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Variation of Trust to address deemed disposition

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Pursuant to the *Income Tax Act*, an inter vivos trust is deemed to dispose of its capital property at fair market value on the 21st anniversary of its date of settlement and each 21st anniversary thereafter. To avoid such a deemed disposition, a common planning step in advance of the 21st anniversary thereafter. To avoid the deemed disposition, a common planning step is to have the trust distribute and transfer appreciated capital property to the capital beneficiaries before the 21st anniversary. What happens, however, if the trust provides no authority or discretion to encroach on capital and distribute at this time?

This was the situation in *Eaton v. Eaton-Kent* 2013 ONSC 7985; the trustees addressed this issue by applying to the court to amend the trust under the *Variation of Trusts Act*. By court order, the trust was varied to add administrative and discretionary powers so that a reorganization could be implemented, leaving all beneficiaries economically whole and accelerating the distribution of capital. In addition, the trustees were empowered to require that a shareholders' agreement, acceptable to them, be entered into before any shares were distributed. (Although the trust deed contained an amendment clause, the trustees chose not to rely on it.)

In 1922, Harold Fishleigh, settled a trust for the benefit of his issue. The terms of the trust provided that Harold's two children (Wayne and Diana) were entitled to the income for life in equal shares. On the death of the first to die of Wayne and Diana, 50 percent of the net income was to be paid to the issue of the deceased beneficiary in equal shares per stirpes; upon the last to die of Wayne and Diana, the capital of the trust was to be distributed to the grandchildren on a per stirpes basis. In 2013, Wayne and Diana were still alive and the 21st anniversary was imminent. There was no provision for encroachment on capital during their lifetimes. The trust's main asset was 57 percent of the common shares of a private real estate corporation and these shares had a significant inherent gain. The remaining common shares of the corporation were held by Wayne, Diana, and their respective children.

The evidence indicated that the corporation declared dividends annually on its common shares. Wayne, Diana and their respective children received dividends by virtue of their direct ownership of shares. Wayne and Diana also received dividends as income beneficiaries of the trust.

The reorganization approved by the court involved the creation of two classes of preferred shares (class A preferred and class B preferred) and four equivalent classes of common shares (effectively one class for each of Diana, Wayne, Diana's children and Wayne's children). Diana, Wayne, Diana's children, and Wayne's children exchanged their respective common shares for a separate class of common shares. The trust exchanged its common shares for two separate classes of common shares and two classes of preferred shares. The proposal was that the trust would distribute one class of common shares to Diana's children and the other class of common shares to Wayne's children. Therefore, on its 21st anniversary, the trust would only hold the two classes of preferred shares.

The class A preferred shares held by the trust were non-voting, non-participating and provided for an annual aggregate six figure dividend. It appears that this amount was intended to equal the annual income distribution that Wayne and Diana received as income beneficiaries before the reorganization by virtue of the trust's ownership of common shares. The proposed shareholders' agreement included a covenant to declare this dividend. There was also a covenant to declare a dividend in a specified amount on each of the four classes of common shares, which appeared to be based on the dividend amount received by the particular person in the year preceding the reorganization. These dividend covenants were to continue until the death of both Wayne and Diana. In this manner, it appears that all beneficiaries were kept economically whole as they would receive the same dividends that they received in the year preceding the reorganization.

The class B preferred shares held by the trust allowed the trust to continue to control the corporation.

The trustees applied for an advance income tax ruling and asked for confirmation that the variation to accelerate the distribution of capital would not result in a resettlement of the trust, a deemed disposition of property held by the trust, or the disposition of an income or capital interest of any beneficiary of the trust. Canada Revenue Agency (CRA) ruled favourably in this respect.

On the 21st anniversary, the trust would have been subject to a deemed disposition at fair market value of the class A preferred shares and class B preferred shares. It appears to have been recognized that there was an inherent gain in respect of the class A preferred shares based on the fixed $1 per share redemption value. The class B preferred shares were non-participating voting shares with no dividend rights and a nominal redemption value, but they represented voting control of the corporation. A ruling was requested that the deemed disposition of these shares would not result in tax liability, but the CRA declined to rule because the matter was one of valuation. The valuation of so-called thin voting shares has been the subject of commentary in recent years, and the CRA's response has not been entirely satisfactory, as is the case here, where it declined to rule.

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