Tax Notes

July 2018
Number 666

21-YEAR TAX ISSUES AND THE NON-SPECIALIST ADVISOR — PART 2[1]

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Part 1 of this Series reviewed what the 21-year deemed disposition rules are and introduced three approaches to planning that appear to be most commonly used to manage the effects of the 21-year deemed disposition rules: Doing Nothing, the *Simple* Roll-Out, and Vesting Indefeasibly. The Doing Nothing approach was discussed in Part 1 of the Series and, in this second instalment, we will delve into the *Simple* Roll-Out approach to planning for the 21-year deemed disposition of a trust.

The *Simple* Roll-Out Approach

Assuming that there are no legal or technical tax issues that might restrict the ability to adopt the *Simple* Roll-Out approach, prior to the 21st anniversary of the trust, the trustees can simply resolve to distribute some or all of the capital of the trust to one or more of the capital beneficiaries.

No tax consequences will arise from the distribution, provided that the ACB and FMV of the distributed property are the same.[2] In addition, so long as the provisions of subsection 107(2) can be satisfied, trust property with unrealized gains should be eligible to be distributed on a tax-deferred basis to beneficiaries of the trust, who would inherit the ACB of the trust in the distributed property.

Subsection 107(2) General Requirements

A number of requirements must be met to qualify for tax-deferred rollover treatment under subsection 107(2). In particular, the trust making the distribution must be a personal trust and the distribution must be made to a beneficiary in satisfaction of all or part of that beneficiary's capital interest.

However, the rollout will not be available if either the beneficiary or the trust elect not to have the rollover apply[3] or if any of the provisions in subsections 107(4) to (5) apply to deny the rollover. For example, subsection 107(4.1) may deny the rollout if subsection 75(2) was ever applicable to a trust, and subsection 107(5) will deny the roll-out of property to nonresident beneficiaries. The subsection 107(4.1) exclusion is discussed below, and the subsection 107(5) exclusion will be discussed in Part 4 of the Series.

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[1] Unless otherwise noted, defined terms in this article have the meaning designated in the first instalment of the Series.

[2] The trustees will still be required to ensure proper reporting of the distribution, if required, in the annual T3 filings of the trust.

[3] In this regard see subsections 107(2.001) and (2.002).

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The *Simple* Roll-Out Approach — Some Tips

Provided that it is possible to implement a *Simple* Roll-Out, it is worth keeping the following tips in mind:

(1) Not all assets need to be distributed. For example, assets without gains can be maintained in a trust beyond the trust's 21st anniversary with no tax consequences using the Do Nothing approach, so using a combination of the Do Nothing and *Simple* Roll-Out approaches, it might be possible for the trust to distribute appreciated assets to beneficiaries who are capable of managing the property and maintain other non-appreciated property in the trust beyond the trust's 21st anniversary for the benefit of beneficiaries who may not be capable of managing distributed property at the time of the trust's 21st anniversary.

(2) Assets with accrued losses could be distributed to beneficiaries without impacting the deferred loss so that the beneficiaries can later realize the losses and utilize them. This might be beneficial to a beneficiary who has recently realized gains since the loss realized in the hands of the beneficiary should be eligible to not only be carried forward but also carried back for up to three years to offset the previously realized gains.[4]

(3) Clients should consider freezing or refreezing existing corporate structures involving trusts when a trust is about 10 years old or at times of critical life events, such as after the marriage of their children, as doing so can often create additional planning flexibility.[5]

(4) Start planning early! Although I've referred to this approach as the *Simple* Roll-Out, as will be discussed below, other than its implementation there is really nothing simple about the *Simple* Roll-Out and even a year may not be enough time.

The *Not So Simple* Roll-Out

Because of the many non-tax and tax issues that will typically complicate *Simple* Roll-Out transactions, more often than not, this option would probably more accurately be referred to as the *Not So Simple* Roll-Out approach.

Issues to be Considered by Trustees

There are many issues that must be considered by trustees in exercising the discretions and powers granted to them under a trust deed or by law. However, as the topic of trustee fiduciary duties, powers, and obligations fills entire text books,[6] all that will be noted on this subject is that even where trustee-related issues are or appear to be non-controversial, it is critical that all material trustee decisions be properly documented and that the trustees act in good faith without *mala fides* (i.e., dishonest intent).

Impact on the Beneficiaries

Because the rollout will result in one or more beneficiaries receiving property, it will be necessary for the trustees to consider how the recipient beneficiary or beneficiaries will manage the property.

It will also often be relevant for the trustees to consider whether beneficiaries will be able to fund death tax liabilities or even potential Canadian emigration tax liabilities once the property has been distributed to them.

In addition, when dealing with married beneficiaries, family law issues should be carefully considered. For example, in Ontario not all distributions from a trust are protected from matrimonial property claims. Also, it should be kept in mind that spouses are entitled to seek an equalization of matrimonial property not just on marriage break down but also on the death of a spouse.[7]

Where a Trust is Employed in Connection with an Estate Freeze — Impact on Freezor[8]

Although arguably not an issue that should be taken into account by trustees, as a practical matter, where a trust was formed in connection with an estate freeze, the impact of the distribution on interested parties such as the freezor will likely be a very real consideration, particularly where the freezor is one of the trustees. For example, issues such as how

[4] The "loss restriction event" rules in the Act should be reviewed to ensure that they will not restrict the ability of a beneficiary to utilize such losses.

[5] Some examples of the benefits of a freeze or refreeze transaction are discussed at the end of this article.

[6] Oosterhoff, A.H., Chambers, Robert & McInnes, Mitchell, "Oosterhoff on Trusts: Text, Commentary and Materials", 8th ed. (Toronto: Carswell, 2014); and Donovan W.M. Waters, Mark Gillen, and Lionel Smith, "Waters' Law of Trusts in Canada", 4th ed. (Toronto: Carswell, 2012).

[7] For more on the subject of family law in Ontario, a specialist in family law matters should be consulted. See also *Family Law Act*, R.S.O. 1990, c. F.3 ("FLA").

[8] Even though the focus in this discussion is an estate freeze, in other contexts the impact on the matriarch or patriarch of a family may be relevant even when an estate freeze is not involved.

a distribution of shares might have an impact on control of a corporation or family group of corporations, the freezor's future liquidity and succession management and overall family equalization should all be kept in mind.

Technical Issues

There are also a number of technical issues that can make the *Simple* RollOut not so simple:

(1) Trust provisions

Particularly for older trusts, which tended to be drafted with more limited classes of beneficiaries, it is not uncommon for the freezor or corporate beneficiaries to have been left out of the class of beneficiaries. In such cases, if it is desirable to make a distribution to such beneficiaries, including prior to the 21st anniversary of the trust, the limited class of beneficiaries would be problematic.[9] While some opportunities may exist to overcome these types of limitations, the solutions will typically not be simple to implement, and the results may often prove to be less than satisfactory.

(2) Non-resident beneficiaries

Direct distributions to nonresident beneficiaries will be taxable under subsection 107(5) and will therefore not be eligible for a tax-deferred roll-out under subsection 107(2).

(3) Denial of the roll-out due to the application of subsection 107(4.1)

Probably the most significant technical issue that can apply to preclude a tax-deferred roll-out is if subsection 75(2) or 94(8.2) has ever potentially been applicable to any property of a trust.[10] In such situations a tax-deferred distribution under subsection 107(2) could be prohibited due to the application of subsection 107(4.1).

You may recall that subsection 75(2) is a complex attribution rule that can potentially apply in situations where property has been transferred to a trust on condition that the property can revert to the transferor or where the transferor maintains direct or indirect control over the property. This provision can apply to anyone who settles or contributes property to a trust, not just the original settlor. Consequently, all contributions to a trust that meet the criteria in this provision need to be considered. When subsection 75(2) is applicable, all income, losses, and capital gains and capital losses associated with property of a trust that has been contributed by a particular contributor will attribute back to that contributor.

What is unique about subsection 107(4.1) is that no income or losses or capital gains or capital losses actually need to have been attributable under subsection 75(2) to cause subsection 107(4.1) to apply. All that is necessary is that subsection 75(2) might, during the existence of the trust, have ever potentially been applicable.

Although there are exceptions to the subsection 107(4.1) roll-out denial,[11] the application of these exceptions can be quite technical. As a result, prior to a trust's 21st anniversary, considerable time should be spent reviewing whether subsection 107(4.1) could deny the roll-out of property from the trust under subsection 107(2).

Pre-Distribution Reorganizations

Hopefully it has become clear that the *Simple* Roll-Out approach is often quite complex. In fact, very often some type of a pre-distribution reorganization will either be beneficial or even necessary to implement prior to a trust's 21st anniversary.

There are many reasons why a pre-distribution reorganization might be considered before distributing trust property. Some of the possible objectives of pre-distribution reorganizations are briefly discussed below:[12]

(1) Freeze and refreeze transactions

These types of transactions might involve freezing corporate interests owned by a trust to permit future growth to be capable of being maintained in the trust beyond the trust's 21st anniversary or to benefit parties other than the trust and the trust's direct beneficiaries. For example, a new trust with modern beneficiaries, including any one or

[9] A distribution to persons who are not beneficiaries of a trust would result in a breach of trust from a trust law perspective. In addition, a distribution in breach of trust would not be eligible for a tax deferred roll-out under subsection 107(2).

[10] Subsection 94(8.2) deals with non-resident trusts that are deemed to be resident in Canada pursuant to section 94. No further comments will be made regarding this provision.

[11] For example, property of a trust that has been contributed by a particular contributor can roll-out to that contributor or his or her spouse. In addition, subsection 107(4.1) will cease to apply at a time when no contributors of property to the trust are alive.

[12] It is assumed that all actions of trustees necessary to implement any reorganization will be implemented following due consideration of the trustees' fiduciary obligations. It is also assumed that the course of actions taken by the trustees will be authorized by the applicable trust deed and would not be restricted by any legal or tax impediments.

more new beneficiaries, such as corporate beneficiaries, the freezor, and key employees, could be created to enjoy the benefit of the future growth.

(2) Crystalize capital gains exemptions

It may be desirable to take steps to crystallize the capital gains exemptions of beneficiaries as part of or prior to a distribution of trust property.

(3) Avoid distributing preferred shares to beneficiaries

Transactions such as refreezes and crystallizations may require the use of preferred shares. However, it may not be desirable to provide beneficiaries with shares that can automatically be redeemed by the holder of the shares (and possibly the creditors of beneficiaries). Therefore, additional planning may be required to ensure that preferred shares are not distributed to the beneficiaries while still accomplishing the other planning objectives.

(4) Create agreements that will help beneficiaries to manage distributed property

Prior to distributing property to beneficiaries, agreements, such as unanimous shareholder agreements, could be put in place to help the beneficiaries to manage the distributed property.

(5) Ensure control stays with the trust/freezor

In some situations a reorganization may be required to bifurcate the shareholdings of the trust so that only non-voting shareholdings are distributed to beneficiaries while the trust maintains the voting shares or distributes the voting shares to only certain of the beneficiaries.

(6) Provide possible family law benefits

In Ontario a gift made after marriage is ordinarily exempt from a matrimonial property claim by an aggrieved spouse.[13] It is possible that a refreeze transaction that is implemented by way of a gift of cash to subscribe for new common shares or the new common shares themselves may allow a beneficiary who was not married at the time of the original freeze to enjoy family law benefits in respect of income and growth in value associated with the new common shares.[14]

[13] See section subsection 4(2) of the FLA.

[14] *Supra*, footnote 7.

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