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TAXSTRATEGY

Wind-up of a Family Trust

Tax Traps

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In last month's article, I noted that family trusts only have a tax life span of 21 years, as they are deemed to have sold all of their assets on each 21st anniversary. So if the appropriate planning is not done, the family trust could-potentially be subject to a deemed capital gain. In order to avoid this deemed tax hit, you may want to consider winding up the trust and distributing the trust capital to the beneficiaries before the 21st anniversary.

The exception to this type of planning occurs when the assets of the trust do not have a pregnant gain that has not yet been realized (for example, if the assets are made up of GICs, with no inherent gain, then the deemed disposition rules would not trigger any capital gain). If however, the assets include shares of a company that might have been put in place as part of an estate freeze, then you should consider distributing those shares to the beneficiaries (assuming of course that the underlying company has grown in value).

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The general rule regarding distributions out of a trust is that trust capital (not income) can be distributed out of a discretionary family trust on a tax-deferred basis to a beneficiary. However, there are a couple of instances in which tax could be triggered at the trust level on any such capital distribution.

The first is where the trust property is distributed to a non-resident beneficiary. So if your children reside outside of Canada, you cannot distribute tax-free to them. However, if the class of beneficiaries includes a corporate beneficiary (a Canadian resident company held by such non-resident children) then the trust assets could be distributed to the Canadian resident company as opposed to the non-resident children in order to avoid the tax to the trust. If the trust does not include a corporate beneficiary, then possible alternatives could include varying the trust to add corporate beneficiaries or having the non-resident beneficiary assign his or her interest in the trust to a Canadian company. But there are certain tax issues that may prevent these options unless properly addressed with your advisor.

A more dangerous tax trap is the application of the attribution rule common referred to as the "reversionary trust rules" under s. 75(2) of the Income Tax Act. In a nutshell, if s. 75(2) ever applied to a trust (even for one moment in time), then you lose the ability to distribute capital out of the trust tax-free, even if to a Canadian beneficiary.

So in order to avoid this trap, it is important to understand when the reversionary trust rules will apply:Where property contributed to a trust (or substituted property) is held on condition that it: may revert to the person from whom the property was directly or indirectly received (i.e. the contributor);may pass to persons determined by the contributor after the creation of the trust. or may not be disposed of during the contributor's life/existence without his or her consent / direction for example, the contributor has a veto power over how the prerty is distributed. The danger is that even if you cure the trust of this tax problem, the damage is already done. The following scenarios should be kept in mind so that you don't trip over this rule, and essentially fall into a tax nightmare.

You contribute property to the trust and you are a beneficiary of the trust. This may also be the case if you are a contingent beneficiary, e.g., if other beneficiaries pass away. (However, there is a distinction where the trust property reverts to you by operation of law because of a failure of the trust, e.g., if the trust fails because there are no beneficiaries left to whom the property can be distributed.)

The trust trips over a subsection 75(2) "technicality". One example is if the trust contains a default distribution mechanism (e.g., if the trustees fail to exercise their discretion to distribute) which is dependent upon the provisions of the contributor's will – i.e., because the property may pass to a person determined by the contributor.

A beneficiary pays expenses on behalf of the trust or contributes cash to allow it to do so. One possible example is where a trust incurs accounting fees (e.g., to file tax returns). Suppose that the beneficiary writes out a cheque to defray these expenses. Even if the cheque is directly to the accountant, arguably, at least, the beneficiary has effectively "contributed" to the trust.

The contributor has a "veto" over the distribution of the trust property (or the power to determine to whom theproperty can pass); for example, the contributor is a trustee and the trust stipulates that he or she must be part of any majority decisions by the trustees.

Another instance in which a contributor may fall in to these circumstances is if the other trustees resign or pass away, leaving the contributor as the sole trustee or one of two trustees.

With respect to the last point, where the contributor is one of two trustees, CanRev has indicated some leniency in applying this attribution rule where the contributor is one of two trustees. So long as the acts of the contributor as trustee stem from the exercise of his or her duty as a trustee (and not greater power), then the CRA has stated that it won't apply the attribution rule. But the moment you give the contributor extra powers (power over distribution decisions), then you're in hot water.

As a result of some case law, however, it is possible for a beneficiary to sell a property to the trust, as long as it is for fair market value. A beneficiaery can also loan money to a trust (as long as it is a true loan) without offending this rule. However, it would be prudent to document the loan as such, just in case the CRA comes knocking on your door. ❐