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NOT QUITE CHICKEN SOUP — PART I: ARE POWERS TO ADD AND REMOVE BENEFICIARIES SAFE FOR CANADIAN FAMILY TRUST PRECEDENTS?

— *Michael Goldberg, tax partner, Minden Gross LLP, a member of MERITAS law firms worldwide*

This article discusses the inclusion and use of powers to add and remove beneficiaries in drafting, planning, and establishing family trusts. Due to its length, it is divided into two parts. Part I addresses some of the more straightforward non-tax and tax issues associated with powers to add and remove beneficiaries ("PARBs"). Part II addresses other potential tax issues that PARBs may pose for tax practitioners. Part II will be published in next month's issue of *The Estate Planner*.

Introduction

Lately I've been coming across more trusts with expansive PARBs. In general, PARBs make me feel uncomfortable, particularly when they are included in Canadian discretionary family trusts ("Family Trusts"). My discomfort stems from concerns about the following:

- whether the inclusion of such provisions in a trust could cause a trust to completely fail in the sense that the trust would not satisfy the "three certainties";[1]
- that PARBs are extremely potent and if not properly thought out and drafted (and even if properly drafted), might be improperly used — particularly after the freezor in an estate freeze or the settlor in other *inter vivos* and testamentary circumstances is no longer alive; and
- potential tax issues that adding such clauses might give rise to.

As will be described in this two-part series of articles, my research into these issues has eased my concern about some but not all of these issues. In particular, I remain concerned that if PARBs become standard terms in Family Trust precedents, unlike "chicken soup", they could end up causing more problems than they solve. As a result, I would encourage practitioners to always consider carefully whether or not it is appropriate to use PARBs in trusts that they draft, particularly in Family Trusts.

In this series of articles, I'll focus on the last of the three points noted above. However, before doing so, I'll distill some commentary on PARBs from an excellent recent article by Donovan Waters.[2]

Non-Tax Matters

As Mr. Waters notes, some "questioners" have been concerned that the inclusion of PARBs might cause a trust to fail to come into existence if the PARB clause(s) would be viewed as not creating the necessary certainty to identify beneficiaries of the trust. However, according to Mr. Waters, such concerns

> . . . can be put aside. The ability of any person to extend or reduce the number of beneficiaries who may be considered does not create any initial or subsequent uncertainty of objects of the power. In the first place it is important to remember that there is no doctrinal requirement contained in the "three certainties"; they represent elements that allow a court to enforce a trust . . . Certainty is established initially and remains later when additions or deletions are made.[3]

PARBs, whether direct or even via a power to amend the beneficiary provisions that is less direct, can be extremely potent. Where such provisions are contemplated, Mr. Waters urges that they be tailored to the client's specific situation, which seems like extremely good advice.

Tax Matters — The CRA's Published Views

The Canada Revenue Agency ("CRA") appears to have provided relatively limited commentary regarding its views on the impact of adding beneficiaries to a trust,[4] whether through specific trust powers (such as PARBs) or through an amendment to the trust itself,[5] and although there have been specific situations in which the CRA has provided positive rulings, for the most part the commentary has not been positive.

In particular, the primary risk seems to be the CRA's view that where a new beneficiary is added to a trust, the existing beneficiaries will generally be deemed under paragraph 69(1)(*b*) of the *Income Tax Act* to have disposed of a portion of their interests in the trust equal to each beneficiary's *pro rata* share of the "fair market value" of the assets of the trust at that time.[6] In this regard, where the trust is a Family Trust, the CRA's general view appears to be that each beneficiary's interest would generally be of equal value unless a beneficiary has "a lesser chance" of receiving a distribution — in which case adjustments may be required.[7]

In his article, Mr. Waters makes a number of strong arguments at law as to why the CRA's administrative positions (which have not as of yet been the subject of litigation) are likely wrong at law, and he notes that others have also put forward their own arguments in this regard.[8] However, since the CRA continues to maintain those positions, planners who amend trusts to add or delete beneficiaries or employ PARBs in their trusts and who are involved in a later exercise of those powers without the benefit of a CRA advance ruling all continue to be faced with uncertainty as to the tax consequences.[9]

Having reviewed some of the more conventional non-tax and tax issues associated with PARBs in Part I of this article, Part II will examine some other potential tax issues that PARBs may pose for unsuspecting tax practitioners.

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Notes:

[1] The three certainties are generally referred to as the certainty of intention (to create a trust), the certainty of subject matter (which involves the requirement to be able to identify the property that is to be held for the benefit of the beneficiaries of the trust), and the certainty of objects (which involves determining the person or purpose who is to benefit from the trust — i.e., to provide a means of identifying the beneficiaries).

[2] See Donovan Waters, "The Power in a Trust Instrument To Add and Delete Beneficiaries" (2012) 31 E.T.P.J. 173.

[3] *Ibid.*, at 187.

[4] The CRA has provided positive rulings in connection with non-PARB trust amendments that result in changes to beneficial interests. For example, rulings have been provided in connection with accelerating interests, deferring vesting dates, encroachment powers over capital, and creation of new trusts to hold funds set aside for minor or unascertained beneficiaries. For more on this subject, see page 11 of Elie Roth's portion of a joint presentation with Donovan Waters, "Adding and Deleting a Beneficiary to a Trust — Income Tax Considerations", presented at the June 2013 STEP conference.

[5] An additional risk of adding beneficiaries or making other fundamental changes through an amending clause is that under some circumstances the trust may be so fundamentally changed as to cause it to be resettled, giving rise to a deemed disposition of the assets of the trust. For more on this subject, see Sian Matthews, "Enigma Variations", 28 E.T.P.J. (2009) 355 at 379.

[6] In this regard, the CRA has been strongly criticized by Waters, Roth, and others for employing concepts of fair market value derived from family law cases such as *Sagl v. Sagl*, 31 R.F.L. (4th) 405 (Ont. Gen. Div.).

[7] For more on the CRA's "standard" position, see CRA Document Nos. 2012-0451791E5, February 11, 2013; 2003-0181465, April 3, 2002; and 2001-0111303, January 1, 2002; among others. See also Roth, *supra* and David Louis, Samantha Prasad, and Michael Goldberg, *Tax and Family Business Succession Planning*, 3rd edition at pages 126–130. For an example of a positive ruling by the CRA, see CRA Document No. 2007-255961R3, January 28, 2008, which is discussed in Louis *et al*. at page 129. See also CRA Document No. 2008-0281411I7, November 20, 2008 — but only released on June 12, 2013, which involved the exercise of a PARB in a trust indenture by the sole trustee to add new beneficiaries who were unrelated to the existing trust beneficiaries. In this case, the CRA held that with the exception of the sole trustee, who was also a beneficiary of the trust, none of the other beneficiaries would have been deemed to have disposed of their interests in the trust as a consequence of the exercise of the PARB.

[8] For example, see Tim Youdan, "Income Tax Consequences of Trust Variation, Revocable Trusts and Powers of Appointment" (2005) 24 E.T.P.J. 141. It is beyond the scope of this article to describe the criticisms that have been raised by Waters and others.

[9] See David Louis, Samantha Prasad, and Michael Goldberg, *Tax and Family Business Succession Planning*, 3rd edition at pages 129 and 130.

TAX COURT CONSIDERS DERIVATIVE ASSESSMENTS AGAINST DEATH BENEFIT RECIPIENTS

— Mark Firman, McCarthy Tétrault LLP

***Higgins v. The Queen*, 2013 DTC 1163 (Tax Court of Canada — Informal Procedure)**

In *Higgins*, the Tax Court vacated the Minister's assessments of two taxpayers pursuant to subsection 160(1) of the *Income Tax Act* (the "Act") and referred back to the Minister for redetermination assessments pursuant to subsection 160.2(2). Both sets of assessments related to amounts received by the taxpayers as a consequence of their father's death.

The taxpayers, Sandra and Karen, were sisters. They were the daughters of Arthur Higgins, who died in 2002.

In 1999, Arthur had designated Sandra and Karen equal beneficiaries of a "non-registered freedom fund segregated fund investment" funded through a policy issued by London Life (the "Policy"). Additionally, Sandra and Karen were equal beneficiaries under Arthur's registered retirement income fund ("RRIF"), which was also funded pursuant to a policy with London Life. Upon Arthur's death in 2002, London Life distributed to Sandra and Karen:

(1) approximately $5,000 each, representing one-half of the beneficiary entitlement under the Policy; and

(2) approximately $15,000 each, representing one-half of the beneficiary entitlement under the RRIF.

Arthur died intestate. Besides the Policy and the RRIF, Arthur had no other significant assets at the time of his death. No administrator was appointed to administer Arthur's estate, and while Karen did respond in the years following Arthur's death to some requests from the Canada Revenue Agency ("CRA") for documents relating to Arthur's affairs, neither she nor Sandra were ever authorized as Arthur's or his estate's legal representatives.

Following Arthur's death, the Minister issued at least two assessments against Arthur's estate. The first, in 2002, was for approximately $3,000 inclusive of interest and penalties. A subsequent assessment in 2005 (which neither taxpayer appears to have received before trial) showed taxes owing of about $11,000 (including the $3,000 from the 2002 assessment). By the time of the assessments against the taxpayers in 2010, the Minister claimed that the estate was liable for unpaid taxes of approximately $18,000, although no assessment appears to have been made against the estate in this amount. As noted above, the Minister relied on subsections 160(1) and 160.2(2) of the Act in support of the assessments against Arthur's daughters, as discussed below.

Subsection 160.2(2) is an anti-avoidance provision specific to RRIFs. It provides that when a person other than the annuitant under a RRIF receives an amount from the RRIF in a year, the recipient and the annuitant are jointly and severally liable in the year of the annuitant's death for an amount equal to the annuitant's tax liability under Part I of the Act, calculated without reference to the amount deemed to have been received under subsection 147.3(6). Subsection 147.3(6) is a provision that applies on the death of a RRIF annuitant to deem the annuitant (here, Arthur) to have received an amount immediately before death equal to the fair market value of the property held to the credit of the RRIF.

Subsection 160(1) is another, broader anti-avoidance provision. Where a person (a "transferor") directly or indirectly transfers property to, among others, a person (a "transferee") with whom the transferor does not deal at arm's length, the transferor and transferee are jointly and severally liable for an amount equal to the fair market value of the transferred property (less the value of any consideration paid by the transferee) or the amount of the transferor's unpaid tax under the Act, whichever is lesser.

In 2010, the Minister assessed Sandra and Karen as follows:

(1) With respect to the amounts paid under the Policy, the Minister assessed each of Sandra and Karen under subsection 160(1) to pay an amount equal to each person's proceeds from the Policy (approximately $5,000).

(2) With respect to the amounts paid from the RRIF, the Minister assessed each of Sandra and Karen under subsection 160.2(2) for taxes equal to approximately $6,000. It is not clear from the decision how the Minister calculated this amount.

The taxpayers appealed to the Tax Court. Their appeals were heard together.

Rowe DJ allowed the taxpayers' appeal in part. He vacated the Minister's assessment under subsection 160(1). Further, he found that the Minister made the assessment under subsection 160.2(2) incorrectly. He referred the assessment back to the Minister for reconsideration and reassessment in line with the reasons summarized below.

In connection with the assessment under subsection 160(1), the Minister argued that Arthur retained control of the funds underlying the Policy, with the result that payment of these funds to the taxpayers on Arthur's death was an indirect transfer by Arthur to the taxpayers to which subsection 160(1) applied. In support of this position, the Minister relied on the fact that Arthur could, and did, make periodic withdrawals under the Policy. The Minister also relied on the fact that Arthur could revoke his beneficiary designation in favour of the taxpayers at any time, although he had not done so. The taxpayers argued that notwithstanding Arthur's ability to make periodic withdrawals and revoke any beneficiary designation, the Policy remained a life insurance policy the payment of death benefits under which was not a "transfer" to which subsection 160(1) applied.

Rowe DJ agreed with the taxpayers' characterization. He relied on a description of the Policy on London Life's website. He found that although the Policy was a hybrid comprised of an insurance policy and a segregated fund investment (from which Arthur could make withdrawals), the Policy was fundamentally a life insurance contract. Upon Arthur's death, London Life therefore paid to the taxpayers death benefits pursuant to a contractual obligation created by Arthur's beneficiary designation in 1999. The fact that the designation was revocable did not change the nature of the arrangement. Rowe DJ also relied on the Tax Court's 2010 decision in *Nguyen* (2010 DTC 1397) for the proposition that proceeds payable to a designated beneficiary pursuant to a life insurance contract do not form part of the insured's estate. In this regard, he found that the Minister's assessment assumed that the Policy was in the same category as an RRSP or RRIF, whereas in substance it was a different kind of arrangement entirely. Following *Nguyen*, he concluded that London Life's transfer of property did not constitute a transfer by Arthur's estate such that subsection 160(1) applied.

In connection with the assessment under subsection 160.2(2), the Court agreed with the Minister that subsection 160.2(2) applied to the payment of the balance of Arthur's RRIF to the taxpayers, but disagreed that the Minister had correctly calculated the quantum of tax owing.

The parties agreed that a transfer of the RRIF amounts occurred on or about February 21, 2002, the date of cheques mailed by London Life to the taxpayers in satisfaction of the RRIF residue. However, the taxpayers challenged the $18,000 amount of tax the Minister claimed was owing, which did not appear to be supported by any assessment but rather only by the statements of a collection officer employed by the CRA.

The Court agreed with the taxpayers' challenge. In so doing, the Court relied on the Tax Court's 2007 decision in *Belanger* (2007 DTC 1747), which involved a similar assessment of the recipient of the balance of a deceased annuitant's RRIF. In *Belanger*, the Minister had not assessed the annuitant's estate and had proceeded to assess the beneficiary in the first instance. The Court found that although subsection 160.2(2) makes both the annuitant and a beneficiary of RRIF benefits jointly and severally liable for the annuitant's unremitted tax, the wording of that provision prevents the Minister from assessing the beneficiary before it has first assessed the annuitant or his or her estate to determine the tax owing. Accordingly, Rowe DJ ordered the Minister to reassess the taxpayers only after first properly assessing the tax owing by Arthur's estate.

While the result for the taxpayers was at best mixed, the decision nevertheless underscores the potentially wide-reaching effects of the Minister's powers under subsection 160(1) (and, to a lesser extent in the specific context of RRIFs, under subsection 160.2(2)). In *Higgins*, there is no indication that Arthur's 1999 beneficiary designation under the Policy was made with the intent to defeat claims by the Minister for unpaid taxes in 2002 and beyond. The taxpayers appear to have been innocently caught in the broad net that the Act casts when a person dies intestate with taxes owing.

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IN PROVING WILL, ONUS OF PROOF YIELDS TO EVIDENTIARY PRESUMPTION

***Yen Estate v. Chan*, 2013 BCCA 423**

The appellants filed a *caveat* requiring the respondent executrix to prove a purported will which appeared, on its face, to comply with the formalities of section 4 of the *Wills Act*. There was no direct evidence at the trial with respect to the signature of one of the two witnesses, whose whereabouts was unknown. And there was also no direct evidence as to whether the witnesses were present together and saw the testator sign the will, nor any direct evidence that the testator was aware of and approved the contents of the document. However, the trial judge held that the respondent successfully proved due execution as well as the testator's knowledge and approval of the document's contents; in so doing, the trial judge relied on certain evidentiary presumptions embodied in the maxim "*omnia praesumuntur rite esse acta*" (all things are presumed to be done in due form).

The Court of Appeal agreed with the trial judge. In the absence of suspicious circumstances or contrary evidence, the trial judge was entitled to rely on the rebuttable presumptions that the execution of the will complied with the requirements of the *Wills Act* and that the testator was aware of and approved the contents of the will. The presumption relied on by the trial judge was upheld by the Ontario Court of Appeal in *Re Laxer*, [1963] 1 O.R. 343, 37 D.L.R. (2d) 192. However, until now, it had not been upheld by the British Columbia Court of Appeal. The latter found that the appellants had not indicated any policy reason why this Court should not accept the use of the presumption of due execution in connection with the execution of wills in British Columbia. In so doing, it noted that it is a presumption only and can be rebutted by direct evidence or suspicious circumstances. Finally, the Court noted that a contrary rule would put a testator in the position of having to monitor the availability of the witnesses to his or her will to ensure that it could be proven in solemn form. Testators would be required to re-execute their wills if the witnesses died or if their locations became unknown. And so, to prevent such a result, the presumption was formally adopted in British Columbia.

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