

## 21-YEAR TAX ISSUES AND THE NON-SPECIALIST ADVISOR — PART 4<sup>1</sup>

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Part 1 of this Series reviewed what the 21-year deemed disposition rules are and introduced three approaches to planning that appear to be most commonly used to manage the effects of the 21-year deemed disposition rules: Do Nothing, the *Simple Roll-Out*, and Vesting Indefeasibly. Part 1 of the Series also reviewed the Do Nothing approach. In the second instalment of the Series, the *Simple Roll-Out* approach was reviewed in detail and the third instalment of the Series reviewed the Vesting Indefeasibly approach.

This fourth instalment will delve into more advanced issues involving planning for trusts nearing their 21st anniversaries that have non-resident beneficiaries.

### Distributions of Appreciated Trust Capital Property to Non-Resident Beneficiaries

The general rules associated with distributions of appreciated trust capital property to non-resident beneficiaries are found in subsection 107(5). Pursuant to this provision, a distribution of appreciated property to a non-resident beneficiary will be subject to subsection 107(2.1), which will give rise to a taxable disposition of the property in the trust instead of a tax-deferred roll-out to beneficiaries that would otherwise occur under subsection 107(2).<sup>2</sup>

There is an election that can be made under subsection 220(4.6) to defer the tax otherwise payable under subsection 107(5) if the property distributed is taxable Canadian property,<sup>3</sup> provided that security is furnished that is acceptable to the Minister.<sup>4</sup> As was mentioned previously, in practice the decision to make the CRA a creditor of a private corporation can be problematic as security agreements can be quite restrictive.

For these reasons, direct distributions of appreciated trust capital property to nonresident beneficiaries are usually avoided.

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<sup>1</sup> Unless otherwise noted, defined terms in this article have the meaning designated in the first instalment of the Series.

<sup>2</sup> Distributions of a share of the capital stock of a non-resident-owned investment corporation or property described in any of subparagraphs 128.1(4)(b)(i) to (iii) (this exception includes an interest in Canadian real estate that is owned directly by a trust) are not subject to subsection 107(5).

<sup>3</sup> As that term is defined in subsection 248(1). The most common class of property that is taxable Canadian property is property that is or derives its value primarily from Canadian real property.

<sup>4</sup> The election, for which there is no prescribed form, must be made on or before the trust's balance due date for the year of distribution. Interest and penalties are deferred until the balance-due date of the year that the trust sells the property that is the subject of the deferral. At the option of the Minister, the election can be late filed under subsection 220(4.63).

## Dealing with Non-Resident Beneficiaries

Treating family members in a similar manner is often an extremely important family objective, often even more important than tax minimization. Consequently, rather than simply excluding non-resident beneficiaries of a trust from receiving their share of distributed trust property, other alternatives are usually examined. For example, sometimes the trust will own sufficient high ACB property, such as cash, so that disproportionate distributions of low ACB trust property to Canadian-resident beneficiaries can be equalized by making disproportionate distributions of the high ACB property to the non-resident beneficiaries.

If the property of the trust is incapable of being distributed tax efficiently to non-resident beneficiaries, then other equalization possibilities may include planning that is independent of the trust. For example, in a typical estate freeze situation, to compensate the non-resident beneficiaries from being excluded or receiving reduced shares of the trust property, the freezor might make disproportionate gifts from his or her personal assets to the non-resident beneficiaries while he or she is alive.

Because the freezor might need all of his or her personal property while he or she is alive, immediate gifting might not be possible and the equalization may need to occur by Will. However, Wills can be changed and/or the freezor's estate might have insufficient property to equalize the non-resident beneficiaries so that the non-resident beneficiaries might never be equalized. In addition, if equalization is to be made by Will, the non-resident beneficiaries may need to wait a long time (i.e., until the maker of the Will has died) to receive their equalizing gifts. As a result, this type of equalization planning may not resolve the potential for family disharmony, since in some situations it may leave the non-resident beneficiaries in a position of uncertainty, which they may view as unfair.

### Direct Distributions to Corporate Beneficiaries<sup>5</sup>

Assuming there are reasons that it is desirable for the non-resident beneficiaries to get their *pro rata* shares of the trust assets, an indirect solution would be to have one or more Canadian-resident corporate beneficiaries of the trust owned by the non-resident beneficiaries or any combination of eligible beneficiaries of the trust, including the non-resident beneficiaries, receive the property.

Where the trust had been drafted to permit corporate beneficiaries this can be a straightforward process from a Canadian perspective. The trustees simply resolve to distribute the non-resident beneficiaries' shares of the trust property to the corporate beneficiary or corporate beneficiaries.

Even though the process described above is straightforward, foreign legal and taxation advice should be sought to ensure that the distributions do not give rise to foreign tax and other issues now or in the future. For example, if a distribution is made for the benefit of a US beneficiary, then PFIC/CFC, US trust throwback, and other rules will need to be reviewed by US counsel.<sup>6</sup> In addition, consideration should also be given to structuring the corporate beneficiary as a flowthrough entity, such as an unlimited liability corporation formed under the laws of British Columbia, Alberta or Nova Scotia.

### Indirect Distributions That Benefit Non-Resident Beneficiaries

Where the trust does not specifically provide for corporate beneficiaries, it may still be possible to make a distribution of trust property to a corporation in some cases. Such planning may be available where the trust deed permits distributions "to or for the benefit of" a beneficiary.<sup>7</sup>

"To or for the benefit of" language is common in many trusts and in such situations, the typical planning will involve a process that will allow non-resident beneficiaries to have fixed interests in the trust, often using the Vesting

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<sup>5</sup> As will be discussed at the end of this article, recent comments by the CRA will impact all corporate beneficiary planning involving non-resident beneficiaries.

<sup>6</sup> Whenever US beneficiaries are involved in a trust, managing these types of issues will almost always be an extremely involved, time consuming, costly, and often unsatisfactory process.

<sup>7</sup> Timothy G. Youdan, "Planning to Deal with the 21-Year Deemed Disposition Rule," in 2008 Ontario Tax Conference (Toronto: Canadian Tax Foundation, 2008), 4:1-16 at page 9. See also M. Elena Hoffstein and Corina S. Weigl, "Overview of the Twenty One Year Rule — A Trust Lawyer's Perspective", in 2014 Ontario Tax Conference (Toronto: Canadian Tax Foundation, 2014), 7:1-62 at page 47. This exception relies on the extended meaning of "beneficially interested" provided in subsection 248(25), which applies to the definition of "beneficiary" in subsection 108(1).

Indefeasibly process that was described in Part 3 of the Series. Once the non-resident beneficiaries have identifiable fixed interests in the trust, the non-resident beneficiaries will transfer those interests into one or more Canadian-resident corporations on a tax-deferred basis pursuant to the rules in section 85.<sup>8</sup> If the trust interests are considered to be taxable Canadian property, then filings under section 116 would be required.

If the trust meets the definition of a fully indefeasibly vested trust then the 21-year rules might not apply to the trust any longer. If subsection 75(2) is not an issue and/or if there is no reason to maintain the trust any longer, then the trust might use *Simple* Roll-Out planning to distribute property comprising the vested interests as capital distributions to the corporation or corporations.

### **Risks and Issues Associated with “to or for the benefit of” Planning**

It appears that the primary tax risk associated with this type of planning is that the general anti-avoidance rule (“GAAR”)<sup>9</sup> could be applicable. In the past some authors suggested that advance tax rulings should be considered. There may also be certain technical tax issues associated with this planning, and foreign advice should be sought.

Notwithstanding these risks, anecdotally it would appear that prior to November 21, 2017, many advisors were relatively comfortable with this type of planning. Perhaps this was the case since the alternatives were often unsatisfactory — cutting out the non-resident beneficiary from the trust, triggering tax, or seeking a variation of trust.<sup>10</sup>

### **Round Table Discussion — November 21, 2017, Q.1**

Unfortunately, due to the CRA’s comments at the Canadian Tax Foundation’s November 21, 2017, Annual Conference Round Table (“Round Table”), there now appears to be significantly greater risk associated with corporate beneficiary planning — regardless of how this planning is implemented.

In particular, question 1 of the Round Table involved a situation in which the CRA was asked whether it agreed that subsection 107(2) would apply to a hypothetical transaction involving the distribution by a Canadian-resident trust of appreciated property to a Canadian-resident corporate beneficiary (“Canco”) owned by non-resident beneficiaries.

In its response, the CRA expressed significant concerns with this hypothetical transaction since, in its opinion, any capital gain distributed to Canco might potentially be deferred indefinitely, and that an indefinite deferral would only be possible because the beneficiary was a non-resident. The CRA also stated that it believes subsection 107(5) exists to ensure that Canada maintains the ability to tax the accrued gain on the trust property and that the implementation of the hypothetical transaction would contravene the underlying purpose of the capital gains tax regime of avoiding indefinite tax deferral.

Based on these concerns the CRA stated that the hypothetical transactions would frustrate the object, spirit, and purpose of multiple provisions in the *Income Tax Act*<sup>11</sup> and the Act as a whole and that it would consider applying the GAAR to such transactions unless there was “substantial evidence” that the GAAR should not apply. The CRA also advised that it would not issue any advance tax rulings on such transactions unless there was “substantial evidence” that the GAAR should not apply.

### **Impact of CRA’s New Administrative Position**

In many situations involving non-resident beneficiaries, the announcement by the CRA of this change in its assessing practices could have severe consequences since, in the absence of corporate beneficiary planning, there may be no way to avoid the subsection 107(5) deemed disposition if a distribution is made to or for the benefit of the non-resident.<sup>12</sup>

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<sup>8</sup> A capital interest in a trust is “eligible property” for purposes of subsection 85(1.1) (see CRA Document 2012-0459541E5 dated May 1, 2013).

<sup>9</sup> See section 245.

<sup>10</sup> A variation of trust can be a complex and costly process that is not without tax risk. For more on the subject of variations of trust see Hoffstein and Weigl, *supra* note 6 at 19.

<sup>11</sup> In particular, subsections 107(5), 107(2.1), 70(5), 104(4) and 107(2) were all noted.

<sup>12</sup> As noted previously in this article, it might be possible to make an election under subsection 220(4.6) if the distributed property is taxable Canadian property. If this election is unavailable, immediate taxation under subsection 107(5) could be deferred if the Do Nothing approach is implemented so that the trust will be taxable under the 21-year deemed disposition rules provided that the trust posts security

## **Does the CRA's Stated Administrative Position Mean this Type of Planning Can't Be Implemented?**

Likely not, and the CRA recognized this in its response to question 1 at the Roundtable. In particular, the CRA noted (grudgingly) that there may be situations involving corporate beneficiary planning that would not be subject to GAAR. Furthermore, the CRA does not make the law. Like tax advisors and taxpayers, the CRA interprets the law and the courts have the final word.

However, a definite impact of the CRA's new administrative position is that planning for non-resident beneficiaries involving corporate beneficiaries is now far more uncertain than was thought to be the case prior to November 21, 2017. Therefore, trustees of trusts involving non-resident beneficiaries will need to even more carefully consider the particular situation and the alternatives available to them, including whether the risk of GAAR being applicable is acceptable in any particular situation.

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and elects to pay the tax over 10 years pursuant to subsection 159(6.1). For more on the subsection 159(6.1) election see Part 1 of the Series.

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