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POWERS TO ADD AND REMOVE TRUST BENEFICIARIES - INCOME TAX CONSIDERATIONS - PART III

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Paragraph 248(25)(b) - PARBs and Non-Arm's Length Persons

As mentioned previously, even if paragraph 248(25)(a) of the Income Tax Act¹ ("the Act") should not be applicable to cause discretionary beneficiaries or persons who can become beneficiaries upon the exercise of certain discretionary powers to be beneficially interested in a trust, in appropriate circumstances paragraph 248(25)(b) may well apply to such persons. In this regard, paragraph 248(25)(b) will only be applicable if the person does not otherwise have a beneficial interest in the trust (i.e., paragraph 248(25)(a) is not applicable), the person's ability to become beneficially interested in the trust is subject to terms in the agreement or other arrangements that involve the exercise of any discretion, and the property was acquired from the person, another person with whom the person does not deal at arm's length, or a controlled foreign affiliate of the person or of another person with whom the beneficiary does not deal at arm's length.

Although under this interpretation certain persons whose rights to become a beneficiary of a trust are themselves subject to the exercise of discretion under powers to add and remove beneficiaries ("PARBs") or otherwise will be considered to be beneficially interested in a trust, the potential scope of application of subsection 248(25) will be limited only to persons who do not deal at arm's length with a person who has made a contribution to the trust. In our view, this constitutes a reasonable limitation.

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¹ R.S.C. 1985, c 1 (5th Supp.).

Application of the Act where Persons are Beneficially Interested

If it is determined that a person has a beneficial interest in a trust, it then becomes necessary to consider the provisions in the Act that may be impacted by a person being "beneficially interested" in the trust within the meaning of subsection 248(25).

Affiliated Person Rules

Because the term "beneficiary" is specifically defined in subsection 251.1(3) of the affiliated person rules to include persons who are beneficially interested in a trust, a PARB could result in a broader group of persons who may be affiliated with a trust than one might otherwise have anticipated. Although in practice the application of the affiliated person rules between a trust and its "beneficiaries" may arise infrequently, this is an issue that should be kept in mind in undertaking trust and estate planning.²

Non-Arm's Length Rules

Assuming that paragraph 248(25)(a) is not applicable and that only paragraph 248(25)(b) applies, a PARB generally should not overly expand the class of persons who would be considered not to deal at arm's length with a trust under paragraph 251(1)(b). This is because the determination of whether a taxpayer and a person beneficially interested in a trust are non-arm's length is to be made without taking into account subclauses 248(25)(b)(iii)(A)(IIHIV).³ Consequently, it should be unlikely that other provisions in the Act that rely on non-arm's length relationships would be impacted by a trust that includes a PARB.

As the non-arm's length definition does not contain restrictions for persons with beneficial interests in trusts pursuant to paragraph 248(25)(a), the application of a broad interpretation of the provision could result in unintended, and potentially adverse, tax consequences if the obiter

² Some other provisions that employ the beneficially interested phrase include: para. 54(c.1), which requires that every person who is beneficially interested in a trust be listed where the principal residence exemption is claimed by a trust; and s 191(2) and (3), which deal with the substantial interest exception in the context of Part VI.1 tax.

³ Subclause 248(25)(b)(iii)(A)(IV) deals with controlled foreign affiliates.

comments made by the courts in *Propep*⁴ and *Lyrtech*⁵ with respect to the scope of the provision were cited with approval and followed in future judicial decisions.

Paragraph 55(3)(a) Exception

If the beneficially interested concept is applicable for purposes of subsection 55(2), it would appear that PARB provisions in trusts could cause those trusts to be unable to avail themselves of the exception to that provision which might otherwise be available under paragraph 55(3)(a). The reason for this is that only trusts that meet the restricted related persons provisions in paragraph 55(5)(e)⁶ qualify for this exception. The CRA has indicated that it "feel[s] that the right described in subparagraph 55(5)(e)(ii) L.T.A. and paragraph 248(25)(a) L.T.A. are fairly similar".⁷ Nonetheless, the CRA's administrative position is that "the concept of a 'person beneficially interested' is irrelevant for the purposes of subparagraph 55(5)(e)(ii)".⁸ While the CRA has not expressly extended its views regarding subparagraph 55(5)(e)(ii) to situations to which paragraph 248(25)(b) applies, there does not seem to us to be any compelling reason why the CRA's current administrative position should not be applicable in this context as well.

Case-Law - Overextension of the Term "Beneficially Interested"?

Advisors have generally taken the position that, even where a specific provision in the Act utilizes the term beneficiary or otherwise deals with trust interests, unless it contains the words "beneficially interested", subsection 248(25) should not be applicable. The correctness of this position is supported by a number of CRA rulings, such as those confirming that a person who was merely beneficially

⁴ *Propep Inc. v R.*, 2009 D.T.C. 5170 (Fr.), 2010 D.T.C. 5088 (Eng.) (F.C.A.), leave to appeal refused 2010 CarswellNat 506 (S.C.C.).

⁵ *Lyrtech RD inc. v R.*, 2013 D.T.C. 1054 (Fr.), 2013 D.T.C. 1147 (Eng.) (T.C.C. [General Procedure]), affirmed 2014 CarswellNat 4604 (F.C.A.).

⁶ Generally, trusts where the only beneficiaries are the lineal descendants of an individual and/or registered charities, which is quite typical in many traditional family trust situations.

⁷ See CRA document number 2004-0086961C6, dated October 8, 2004.

⁸ *Ibid.*

interested in a trust would not be subject to the association rules in section 256 if they were not a beneficiary under the trust.⁹ Unfortunately, due to the comments made in obiter in the Propep and Lyrttech decisions, a broader scope for the application of the term beneficially interested in the Act may be emerging. In our view, this extended interpretation of the position is not supported by the language of subsection 248(25) of the Act or by a purposive analysis of the statute, and there is no jurisprudential precedent for an interpretation that extends the application of the beneficially interested concept in this manner.

Case Summary - Propep

The Propep case¹⁰ involved the reassessment of the taxpayer, Propep Inc., on the basis that it and certain other corporations were associated and would need to share a single small business deduction limit, based on a combination of the application of the provisions in paragraph 256(l)(c), subparagraph 256(1.2)(f)(ii) and subsection 256(1.3).

The facts of Propep involved a trust deed formed under the laws of the Province of Quebec, which was designed so that it had a

1. "first ranking" numbered company beneficiary ("9059"), of which it was the sole shareholder, which was entitled to all income and capital of the trust until 9059 was wound-up; and
2. "second-ranking beneficiary", the minor child/grandchild of the controlling shareholder(s) of Propep Inc., whose rights to benefit under the trust were subject to a "suspensive condition" (i.e., the wind-up of 9059).

At the Tax Court of Canada level, it was determined that the minor was not a beneficiary of the trust and as a result the association rules were inapplicable.

The Federal Court of Appeal took a different approach to the nature of the minor's rights and ultimately concluded that that Propep Inc. and the other corporations were associated with each other. In particular, Noel J.A., writing for the court, indicated that since 9059

⁹ See CRA document number 2008-0285041C6, dated October 10, 2008.

¹⁰ *Propep Inc. v. R.*, supra note 4.

could be wound up at the discretion of the trustees, the minor should have been considered to be a beneficiary of the trust. The logic for this conclusion relied on an analysis of the application of the "income interest" definition in subsection 108(1) that has been subject to significant criticism.¹¹

Although this finding, whether or not it was correct, would have been entirely sufficient to fully dispose of the matter, Noel J.A. went on to review whether the minor was beneficially interested in the trust and then provided his views of the impact of such an affirmative finding in respect of the association rules, even though those provisions do not contain the phrase "beneficially interested".

In this regard, Noel J.A. stated that:¹²

With respect, the expression "beneficially interested" does not have to be reproduced in each provision where it is likely to be applied. This concept applies each time the question arises whether a person is "beneficially interested" in a particular trust. A person who has a contingent right to the capital or income of a trust is "beneficially interested" for the purposes of the Act.

In the first instance, Noel J.A. seems to have concluded that the minor's "right, 'whether absolute or contingent', to receive income or capital of a trust" made him beneficially interested in the trust pursuant to paragraph 248(25)(a). This conclusion is surprising, both because it was entirely unnecessary on the facts at issue for the court to consider the beneficially interested definition at all, and also because it would in any event have been possible for the Federal Court of Appeal to have based its conclusion solely on paragraph 248(25)(b), without having had to resort to such a broad interpretation of paragraph 248(25)(a).

For the reasons discussed previously in this paper, interpreting paragraph 248(25)(a) of the Act broadly so as

¹¹ For example, see Philip Friedlan, "Propep Inc.: Association via a Trust Beneficiary" (2010), 10 *Tax for the Owner Manager* 3, pp. 3-4; Kate Harris, "ITA 256(1.2)(f)(ii) - Who is a Beneficiary?," 2010 *Atlantic Provinces Tax Conference* (Halifax, Canadian Tax Foundation, 2010), 4C:1-8; and Jack Bernstein, "Association Through a Trust: When is a Person a Beneficiary?" (March 2010), *Tax Profile*, no. 3.

¹² At para. 24.

to have general application in this manner could give rise to perverse and unintended consequences and to significant uncertainty in the application of other provisions of the Act. It also has the effect of rendering paragraph 248(25)(b) of extremely limited consequence. It is hoped that future decisions will cast doubt on the correctness of Noel J.A.'s comments in obiter, and instead focus on the potential application of paragraph 248(25)(b) in this context.

In our view, the court's comments on the potential application of the phrase "beneficially interested" to provisions in the Act, such as the association rules, which do not contain this language should be viewed as incorrect. They run counter to fundamental principles of statutory interpretation, and in this regard are deficient in that they fail to impose definitive outside boundaries to the potential application of subsection 248(25) of the Act. These comments, if ultimately followed by a court required to interpret and apply the provision to the facts of a case properly before it, would create considerable uncertainty in the estate planning context for taxpayers and their advisors.

Case Summary-Lyrttech

For purposes of this paper, Lyrttech¹³ is primarily of interest as a consequence of the Tax Court's comments in obiter concerning the interpretation of the term "beneficially interested" as that term is used in paragraph 248(25)(a) of the Act.

Lyrttech involved a corporate restructuring that was intended to enable Lyrttech Inc., an otherwise publicly controlled entity that carried on significant SR&ED activities, to claim the refundable tax credits available to a Canadian controlled private corporation ("CCPC").¹⁴ The restructuring involved the transfer of Lyrttech Inc.'s SR&ED activities to a new corporation, the appellant, Lyrttech RD Inc. The shares of the appellant were owned by a newly formed trust, which had been structured with the intention of enabling the appellant to qualify as a Canadian-controlled private corporation ("CCPC").

¹³ *Lyrttech RD Inc. v. R.*, supra note 5.

¹⁴ As that term is defined in s. 125(7).

The Minister of National Revenue (the "Minister") argued that the restructuring had not achieved its objective because Lyrtch Inc. continued to have de facto control over the appellant or, in the alternative, because the corporate beneficiaries of the trust, which were in turn controlled by Lyrtch, had "indirect de jure control of the appellant pursuant to subparagraph 251(1)(5)(b)(i) and subsection 248(25)" of the Act.

After an analysis of the facts, Favreau J. concluded that Lyrtch Inc. had de facto control of the appellant¹⁵ and, as a result, the appellant was not a CCPC eligible for refundable tax credits.

Although these findings were sufficient to fully dispose of the matter, Favreau J. went on to consider the Minister's alternative argument, which would be successful if the Minister could successfully establish that:

1. The corporate beneficiaries were beneficially interested in the trust for purposes of subsection 248(25); and
2. their beneficial interests in the trust constituted the type of right contemplated by paragraph 251(5)(b).

Regarding the first of these points, Favreau J. described how the trust had been specifically designed so that "persons designated as Beneficiaries are merely potential beneficiaries of the trust and that until they have received some part of the revenue or capital of the trust, they have no right, either pursuant to a statute or under the trust deed, as beneficiaries of the trust."¹⁶ He went on to comment that this drafting was "intended precisely to avoid the application of subsection 248(25)".¹⁷

He then reviewed a number of articles concerning subsection 248(25), including M. Fortin's article discussed in detail earlier in this paper. In Favreau J.'s summary of the "inescapable" conclusions from this article, he noted among other things that:¹⁸

... despite the legal nature of a beneficiary's rights under a discretionary trust, the wording of a statutory provision may be very broad so as to include the personal right of a beneficiary under a discretionary trust.

Following his review of the Literature, Favreau J. stated that subsection 248(25) was indeed broad enough to include the "precarious nature of the right of the beneficiaries" of the trust in Lyrtch.¹⁹

In coming to this conclusion, he cited with approval the Federal Court of Appeal's reasons for judgment in Propep²⁰ and then restated the Minister's view that:²¹

[A] "conditional right" is broad enough to include cases where a discretionary power must be exercised in order for a fact to arise.

It is unclear whether Favreau J.'s conclusion was ultimately based on paragraph 248(25)(a) or (b). If the latter, his conclusion would appear to be consistent with the approach described previously in this paper and might be of assistance in moving away from the problematic interpretation of the "beneficially interested" phrase adopted by the court in obiter in Propep.

Having concluded that the corporate beneficiaries were beneficially interested in the trust, Favreau J. noted that, as was the case in Propep with respect to the association rules in section 256, paragraph 251(5)(b) does not refer to the expression "beneficially interested". Nonetheless, he quoted from Noel J.'s decision in Propep and relied on his comments that the beneficially interested expression "does not have to be reproduced in each provision where it is likely to be applied".²²

This left Favreau J. with the task of determining whether such a beneficial interest would be a right within the contemplation of paragraph 251(5)(b). In this regard, he concluded that this could not be the case because the subsection 248(25) rights did not confer rights on the corporate beneficiaries to acquire shares in the appellant and because such rights were, in his opinion, "far too broad in scope and much too vague" to

¹⁹ Lyrtch RD inc. v R, supra note 5, at para. 46.
²⁰ At para. 47 of the decision: Propep Inc. v R, supra note 4.

²¹ Lyrtch RD inc. v R, supra note 5, at para. 48.

²² Lyrtch RD inc. v R, supra note 5, at para. 24.

be applicable in the context of paragraph 251(5)(b).²³

Although Favreau J.'s disposition of the Minister's alternative position was ultimately decided in favour of the taxpayer, his apparent willingness to follow the court's comments in Propep, and particularly his reference to Noel J.'s views expressed in obiter that the term beneficially interested can effectively be read into other provisions of the Act, is particularly troubling for the reasons described in detail above.

Concluding comments

There is no question that in appropriate circumstances the inclusion of PARBs in family trusts may be beneficial. The court's comments in each of Propep and Lyrtch were made in obiter, and for the reasons described above the views expressed in the reasons for judgment in those cases appear to be unsupported by the relevant statutory language or judicial precedent. Nonetheless, if this judicial commentary, limited though it may be, were ultimately to be followed by a court that is required to interpret the "beneficially interested" definition in paragraph 248(25)(a) on the facts before it, the inclusion of PARBs in trust documents could give rise to unintended tax consequences or risks. Fortunately, because modern family trusts can often be drafted with corporate, trust and bail-out²⁴ beneficiaries, it should in most cases be possible to draft settlements with the required flexibility while mitigating any risk that the Canada Revenue Agency or Canadian tax courts will ultimately determine to uphold or affirm the comments made in obiter in the Propep and Lyrtch cases.

²³ Lyrtch RD inc. v R, supra note 5, at paras. 55 and 56 of the judgment.

²⁴ Usually the freeze in a family trust settled for the purpose of implementing an estate freeze.

¹⁵ For more on Favreau J.'s discussion of de facto control, see the case comment by Lindsay Hollinger, "Taxpayer Not a CCPC, Given De Facto Control by Public Company", 2147 Tax Topics (CCH, May 2, 2013).

¹⁶ Lyrtch RD inc. v R, supra note 5, at para. 41.

¹⁷ Lyrtch RD inc. v R, supra note 5, at para. 42.

¹⁸ Lyrtch RD inc. v R, supra note 5, at para. 43 of his reasons for judgment.