Tax Notes

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

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What To Do When Your Trust Comes of Age

Although I can barely remember it any more, turning 21 is a big deal! For example, when you turn 21 pretty much everyone thinks of you as an adult, and if you haven't already done so, you can go to university, go to bars around the world, and move out of your parents' house — though I didn't move out until I was 27.

Well, in Canada, when a trust turns 21, it's a big deal too — principally because when a trust turns 21 it will be deemed to have disposed of many of its assets at their fair market value ("FMV"), which for trusts that hold valuable property can give rise to a hefty tax bill. The purpose of this four-part series of articles ("Series") is to help prepare your clients for their trusts' "coming of age" and, in particular, to help them manage the "21-year deemed disposition rule."[1]

What is the 21-Year Deemed Disposition Rule?

Although the 21-year deemed disposition rule is often referred to in the singular, it is actually a series of rules that deems there to be a disposition (and reacquisition) of trust property at FMV. As a result, throughout the Series these rules will be referred to as the 21-year deemed disposition rules.

In particular,

- Subsection 104(4) of the *Income Tax Act* (Canada) ("Act")[2] — deals with the deemed disposition of capital property;
- Subsection 104(5) — deals with the deemed disposition of depreciable property; and
- Subsection 104(5.2) — deals with the deemed disposition of resource property.

Without these rules, trust property could effectively pass from generation to generation to generation, and so on, without tax.

The 21-year deemed disposition rules cause a trust to be deemed to have disposed of the aforementioned types of property at FMV, which gives rise to the deemed realization of capital gains or capital losses as well as ordinary income or losses, including recaptured capital cost allowance. Interestingly, rules that would deny non-arm's length

[1] A discussion of how to help your clients manage their 21-year-old children is beyond the scope of this Series.

[2] Unless otherwise noted all statutory references are to the Act.

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loss realization, the so-called superficial loss rules, do not apply to 21-year deemed dispositions.[3]

Exceptions to 21-Year Deemed Disposition Rules

It is possible to "elect" to pay the deemed disposition tax over no more than ten years.[4] However, it is only possible to make this election in respect of capital property — not depreciable property or resource property.

Also, although the making of the election seems like a good idea, in practice the decision to make the election can be more complicated. The Canada Revenue Agency ("CRA") requires "acceptable" security to be provided for the deferred tax and for the parties to put in place security agreements, the terms of which can be quite restrictive.

Where the only assets available to post as security are private company shares, these issues can be exacerbated as the security arrangements will result in the CRA being a creditor of the private company. In that regard, typically the security agreements will provide that the CRA would need to be advised of and approve of all future corporate transactions that could impact the posted security for as long as the security is in place.

There are exceptions to the application of the 21-year deemed disposition rules. For example, the rules do not apply to:

- properly structured "life interest trusts"[5] during the life of the life interest beneficiary or beneficiaries;
- non-capital property such as business inventory, excluding land inventory;
- certain trusts specifically excluded from the 21-year deemed disposition rules as provided for in the definition of "trust" in subsection 108(1);[6] or
- "exempt property" or "excluded property", both of which deal with nonresident issues.[7]

What To Do Before Your Trust Turns 21

Having reviewed what the 21-year deemed disposition rules are, we can now begin to discuss some of the ways to manage the effects of the 21-year deemed disposition rules.

Before delving into detailed planning options there is one planning point that is worth stressing. Whenever possible, advanced planning for the impact of the 21-year rules is recommended. In fact, to be safe, at least a year's advance planning is recommended as there are many options and variations of options to consider and choose from.

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[3] Paragraph (*c*) of the definition of "superficial loss" in section 54 specifically excludes a loss arising from the disposition deemed by subsection 104(4) of the Act.

[4] Pursuant to subsection 159(6.1), the election can be made by filing form T2223 by the date on which the tax would otherwise be payable in full. The tax must be paid in equal annual instalments. The first instalment is due on the balance-due date for the trust, and each subsequent instalment is due on the anniversary of the balance-due date. In addition, interest will accrue from the date that tax would otherwise be payable at the prescribed rate in effect at the time the election is made on the outstanding amount, and the interest accruing each year must be paid at the due date for each instalment (see subsection 159(7)).

[5] Spousal trusts, including testamentary spousal trusts, as well as alter ego, joint spousal, and self-benefit trusts, are all life interest trusts.

[6] Excluded from the 21-year deemed disposition rules are: unit trusts, mutual fund trusts, a trust governed by an RPP, foreign retirement arrangement, EPSP, RSUBP, RRSP, DPSP, RESP, RRIF, EBP, RDSP, TFSA, employee trusts, master trusts (as described in paragraph 149(1)(*o*.4)), related segregated fund trusts, amateur athlete trusts, trusts deemed to exist under subsection 143(1), and retirement compensation arrangements.

[7] As those terms are defined in subsection 108(1). Exempt property is not taxable under part I of the Act because the taxpayer is non-resident or because of a provision in a tax treaty. Since under certain conditions a non-resident trust can be subject to the 21-year deemed disposition rules, it is important to exclude exempt property from the 21-year deemed disposition rules to prevent a deemed disposition from causing an increase in the adjusted cost base ("ACB") of that property which might otherwise be used to allow Canadian beneficiaries to enjoy an ACB step up without Canadian tax having been paid. "Excluded property" is shares of a non-resident investment corporation.

The principle options (approaches) are grouped into three categories below.

(1) Doing Nothing

If the trustees Do Nothing, the 21-year deemed disposition rules will apply and the trust will be liable to pay tax on its unrealized gains.

In some cases the trust will have little, if any, gains so this may be a viable option. It's also worth keeping in mind that if the trust has unrealized losses, Doing Nothing will crystallize losses in the trust. This might be beneficial to the trust if it has recently realized gains since the losses realized by the trust should be eligible to not only be carried forward but also carried back in accordance with the provisions of the Act to offset the previously realized gains.

(2) Using the *Simple* Roll-Out[8]

The most common approach to managing the 21-year deemed disposition rules is for the trustees to take steps to distribute trust property to one or more of the trust beneficiaries. This planning is of particular interest in situations where property with appreciated gains can be distributed to beneficiaries by rolling-out the property to the beneficiaries in a tax-deferred manner.[9]

(3) Vesting Indefeasibly

If it is not desirable to distribute appreciated property because there are concerns that the property will not be eligible for a tax-deferred distribution or for non-tax reasons, planning can be implemented to avoid the deemed disposition altogether by causing "all interests … in the trust to … vest indefeasibly."[10]

These approaches are not mutually exclusive and may be combined to achieve superior outcomes than if any particular approach is used on its own. While the Doing Nothing approach is discussed in more detail below, the *Simple* Roll-Out approach will be reviewed in detail in Part 2 of the Series and the Vesting Indefeasibly approach will be reviewed in detail in Part 3 of the Series. Part 4 of the Series will delve into more advanced issues involving planning for trusts nearing their 21st anniversaries that have non-resident beneficiaries.

Non-Tax Issues to Consider

In making a choice among the alternatives, non-tax issues may be very important and, in particular, family dynamics may be critical to keep in mind.

Some examples of non-tax issues include:

- considering whether ongoing control and management of trust assets by trustees is desirable — the ability of beneficiaries to manage property could be key to these types of decisions;[11]
- if the trust is discretionary, determining who among the beneficiaries should receive the distributed trust property and also determining how much of the trust property each recipient beneficiary should receive (the amounts do not need to be equal);
- addressing the impact of family law and other creditor issues; and
- reviewing and updating personal planning for beneficiaries, including will, estate, succession, and insurance planning, which may be impacted by the beneficiaries suddenly becoming owners of significant amounts of valuable property.

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[8] As I will discuss in Part 2 of the Series, there will often be very little that is simple about this option.

[9] Pursuant to subsection 107(2).

[10] See paragraph (*g*) of the definition of the word "trust" in subsection 108(1).

[11] In freeze situations, ongoing control and management of corporate assets may have been retained by the freezor rather than the trust. Whether this remains desirable following the distribution of trust assets may also be a consideration.

Doing Nothing Approach

Although often not the case, there may be situations where the trustees deciding to Do Nothing is okay. For example, as mentioned previously, Doing Nothing may be appropriate when no tax will arise or an acceptable amount of tax will arise as a result of the application of the 21-year deemed disposition rules.

Other approaches may not be acceptable because of the situation of the beneficiaries, for example, if beneficiaries are considered to be incapable of handling distributed trust property due to age, being unsophisticated, exposed to creditors, or spendthrift. Consequently, sometimes it's just better to pay the tax.

A Bit More Than Nothing

Although this approach is often described as Doing Nothing because the trustees won't be distributing trust property, it is possible that prior to the 21st anniversary of a trust, steps could be taken to reduce the value of the unrealized gains that the 21-year deemed disposition rules would otherwise give rise to. For example, if a trust holds shares in an underlying closely held private corporation that has tax pools such as RDTOH or CDA, the directors of the corporation might distribute these tax pools as tax-efficient dividends to the trust, which would have the effect of reducing or possibly eliminating the unrealized capital gains in the trust's corporate shareholdings.

With the unrealized capital gains having been eliminated, Doing Nothing might then become a viable option.

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