MONEY & FAMILY LAW

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PROVIDING NEWS AND INSIGHT TO PROFESSIONALS IN FAMILY LAW, ESTATE AND TAX PLANNING SINCE 1986

EXECUTORS: LIARS AND THIEVES?

is paying the correct amount of EAT. If that is the case, perhaps the Minister does not care whether the cost of the program exceeds

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In order to bind all shareholders and both spouses, the shareholders' agreement should be unanimous and the non-shareholder spouse should sign an adoption agreement.[11] A shareholder's spouse could also be asked to waive his or her right to shares in the business upon a breakdown of the relationship. The parties should also consider including provisions in articles of incorporation that:

- require all shareholders to be a party to the shareholder agreement;
- create a non-voting class of shares for one spouse where both spouses are shareholders in the same business;
- restrict the issuance, transfer and encumbrances and reclassification of shares; and
- regulate pre-emptive rights and the redemption and conversion of shares.

If one of more spouses is an employee of a family-owned business, the employment contract may contemplate confidentiality and disclosure issues that arise in family law litigation.

VIII. Conclusion

When family law and corporate law worlds collide, the parties must contemplate basic corporate law principles in the context of often emotional family break ups that give rise to family law rights and obligations. Ontario's evolving case law offers a refined approach to piercing (or lifting) the corporate veil in the family law context. Advisors of family law litigants may continue to find themselves turning to corporate law principles and remedies in an effort to advance their family law claims or in establishing protection techniques to minimize the effect of corporate law on relationship breakdown.

[11] Halpern, *supra* note 7, at A6.70(b)(i).

POWERS TO ADD AND REMOVE TRUST BENEFICIARIES — INCOME TAX CONSIDERATIONS–PART I

By Elie S. Roth* and Michael Goldberg**

This paper reviews a number of income tax considerations under the *Income Tax Act*[1] (Canada) (the "Act") relevant to the exercise of a power to add beneficiaries under a discretionary trust and to the inclusion of powers to add and remove beneficiaries ("PARBs") in trust instruments, in particular in the context of Canadian family trusts.

Part I of the paper critically considers the administrative position of the Canada Revenue Agency (the "CRA") that the addition of a new beneficiary pursuant to the exercise of a power to add beneficiaries would vary the rights of the existing discretionary beneficiaries of the trust, who would be considered to have disposed of part of their existing interests in the trust to the newly added beneficiary for purposes under the Act. Part II reviews other potential issues under the Act that may arise in the context of the inclusion of PARBs in deeds of settlement of Canadian family trusts.

Part I – Exercise of Powers to Add Trust Beneficiaries

Where the relevant trust deed contains an existing power to add new beneficiaries to a discretionary trust, the addition of a new beneficiary pursuant to the exercise of the power should not result in a resettlement of the trust or in the creation of a new trust —- and accordingly there should not be a disposition of the trust property for tax purposes —- by virtue of the exercise of the power.[2] However, the CRA has taken the position that the addition of a new beneficiary pursuant to the power to add beneficiaries would vary the rights of the existing discretionary beneficiaries of the trust, who would be considered to have disposed of part of their existing interests in the trust to the newly added beneficiary.[3]

The CRA initially stated this position in an advance income tax ruling issued in 2002[4], which involved a discretionary trust ("Subject Trust") that included as one of its beneficiaries another trust under which the taxpayer was a beneficiary. The beneficiary trust had been subject to the attribution rule in subsection 75(2) and as a result distributions could not be made to the taxpayer from that trust on a rollover basis by virtue of subsection 107(4.1) of the Act. The terms of the Subject Trust provided that, subject to certain limitations, it could be amended by a written indenture signed by the settlor and all of the trustees. The proposed arrangement that the CRA considered involved an amendment to the Subject Trust to add the taxpayer as a discretionary beneficiary directly, so that property could be distributed to him on a rollover basis under subsection 107(2) of the Act. The CRA ruled that the amendment to add the taxpayer as a beneficiary directly would not, in and of itself, result in a disposition of any of the property of the Subject Trust. However, the CRA concluded that it would give rise to a disposition, within the meaning of subsection 248(1) of the Act, of a portion of each discretionary beneficiary's interest in the Subject Trust

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This paper was presented at the Law Society of Upper Canada, 17th Annual Estates and Trusts Summit, November 4, 2014 and is being reprinted here with the permission of the authors.

[1] R.S.C. 1985, c. 1 (5th Supp.).

[2] For detailed consideration of this issue in the specific context of subsequently adding the freezor as a beneficiary of the trust settled to acquire the growth shares on an estate freeze, see Elie S. Roth, "Including or Adding the Freezor as a Discretionary Trust Beneficiary", 2013 *Ontario Tax Conference* (Toronto, Canadian Tax Foundation, 2013).

[3] See CRA document number 2012-0451791E5, dated February 11, 2013; CRA document number 2007-0255961R3, dated January 28, 2008; CRA document number 2003-0181465, dated April 3, 2002; CRA document number 2001-0111303, dated January 1, 2002; CRA document number 2000-0059795, dated November 8, 2001; and CRA document number 9209655, dated July 22, 1992.

[4] CRA document number 2001-0111303, dated January 1, 2002.

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at the time the amendment was made. Each discretionary beneficiary would be deemed under paragraph 69(1)(b) of the Act to have received proceeds of disposition equal to the fair market value of part of the discretionary trust interest disposed of by them.

For this purpose, the CRA concluded that the value of each beneficiary's interest in the Subject Trust "at a particular point in time will approximate a proportionate share of the fair market value of the total of the trust's property at that time". Accordingly, the CRA concluded that each beneficiary's discretionary trust interest would have a fair market value equal to its *pro rata* share of the aggregate fair market value of the property of the Subject Trust.

The CRA confirmed its position with respect to the valuation of an interest in a discretionary trust in a subsequent technical interpretation, noting that it would be unreasonable to conclude that the fair market value of an interest in a discretionary trust holding property with significant value has a fair market value of nil simply because it is difficult to determine what the fair market value of the trust interest should be.[5] In reaching its conclusion, the CRA relied on the Ontario family law judgment in *Sagl v. Sagl*,[6] stating that, based on this decision, a reasonable approach would be to value the trust interest as if the trust assets were fully distributed equally among all of the discretionary beneficiaries on the valuation date. In this regard, it noted as follows:

> In our view this would be a reasonable approach to take in many cases involving the valuation of an interest in a discretionary trust. However, where the terms and conditions of the trust are such that this approach does not yield an appropriate result, it may be necessary to apply a discount factor in recognition of the uncertainty caused by any condition precedent or condition subsequent that could affect the value of the beneficiary's interest in the trust.

The CRA went on to note that in the absence of any "term of the trust that would direct the trustees to favour one beneficiary over another the even hand principle would suggest that the value of each beneficiary's interest was approximately equal".

These interpretations appear to have represented a change in the CRA's position. It had previously adopted the view that the "fair market value of an interest (either income or capital) in a fully discretionary trust is, generally, indeterminable due to the discretionary power of the trustee".[7] Subsequently, the CRA referred to its earlier view, noting as follows:[8]

> At the 1992 Canadian Tax Foundation B.C. Conference, we admitted that it would be difficult to quantify the value of an interest in a discretionary trust. However, in our view, it would be unreasonable to conclude in all cases that an interest in a discretionary trust holding property with significant value has no value.

The CRA noted that it does not have a general valuation position or policy with respect to the valuation of an interest in a discretionary trust, concluding that as "trusts are established through legal documents that can materially differ from one trust to another, each situation must be judged on its own merits", and that the valuation of an interest in a trust involves "an analysis of all relevant information, and the exercise of judgment in determining the appropriate method of valuing such an interest".[9]

The CRA reconfirmed its position concerning the tax consequences of adding a beneficiary to a discretionary trust pursuant to the exercise of a power contained in the trust deed in a technical interpretation released last year. The interpretation involved a discretionary family trust settled for the benefit of the taxpayer and his family. The taxpayer was the sole trustee, and the beneficiaries were the taxpayer, his spouse and their children, but only to the extent that a particular beneficiary was a resident of Canada for income tax purposes at the particular time. The trustee had the ability, in his absolute discretion, to pay or transfer all or any part of the income or capital of the trust to any beneficiary pursuant to the terms of the trust provided the beneficiary was a resident of Canada for purposes of the Act. One of the children of the taxpayer was a Canadian citizen who had been living in the United States and was a non-resident of Canada for tax purposes, but was contemplating returning to Canada and reestablishing Canadian tax residence. The CRA was asked whether the re-establishment of Canadian residence by the non-resident beneficiary would result in a disposition of the existing beneficiaries' interests in the trust. The CRA confirmed that where the terms of a discretionary trust provide for the addition of a beneficiary, and the trustees exercise the power to add a new discretionary beneficiary, this would not result in the creation of a new trust or in a resettlement of the trust. The CRA went on to note that it appeared based on the facts under consideration that the non-resident beneficiary was beneficially interested under the trust within the meaning of subsection 248(25) from the date of its settlement, and thus should be considered to be a beneficiary thereunder, although she would be entitled to receive distributions from the trust only upon becoming a resident of Canada for purposes of the Act. However, the CRA cautioned that this determination would depend upon the terms of the trust agreement and other related documentation.

The interpretation further noted where the addition of a beneficiary has the effect of varying the rights of the existing beneficiaries under the trust, they will generally be considered to have disposed of a portion of their interests in the trust. Subsection 106(2) would apply where a taxpayer was deemed to have disposed of an income interest (as defined in subsection 108(1) of the Act) in a trust (assuming subsection 106(3) was not applicable), and the specific rules in subsection 107(1) would apply to the deemed disposition of a capital interest in the trust. The CRA noted that if it could be established that no beneficiary had been added at the time the non-resident became a resident of Canada for tax purposes (because the non-resident was already a beneficiary under the trust), then in its view there would be no disposition

[5] CRA document number 2003-0181465, dated April 3, 2003.

[6] (1997), 31 R.F.L. (4th) 405 (Ont. Gen. Div.), additional reasons (1997), 35 R.F.L. (4th) 107 (Ont. Gen. Div.).

[7] CRA document number 9213470, dated September 1, 1992.

[8] CRA document number 2004-0062291E5, dated March 30, 2004.

[9] *Ibid.*

of any income or capital interest in the trust by the other beneficiaries. However, the CRA noted that this was ultimately a question of fact.

In the rulings and technical interpretations described above, the CRA specifically concluded that because the terms of the trust already provided for the addition of beneficiaries pursuant to an amendment power or an express power to add beneficiaries contained in the deed of settlement, the exercise of the power by the trustees to add a beneficiary would not result in the creation of a new trust or in a deemed disposition of the trust property. What would the CRA's position be in a case where the trust did not already contain an amendment power or a specific power to add beneficiaries? The CRA has taken the position that it is generally a question of fact whether or not an amendment or variation will involve the creation of a new trust. In this regard, it will consider whether the variation has caused such a fundamental change in the terms of the trust that a new trust is considered to have been created, in which case there may be considered to have been a disposition from the old trust to the new trust for purposes of the Act. This may have significant tax consequences if it occurs on a taxable basis and no rollover is available in respect of the deemed disposition.

Where the variation affects only the administration of the trust, and does not involve a change to the beneficial interests, there is generally little risk that the variation will have adverse tax consequences. However, even in the case of variations that involved fairly significant changes to beneficial interests, the CRA has issued rulings confirming that these changes did not give rise to a deemed resettlement. There are, for example, favourable rulings that have been issued in the context of the acceleration of trust interests, often to address the 21-year deemed disposition rule; variations to defer or extend vesting and termination dates; variations to include encroachment powers over capital of the trust; and a number of rulings that have addressed amendments to create new trusts to hold funds set aside for the benefit of minor or unascertained beneficiaries.

The recent decision of the Ontario Superior Court of Justice in *Eaton v. Eaton-Kent*,[10] involved an application by the contingent beneficiaries of a trust for an order approving a proposed variation. The trust held shares of a corporation that had appreciated materially since the settlement of the trust in 1992, and would have been subject to tax on the capital gain as a result of the 21-year rule on the trust's 21st anniversary. While the capital gains could be deferred by distributing shares to the capital beneficiaries in satisfaction of their respective capital interests in the trust pursuant to subsection 107(2) of the Act, the terms of the trust did not provide the trustees with the power to encroach on capital before the termination date of the trust, which was to occur on the death of the last to die of the two children of the settlor.

In December 2013, both of the settlor's children were still alive, and the 21st anniversary date of the trust was pending. All of the adult beneficiaries and the trustees of the trust consented to a variation that would amend the trust pursuant to the Ontario Variation of Trusts Act. Morawetz J. approved the applicants' proposed variation of the trust, on the basis that it was for the benefit of the minor, unborn, unascertained and incapable beneficiaries. The variation added administrative and discretionary powers so that a corporate reorganization of the trust's holdings could be implemented, leaving all of the beneficiaries economically whole and accelerating the distribution of capital. Interestingly, while there was a power to amend the terms of the trust contained in the Deed of Settlement and, under that provision, the terms of the trust could be amended to allow for an encroachment of capital in favour of all or any of the capital beneficiaries of the trust, the trustees determined to proceed by way of an application to vary the trust with court approval on behalf of the minor, unborn, unascertained and incapable beneficiaries rather than relying on the power to amend the trust contained in the Deed of Settlement.

In connection with the variation, the CRA provided an advance income tax ruling confirming that the reorganization and distribution of the assets of the trust and the reorganization of the capital of the corporation, of which the trust owned 57 percent of the issued share capital with the remaining common shares held directly by the children and grandchildren of the settlor outright, would not give rise to current taxation and would enable the distribution to be effected pursuant to the variation on a rollover basis in accordance with the provisions of subsection 107(2) of the Act.

The reorganization approved by the court involved the creation of two classes of preferred shares and four classes of common shares. Each of the settlor's children and grandchildren exchanged their common shares for a separate class of common shares, and the trust exchanged its existing common shares for two separate classes of common shares and two classes of preferred shares. One class of common shares was to be distributed to the children of each of the children of the settlor. The remaining common shares of the corporation were held directly by the individual beneficiaries, including the settlor's children and grandchildren. Accordingly, on the 21-year deemed disposition date, the trust would hold only the two classes of preferred shares. One class appeared to represent a thin class of scrip voting shares that enabled the trust to continue to control the corporation. The other class of preferred shares was non-voting, non-participating and provided for an annual dividend that appears to have been intended to be equal to the annual income distribution that was received by the settlor's two children before the reorganization as income beneficiaries on the common shares previously owned by the trust. The arrangement approved by the court also empowered the trustees to require that a shareholders' agreement be entered into before the distribution of the common shares; this agreement included a covenant to continue to declare the dividends on the preferred shares retained by the trust, as well as a dividend in a specified amount on the four classes of common shares, such that all of the beneficiaries would continue to receive equivalent dividends to those received in the period preceding the reorganization of capital. The CRA issued an advance

[10] *Fishleigh-Eaton v. Eaton-Kent*, 2013 ONSC 7985 (Ont. S.C.J.).

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income tax ruling confirming that the variation to accelerate the distribution of capital to the capital beneficiaries under the trust would not result in a resettlement of the trust, a deemed disposition of property held by the trust, or a disposition of the income or capital interest of any of the beneficiaries under the trust.

Notwithstanding these favourable rulings and administrative interpretations issued by the CRA in the context of changes made to beneficial interests under trusts, the CRA has taken the position that the addition of new beneficiaries to a trust can result in a resettlement of the trust property and thus in the creation of a new trust. In another recent technical interpretation, the CRA applied these positions in the context of a proposed variation of trust to add a corporation as a discretionary beneficiary. All of the shares of the corporation were owned by one or more existing individuals who were already existing discretionary beneficiaries under the trust. The CRA's position was that the variation would result in a partial disposition of the capital interests of the original beneficiaries under the trust. Pursuant to paragraph 69(1)(b) of the Act the beneficiaries would be deemed to have received proceeds of disposition equal to the fair market value of their interests in the trust, which in the CRA's view was a question of fact. The CRA noted that the non-resident beneficiaries would be required to comply with section 116 as a result of the partial disposition of their interests in the trust, presumably on the basis that the trust interests constituted taxable Canadian property. Moreover, it went on to state that where a new beneficiary is a corporation, and the majority of the voting and participating shares are held by persons other than the original beneficiaries of the trust, it will be necessary to consider whether this change is significant enough to result in a new trust, with all of the property of the old trust deemed to have been disposed of in favour of the new trust. Accordingly, where the corporate beneficiary added is owned and controlled by "new" shareholders who are not existing beneficiaries, the CRA's view is that the addition may result in the deemed creation of a new trust for purposes of the Act.

The CRA's stated position in these interpretations would appear to be extremely difficult, if not impossible, to apply in practice where a class of corporate beneficiaries, rather than a specific corporation, is added pursuant to the amendment. For example, where the class of beneficiaries is amended to include "any corporation all of the shares of which are owned beneficially by any one or more" of the named individual beneficiaries, how is the CRA's position to be applied? There may be no qualifying corporation in existence at the time of the amendment, or alternatively there may be a number of potential corporations in existence that may fall within the class, none of which may ever receive a distribution of property from the trust. In light of the fundamental distinction drawn by the CRA between the exercise of an existing power to add beneficiaries or amend the trust to do so pursuant to an existing amendment power, which does not result in a resettlement but may be deemed to give rise to a disposition by existing beneficiaries of their trust interests, and a variation to add a beneficiary, which can potentially result in a resettlement of the trust and a deemed disposition of all of its property, it may be considered that in appropriate circumstances there may be a benefit to first amending the trust to add a power to add or delete beneficiaries, and only subsequently exercising the power to add a beneficiary to the class.

Most recently, the CRA considered a circumstance in which the sole trustee of a discretionary trust exercised a power in the trust instrument to add a number of new beneficiaries under the trust. The trustee was one of the existing discretionary beneficiaries under the trust. It appears from the published version of the ruling that the new beneficiaries added to the class were unrelated to, and were otherwise considered to have dealt at arm's length with, the existing discretionary beneficiaries under the trust. The CRA recognized that the beneficial interest of a discretionary beneficiary in a trust is "essentially a right of that beneficiary to be considered by the trustee as to whether or not any trust property . . . should, in the trustee's discretion, be distributed or paid to or otherwise transferred or used for the benefit of that beneficiary", and that the right to be so considered or to have that right protected by a court is enforceable as such, although it does not necessarily provide the beneficiary any entitlement to a proprietary or ownership interest or right to or in the property of the discretionary trust. However, the CRA went on to note, somewhat anomalously, that when additional beneficiaries are added to a trust, whether as a result of a variation of the trust or pursuant to the terms of the trust, the "rights of the existing beneficiaries . . . are arguably diminished and as a result, each of the existing beneficiaries realizes a disposition of a part of the bundle of rights that forms his or her interest in the discretionary trust", and on this basis expressed the view that the existing beneficiaries realized a disposition of part of their interests in the trust when the new beneficiaries were added pursuant to the exercise of the power to add beneficiaries pursuant to the deed of settlement.

On the facts at issue, the CRA concluded that the addition of the new beneficiaries would not result in any actual or deemed proceeds in respect of that disposition, other than to the existing beneficiary who was the sole trustee of the trust. The CRA noted that its conclusion in this regard was based on substantially the same reasons as set out in paragraph 9 in Interpretation Bulletin IT-385R2, in respect of the release or surrender of an income interest in a trust. The CRA's position is that a beneficiary who, for no consideration, validly releases or surrenders an income interest in a trust in respect of future payments that are not due and payable at the time the release or surrender is executed, will not be considered to have received any proceeds of disposition for the purposes of subsection 106(2) of the Act, provided the beneficiary does not direct in any manner who is entitled to receive the benefit on the release or surrender, or if the beneficiary designates or otherwise agrees who will benefit by reason of the release or surrender, if the same person or persons would be entitled to benefit in the same manner under the trust in the absence of the beneficiary's designation or agreement. In contrast, in the CRA's view the trustee of the trust would be viewed as having made a gift to the new beneficiaries of a portion of the

trustee's beneficial interest in the trust, with the result that subparagraph 69(1)(b)(ii) would be applicable. This provision is not dependent upon a conclusion that the trustee was not dealing at arm's length with the new beneficiaries, and CRA considered that it could apply by virtue of the fact that the trustee was also a beneficiary under the trust who had realized a disposition of part of his interest in the trust as a result of the addition of the new beneficiaries.

The CRA's conclusions in this ruling are difficult to reconcile with its previously expressed administrative position. The ruling appears to suggest that subparagraph 69(1)(b)(i) would not be applicable in this case, as the existing beneficiaries dealt at arm's length with the newly added beneficiaries; however, subparagraph 69(1)(b)(ii) could apply to view the trustee as having made a gift of a portion of its interest in the trust to the new beneficiaries added by the trustee pursuant to the exercise of the power. This conclusion appears to confuse the capacity in which the trustee was acting in adding the beneficiaries pursuant to the power (as trustee, rather than in the personal capacity of a beneficiary making a gift), and also raises the question of why, if the position traditionally expressed by the CRA concerning variations of trust could be viewed as correct, the disposition considered to arise in respect of the other existing beneficiaries' discretionary interests in the trust would not also be viewed as a gift made by the existing beneficiaries, such that the proceeds deemed to arise under subsection 69(1) would not be considered to arise only in circumstances where the newly added beneficiary does not deal at arm's length with the existing beneficiaries.

Part II of this article will appear in the 30-11 issue of *Money & Family Law*, to be published in November 2015

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Monday through Friday,
8:30 a.m. to 5:30 p.m. Eastern Time

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We acknowledge the financial support of the Government of Canada, through the Publications Assistance Program, (PAP), toward our mailing costs.

Publications mail Agreement #40065782