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Is a Family Trust Vulnerable to the CRA? More Warning Signs: Subsections 75(2)/107(4.1)

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In this month's article, I continue my discussion in the last edition of [*Tax Notes*] about warning signs that a family trust structure may be vulnerable to a CRA attack.

This month I will focus on transactions that could trigger one of the most dangerous tax traps in the estate planning field. This is the application of subsection 107(4.1) which, in turn, is dependent on the application of the "reversionary trust rules" in subsection 75(2)**[1]**. This provision is intended to preclude a rollout of the trust's assets – that is, on a tax deferred basis – to anyone other than the person from whom the property was received or his or her spouse**[2]** if subsection 75(2) was applicable <u>at any time</u> in respect of <u>any property</u> of the trust, and the contributor of such "tainted property" is alive ("in existence") at the time the property is distributed**[3]**.

Of course, one of the most important times at which the rollout is desired is just before the trust's 21st anniversary, in order to duck the tax in the trust that otherwise occurs on this anniversary by virtue of the deemed sale rules. The application of subsection 107(4.1) means that, rather than a rollout, there will be a deemed sale at fair market value when the property is distributed from the trust.**[4]** Note that the rectification of a situation such that subsection 75(2) no longer applies will not preempt the application of subsection 107(4.1) to property distributed by a trust**[5]**.

The reversionary trust rules themselves - in subsection 75(2) - apply if property contributed to the trust (or substituted property) is held on condition that it:

may revert to the person from whom the property was directly or indirectly received**[6]**;

may pass to persons determined by the contributor after the creation of the trust**[7]**;

or

may not be disposed of during the contributor's life/existence without the consent or in accordance with the contributor's direction**[8]** – i.e., the contributor has a veto power over the disposition of the transferred property.

Because subsection 107(4.1) came into effect in the late '80s and did not receive much attention at first, trusts which are now reaching their 21st anniversary may often overlook the impact of this provision.**[9]**

Sign Sign Everywhere a Sign

The following are some common situations where subsection 75(2) - and potentially subsection 107(4.1) - may apply:

The contributor is a beneficiary of the trust**[10]**. This may be the case if the contributor is a contingent beneficiary, e.g., if other beneficiaries pass away. (However, there is a distinction where the trust property reverts to the contributor 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". The CRA interprets the reversionary trust rules quite strictly. An example of a situation where a trust may trip over subsection 75(2), and therefore subsection 107(4.1), is if there is 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**[11]**.

- A beneficiary buys or sells property to the trust, even if at fair market value**[12]**. Although there is an exception for a *bona fide* loan to a trust, there is not an exception for other transfers, even if at fair market value. For example, suppose that an adult child is a beneficiary of a family trust (or an estate, for that matter), and the trust holds, say, a vacation property. If the child decides to buy the vacation property from the trust at fair market value, he or she will have transferred property (i.e., cash) to the trust. As the child is also the beneficiary, the cash (or property substituted for it) could revert to the child.**[13]**

A beneficiary defrays the trust's expenses e.g., by advancing cash to allow the trust to pay a bill. Could subsection 107(4.1) be applicable in such circumstances? About a year ago, a release from a major accounting firm suggested that no one should put additional money or other assets into the trust, or pay the trust's expenses. While this is certainly conservative and prudent advice, another alternative may be to account for the payment as a loan to the trust. This approach may be more problematic if the trust doesn't keep books and records (this might be the case if an estate freeze is undertaken and the trust simply holds common shares acquired for a nominal amount)**[14]**.

One would hope that the CRA would not deny the rollout of assets from the trust, e.g., prior to its 21st anniversary, on the grounds that a few cheques were made out by beneficiaries over the years**[15]**. But there is no denying that prudent thing to do is to pay such expenses out of the trust's income. For example, in a freeze-type structure, dividends could be declared from time to time to defray such expenses.

The contributor has a "veto" over the disposition of the contributed property (or the power to determine who the property can pass to); 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 into these circumstances is if the other trustees resign or pass away, leaving the contributor as the sole trustee or one of two trustees.

In some of the situations in respect of the last point, subsection 75(2) may technically apply, but the CRA has indicated some administrative largesse. In general, where the issue stems from the exercise of an individual's duty as a trustee, a series of technical interpretations**[16]** indicate that the CRA may not apply subsections 75(2) and 107(4.1)**[17]**. According to a recent technical interpretation, this administrative largesse could occur where the transferor is one of two trustees or unanimity is required for trustees' decisions. However, the CRA's largesse would not apply where a trust expressly requires the contributor's consent to any decision made by the trustees as a whole (this would include the situation where the trust stipulates that decisions are made by a majority of trustees provided that the trustee-contributor is one of that majority)**[18]**. Also, the largesse would apparently not apply where the contributor is the sole trustee.

The administrative largesse is limited to situations in which the powers that otherwise run afoul of subsection 75(2) are exercised as a trustee in a fiduciary capacity versus powers reserved in some other capacity. Accordingly, the largesse would not apply where the contributor reserves a power of appointment over the contributed property.

I would like to make one last observation: over the years, I have been surprised at the number of structures involving family trusts that have turned out to have deficiencies. Perhaps one reason is that the structures may start out as "small dollar" files. But as the client's wealth accumulates, the dollar value of the structure increases, so that what once may have been the financial equivalent of a one-room shack becomes a castle – built on a foundation of sponge. If so, it may be time to take a second look at the structure – before the CRA puts it under a microscope.

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[1] For fairly recent articles on these provisions, see “Subsection 75(2): The Spoiler”, Brenda L. Crockett, 2005 CTJ 3, p.806; and “Reversionary Trust Review”, Robert Spenceley, *Estate Planner* No. 131, December 2005, and “Reversionary Trust Update”, *Estate Planner* No. 141, October 2006.

[2] Or other individual in respect of whom subsection 73(1) would be applicable in respect of the contributor, including a former spouse, common-law partner or qualifying spouse trust. If a trust holds identical properties, some received from the contributor, the CRA will allow the trust to identify which properties are to be distributed to the contributor/spouse (etc.) so as to avoid the application of subsection 107(4.1). See Doc. No. 9215065, August 7, 1992.

[3] Unlike subsection 75(2), if the contributor emigrates from Canada, subsection 107(4.1) will continue to apply.

[4] See subsection 107(2.1). It appears that the result of the distribution is that the resulting income would be taxable to the beneficiary. See Doc. No. 9823605, May 10th, 1999.

[5] Also, it is the CRA’s position that, although the trust may not have had any income attributable to the settlor of the trust under subsection 75(2) of the Act, subsection 107(4.1) still remains applicable. See Doc. No. 9207365, July 22, 2002.

[6] Subparagraph 75(2)(a)(i).

[7] Subparagraph 75(2)(a)(ii).

[8] Paragraph 75(2)(b).

[9] Counter-strategies may exist; these are beyond the scope of this article.

[10] Presumably, the trust will specifically provide that it is irrevocable.

[11] Per subparagraph 75(2)(a)(ii). Similarly, a power of appointment to be exercised through the will of a beneficiary will be problematic because the property could revert to the contributor under the will (per subparagraph 75(2)(a)(i)), unless the terms of the power prevents the donee of the power from appointing the contributor. However, if the property becomes part of the beneficiary’s estate, the reversionary conditions in subparagraph 75(2)(a)(i) would not be considered to be satisfied with respect to the potential acquisition of the property by the contributor in accordance with the beneficiary’s will. See Doc. Nos. 2002-0116535, February 19, 2002; 2002-0139205, July 22, 2002; and 2002-0162855, April 25, 2003.

Another noteworthy situation in which subparagraph 75(2)(a)(i) might apply is where the trust subscribes to shares of a corporation which is also a beneficiary of the trust. Although this was originally identified as problematic, in Doc. No. 2006-0218501E5, March 9, 2007, the CRA reconsidered its position, indicating that section 75(2) of the Act should not be applied where a trust subscribed to shares of a corporation for fair market value consideration, on the premise that the corporation did not own the shares prior to their issuance to the trust. (If the shares are issued at less than fair market value, subsection 75(2) could apply, based on “Kieboom-type” reasoning.) The non application of subsection 75(2) has been extended to dividends and proceeds of the redemption of the shares (see Doc. No. 2007-0243241C6 – 2007 APFF Round Table, Question 13).

[12] In this point and the next, transactions with trustees may also be problematic, if the trustee has powers specified in subparagraph 75(2)(a)(ii) or paragraph 75(2)(b).

[13] If it did so, it appears that the property or substituted property would not be subject to subsection 107(4.1) by virtue of subparagraph 107(4.1)(c)(i). However, it appears that, in the absence of administrative largesse, the situation would leave other beneficiaries subject to subsection 107(4.1).

[14] It may be prudent to insert a clause in the trust that any such payment is deemed to be a loan rather than a contribution.

[15] However, in Doc. No. 9610435, August 13th, 1996, the CRA indicates that the value of the property, nominal or otherwise, would not affect the application of subsection 107(4.1).

[16] Including Doc. No. 2000-0042505, April 30, 2001; Doc. No. 2001-0067955 January 03, 2002; Doc. No. 2003-0050671E5 April 05, 2004 ; Doc. No. 2004-0086921C6 (2004 APFF Round Table Question 24) October 08, 2004; Doc. No. 2008-0292061E5 October 27, 2008.

[17] For example, in Doc. No. 2001-0067955 the CRA indicates that, in respect of subparagraph 75(2)(a)(ii) (property passing to persons determined by the contributor):

> Where the beneficiaries under a trust are named in the trust indenture and cannot be modified (i.e., the person from whom the property was received by the trust cannot select additional beneficiaries after the creation of the trust), subparagraph 75(2)(a)(ii) is generally not considered applicable. This is true even though the person from whom the property was transferred to the trust may be able to determine the amount of the trust property that is to be distributed to beneficiaries already identified in the trust documents. However, subparagraph 75(2)(a)(ii) is worded broadly and there could be exceptions to this general position depending on the situation.

In respect of paragraph 75(2)(b) (property cannot be disposed of without the contributor's consent or in accordance with the contributor's direction):

> It is our view that the condition in paragraph 75(2)(b) might not be met in respect of property which is contributed to the trust by a person who is one of two or more co-trustees acting in a fiduciary capacity in administering the trust property where the property is subject to standard terms ordinarily found in trust indentures and there are no specific terms outlining how the trust property is to be dealt with.

[18] Doc. No. 2008-0292061E5 October 27, 2008.