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Unsuccessful Rectification Application

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The Ontario Superior Court denied a rectification application in the recent case of *Kanji v. Attorney General of Canada*, 2013 ONSC 781. This application was made shortly before the 21st anniversary of the date of settlement of a trust. For Canadian income tax purposes, subject to limited exceptions, there is a deemed disposition at fair market value of all capital property owned by an inter vivos trust on the 21st anniversary of its date of settlement and each 21st anniversary thereafter. Typical planning before the 21st anniversary involves the distribution of trust property to the beneficiaries, usually on a rollout basis (a distribution at cost). Because the beneficiaries are often members of the next generation, the distribution of the growth assets to them achieves a deferral.

Mr. Kanji settled the Kanji family trust in 1992 by means of a transfer of \$5,000 cash. The initial trustees were Mr. and Mrs. Kanji. The beneficiaries were Mr. and Mrs. Kanji and their issue. All beneficiaries were eligible to receive both income and capital. Mr. Kanji had the power to remove or substitute trustees and to appoint additional trustees. The trust became the shareholder of a private corporation, Sutter Hill. The evidence indicated that there were income distributions to Mr. and Mrs. Kanji in certain years.

Mr. Kanji obtained advice that because he was the settlor, one of two trustees, and a capital beneficiary, subsection 75(2) of the *Income Tax Act* could apply to cause attribution consequences with respect to the initial \$5,000 contribution to the trust or property substituted for it. In other words, the income or loss or the capital gain or capital loss from this property or substituted property could be attributed to Mr. Kanji. Subsection 75(2) requires a transfer of property and the satisfaction of a statutory control condition or reversion condition. Because Mr. Kanji was the settlor, he transferred funds to the trust. The reversion condition was met because he was a capital beneficiary, and therefore the trust property could be distributed to him. The control condition was arguably met because he was one of two trustees and effectively had a negative veto. Thus, trust property could not be disposed of without his consent. Because the Canada Revenue Agency has commented favourably on the trustee/negative veto situation in recent years, arguably the statutory control condition was not met.

It was not the attribution consequence of subsection 75(2) that was problematic. Mr. Kanji was also advised that when subsection 75(2) applied to any trust property, subsection 104(7.1) denied the rollout of capital property distributed to anyone other than himself. If capital property were distributed to Mr. Kanji, it would roll out at the trust's cost. However, if property were

transferred to his issue, the transfer would trigger a deemed disposition at fair market value with resultant tax consequences for the trust. The trust's assets had increased considerably in value, so the inability to distribute on a rollout basis to the next-generation beneficiaries before the 21st anniversary would have triggered significant income tax.

Although not explicit in the judgment, the rectification that Mr. Kanji sought was presumably the striking of the clause in the trust agreement that designated Mr. Kanji as a capital beneficiary, because this would have avoided the statutory reversion condition in subsection 75(2). If subsection 75(2) had not applied to any trust property, the rule denying the rollout to next-generation beneficiaries would not have applied.

The court noted that in a rectification application the applicant bears the onus of proof. In this case, Mr. Kanji was required to demonstrate on a balance of probabilities that at the time he settled the trust, he intended to do so in a tax-efficient manner to allow a tax-deferred transfer of the trust's assets to his children in the future. The court held that the burden of proof was not met. The only evidence tendered was the affidavit of Mr. Kanji, who deposed that he did not intend to receive any capital distributions from the trust, notwithstanding that he was designated as a capital beneficiary, and that he believed that his lawyers had made a drafting mistake since they did not consider the effect of subsection 104(7.1). The court drew a negative inference from the lack of contemporaneous documents regarding his intention, including the lack of evidence from the lawyers involved in setting up the structure. The rectification application failed.

The judgment implies that a specific intention to avoid the unintended tax consequence was needed to support the rectification application. Because 21st anniversary planning is so important for an inter vivos trust, the intention to roll out (or the risks of not being able to do so) should be documented at the time of settlement.

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