).

A number of points should be noted about this provision. Firstly, if the reservation of the power is exercisable for a limited period of time or until the happening of an event, subsection 75(2) should not apply as subsection 75(2)(b) refers to "during the existence of the person".[208]

Secondly, CRA has issued a number of interpretations relating to subsection 75(2)(b) and subparagraph 75(2)(a)(ii) which consider a number of scenarios where subsection 75(2) will apply where a certain amount of control is retained by the contributor acting as a trustee.

In early technical interpretations, CRA advised that subsection 75(2) will apply in the following circumstances:

(a) if the contributor is the sole trustee;[209]

(b) if the contributor is one of two trustees;[210]

(c) even if the contributor is one of three or more trustees;

(i) if the trust indenture provides for the unanimous consent of the trustees to make decisions;[211]

(ii) and even if the trust provides for decision-making by majority vote, if the contributor must form part of the majority or if in fact at any time there are only two trustees or the settlor retains veto rights.[212]

In later technical interpretations CRA appears to have reversed its earlier positions and has stated that subsection 75(2) "should not apply to a trust solely by virtue is the fact that the settlor is one of two or more trustees acting in their fiduciary capacity to decide issues" by majority or where standard terms of the trust require the decisions of the trustees to be unanimous.[213]

With respect to the situation where the settlor is the sole trustee, however, CRA has consistently maintained that it will apply subsection 75(2).[214]

Power to Appoint and Remove Trustees

The administrative position of CRA[215] is that where "the settlor/trustee has the power to appoint, remove or replace any trustee", "it is a question of fact whether the property held by the trust could only be disposed of with the consent of the settlor/trustee". Thus, where a settlor/contributor also desires to be a trustee, one must compare the risk of subsection 75(2) applying against the benefit of conferring such a power on the settlor.

Letter of Wishes

CRA has expressed the view that signed letters of wishes can be considered part of the trust document.[216] This is relevant in considering the possible application of subsection 75(2). It has been argued that the CRA position is not correct and that letters of wishes whether signed or not signed are only non-binding expressions of wishes and not to be recorded as part of the Trust document. They are just one of many factors to be taken into consideration in their decision making.[217]

Avoiding the Application of Subsection 75(2)

In order to avoid the possible application of subsection 75(2), the settlor or other contributor to the trust should not be a trustee or if the settlor or other contributor to the trust is to be a trustee, he or she should be able to be outvoted on every issue relating to the determination of which beneficiary will benefit and to what extent. The easiest way to ensure that this happens is to require a minimum of three trustees at all times with decision-making by majority. The trust indenture should not provide that the settlor/contributor must form part of the majority and should provide that, if at any time there are two trustees of whom the contributor/settlor is one, the trustees are constrained from making decisions concerning distribution to beneficiaries until a third trustee is appointed. Similarly, the settlor or transferor should not be given any right to veto distributions to beneficiaries.[218]

Subsection 107(4.1)

In many cases, it may be considered that subsection 75(2) will not pose any significant problem as the only property which is contributed to the trust is the settled amount, which may not generate income. For example, an *inter vivos* trust is often used in an estate freeze where common shares are acquired by the trust. The trust maybe settled with a coin where does not generate any income. In order to avoid the application of other attribution rules, the trust will acquire the common shares with funds borrowed from an arm’s length third party, usually a financial institution. Even though the application of subsection 75(2) in respect of the settlement amount may be insignificant, the greater concern is the possible application of subsection 107(4.1).

Generally, a distribution of capital out of a trust to a capital beneficiary in satisfaction of that beneficiary’s capital interest is effected on a tax-deferred rollover basis. Subsection 107(2) of the Act provides that where any property of a personal trust[219] has been distributed by the trust to a beneficiary in satisfaction of all or any part of the beneficiary’s capital interest in the trust, the trust will be deemed to have disposed of the property for proceeds of disposition equal to the cost amount of the property to the trust. As a result, the trust will not realize any income or capital gain on the distribution of the property.

There are several important situations in which property cannot be distributed by a personal trust to a beneficiary in satisfaction of the beneficiary’s capital interest in the trust on a rollover basis.

One such situation is the distribution of property which is capital property, resource property or land inventory by a spousal trust to a beneficiary other than the spouse while the spouse is alive (subsection 107(4)) of the Act.

Another situation in which a trust cannot distribute property on a tax-deferred basis to a beneficiary is found in subsection 107(5) of the Act. Pursuant to this subsection, where a trust distributes property other than Canadian real property, Canadian resource property, timber resource property, property used in a business carried on in Canada through a permanent establishment, including rights and shares of a non-resident investment corporation, to a non-resident beneficiary, the trust is deemed to have disposed of the property for proceeds of disposition equal to its fair market value at that time. The beneficiary will be deemed to have acquired the property at a cost equal to its fair market value and generally to have disposed of his or her interest in the trust for proceeds of disposition equal to the adjusted cost basis of that interest.

By far the harshest exception, however, is found in subsection 107(4.1) of the Act.

Subsection 107(4.1) provides that where subsection 75(2) is applicable at any time to any particular property of a trust, then the trust will not be able to distribute any property of the trust on a tax-deferred basis pursuant to subsection 107(2) to any beneficiary other than the person from whom the property or property substituted therefor was received (or the spouse or former spouse of that person) during the lifetime of that person. Instead subsection 107(2.1) will apply and the trust will be deemed to have disposed of the property and received proceeds of disposition equal to the fair market value of such property and the beneficiary will be deemed to have acquired the property at a cost equal to its fair market value. Generally, the beneficiary will not realize any capital gain in respect of the disposition of his or her capital interest in the trust.[220]

Subsection 107(4.1) appears to apply in respect of the distribution of any property of a trust and is not limited to the property over which a person has the control described in subsection 75(2). Accordingly, the section could lead to very harsh results. For example, if a settlor contributed $100 to a trust and reserved one or more of the powers described in subsection 75(2) or subsection 75(2) otherwise applied because the settlor was a trustee in circumstances described above, even if the balance of the assets of the trust were contributed by others or acquired with borrowed funds, subsection 107(4.1) would potentially apply to the distribution of every asset of the trust.[221]

Additionally, CRA has indicated that even after the condition which caused subsection 75(2) to apply has disappeared, subsection 107(4.1) may still apply.[222]

It is noted that there is no provision in subsection 107(4.1) as there is in subsection 75(2) that restricts the application of subsection 75(2) once the settlor ceases to be resident in Canada. Thus subsection 107(4.1) will continue to apply even after the emigration of the settlor.

As noted above, CRA has also taken the position that subsection 107(4.1) will apply even if the property to which subsection 75(2) applies has modest or nominal value with reference to the balance of the trust property and even if there may not have been attribution of income pursuant to subsection 75(2).[223]

CRA has also indicated that while it may be possible to avoid the application of subsection 75(2) by transferring property from a trust to which subsection 75(2) applied to a new "clean" trust to which subsection 75(2) does not apply, subsection 107(4.1) will continue to apply to the new trust.

In addition subsection 107(4.1) may have retroactive application in that it appears to apply to trusts which were in existence at the time subsection 107(4.1) was enacted in 1988. There has been some concession by the CRA with respect to the retroactive effects of the provisions but it is quite narrow.

In summary, the extremely negative outcome that will arise if subsection 75(2) and subsection 107(4.1) apply to a trust make it imperative that when the Distribution Option is being considered, it is critical for the trustees to review the history of the trust. Ultimately the trustees want to be able to conclude:

- is the settlor is alive, the settlor of the trust was never a trustee of the trust, or if s/he was they were one of three or more trustees acting by majority;[224]
- there is no other contributor of property to the trust. If so, then the same conclusions *vis a vis* the settlor must be reached in respect of such contributor;
- the settlor of the trust was never a beneficiary of the trust, or if s/he was, their rights were limited to being a beneficiary of the income of the trust;
- no trustee of the trust has ever contributed or lent property to the trust unless for fair market value consideration;
- no beneficiary has ever contributed or lent property to the trust unless for fair market value consideration;

- where a corporation is a beneficiary of the trust but the trust also owns shares of the corporation, the corporation has not paid dividends to the trust that are then paid back to the corporation *qua* beneficiary unless the corporation has been wound up.[225]

If, however, the settlor (or other transferor of property) is no longer alive then subsection 107(4.1) will no longer apply.

(v) Trustees Intend to Discriminate[226]

In the context of a discretionary trust where the trustees are granted "absolute" discretion when making capital (and income) distributions, the conclusion reached by any reader with some knowledge of common English language would assume that the trustees' actions are beyond question. Absolute means absolute – what could be broader. Unfortunately, notwithstanding the clarity to any reader other than a trust lawyer, this phrase (and similar phrases), takes on an entirely different meaning in the legal context. As will be seen from the discussion above under the heading "*When Will a Court Interfere with a Trustee's Exercise of an "Absolute" Discretion"*, absolute discretion does not mean beyond scrutiny.

(i) Given the ability of the courts to interfere even where a trustee's discretion is absolute, it is important as practitioners that we provide guidance to trustees, either in the trust instrument itself or during the administration of the trust, as to the manner in which their discretion should be exercised.

(ii) Regarding the constraints imposed upon the use of discretionary powers, while the law has articulated principles that are simple to state in the abstract, in practice it is difficult to determine with certainty how those principles will apply to a given set of facts. One cannot advise trustees and settlors that the use of the words "absolute" and "uncontrolled" will give the trustee total freedom to act. Similarly, the elastic nature of the concept of mala fides, means a trustee should not take total comfort in a decision simply because it was reached honestly. If the trustees do determine to discriminate among the beneficiaries of a trust as part of engaging in the Distribution Option, they would be well advised to minute their considerations and their reasoning. This process might ultimately lead to a conclusion that it is not appropriate to discriminate (or exclude a beneficiary). If, however, the trustees remain steadfast, their reasons for the unequal division should focus more so on family relations and harmony and the best interest of the trust assets, such as the family business and its future operations, and conversely less so or not at all on the reasons applicable to the particular beneficiary to be discriminated against.

(iii) It is important to have regard to when the concept of discrimination in the context of planning for the 21 Year Tax Rule arises. The obvious circumstance would be when the trustees intend to engage in the Distribution Option and intend to exclude a particular beneficiary, such as one child among a group of children. However, the concept of discrimination can also manifest itself in other planning.

(iv) Consider the situation of the trustees engaging in a refreeze of trust assets, with a distribution to the beneficiaries of the current trust of the frozen assets, coupled with the creation of a new discretionary trust to own the future growth in value of the trust assets. If the beneficiaries of the new discretionary trust exclude members of the beneficiaries of the current trust, for example, children are excluded from the new trust, the trustees ought to be concerned with the fiduciary implications of such a transaction.

(vi) Successive Beneficiaries

Where the trust involves beneficiaries with successive interest (i.e. a life interest to child, followed by remainder interest to their children), planning for the 21 Year Tax Rule becomes quite complicated. Essentially the strategies involve engaging in an actuarial valuation of the life interest and the remainder interest and a distribution of trust property to each of the life tenant and remainderman in satisfaction of their respective interests. A useful overview of the strategies and the issues they raise, is provided in Wolfe Goodman's article "Coping with Deemed Realization of Estates and Trusts".

(d) Indefeasible Vesting

Paragraph (g) of the definition of "trust" in subsection 108(1) provides that the 21 Year Tax Rule does not apply to a trust "all interests in which, at that time, have vested indefeasibly". The rationale for this exception is because the interest the beneficiary has in such a trust does not cease on death, such that it is subject to the rule in subsection 70(5) which provides for a deemed disposition of all capital property that a taxpayer then owns. As a result, distributing property to a trust that meets the parameters of an indefeasibly vested trust, will avoid the implications of the 21 Year Tax Rule.

In order to rely on this option, it is necessary to understand the meaning of "vested indefeasibly". The Act does not provide a definition.[227] As a result, we must rely upon the common law related to property interests to understand its meaning.

From a property law perspective, the concept of vested indefeasibly essentially means that the beneficiary who is entitled is in existence and ascertained and the beneficiary's interest in the trust cannot be subject to any condition or limitation, in whole or in part; there can be no condition precedent, condition subsequent or a determinable limitation. For example, there can be no condition that the beneficiary be alive at a particular date. Rather, the beneficiary has an entitlement to a portion of the trust property that is quantifiable at any given moment.

Interpretation Bulletin IT-449R "Meaning of Vested Indefeasibly" (September 25, 1987) offers some guidance on CRA's views on the meaning to be ascribed to this concept for purposes of the Act. The following is stated therein:

> *the term 'vested indefeasibly' refers to "the unassailable right to ownership…that, in consequence of death…has been transferred or distributed…to a spouse, spouse trust or child of the deceased…property vests indefeasibly…when such a person obtains a right to absolute ownership of that property in such a manner that such right cannot be defeated by any future event, even though that person may not be entitled to the immediate enjoyment of all the benefits arising from that right.*[228]

The Federal Court of Appeal considered the concept of "indefeasible vesting" in the decision of *The Queen v. Boger Estate*.[229] In particular the following criteria were noted:

> *He found that "to be vested 'indefeasibly' an interest must not be subject to a condition subsequent or a determinable limitation set out in the grant."…[T]he property interests here in issue are "unquestionably vested". He so concludes because: (a) there is no condition precedent to be fulfilled before the gift can take effect; and (b) the persons entitled (the children) are ascertained and ready to take possession forthwith, there being no prior interests in existence. Likewise, he held that the vested interest of the children is not defeasible since it is not subject to any condition subsequent contained in the will.*
>
> (emphasis added.)

Catherine Brown has written a comprehensive article entitled "Vested Indefeasibly: Its Importance for Tax Purposes."[230] She offers the following summary statement:

> *With these provisos in mind, the following may serve as a useful framework to determine whether an interest is "vested indefeasibly."*[231]
>
> - *The interest must be ascertainable. What is the interest?*
> - *The recipient must be identifiable or ascertainable.*[232] *Who is the beneficiary?*
> - *The interest must not be subject to a condition precedent (except for the expiry of a previous interest). Is the beneficiary's right dependent on a condition of acquisition (for example, successfully completing university)?*
> - *The interest must not be subject to a condition subsequent. Such an interest is usually created by the use of words such as "but if" and "provided that." Is a condition of retention attached to the gift that might cause it to be defeated (for example, "to Jeremy provided that he remains a tax resident of Canada")?*
> - *The interest must not be subject to a determinable limitation. Such an interest is usually created by the use of words such as "while," "during," "so long as," or "until." Does a limitation exist (for example, "to A so long as he maintains his primary residence in Canada")?*
> - *The interest must not be subject to partial divestment. This can occur if the gift is to a class of recipients, such as "my children at age 25." Is the wording of the gift such that others might share in the gift at a future time (for example, might more children be born into a class)?*
> - *The interest need not vest "in possession"; it may vest only "in interest." Does the interest provide either an immediate or a present subsisting future right to future enjoyment (for example, on the death of the life interest holder)?*
>
> *In summary, in order to vest indefeasibly, the gift must be transferred "with no strings attached" that would prevent the recipient from acquiring the gift either immediately or in the future, or defeat the gift once it has been made. Thus, if a gift is "to A for life, remainder to B absolutely," B's interest is vested indefeasibly. If B predeceases A, B's interest will vest in his estate. B's interest will also vest indefeasibly if the income and capital of a trust are to be held in trust for B and distributed when B reaches the age of 25. B's interest in this case is both vested and indefeasible, but subject to a postponement of enjoyment until B reaches the age of 25.*

Whether this planning option to address the 21 Year Tax Rule is available to the trustees will depend upon the following:

1. *Do the terms of the trust allow the trustees to vest all the interests in the trust indefeasibly in the beneficiaries? For this to be the case, the beneficiaries must be known with no potential for additional beneficiaries to be added. In particular, the class of beneficiaries must be closed. This is often not possible with a fully discretionary trust that is commonly established to own shares of a private company.*

2. *Do the terms of the trust permit a distribution to a trust established for the benefit of the individual beneficiaries? If so, are the terms of such a trust consistent with a vested indefeasible trust? Whether this is the case will depend upon the beneficiaries included within the class of capital beneficiaries. Alternatively, it may be the case that there is a provision in the trust document that pertains to minor beneficiaries. Often the provisions of such a clause meet the parameters of a vested indefeasible trust.*

3. *Are there any provisions in the trust that impose a restriction on a beneficiary's ability to dispose of his or her interest in the trust? Provisions of this nature are often referred to as "spendthrift" provisions. They are often included in a discretionary trust as a means to protect against creditor risks a beneficiary may face. Unfortunately if such provisions apply they will impact the ability to rely upon this option.*

As noted by Baxter: "Ideally the trust document will contain a clause allowing the trustees to convert a discretionary interest to a non-discretionary interest specifically assigned or fixed to a beneficiary on a chosen date."[233]

If the terms of a trust do not permit the trustees to rely upon this option, the trustees can consider amending the terms of the trust to allow for this option. The ability of the trustees to amend the terms of a trust are further discussed below under the heading "*Ability to Amend Trust Terms*".

The advantages and disadvantages of this strategy are similar to the Distribution Option discussed above but with some distinctions.

In terms of its advantage, provided the terms of the trust allow for a distribution to a vested indefeasible trust for the benefit of an Individual Beneficiary, this option, in theory, will allow the trustees the ability to continue to retain legal control of the trust property. While the trustees can be given the authority to control when a distribution from a vested indefeasible trust is to be made to the beneficiary, for example at an age beyond the age of majority, if the rule in *Saunders v. Vautier* applies, it will be open to the beneficiary to direct an earlier termination of the trust. This rule is discussed in greater detail under the heading "*Ability to Amend Trust Terms"*. At present Alberta and Nova Scotia are the only provinces to have legislated away the ability of a beneficiary to rely upon this decision.

Given the beneficiaries interest in a vested indefeasible trust is "vested", the beneficiary will, effectively, own the trust property. As a result, similar to the Distribution Option, the downside of this option is that the benefits of the trust relationship governing the trust property will no longer apply. For instance, the beneficiary's interest in the vested indefeasible trust will be subject to the creditor risks and personal circumstances and vagaries of the beneficiary's life. Where the beneficiary is a minor the considerations referred to under the heading "*Trustee Considerations Where Beneficiaries Include Minors*" must be borne in mind.

The other disadvantage is the potential for double tax applicable to the beneficiary who dies owning an interest in a vested indefeasible trust.[234]

Part VI - Process Trustees Should Follow When Considering Planning

The following is, by necessity, general in nature. The actions trustees ought to take when faced with the application of the 21 Year Tax Rule will depend upon (i) the terms of the particular trust, (ii) the personal and financial circumstances of the beneficiaries, (iii) the nature of the assets, their financial attributes and the overall liquidity available, and (iv) the time frame available to the trustees. As noted earlier in this paper, planning to address the 21 Year Tax Rule takes time to address. It is often both appropriate and necessary to consider the implications of the Rule several years in advance.

1. *Obtain Advice*

Once the trustees become aware of the pending application of the 21 Year Tax Rule, the first step they ought to take is to seek appropriate professional advice. Depending on the facts, this advice will involve expertise in a variety of disciplines including:

(i) tax advisor,

(ii) trust and family law,

(iii) tax and trust accounting, and

(iv) property valuation.

The first action the trustees ought to engage is to retain appropriate valuators in order to have a valuation of the trust property completed. The purpose of this exercise is for the trustees to determine the extent of the liability. While it is appropriate for the trustees to engage in a formal valuation, whether this is ultimately necessary will depend upon the planning ultimately implemented to address the 21 Year Tax Rule. If, for instance, the decision is to pay the tax liability that will arise or to engage in a "freeze" of the value of the trust assets, then the trustees will need to engage in a formal valuation. If, however, the strategy adopted is designed to ultimately distribute the trust assets to the beneficiaries then it may not be necessary for a formal valuation to be obtained. However, in this context it would be prudent to provide the beneficiaries to whom trust assets are distributed with this information.

Once aware of the extent of the liability the trustees ought to ensure they have information about all the current and potential beneficiaries of the trust. Ideally the trustees have had an ongoing interaction and dialogue with the beneficiaries over the term of the trust such that this process is simply to update the trustees of current circumstances. Regardless of whether the trustees have had an ongoing interaction with the beneficiaries, ultimately it is incumbent on the trustees to gather information pertaining to their (a) personal and family circumstances, such as their spousal status, age, details of any children, dependencies, educational background and prospects, and (b) details of their financial circumstances, such as educational background, employment status or prospects, personal net worth, financial needs, dependencies and other matters of a similar nature. The purpose of this information is to provide the trustees with a context within which they are to make decisions related to the trust assets.

Trustees ought to then work with tax, trust and family law advisors. On the side of trust law matters, the role of the trust law lawyer is to review the trust document with a view to providing the trustees with advice concerning:

(i) the settlor's purpose in establishing the trust, to the extent this can be gleaned from the trust document;

(ii) the nature and scope of the trustees' powers and discretions available;

(iii) any limitations imposed on the trustees;

(iv) preparing trustee resolutions to document the decisions taken by the trustees;

(v) advising the trustees on the risks pertaining to all potential planning strategies, together with an assessment of the advantages and disadvantages of each. Encompassed within this ought to be advice about appropriate actions to take to protect the trustees.

The role of the family law advisor is to ensure the trustees appreciate the family law consequences to the various strategies available to address the 21 Year Tax Rule. Each strategy will have its own potential implications. Depending on the nature of the trust assets, those implications may have greater or lesser import. It is necessary for trustees to have an understanding of those implications when considering the planning strategies.

The role of the tax advisor is to consider the various planning options that are available to the trustees to address the 21 Year Tax Rule. When doing so, it will be important for the tax advisors to work closely with the trust and family law advisors in weighing the benefits and risks associated with each of the available strategies. The best developed advice to trustees is that which has taken a multi-disciplinary approach when considering the available strategies.

At the end of this exercise the trustees will have worked with all of their advisors to carefully weigh all of the available strategies, ultimately choosing the solution they determine to be in the best interests of the beneficiaries.

2. *Trustee Resolution*

From a trust law perspective, the next step in the exercise is to document the decision reached. While documenting the reasons to support the decision reached by the trustees is not absolutely necessary, in the opinion of the authors it is a prudent course of action to follow. Any decision reached by the trustees will involve the exercise of one or more of the discretionary powers given to the trustees in the trust document. As a result, prior to exercising any power, the trustees should ensure they comply with the following due diligence and administrative process:

(a) The trustees must turn their mind to the exercise of the discretionary power and consider all of the circumstances that are relevant to the power being exercised;

(b) In the abstract, the trustees' starting point will ordinarily be to look for a broadly equal division among the beneficiaries. If the basic principle of equality is deliberately departed from, the trustees will ordinarily require cogent reasons for doing so;

(c) The execution by the trustees of written resolutions detailing such reasons, while unnecessary at law, would be prudent to forestall certain potential objections to the exercise of the discretionary power;

(d) The trustees should inform themselves of the situation of all the potential beneficiaries of the discretionary power. This may require obtaining information from the beneficiaries that is relevant to the exercise of the discretionary power; and

(e) Prior to exercising the discretionary power(s), the trustees should have complete information pertaining to the assets of the trust and the anticipated tax liability, as well as all necessary fiscal and other relevant professional advice pertaining to the foregoing issues.

Having gone through the foregoing due diligence process, an appropriate trustee resolution ought to be prepared. The overall goal to be achieved with the trustee resolution is to:

(i) identify the settlor's purpose in (i) establishing the trust, (ii) providing for the particular beneficiaries, and (iii) granting the particular discretionary powers to be relied upon by the trustees in addressing the 21 Year Tax Rule; and

(ii) identify the manner in which the proposed strategy to address the 21 Year Tax Rule furthers those purposes, or remains consistent with those purposes; and

(iii) outline the reasons supporting the trustees' decisions.

3. *Implementation*

Having reached a decision as to how to proceed, the next step is for the advisors to move forward with implementation of the chosen strategy. If either a court application or an advance tax ruling are required, implementation may involve significant time. As a result, sufficient lead time will be necessary to allow for implementation.

4. *Protect the Trustees*

It is trite to say that all strategies to address the 21 Year Tax Rule will have an element of risk to the trustees. As part of the advisory stage it will be important for the advisors to consider the risks and take appropriate steps to mitigate those risks. As noted earlier, reliance on the exculpatory clause in the trust document alone may not be sufficient. In certain circumstances it may be appropriate to obtain a release and indemnity from the beneficiaries. Consideration may also have to be given to whether a court approved passing of the trustees' accounts is warranted.

Part VII - Drafting Tips to Follow to Allow for Planning

Now that we have considered the various options available to address the 21 Year Tax Rule and the trust law considerations that trustees ought to have regard to when implementing the various options, as was noted above, whether certain of the options are available to trustees will depend upon the terms of the trust. With many trusts now facing their first 21st anniversary many advisors are facing trust documents that do not allow for one or more of the planning options to be implemented in a cost-effective or efficient manner. As a means to learn from the limitations that may exist in current trust documentation, we offer the following suggestions for drafting trust documents. By way of over-arching commentary, it is useful to draft a trust document with sufficient flexibility to allow for unforeseen circumstances (such as changes in laws) to be addressed. Below we offer our thoughts on drafting considerations. Ultimately, though, providing flexibility must have regard to the purposes to be achieved by establishing the trust relationship in respect of property.

1. *Include a Statement Expressing the Purpose of the Trust,*

2. *Include Provisions to Allow for Indefeasible Vesting,*

3. *Include a Capital Encroachment Power Together with a Discretion to Terminate,*

4. *Allow an Ability to Allocate Phantom Income and Expressly Refer to subsection 104(21) of the Act,*

5. *Consider Including a Power to Vary or Amend the Terms of the Trust,*

6. *Consider Including a Mandated Distribution on the 21st Anniversary,*

7. *Include Powers to Implement Corporate Re-Organizations,*

8. *Include Corporations and Trusts Within Class of Beneficiaries,*

9. *Ensure Discretionary Powers Allow for Distributions "to or for the benefit of",*

10. *Consider Including a Provision that Allows for "Laddered Freezes",*

11. *Include a Provision that Allows the Income Tax Consequences of Distributions to be Allocated to Beneficiaries, and*

12. *Include Appropriate Exculpatory Clauses.*

Conclusion

A trust is a very flexible vehicle. The use of a trust - either an inter vivos or a testamentary trust - can achieve a number of goals in an estate plan, both tax and non-tax. It is important, however, to be cognizant of the numerous income attribution rules and other income tax consequences such as the 21 Year Tax Rule at the time of drafting the trust. Ultimately, one should not let the "tax dog wag the tail" when considering the use of a trust as part of an estate plan. Rather, the use of a trust should fulfill other aspects or intentions of the client in his or her estate plan.

APPENDIX I

[1] M. Elena Hoffstein is a Partner at Fasken Martineau DuMoulin LLP practicing as part of the Trusts, Wills, Estates and Charities practice group.
[2] Corina S. Weigl is a Partner at Fasken Martineau DuMoulin LLP practicing as part of the Trusts, Wills, Estates and Charities practice group.
[3] The authors wish to acknowledge the assistance of Vanessa Mui, Student-at-Law, Fasken Martineau DuMoulin LLP with the preparation of certain parts of this paper; any errors are those of the authors. This paper is provided as an information service by Fasken Martineau DuMoulin LLP. It is current only as of the date of the paper and does not reflect subsequent changes in the law. This handout is distributed with the understanding that it does not constitute legal advice or establish a solicitor/client relationship by way of any information contained herein. The contents are intended for general information purposes only and under no circumstances can be relied upon for legal decision-making. Readers are advised to consult with a qualified lawyer and obtain a written opinion concerning the specifics of their particular situation.
[4] R.S.C. 1985, c. 1 (5th Supp.), as amended, and the reputation thereunder, hereinafter in this paper referred to as the “Act”. Unless otherwise noted, all statutory references in this paper are to the Act.
[5] The one exception to this is in the context of a bare trust where the trustee has no independent powers.
[6] It is important that the trustees appreciate the settlor’s intention for establishing the trust relationship. As will be seen below, those purposes ought to guide a trustee’s decision-making.
[7] The property governed by the trust relationship is often referred to as the *corpus* (or capital) of the trust. Where there is a bifurcation between those entitled to the income of the trust, and those entitled to the capital of the trust, the former are referred to as the life tenant(s) and the latter as the remaindermen.
[8] The foregoing comments must be tempered by the application of the “Kiddie Tax” under subsection 120.4. Notwithstanding, given there are trusts that predate the implementation of the Kiddie Tax in 1999, the foregoing may have been a settlor’s impetus in establishing a family trust.
[9] *Fraudulent Conveyance Act*, R.S.O. 1990, Chapter F.29.
[10] Subsection 67(l)(a) of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B.3, renamed by S.C. 1992, c.27 provides that the property of a bankrupt divisible among his creditors does not include property held by the bankrupt in trust for any person.
[11] In order to avoid having the trust settlement attacked under one or more of the statutes dealing with fraudulent conveyances, the trust settlement must be implemented when the individual is solvent and has no actual or potential creditors. Further, since claims by the bankrupt that properties are held in trust will be closely scrutinized by the court, it is vital that (i) all of the requirements for the validity of a trust are satisfied, (ii) the terms of the trust be documented, and (iii) the property be effectively transferred to the trustees.
[12] R.S.O. 1990, c.F.3.
[13] The caveat to be aware of is that very different results flow where a trust arrangement is established after a child’s marriage and one that is established before the child’s marriage. In the case of a post-marriage trust, it is possible that both the increase in value of the child’s interest in the trust (or of property received in substitution for such interest) and any income received by the child from the trust or from substituted property, may be completely excluded from equalization under the *Family Law Act*. Where, however, the trust arrangement pre-dates the child’s marriage, only the value at the date of marriage will be excluded from equalization. In this case a marriage contract is necessary to protect the increase in value during the child’s marriage of his or her beneficial interest in the trust, as well as in respect of any property distributed to the child.
[14] *Ontario Disability Support Program Act*, S.O. 1997, Chapter 25, Schedule B.
[15] S.O. 1998, c. 34. Subject to some exceptions, the tax is generally based upon (i) the gross value of all of the personal property of the deceased, wherever located, and (ii) of all real property located in the province. There is no deduction for personal debt, other than for mortgages on personally held real estate. If one asset of the estate governed by the Will requires probate, subject to a few exclusions, the value of the entire estate governed by that Will must be set out to determine the amount of the tax payable.
[16] M. Gillen, L. Smith & D.W.M. Waters, *Law of Trusts in Canada*, 3rd ed. (Toronto: Carswell, 2005) at 689 (hereinafter “Waters”).
[17] For purposes of this paper the concept of intentions can be equated to the settlor’s purposes in establishing the trust. As noted earlier, understanding those purposes will be important to the manner in which the trustees exercise their powers.
[18] For a detailed consideration of this topic, reference should be had to M. Elena Hoffstein and Rosanne Rocchi, “Trusts and Estates that Control Corporations”, 10th Annual LSUC Estates and Trusts Summit (April 16, 2012).

[19] One can exchange the word “absolute” with any word or phrase of a similar import, e.g. unfettered, without review, unconditional. The comments which follow apply equally regardless of the particular adjective chosen.

[20] It should be noted that courts have not restricted the application of this principle to trusts in which the trustee’s discretion is described as “absolute,” “uncontrolled,” “unfettered,” etc. The *Gisborne* rule has therefore been treated as a general rule that applies irrespective of whether the trustees’ discretion has been so characterized in the trust instrument. Maurice Cullity has described this phenomenon as follows: “The proposition that the governing principles are the same irrespective of whether a discretion is described as absolute or uncontrolled is borne out by the numerous cases in which the rule of non-intervention in the absence of mada fides has been applied to discretions which were not so described.” See Maurice Cullity, “Judicial Control of Trustees’ Discretions” (1975), 25 *University of Toronto Law Journa*l 99-119, at 113. See also Howard Carr and M. Elena Hoffstein, “Trusts — Powers, Amendments and Variations,” in *Special Lectures of the Law Society of Upper Canada*, 1996, at 135-71. See also Corina S. Weigl, "Keeping Fiduciaries Fit: The Exercise of Discretion", CBAO The Outer Limits: Exploring Issues and Opportunities in Agency, Attorney and Trusteeship (Toronto: CBAO, January 28, 1999) ; and Corina S. Weigl, "Absolute Discretion is Not Absolute: Reminding Clients about Fiduciary Obligations and Documenting Exercises of Discretion", LSUC The Six-Minute Estates Lawyer 2006 (Toronto: LSUC, March 22, 2006).

[21] In commenting upon the “uncontrollable” discretion that had been given to the trustees in *Gisborne v. Gisborne*, (1877), 2 App. Cas. 300 (HL), Lord Cairns held:

> *My Lords, larger words than those, it appears to me, it would be impossible to introduce into a will. The trustees are not merely to have discretion, but they are to have “uncontrollable,” that is, uncontrolled, “authority.” Their discretion and authority, always supposing that there is no mala fides with regard to its exercise, is to be without any check or control from any superior tribunal.*
>
> (emphasis added).

[22] The two most recent significant cases in Ontario demonstrate a trend to judicial deference when reviewing exercises of discretion by trustees of family trusts, even in situations where the exercise of the trustees’ discretion has had the effect of completely excluding a beneficiary from receipt of trust assets.

The first is *Martin v. Banting* – This decision involved an action against two trustees for the unequal distribution of the assets of two trust funds. The trustees were given broad discretion to distribute the trust assets among the beneficiaries, consisting of two brothers and their issue. The trustees determined to distribute all of the trust assets to only one brother after a careful consideration of the two brothers’ character and conduct. The excluded beneficiary argued that the trustees’ reasons were ludicrous, irrational and wrong, that they acted out of spite to break him, that the matters the trustees considered were all irrelevant and thus that the discretion that was exercised was mala fides. The court held that the trustees’ view that the plaintiff had a bad attitude, was ungrateful and lacked industry and loyalty to the family was not irrelevant given the unlimited discretion conferred upon the trustees in the trust deeds. The court held that the trust instruments provided no fetters to the trustees’ discretion and where “the discretion is not limited and no purpose or criteria are set out in the deed, what is a proper consideration for the exercise of the discretion would therefore appear to be unlimited subject to the residual jurisdiction of the Court to interfere where the trustee has acted with mala fides or for reasons which are contrary to public policy as in *Fox v. Fox Estate* (see endnote 26), where the trustee’s discretion was motivated by racial discrimination. There is no suggestion of that here.” The court also stated the view that even if the trustees had a motive of punishing the objecting beneficiary for his past behaviour, and such a motive was not a proper consideration in the exercise of a trustee’s discretion, “the presence of such a motive would not render unlawful or invalid the exercise of the trustee’s discretion where proper and relevant considerations existed to support the exercise of the discretion.” The court also saw fit to make the following pronouncement on the judicial review of exercises of discretion by trustees: “The trustees, in exercising their discretion do not do so in a quasi judicial capacity and the Court does not sit as a Court of Appeal upon the trustees’ reasons for exercising their discretion the way that they did. The trustees have no obligation to give reasons in the first instance, and where no mala fides is shown, the Court will not interfere. Here, where the evidence is uncontradicted that the trustees held opinions as to matters which are not irrelevant to the discretion given its scope under the terms of the trust, it matters not whether the opinions were objectively accurate.”

The second is *Edell v. Sitzer* (see endnote 42). The facts involved a husband, Paul Sitzer, who survived his spouse to become the sole trustee of trusts he and his wife established to hold valuable shares of the family businesses. The trust deed allowed for wide discretion to distribute the trust assets, with the trustee granted the discretionary power to terminate the trust or divide the trust assets among any one or more of the couple’s children to the exclusion of any others as they determined advisable or expedient. The Sitzers had two children, Jodi and Michael. Michael participated in the running of the family business; whereas Jodi had no business experience. Due to an acrimonious relationship between Jodi Sitzer and the rest of the family, Paul became concerned with the governance of the business should the shares be equally distributed. The trust capital was encroached upon before the distribution date and Paul gave all the shares to Michael. Jodi claimed the encroachment of the capital of the trust was not a bona fide exercise of the trustee's discretion and that the distribution was motivated by revenge. The court found that Paul's concern with the future of the family business was a relevant consideration. The wide discretion left to trustees in combination with Paul's position as the decision maker in the Sitzer family, indicated that the intention of settlors was to allow Paul to distribute the assets as he saw fit. Although the circumstances of the case suggested that Paul may have felt resentful towards his daughter, his real motivation was in preserving the assets of the trust. He had a duty to consider the interests of all of the proposed beneficiaries but, according to the court, this duty did not prevent him from exercising his discretion in such a manner so as to favour a single beneficiary, as was clearly contemplated in the language of the trust instrument. In the decision of Justice Cullity, some general comments are made regarding the judicial review of the exercise of trustee discretions, including the following: "Non-interference is still the general rule. The court is not to substitute an exercise of its discretion for that of the trustee; it is not exercising a *parens patriae* jurisdiction." The decision then goes on to explain how this standard of judicial review is applicable to the factual circumstances of the case: "The discretion was conferred on Paul and not on the court and it necessarily involves an exercise of personal judgment with which the court should not readily interfere. If, of course, the discretion was exercised on the basis of a belief that that no reasonable person could hold, it would be legitimate for the court to infer that extraneous matters – whether emotional or otherwise – must have influenced his judgment……on a question such as this, which involves an exercise of personal and business judgment by the person on whom the discretion was conferred, I believe the court should be slow to characterize Paul's conviction and concern as unwarranted or unreasonable and should certainly not do so where, as here, there is ample evidence on which such a conclusion might reasonably be based."

23 The following categorization is taken from Cullity, *supra* note 20, at 114-18. Cullity's lucid observations in this paper have been widely cited in both academic and judicial opinions. The reader is encouraged to refer to this paper for a more in-depth consideration of this issue.

24 In *Dunlop v. Ellis* (1917), 41 O.L.R. 303 (HC), Middleton J articulated this idea (at 307) as follows: "*Where there is, as here, a trust coupled with a discretionary power, the Court is entitled and bound to interfere where there is no attempt to exercise the discretion for the purpose for which it was given, but an attempt to accomplish a purpose quite alien from the intention of the testatrix, the author of the power.*"

25 Cullity, supra note 20, at 115-16.

26 *Fox v. Fox Estate*, 1996 CanLII 779 (ON CA), 28 O.R. (3d) 496.

27 This distinction is highlighted in the following excerpt from the judgment of Arnup JA in *Re Smith,* 1971 CanLII 577 (ON CA), at 543:

"This is not a case in which the trustee, having a discretion to retain or sell some or all of the Imperial Oil Ltd. shares, considered its respective obligations to the life tenant and the remaindermen and exercised its discretion by a decision not to sell. There is no evidence that the trustee put its mind to the question of what it should do to carry out those obligations."

28 See *Re Sayers and Philip* (1973), 38 D.L.R. (3d) 602 (Sask. CA) as per Cullity, *supra* note 20, at 118.

29 This section of the paper is drawn from M. Elena Hoffstein, "Beneficiaries' rights to trust information: Commentary in light of the Privy Council case of *Schmidt* v. *Rosewood*" in The Six-Minute Estates Lawyer, presented to the Law Society of Upper Canada (February 8, 2005).

30 Professor Hayton, "Developing the Obligation Characteristic of the Trust" 2001 LQR 94.

31 1996, 5 J. Int. Trustee and Corp Planning 3.

32 (2003) 2 W.L.R. 1442.

33 This discussion is relevant to planning for the 21 Year Tax Rule. The indifferent response to trustee clients that they need not worry about how they exercise their discretionary powers because the beneficiaries will never know of the trust or the trustee's decisions, can pose significant challenges. The corollary of the right of a beneficiary to information, is the duty of a trustee to disclose the existence of the trust to the beneficiaries. It is important for the advisor to appreciate that an indifferent concern for this duty can lead to challenges for the trustee.

34 (1920) AC 581 (H.L.).

35 (1965) 2 W.L.R. 229, (1964) 3 All E.R. 855 C.A.

36 *Schmidt*, *supra* note 32 at para 51.

37 *Schmidt*, *supra* note 32 at para 54.

38 *Schmidt*, *supra* note 32 at para 67.

39 LSUC, CLE programme, Fourth Annual Estates and Trusts Forum (Nov. 2001).

40 The *Schmidt* decision may find support in Ontario. In that regard it is interesting to note that in the *Re Ballard Estate* case, (1994) 119 D.L.R. (4th) 750, 20 O.R. (3d) 350, 6 E.T.R. (2a) 34 (Gen. Div.) in considering the *Re Londonderry Settlement* case, Mr. Justice Lederman suggests that the tension between trust disclosure and the need to preserve confidentiality of trustee deliberations is not static. Balancing of interests may call for a different result

depending on the circumstances. In that same case in considering the *O'Rourke* decision, Mr. Justice Lederman rejected the proprietary argument for determining the rights of beneficiaries to disclosure and found that the beneficiary was entitled to access the legal opinions between trustees and solicitors not because they had an ownership interest in these opinions, but because the beneficiary might have an interest in ensuring the administration of the trust was properly carried out and that interest may be compromised if the opinions were not disclosed.

[41] Memorandum issued by the Jersey law firm of Bedell Cristin in February 2004.

[42] (2004) CanLII 654 (ON CA).

[43] *Re Londonderry's Settlement* (1964), [1965] Ch 918 (CA).

[44] Waters (4th edition), supra note 16 at 1125.

[45] *Wells (Estate) v. The Society for Pastoral Counselling Research*, 2014 O.N.S.C. 347; *Pothos Leasing Ltd. v. Headon*, 2003 CanLII 25534 (ON SC); *Camosun College Faculty Assoc. v. College Pension Board*, 2004 BCSC 941; *Haydu v. Nagy*, 2012 B.C.S.C. 1870; *Kozicki Estate v. Kozicki Farms Ltd*., 2004 SKQB 125.

[46] (1994), 20 O.R. (3d) 350.

[47] *Ibid*.

[48] *Supra*, note 32.

[49] 2005 BCSC 207, 2005 CarswellBC 300.

[50] 2009 BCSC 1407, 2009 CarswellBC 2726.

[51] *Supra*, note 43.

[52] (1865) 62 E.R. 728.

[53] 2005 BCCA 112.

[54] *Talbot*, *supra*, note 52.

[55] *Supra*, note 26.

[56] Wills & Trusts, O'Brien's Encyclopedia of Forms. 11th Ed. div V (Toronto, Canada Law Book) form 37:30.

[57] A trustee is liable for both his or her own acts and his or her *omissions*. A trustee may therefore be liable for a breach of trust that was technically committed by his or her co-trustees if he or she merely stood by and allowed them to commit the breach of trust.

[58] Robert Whitman, "Exoneration Clauses in Wills and Trust Instruments" (1992), 4 *Hofstra Property Law Journal* 123, at 125.

[59] This clause was held by Dilks J, in *Crawford v. Jardine*, [1997] O.J. No. 5041, to relieve the trustees from the consequences that would normally flow from their disparate treatment of the income and capital beneficiaries.

[60] Maurice Cullity has made this observation in the following words "By making the decision of the trustee the sole condition of an exercise of the power, the draftsman has attempted to exclude the standards of equity to which the trustee would normally be expected to adhere." See Maurice Cullity, "Trustees' Duties, Powers and Discretions — Exercise of Discretionary Powers," in *Special Lectures of the Law Society of Upper Canada*, 1980 (Toronto: De Boo, 1980), 13-41 at 16.

[61] A.W. Scott and W.F. Fratcher, *The Law of Trusts*, 4th ed., Vol. III (Boston: Little, Brown & Co., 1988), at 388.

[62] Waters, *supra* note 16 at 756.

[63] R.S.O. 1990, C. 12, s.47(1).

[64] The Children's Lawyer is the provincial body designated to represent the interests of minors, unborn and unascertained beneficiaries of a trust (or estate).

[65] The other obvious risk is the ability of the minor to call for the trust property upon attaining age 18.

[66] (1841) 49 ER 282 (Rolls Ct.); aff'd. (1841), 41 ER 482 (Ch.D.).

[67] While the focus of our paper is on the law of Ontario, we note that certain provinces, such as Alberta, have abolished this rule. See subsection 42(2) of the *Trustee Act*, R.S.A. 2000 c. T-8.

[68] See Maria Elena Hoffstein, "Restructuring the Will and the Testamentary Trust: Methods, Underlying Legal Principles, and Tax Considerations" in "Personal Tax Planning," (2012), vol. 60, no.3 Canadian Tax Journal, 719-739. As well, see M. Cullity, "*Post Mortem Tax Planning: Renunciations, Disclaimers, Surrenders and Elections*" (1998), 18 E.T.P.J. 3.

[69] R.S.O. 1990, c. V.1.

[70] *Buschau v. Rogers Communications Inc.* (2004), 6 E.T.R. (3d) 236 (B.C.C.A.); *Sutherland v. Hudson Bay Co*., (2005), 17 E.T.R. (3d) 287 (Ont. S.C.J.); *Concentra Financial Services Assn. v. Blashill* (2005), 271 Sask. R. 65 (Q.B.). See also Bernadette R. Dietrich, "Variation of Trusts – A Update", *Trusts, Trustees, Trusteeships – All You Need to Know and More…* (Toronto, ON: Ontario Bar Association, Continuing Legal Education, 2006).

[71] See subsections 1(a)-(d) of section 1 of the *Variation of Trusts Act*.

[72] D.G. Fuller, "Modification and Termination of Trusts", in L.S.U.C. Special Lectures (Toronto: De Boo, 1980), at p. 137.

73 (1975), 66 D.L.R. (3d) 387, 11 O.R. (2d) 443, 1975 CarswellOnt 581.

74 *Irving Re*, *ibid* at 48 (CarswellOnt).

75 *Seale's Marriage Settlement (Re)*, [1961] 3 All E.R. 136, [1961] Ch. 574; *Weston's Settlements (Re)*, [1968] 3 All E.R. 338, [1969] 1 Ch. 223 (C.A.).

76 *Lafortune v Lafortune Estate* (1990), 37 E.T.R. 299, *Finnell v. Schumacher Estate (H.C.J.)*, 1988 CanLII 4653 (ON SC); 1990 CanLII 6766 (ON CA).

77 *Finnell*, *ibid.*

78 *Zekelman (Re)* (1971), 19 D.L.R (3d) 652, [1972] 3 O.R. 156 (H.C.J) at p. 158 O.R., where a trust was varied to permit children born after the trust was settled to be included as beneficiaries together with children named therein on the basis that this would promote harmony and avoid family friction.

79 W.A. McTavish and R.R. Anger, "Variation of Trusts: The Official Guardian's View" (1988-89), 9 E. & T. J. 132.

80 *Charlesworth Estate (Re)*, [1996] 5 W.W.R. 578, 12 E.T.R. (2d) 257, 108 Man. R. (2d) 228, where a will trust was varied to permit a beneficiary born after the testator's death, who was the brother and cousin of the other beneficiaries. While the other beneficiaries did not benefit financially, family well-being was enhanced; see also *Remnant's Settlement Trusts (Re)*, [1970] Ch. 560, [1970] 2 All E.R. 554.

81 For a discussion of the use of life insurance to provide such financial benefit in certain circumstances see McTavish and Anger, *supra* note 79 at p. 153 *et seq*.

82 [1976] 1 W.L.R. 915 (Ch. D.).

83 Under paragraphs 69(1)(b) and 106(2)(a).

84 (1980) 80 D.T.C. 6314 (F.C.T.D).

85 *Gartside v. Inland Revenue Commrs*., [1968] A.C. 553, at 617-18 (H.L.).

86 Jason Stephan "*Understanding and Dealing with the 21-Year Deemed Disposition Rules Affecting Certain Trusts*", 2008 Prairie Provinces Tax Conference, (Toronto: Canadian Tax Foundation, 2008), 14:1-35.

87 *Supra*, note 73.

88 See CRA document no. 9624583, 1997.

89 See CRA document no. 2000-0059795, November 9, 2001, where the CRA did not reach a conclusion on whether the variation would create a new trust, but provided a general view on the matter and noted that the beneficiary's tax consequences would depend on whether the transfer of rights to others resulted from a disclaimer, release, or surrender within the meaning of subsection 248(9).

90 The abolition of graduated rates for testamentary trusts (other than graduated rate estates) tabled in the 2014 Federal Budget would appear to make this latter point less relevant.

91 See subsection 104(5.8) of the *Income Tax Act*.

92 Defined in subsection 107.4(1). Section 107.4 was added to the Act by the 2001 technical bill (SC 2001, c. 17), effective for dispositions after December 23, 1998.

93 For a more detailed discussion , see M. Elena Hoffstein and Rosanne Rocchi, "Trusts and Estates that Control Corporations", 10th Annual LSUC Estates and Trusts Summit (April 16, 2012), from which this section of the paper is extracted.

94 Waters, *supra* note 16 at 966-7.

95 In applying the even-hand rule, it is necessary to bear in mind that "income" is defined differently under tax law than it is under trust law. Capital gains, for example, are defined as income under tax law but constitute capital under trust law. Similarly, stock dividends are defined as income under tax taw but capital under trust law.

96 *Josephs v. Josephs Estate* (1992), 7 O.R. (3d) 403 (Gen. Div.); aff'd. (1993), 15 O.R. (3d) 319 (CA). The example ignores allocating the burden of depreciation.

97 The form rule was promulgated by the Privy Council in *Hill v. Permanent Trustee Co. of New South Wales, Ltd*, [1930] A.C. 720.

98 The Privy Council did, however, indicate that the trust instrument would trump the form rule where it clearly defined the "respective rights of income and corpus in regard to moneys received by the trustee from limited companies, in respect of shares therein held by him as part of the trust estate." (Ibid., at 92.) This is discussed in greater detail below.

99 This is in stark contrast to the *Bouch v. Sproule* (1887), 12 App. Cas. 385 (HL) framework that *Hill* essentially replaced. Under the *Bouch v. Sproule* paradigm, corporate intention was the salient variable for determining whether corporate distributions should be characterized as income at capital in the hands of trustees. The form and substance of corporate distributions were employed under this earlier framework simply as proxies of corporate intention.

100 See for example *Allan's Trust*, [1985] M.J. No. 76, and *Sinclair v. Lee*, [1993] 3 W.L.R. 498 (Ch. D.).

101 Waters, *supra* note 16 at 1027.

102 *Ibid.*

[103] Waters describes this general rule, *supra* at 1030 as follows: *"Whether a benefit issuing from a corporation to its shareholders constitutes capital or income as between life tenants and remaindermen is exclusively for the courts to decide... The testator may not confer upon the trustees the power of characterizing the benefit."* (emphasis added), and see *Re Raven* [1915] 1 Ch. 673, *Re Bronson* [1958] 14 D.L.R. (2d) 51 (ONT HC), *Re Wynn Will Trusts* [1952] 1 Ch-27, and *Re Kent* (1982), 139 D.L.R. (3d) 318, at 321 (BC SC).

[104] 87 D.T.C. 504 (TCC).

[105] For further discussion of this issue see C. Weigl "Income or Capital? Who Would Know? Death and Taxes (Toronto: L.S.U.C., 1998).

[106] *Ibid* at 512.

[107] *Ibid* at 514.

[108] In particular, Tremblay TCJ held (*ibid* at 514): *"[The clause] cannot in substance be regarded as giving the executors the power to change an amount received as income into an amount received as capital or vice versa at their whim. They are only entitled to apply the appropriate accounting principles to determine the nature of an amount received and administer it accordingly."*

[109] *Butt v. Kelson*, [1952] 1 All E.R. 167 (C.A.), *Re Fleming* [1973] 3 O.R. 588 (H.C.) and *Re William George King Trust*, (1994) 113 D.L.R. (4th) 701 (One. Gen. Div.).

[110] Commentators on the law of trusts have also assumed that the duties imposed upon trustees carry over into their role as directors. Thus, it has been observed that it would be a breach of the duty to maintain an even-hand for a trustee acting in his capacity as a director to cause the underlying corporation to sell its capital assets and to then distribute all of the resultant proceeds to the income beneficiary via a cash dividend. See Wolfe Goodman, "Trusts that Control Corporations,"‘ in *Business Issues for Fiduciaries: Conflicting Duties and Discretions* (Toronto: Canadian Bar Association — Ontario, May 3, 1996), tab 2, at 4-5. See M. Elena Hoffstein and Rosanne Rocchi, *supra* note 18.

[111] For purposes of this discussion we are assuming the context of a settlor having transferred specific assets to an *inter vivos* or testamentary trust for successive beneficiaries. In this context, the settlor, by assigning specific property to the trust, has demonstrated an intention that those assets are to be enjoyed by the successive beneficiaries. The settlor does not, in this context, intend that the assets be converted. As a result, the principle of apportionment may be applied differently. In other contexts, for example a testator who directs that the residue of his estate be held in trust, this would not be the case as the testator will not necessarily know what assets will form the residue of the estate. Here, absent directions to the contrary, there will be an obligation to convert the assets so to create a fund of authorized investments. This is known as the first part of the rule in *Howe v. Dartmouth* (1802), 7 Ves. J. 137, 32 E.R. 56. The even-hand duty will, whenever there is a duty to convert, whether express or implied or imposed by *Howe v. Dartmouth*, then impose a duty to apportion receipts pending actual conversion, or the proceeds upon conversion. This is referred to as the second part of the rule in *Howe v. Dartmouth*. It also applies to all trusts of successive interests where there is a duty to convert.

[112] (1923) 54 O.L.R. 497.

[113] To assist the reader in understanding the application of the relevant principles, the focus of this discussion is on the context of trust property comprised of shares of a private company, where the beneficiaries entitled to income, being the life tenants, differ from those entitled to the capital as the remaindermen. For the years prior to the 21 Year Tax Rule, dividends have been paid on the shares thereby providing the life tenants with a stream of income sufficient to maintain their lifestyle. Notwithstanding the particular context, the general principles apply to the context of other property. It is to be noted that the relevant principles in this area, like much in trust law, were established many years ago. As a result the jurisprudence referred to may be considered antiquated. Notwithstanding its age, the principles established by the jurisprudence are still applied today. Finally, this area of the law is complex and may be impacted by the particular facts at issue. Ultimately the goal with the application of the principles is to ensure an impartial balance is achieved between the beneficiaries entitled in succession. The trustees must always have in mind their duty to maintain an even-hand.

[114] This general principle is subject to the terms of the trust document that may augment the manner in which financial burdens are to be allocated.

[115] Donovan Waters, *Law of Trusts in Canada* (Student Edition) 2nd ed. (Carswell: Toronto, 1984) at 845.

[116] It is to be noted that the majority of the law referred to is in the context of testamentary trusts (and estates). Notwithstanding, the principles apply equally to *inter vivos* trusts.

[117] See *Re Fleming*, [1973] 3 O.R. 588 (H.C.) [where an estate held shares in trust, the even-hand principle required the trustee/directors to apply the proceeds of the corporation's sale of a building to redeem preferred shares rather than pay dividends on common shares].

[118] Vol. 42, Settlements at para. 961.

[119] See *Re McDonald* (1919), 46 O.L.R. 358, 50 D.L.R. 658 (C.A.) [municipal taxes on dwelling occupied by life tenant]; *Re Jackson* (1977), 17 O.R. (2d) 318, 80 D.L.R. (3d) 275 (H.C.) [municipal taxes, fire insurance premiums, and repairs on dwelling occupied by life tenant]; *Waldie v. Denison* (1893), 24 O.R. 197 (Ch.—Boyd C.) [municipal taxes]; *Re Armstrong* (1904), 3 O.W.R. 627 (H.C.—Boyd C.) [municipal taxes and repairs]; *Biscoe v. Van Bearle* (1858), 6 Gr. 439 (U.C. Ch.—Spragge V.C.) [municipal taxes, based on principle that life tenant keeps down the interest on any mortgage, at p. 442]; *Re Cunningham* (1917), 12 O.W.N. 268 (H.C.) [municipal taxes, but not repairs or insurance premiums].

[120] In 1748, in *Revel v. Watkinson* (I Ves, Sen. 93, 27 E.R. 921) Lord Chancellor Hardwicke applied what was accepted as an established rule that the life tenant was obligated to apply rents and profits to keep down the interest on encumbrances on the estate.

[121] *Supra* note 118 at para. 966.

[122] 2 Bro. C.C. 128, 29 E.R. 75. The facts were as follows: Upon his marriage, Robert Tracy settled his estate to himself for life with a power to charge the estate, with various remainder interests to various persons. Various charges had been created after the estate had been settled. Later, Lady Hereford received two separate life interests from the estate upon the deaths of Anna Maria Tracy and, later, John Tracy Atkyns. At issue was whether the rents and profits from the second life interest were chargeable with arrears of interest that accrued on the charges to the estate during the first life interest because there had been insufficient rents and profits, or whether the remaindermen should be charged for the interest shortfall accumulated before Lady Hereford acquired the second life interest.
The appellant argued on two grounds: the intention of the testator, and the principle of apportionment as between persons claiming different interests in lands subject to charges. As to the former, the appellant argued that applying the profits from the second life interest (of which the appellant was not in physical possession) would completely deprive the life estate of any value, and it should not be presumed that the testator would have intended only the remaindermen to receive any value. As to the latter, the appellant argued that the accrued interest burden should be apportioned proportionally between the life interest and remaindermen. The appellant argued that the rule that the life tenant keep down the interest was a rule of convenience only as the medium by which to apply the more general rule of equity that a due proportion of the charge should be borne by every taker. The appellant argued that where the life tenant was not in possession and the interest arrears exceeded the rent, the interest arrears should be made into principal (chargeable to the remaindermen) and the life tenant apply rents and profits to the interest thereon.
The Lord Chancellor rejected these arguments without hearing submissions from the respondent. As to the argument of equitable apportionment, the court held that the allocation between life interest and remaindermen is subject to contingencies of the nature of the property without attempting to value such contingencies:
With respect to the latter ground, no rule has ever been laid down that two estates in the same land shall contribute in proportion to their respective values, in such a case as this: if there had, the Court would have marked it by valuing the estate for life, then valuing the reversion, and decreeing each to bear its proportion; but this has never been done but where the estate has ceased to have continuance by some act of the donor's; there the charge has rested on the reversion. A tenant for life without impeachment of waste cannot sell the timber growing on the estate, nor take the produce of mines unopened, both of which are the property of the person entitled to the inheritance; yet if the estate is sold to pay debts, the Court gives a life estate in the interest of the surplus money to the tenant for life, although the sum is increased by that which belonged to the inheritance, and would have yielded the tenant for life no profit; but, according to the argument, all that increased surplus ought to go to the remainderman in fee; so in cases where there have been contingencies which might increase the value of the tenant for life's estate, there is no instance where the Court has calculated the value of such contingency, in order to burden the estate of the tenant for life, further than keeping down the interest of the charge out of the annual rents and profits. It has only compelled the application of the rents year by year, to keep down the interest of the charge; and if this rule were departed from, it would be impossible to draw the line what proportion each part of the estate should pay.

[123] [1952] O.R. 282 (C.A.), affirmed [1953] 2 S.C.R. 1.

[124] See also, *Re Bronson* (1958), 14 D.L.R. (2d) 51 (H.C.); *Re Zive Estate* (1977), 23 N.S.R. (2d) 477 (T.D.) at 493-494.

[125] Lord Chancellor stated the following: *Then as a question of intention, I agree it is so; the testator considered it as a fund to be divided, and that each tenant for life should leave the estate to his successor in as good a condition as he found it; his intention was, therefore, to give it, subject to all reprises; all reprises must, therefore, be borne by each tenant for life. The counsel have put cases which might not occur to the testator. Cases often happen, where the rule must deprive the donee of everything. The argument supposes the testator meant to give to teach a certain benefit; but he did not give a certainty ,and he gave no certain term. Arguing in that manner is arguing wide of his intention. A man who gives a contingent estate, as a life interest in a reversion must be, gives that which may or may not be productive yet she might have made it certain by selling her interest; but as every contingency may or may not be productive, all she can take is the surplus after such charges as affect the contingency she is to take. The*

intention of the testator, therefore, will be fully satisfied by applying the common rules of the Court, that the taker of two funds, one productive, the other unproductive, must keep down the interest of the charges upon them and pay off the accrued interest out of the rents and profits of the reversion, before she can take any benefit of the devise, and cannot throw the charge on the reversion. By this decree she can never be injured, as, if the estate produces nothing, she never can be charged with anything.

[126] *Supra* note 118 at para. 972.

[127] In *Lord Penrhyn v. Hughes* ((1799), 5 Ves. June 99, 31 E.R. 492), the Court of Chancery accepted as settled law that the life tenant was responsible for interest on encumbrances against the trust corpus. The Master of the Rolls held that the authorities were clear that the life tenant's rents and profits were to be charged to keep down the interest on encumbrances, whether the interest arose before or after the life interest came into being. The court observed that a dissatisfied tenant for life might apply to have the assets sold. Similarly, in *Honywood v. Honywood*,((1902) 1 Ch. 347) the court held that the life interest must not only keep down the interest accruing during the life tenancy, but if current rents are insufficient, subsequent surplus rents must be applied to make up any arrears. Byrne J. held that this followed from the principle that the life tenant bears the interest and that where there are multiple properties, rent from one property is to be applied to satisfy arrears of interest accrued on another property.

[128] *Pemberton v. O'Neil* ((1851), 2Gr. 263 (U.C.Ch.)) a widow was to receive land from her late husband. She remarried and the land was settled to her as a life tenant and her new husband as remainderman; however, title was held by a third party pending satisfaction of payments that had been required to obtain the patent to the land. Creditors of the new husband sought to sell the land and apply the proceeds to satisfaction of debts. The court held that the life interest of the wife was paramount, subject however, to the encumbrance from the charge to acquire the patent, of which the wife must either keep down the interest or pay a proportionate share. The same principle—that the life tenant keeps down the interest—has been held to apply where the estate has had to borrow money to discharge an obligation: See *Gordon v. Gordon*((1907) 1 Ch. 30).

[129] (1872) L.R. 19 Eq. 69.

[130] [1933] O.W.N. 478.

[131] [1996] O.J. No. 1005 (Gen.Div.).

[132] *The Law of Trusts*, 4th ed., at 232, *Impartiality Between Successive Beneficiaries*.

[133] It is important to bear in mind that the payment of the tax liability due to the 21 Year Tax Rule increases the adjusted cost base of the property; this is a real economic benefit to the remainderman as it serves to reduce the tax payable on a future realization.

[134] (1804) 9 Ves, Jun. 554, 32 E.R. 718.

[135] *Ibid* at 560 (E.R. 720).

[136] [1999] B.C.J. No. 326 (S.C.).

[137] *Supra* note 136 at paragraphs 23-25.

[138] [1996] O.J. No. 1005 (Gen. Div.).

[139] [1987] 1 S.C.R. 32.

[140] One could also argue that it was done to facilitate the overall strategy of preferring the accumulation of capital gain at the expense of income production.

[141] 70 D.T.C. 6351 (Ex. Ct.—Jackett P).

[142] [1996] 1 S.C.R. 305.

[143] Darren Baxter, "*Trusts – The 21-Year Rule*", 2013 Atlantic Provinces Tax Conference, (Toronto: Canadian Tax Foundation, 2013), 4:1-20 (hereinafter referred to as "Baxter").

[144] Up until this time capital gains were not subject to tax under the Act.

[145] As noted above a trust is not a legal entity. Rather, it is a relationship which arises whenever a person called the trustee holds property, whether real or personal, for the benefit of other persons called the beneficiaries in such a way that the benefit of the property accrues to the beneficiaries of the trust. It is only for purposes of the Act where a trust is given the status of a person. See subsection 104(2) where a trust is deemed to be an individual in respect of trust property. This is necessary in order to ensure tax can be imposed as the trust earns income, recognizing that under the Act capitalized income can be distributed tax-free to the beneficiaries.

[146] Subject to the rule against perpetuities not being applicable to the trust.

[147] See discussion above under the heading "*When Will a Court Interfere with a Trustee's Exercise of an "Absolute" Discretion*".

[148] [1968] 1 All E.R. 121 at 134.

[149] [1982] 3 All E.R. 808.

[150] Canada Revenue Agency ("CRA") has recently stated that the value of an interest in a discretionary trust should be based upon an equal division of the trust property among the beneficiaries: see Technical Interpretation No.

2001-0111303 (November 27, 2002) and No. 2003-0181465 (April 3, 2003). In the authors' view this is due to a misunderstanding of the even-hand rule and a misapplication of a decision by the Ontario court in the family law context of *Sagl v. Sagl*, [1997] OJ No. 2837.

[151] Subsection 104(5) and (5.2) apply similarly to other forms of trust property. We note that there are other deemed disposition rules that apply to trusts. See, for example, subsection 104(4)(a)(iv) which ensures an alter ego trust recognizes gains on the death of the contributor of property and spousal trusts recognize gains on the death of the spouse.

[152] Wolfe D. Goodman provides a useful analysis of why the matter of when a trust is created is not so simple when dealing with testamentary trusts. See Wolfe D. Goodman, "Deemed Realization on the 21st Anniversary of a Trust", *Tax, Trusts and Estates: The Worlds Collide* (OBA, September 12, 2000) (hereinafter referred to as "Goodman").

[153] See subsection 104(5.8) of the Act.

[154] This is subject to the application of any rules that might advance the date.

[155] "Capital property" is defined in subsection 54(b) of the Act to include any property the gain or loss from the disposition of which is treated as a capital gain or loss. Subparagraph 39(1)(a)(iii) excludes gains or loss arising from the disposition of certain insurance policies. Therefore, a life insurance policy would not be considered to be a capital asset of a trust.

[156] Taxable Canadian property is defined in subsection 248(1) of the Act. The most common property caught by non-resident trusts is Canadian real property. To the extent a non-resident trust owns Canadian real property, regard must be had to the 21 Year Tax Rule.

[157] It is beyond the scope of this paper to consider the rules applicable to non-resident trusts in any further detail. Many excellent articles are available which consider these rules.

[158] The other exceptions provided for in subsection 108(1)(a) through (f) are in respect of trusts that are for a specific purpose being: unit trusts, segregated fund trusts, amateur athletic trusts, certain religious trusts, various employment related trusts, retirement compensation arrangement trusts, registered savings plans and TFSAs, trusts for cemetery care or eligible funeral arrangements. As Baxter notes though: "it is recommended that an apparently exempt trust be examined carefully as the CRA has applied these exemptions narrowly in previous interpretations. See Technical Interpretation 9813645 (November 30, 1998)." (see Baxter, *supra* note 143).

[159] In particular, they are not a beneficiary of the trust nor do they act as a trustee of the trust in a manner that could offend subsection 75(2).

[160] In the context of trust assets that involve a portfolio of marketable securities, a related strategy for the trustees to consider is to begin to prudently realize gains prior to the twenty-first anniversary. However, as this strategy is ultimately dependent upon the investment authority of the trustees, due regard to the applicable standard of care is required.

[161] These issues are discussed above.

[162] David Thompson, "*The 21-Year Rule*", Thorsteinssons LLP In-house CLE session October 12, 2010 (hereinafter referred to as "Thompson").

[163] Other anti-avoidance rules applicable to 21 Year Tax planning exist but are not discussed here. Readers are encouraged to review other articles on the topic of the 21 Year Tax Rule.

[164] See subsection 108(1) of the Act's meaning of "exempt property".

[165] This step may ultimately require the trustees to obtain a valuation of the trust assets. Depending upon the circumstances, where the trust assets are private company shares, this may pose a challenge. In particular, if the trustees are not in a position to control the company, their ability to obtain the relevant information in order for their advisors to prepare a valuation may be hindered. In our experience, this is not an issue that practically arises such that we do not discuss the challenges this may present to the trustees. We merely raise it here as it is an issue that, depending upon the circumstances, may exist.

[166] While the focus of this paper is on the context of the trust assets comprising shares of a private company, the comments may be particularly apt where the trust assets are comprised of a portfolio of marketable securities. Active trading leading up to the 21 Year Tax Rule, together with realized losses, unrealized loss carry forwards and any inherent losses, given the superficial loss rules in section 54 are expressly not applicable to losses realized on a deemed disposition, can mitigate the potential impact of the 21 Year Tax Rule to an acceptable level.

[167] The lifetime capital gains exemptions that may be applicable are those in respect of: "qualified small business corporation shares", "qualified farm property", "qualified fishing property" and "shares of the capital stock of a family fishing corporation". Where the trust owns a property that qualifies as a "principal residence", this exemption should also be considered. However, care ought to be taken with a trust claiming the exemption. This is because the Act will deem the exemption to have been used by all "specified beneficiaries" of the trust for the years claimed by the trust. The trustees ought to consider distributing the principal residence to one or more beneficiaries pursuant to subsection 107(2) and then relying upon subsection 40(7) in the beneficiaries' hands.

[168] It is beyond the scope of this paper to discuss the meaning of "qualified small business corporation shares". In this regard we note that it will be incumbent on the trustees to obtain advice in respect of whether the shares qualify. Further, as there are planning strategies that can be implemented to ensure shares meet this definition, it is important that the trustees give this consideration well in advance of the 21 Year Tax Rule. This is another reason for the trustees to establish a "tickler" of the 21 Year Tax Rule well in advance of its actual date.

[169] See Technical Interpretation 9504985 (March 5 1995), 9522330 (October 6, 1995) and 9428005 (February 28, 1995) where CRA takes the position that the terms of a trust must allow the allocation of phantom income.

[170] It is arguable the CRA's position is incorrect from a trust law perspective. Assuming the trust assets have increased in value such that there are accrued capital gains, within the meaning of the Act, that enhanced value is capital of the trust regardless of whether it has been realized, on a deemed or real basis. Accordingly, if the trustees determine to allocate a portion of the capital value pursuant to an encroachment power, in accordance with what is determined be a realized capital gain under the Act, whether deemed or real, the allocation ought to be acceptable from an income tax perspective.

[171] See subsection 104(6), (13) and (24).

[172] There are lifetime capital gains exemptions available to shelter the capital gain realized in respect of "qualified farm property", "qualified fishing property", "qualified small business corporation shares" or "shares of the capital stock of a family fishing corporation". In addition, if the assets include a "principal residence", the principal residence exemption may be available to shelter the income tax liability on such an asset.

[173] Other capital property, such as marketable securities or real property, will not benefit from this strategy.

[174] "Some Methods of Dealing with the 21-Year Deemed Disposition" (1999), 8 *Goodman on Estate Planning* 623-626.

[175] It may also be the case that a distribution of capital is authorized by a court order or relevant trust law. As these contexts occur relatively infrequently, our focus is on relying upon the terms of the trust document.

[176] The ownership of the distributed capital property on the death of the recipient beneficiary will result in the property being subject to a deemed disposition pursuant to the provisions of subsection 70(5) of the Act.

[177] The benefits of a trust as a form of property ownership are considered above under the heading "*Purposes of a Trust as Part of an Estate Plan*".

[178] Where the trust property includes private company shares, it is possible to address some of these concerns by the trustees first preparing a shareholder agreement and then imposing a condition on a recipient beneficiary who wishes to accept the distribution, to enter into the shareholders' agreement. However, such an agreement will only be able to offer safeguards of a certain nature.

[179] The concept of "necessity" may entail a number of considerations including a determination, from a review of the trust document, that it was the settlor's intention that the property be held beyond the 21st anniversary and s/he was aware of the implications of the 21 Year Tax Rule. This may be the case where, for instance, it is apparent that the settlor intended to benefit succeeding generations. Necessity may also entail a determination that protecting the ongoing value of the trust property requires the trust property to be within the control of trusted individuals who have an appreciation of the nature of the trust property.

[180] Where the trust property includes shares of a private company, there are a number of variations of the Distribution Option that can be implemented. These variations can be designed to allow the trustees to continue to control the company, either directly or indirectly, or to continue to control the ability of a beneficiary to realize upon the economic value. A useful summary of these variations can be found in Baxter, *supra* note 143 at pp. 11-12.

[181] See Technical Interpretation 9637535 (January 9, 1997).

[182] This raises complex issues about remedies that may be available. It is beyond the scope of this paper to address this issue.

[183] Wolfe D. Goodman, QC, "*Coping with Deemed Realization of Estates and Trusts*," Report of Proceedings of the Forty-Second Tax Conference, 1990 Conference Report (Toronto: Canadian Tax Foundation, 1991), 36:1-6.

[184] Where a non-resident beneficiary has an interest in a Canadian resident corporation, the implications of the income tax regime of the jurisdiction applicable to them personally, will need to be considered. For instance, a U.S. resident beneficiary may benefit from the corporation being structured as a "look through entity", such as a Nova Scotia unlimited liability corporation.

[185] Tim Youdan, *Planning to Deal with the 21-year Deemed Disposition Rule* at 10.

[186] Brown et al., *Taxation and Estate Planning*, 3rd ed. at 5.4.8(4).

[187] Subsection 75(2) of the Act provides as follows:

> *Where, by a trust created in any manner whatever since 1934, property is held on condition*
>
> *(a) that it or property substituted therefor may*
>
> *(i) revert to the person from whom the property or property for which it was substituted was directly or indirectly received (in this subsection referred to as "the person"), or*

(ii) pass to persons to be determined by the person at a time subsequent to the creation of the trust, or

(b) that, during the lifetime of the person, the property shall not be disposed of except with the person's consent or in accordance with the person's direction,

any income or loss from the property or from property substituted therefor, any taxable capital gain or allowable capital loss from the disposition of the property or of property substituted therefor, shall, during the lifetime of the person while the person is resident in Canada be deemed to be income or loss, as the case may be, or a taxable capital gain or allowable capital loss, as the case may be, of the person.

188 While drafting considerations are outside the scope of this paper, the implications of these two subsections applying to a trust make it critical when establishing a trust, to carefully determine the identity of the settlor, the trustees, the manner in which decisions are to be made by the trustees and the beneficiaries and their interests in the trust (income/capital).

189 In this section of the paper, the term contributor and settlor will be used interchangeably to refer to the person transferring property to the trust.

190 IT-369R para. 11 as amended by Special Release June 24, 1994. Brenda L. Crockett "*Subsection 75(2): The Spoiler*", Personal Tax Planning (2005) vol. 53 no. 3 CTJ 806-830 at p.806.

191 CRA Document Number 2002-0127085 (April 2, 2002); CRA Interpretation Bulletin IT 369R: Attribution of Trust Income to Settlor at para 10.

192 74.5(1), 74.1(1), (2) and 74.(2), and see Tax Window File #9332575 (January 27, 1994); CRA Document Number 2001-0114045 (July 11, 2002); CRA Document Number 2004-008694 (October 8, 2004); CRA Document Number 9601665 (August 26, 1996); CRA Document Number 9411115 (April 28, 1994); CRA Document Number 9203385 (January 26, 1992); CRA Document Number 2002-0168255 (June 10, 2002); CRA Document Number 2000-0012557 (July 17, 2000); CRA Document Number 2000-D1267A (February 2, 2003).

193 2012 F.C.A. 207.

194 Elena Hoffstein and Michelle Lee, *Revisiting the Attribution Rules*, Distributed at 2012 Ontario Tax Conference, October 29-30, 2012. This contains a comprehensive discussion of each of these questions and from which the 75(2) and 107(4.1) discussion is taken.

195 Black's Law Dictionary, Eighth Edition, (St. Paul, MN: West, a Thomson business, 2004).

196 In CRA Document Number 2002-0162855 dated April 25, 2003 the CRA was asked to consider a situation where a trust was established for the benefit of certain named individuals, and their present and future spouses and their issue. At the time the trust was settled the settlor was not within the class of beneficiaries but later became a discretionary beneficiary when he married one of the named beneficiaries. The word "may" in subsection 75(2)(a)(i) was relied on by CRA to conclude that even if there is a remote possibility the property can revert to a contributor, that is sufficient to invoke the application of subsection 75(2) even if the possibility did not exist at the time of establishment of the trust. See also CRA Document Number 2009-0352711E5 May 11, 2010; CRA Document Number G304585, May 17, 1993; CRA Document Number 2003-0050671E5, April 5, 2004.

197 Tax Window File #9332575, January 27, 1994; Tax Window File #9304585, May 17, 1993; 2003-0050671E5 April 5, 2004.

198 APFF 2004 Conference Round Table Question 26.

199 Annual Conference of the Canadian Tax Foundation, Toronto, November, 1991, Question 8, *Access to Canadian Income Tax*, para. C56-124. See also Question 46 at the 1986 Annual Conference where it was stated that the making or repayment of a loan does not constitute a reversion within the meaning of subsection 75(2) of the Act; and see IT-369R; and see CRA Document Numbers. 9224425 December 16, 1992 and 9212378 May 25, 1992. The CRA position also applies if lender is the Settlor or sole Trustee or both.

200 CRA has expressed its view on what it considers to be a genuine loan in paragraph 8 of Interpretation Bulletin IT-258R2 dealing with "Transfers of Property to a Spouse" and paragraph 3 of IT-260R entitled "Transfers of Property to a Minor". Generally speaking, CRA will accept a loan as "genuine" where there has been a written and signed acknowledgment of the loan by the borrower and an agreement to repay it within a reasonable time. Consequently, a promissory note or other such document should be executed by the trustees of the trust evidencing the indebtedness. However, as a result of *Howson v the Queen* (2007 D.T.C. 141 (TCC)) the CRA has changed its administrative position (CRA document number 2007-0240421 and see also CRA document number 2009-033025 October 9, 2009). The facts in this case are as follows. Mr. and Mrs. Howson immigrated to Canada and established an immigration trust to take advantage of the 60 month tax exemption. Mr. and Mrs. Howson and their

children were the beneficiaries of the trust. Mrs. Howson loaned funds to the trust. This loan was not documented initially other than in the financial statements of the trust. It was documented three years after it had been made. The loan document provided for repayment no later than ten years after it had been made. The loan was non-interest bearing. The court held that the loan was *bona fide* and confirmed loans are not subject to attribution under subsection 75(2) as a loan "returns to the lender by operation of the loan itself and the law of creditor rights" (p. 144).

[201] Elie Roth and Tim Youdan, "*Subsection 75(2): Is CRA's Interpretation Appropriate*" 2010 Conference Reports. Chapter 34:1 (hereafter "Roth-Youdan"). The authors disagree with other commentators (Robert Spenceley Reversionary Trust Review, The Estate Planner, December 2005 and Crockett CTJ 2005 vol 53 #3, 806-830) who suggest that the subsection might apply even if a number of years have passed between the two transfers - for example parent gifts property to child and a few years later, child settles the property on a trust of which parent is a contingent capital beneficiary. The Roth-Youdan paper contains an excellent analysis of the various elements of subsection 75(2) and critique of many of the positions taken by CRA. Portions of this section of this paper summarize some of their analysis.

[202] CRA Document Number 2002-0116535 (February 19, 2002); CRA Document Number 2003-0050671E5; CRA Document Number 2002-0162855 (April 25, 2003); CRA Document Number 2004-008695 (October 8, 2004).

[203] CRA Document Number 2002-0016535 (February 19, 2002).

[204] CRA Document Number 2002-0139205 (July 22, 2002).

[205] Roth-Youdan, *supra* note 201 at 34:20.

[206] CRA Document Number 9213965 (August 11, 1992) provides as follows: "When the person from whom the property was received by the trust cannot determine the identity of the beneficiaries but can only determine the quantum of the trust property to be distributed to the beneficiaries which have already been identified by the trust documents, we are of the opinion that subparagraph 75(2)(a)(ii) and paragraph 75(2)(b) of the Act may not be applicable. However, if the possibility to determine the quantum of the trust property is such that it results in the possibility to determine the beneficiaries to whom the property will pass, it is our view that subparagraph 75(2)(a)(i) and paragraph 75(2)(b) of the Act could apply. This situation may occur, among others, if the settlor retains the possibility to identify which property can be distributed to a beneficiary or if he retains the possibility to fix the quantum (for example, in allocating nothing to a beneficiary) so that he has retained the possibility to identify the beneficiary."; and see CRA Document Number 9202455 (February 27, 1992) but see CRA Document Number 58845 (November 16, 1989).

[207] See CRA Document Number 2001-0067955 which provides: "Where the beneficiaries under a trust are named in the trust indenture and cannot be modified (i.e., the person from whom the property was received by the trust cannot select additional beneficiaries after the creation of the trust), subparagraph 75(2)(a)(ii) is generally not considered applicable. This is true even though the person from whom the property was transferred to the trust may be able to determine the amount of the trust property that is to be distributed to beneficiaries already identified in the trust documents. However, subparagraph 75(2)(a)(ii) is worded broadly and there could be exceptions to this general position depending on the situation."

[208] See *No. 40 v M.N.R.* 52 DTZ 16 (T.A.B.).

[209] Tax Window File #9317655, February 27, 1992; 2001-0110425 June 10, 2002.

[210] Tax Window File #9213965, August 11, 1992; Tax Window File #9407905, June 6, 1994 but see 2000-0042505 and CRA Document Number 2001-0067955 whereby CRA noted "With respect to paragraph 75(2)(b), it is our view that the condition in paragraph 75(2)(b) might not be met in respect of property which is contributed to the trust by a person who is one of two or more co-trustees acting in a fiduciary capacity in administering the trust property where the property is subject to standard terms ordinarily found in trust indentures and there are no specific terms outlining how the trust property is to be dealt with. However, a determination of whether this condition is met in respect of any particular property can only be made on a case by case basis following a review of all the facts and circumstances surrounding a particular situation." And see 2003-0050671E5, April 5, 2004. Note that the comment does not appear to differentiate between co-trustees of a trust governed by majority vote.

[211] Tax Window File #9317655, December 17, 1993 but see 2000-0042505.

[212] Tax Window File #9407905, June 6, 1994. See also Tax Window File #9514275, August 21, 1995 for comments about the interplay between subsection 75(2) and 107(4.1); Tax Window File #9717815, November 19, 1997 CRA Document Number 0013055 (1999).

[213] CRA Document Number 2008 - 0292061 E5 (October 22, 2008); 2003-0050671 ES, 1999-0013085 (August 1, 2002), 1999-0013055 (June 20, 2002). CRA Document Number 1999-0013085 (August 1, 2002). CRA Document Number 1999-0013085 (August 1, 2002). CRA seems to distinguish between the situation where the settlor is acting in a personal capacity, and the situation where the settlor is acting in a fiduciary capacity under "standard terms of trust". In the case of the settlor acting in a fiduciary capacity it would appear that subsection 75(2) may not apply. However the CRA indicates that subsection 75(2) will apply if the settlor is acting in a personal capacity where, for example, the trustees may not exercise the discretion permitted to them under the terms of the trust unless the settlor concurs with their decision or if the trust provides for majority decisions of the trustees so long as the settlor-trustee must form part of the majority.

[214] 2008-0292061 ES (October 27, 2008); 1999 - 0013085 (August 1, 2002).

[215] Tax Window File #9407905, June 6, 1994.

[216] CRA Document Number 2000-0023997, November 3, 2000.

[217] Roth-Youdan, *supra* note 201.

[218] Tax Window File #9514275, August 21, 1995; Tax Window Files #9213965, August 11, 1992; #9514275, August 21, 1995; #9717815, November 19, 1997.

[219] A personal trust is defined in subsection 248(1) to mean a testamentary or an *inter vivos* trust in which no beneficial interest in the trust was acquired for consideration payable to the trust or to any person who has made a contribution of property to the trust.

[220] Subsections 107(4.1) and 107(2.1) of the Act.

[221] CRA Document Number 1999-0013085 (August 1, 2002); CRA Document Number 2001-0110425 (June 20, 2002); CRA Document Number 9610435 (August 13, 1996).

[222] CRA Document Number 9207365 (July 22, 1992).

[223] CRA Document Number 2005-0018181ES (November 17, 2005).

[224] The same would apply to any contributor of property to the trust.

[225] From a drafting perspective, the corporation that is owned by the trust ought to be excluded from the class of beneficiaries.

[226] For a useful discussion of the trustee considerations in the context of a plan to exclude a beneficiary in the context of a refreeze transaction see STEP Canada, David Louis, Moderator, *Estate Freeze From Hell* (June 7, 2004).

[227] Subsection 248(9.2) provides a statement as to when property is considered not to vest indefeasibly. As a result, it is not a complete definition. In addition, it is principally relevant to determining whether the rollover provisions in various sections of the Act have been fulfilled. A review of the provision reveals that it does not offer assistance in understanding the meaning of "vested indefeasibly" for purposes of subsection 108(1)(g).

[228] See also the following Views documents: 2002-0165635, 2006-0193111I7, 2007-0235171E5, 2007-0251591E5, 2010-0378451E5, 2011-0391911E5.

[229] [1993] DTC 5276 (F.C.A.) at 5281.

[230] (2006) 54(4) CTJ at 968-991.

[231] See Véronique Denys, "Indefeasibly Vested," in *The Harmonization of Federal Legislation with Quebec Civil Law and Canadian Biguralism: Second Collection of Studies* (Ottawa: Department of Justice, 2005), 4:1-188, at 4:34

[232] The first requirement of ascertainability was explained in *Leigh's Settlement Trusts, In re*, [1938] Ch. 39 (CA), which followed the decision in *Whitby v. Von Luedecke*, [1906] 1 Ch. 783 (Ch. D.). In *Leigh's Settlement Trusts*, the testator was granted a special power of appointment and named his two grandchildren as the income beneficiaries of his estate for their joint lives, with the remainder (the life interest in the whole income) to the survivor. Even though the survivor necessarily had to be one of the siblings, since it could not be ascertained which one it would be, the remainder was contingent.

[233] *Supra* note 143 at 12.

[234] *Ibid*; and see Jason Stephan "*Understanding and Dealing with the 21-Year Deemed Disposition Rules Affecting Certain Trusts*", 2008 Prairie Provinces Tax Conference, (Toronto: Canadian Tax Foundation, 2008), 14:1-35 at 9.