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Estate Cases Raise Taxing Issues

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This article discusses a couple of recent cases – both involving estates - that raise interesting tax-related issues. The first illustrates the insidious effect of "boilerplate" provisions in a will can have on qualifying spouse trust status. The second shows that, while the attribution rules relating to spousal transfers stipulate that the transferor-spouse must report the gain on a subsequent disposition, this does not necessarily mean that the spouse is contractually responsible to defray the taxes. Originally published in CCH Tax Notes 570.

Balaz – Rectification of a Spouse Trust Will

The first case, Balaz**[1]**, involves a rectification order to a will in which a number of so-called boilerplate provisions were deleted, the objective being to create a qualifying spouse trust, so as to permit a rollover of assets into the trust.

Besides the requirement that, during his or her lifetime, the spouse must be entitled to all of the income of the trust, another key requirement for qualifying spouse trust status is that no person other than the spouse may, before the spouse's death, receive or otherwise obtain the use of any of the income or capital of the trust.

As it relates to boilerplate provisions in a will, this requirement is discussed in Chapter 8 of our book, Tax and Family Business Succession Planning**[2]** as follows:

> As the "no use" requirement must presumably be met under the terms of the trust, appropriate language should be inserted in the document. It therefore appears to be advisable to examine closely the powers given to trustees in a spouse trust in order to make sure . . . that the "boilerplate" does not trip over the "no use" requirement, e.g., by providing for a power to lend on any terms they see fit.**[3]**

Another example of boilerplate which could be problematic relates to provisions allowing the use of real estate, such as a home or vacation property, on non-commercial terms.**[4]**

Both of these provisions were the subject of the Balaz rectification order.**[5]** But the order involved a third provision which I found to be of interest: a standard corporate boilerplate provision allowing the trustees to incorporate and transfer assets of the estate into the corporation on such terms as they consider advisable, which was also struck out in the rectification order.**[6]**

The rationale for striking this clause stems from the fact that a corporation is a separate person - and the no-use requirement is that no person other than the spouse may, before the spouse's death, receive or otherwise obtain the use of any of the income or capital of the trust.**[7]**

The rectification order was granted on the grounds that it was the intention of the testator to create a qualifying spouse trust so as to defer death tax exposure**[8]**. Interestingly, the CRA did not oppose the order.**[9]** It appears from the court proceedings that the issues emanated from the surviving spouse's tax advisor, rather than adverse proceedings on the part of the CRA.

I am not aware of the CRA taking the position that a provision allowing the estate to form a corporation and transfer property thereto on such terms as the trustees see fit disqualifies spouse trust status.**[10]** However, what is becoming increasingly obvious is that, from a technical standpoint, it is surprisingly easy to trip over the "no-use" requirement. As another example, as discussed in

Chapter 8 of our book, Question 14 of the 2008 APFF Round Table**[11]** may suggest that a spouse trust should contain a non-assignability clause.

Zeitler – The Attribution Rules Apply – But Who Pays the Tax?

The second case, Zeitler**[12]**, was recently decided by the British Columbia Court of Appeal and dealt with the spousal attribution rules, which generally require the transferor-spouse to pay the tax on a subsequent disposition of a transferred property**[13]**. The Zeitler case dealt with whether - in spite of the attribution rules - there was nonetheless an implied term in the transfer agreement in question that the transferee-spouse should defray the tax.

The case involved a wife's purchase of two rental properties in the mid '80's. A couple of years after the purchase, the properties were transferred to the husband for fair market value consideration**[14]**. After the transfer, the wife had no further involvement with the properties. The husband passed away intestate, such that the husband's children would be entitled to most of the estate, but under the attribution rules, the wife would have to pay tax on a deemed disposition of the property, arising from the husband's death.**[15]**

The court held that the operation of the attribution rules so as to tax the gain in the hands of the wife (i.e., transferor-spouse) was not determinative as to whether there was a contractual obligation for the transferee-spouse to defray these taxes**[16]**.

The court further held that there was an implied term in the transfer agreement between the spouses that the husband – now his estate – would pay the taxes on a subsequent disposition. Although a court should be reluctant to rewrite contracts, cases indicate that this can be done based on the presumed intention of the parties where the implied term must be necessary to give business efficacy to a contract.**[17]** The judgment indicates that it seems to be "obvious that, if asked at the time they formed the contract which of them was to be responsible for the tax, both parties would have said that Mr. Zeitler would be responsible. He acquired both the legal and the beneficial interest in the property. He was entitled to the gain for his sole use."**[18]**

These sorts of issues might arise, for example, on a second marriage for both spouses. Suppose that the husband's and wife's assets are each to be left to children of their first marriages. However, the husband agrees to fund the purchase of a luxury vacation property to be owned by the wife – and to be left to her children**[19]**. If the wife were to predecease the husband**[20]**, the husband may assert that, based on Zeitler, there is an implied term that the wife's estate – i.e., the children from her first marriage - should pay the taxes on the deemed disposition of the vacation property.

But when should there be such an implied term?**[21]** In the Zeitler case itself, it appears that the transfer price was at or near the cost of the properties, so that the implied obligation of the transferee-spouse to pay tax in respect of the transferred properties did not have to take into account deferred tax liability existing at the time of the transfer. Suppose, however, that this was not the case – i.e., there was deferred tax exposure at the time of the transfer. Should there still be an implied term? Does this depend on the magnitude of the deferred tax exposure relative to the total tax? Should the implied term relate only to post-transfer appreciation?

While it may be said that the Zeitler case may add some uncertainty as to who must pay the tax when the attribution rules apply, the situations in which this may actually be in dispute may be fairly limited, in view of the fact that specific rules apply when spouses separate**[22]**.

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[1] *Balaz* v. *Balaz, et al*, 2009 CanLII 17973 (ON S.C.).

[2] By the author, Michael Goldberg, and Samantha Prasad, 2009 CCH Canadian Limited. See also "Spousal Trusts", by the authors of *Tax and Family Business Succession Planning*, in the August 2009 edition of *Tax Notes* (No. 560).

[3] As pointed out in Chapter 8, Document No. 2003-0019235 (July 17, 2003) indicates that where the trust permits funds to be loaned (or any other form of assistance to be provided) to anyone other than the spouse for inadequate consideration, this would disqualify the trust, whether or not such a loan was actually made.

[4] Paragraph 16 of Interpretation Bulletin IT-305R4 sanctions the renting of real estate at market value or the lending of money on commercial terms (including market rates of interest, appropriate securities and a reasonable repayment schedule).

[5] The real estate provision contained a clause allowing the trustees to lease real estate upon such terms, covenants and conditions the trustees deem appropriate, etc.

[6] The following is the wording of provision that was struck:

> At the expense of my estate to incorporate or cause to be incorporated alone or in conjunction with any person or persons one or more corporations (any portion of the outstanding shares of which may form part of my estate) under the laws of the Province of Ontario or any other jurisdiction, which corporation or corporation *[sic]* may have whatever objects and undertakings and continue or carry on any business or businesses that my Trustees in their absolute discretion consider to be in the best interest of my estate and the beneficiaries thereof, and my Trustees may in their absolute discretion at any time or times sell, convey or otherwise transfer any part or parts of my estate for the time being (including any business or businesses) to any such corporation at such prices and subject to such terms and conditions as my Trustees shall in their absolute discretion consider advisable and in consideration for any such sale, conveyance or transfer may accept as consideration securities (whether or not such securities have been issued by such corporation) or other real or personal property and any such consideration so received shall be an authorized investment under this Will.

[7] Should the concern be about whether a transfer to the corporation *per se* violates the no-use requirement – i.e., because another person has the use of the capital, or whether the power of the trustees to transfer assets from the estate *on such terms the trustees consider advisable* means that the consideration for the transfer could be on non-commercial terms and/or not fair market value.

As pointed out previously, the CRA's position has been that the no-use requirement will be met if the use of real estate or a loan is at fair market value/commercial terms. Therefore, the latter concern seems to be more analogous to the CRA's position – e.g., the CRA has not taken the position that a loan or rental of real estate *per se* violates the no-use requirement.

The rectification Endorsement itself alluded to the concern that the three provisions to be deleted could be construed as "conferring a benefit" to someone other than the surviving spouse [paragraph 5].

[8] The lawyer who drafted the will deposed that the provisions in question were included inadvertently in the Secondary Will, without the testator's knowledge or approval.

[9] It approved the form of the draft judgment submitted by the applicant.

[10] Paragraph 1 of the Endorsement indicates that, without the rectification of all three clauses in question, the CRA "would take the position that the Secondary Will did not create a valid spousal trust within the meaning of the *Income Tax Act*."

[11] Doc. No. 2008-0285071C6, October 10, 2008.

[12] *Zeitler* v. *Zeitler (Estate)*, 2010 BCCA 216.

[13] See in particular section 74.2.

[14] Consisting of the assumption of liabilities and a promissory note for the difference.

[15] Subsection 74.5(1) provides that the attribution rules no longer apply if the property is transferred at fair

market value and the parties elect to opt out of the spousal rollover in subsection 73(1). The Court of Appeal's judgment makes no reference to this provision.

[16] See paragraph 22. In paragraph 23, the court indicated that the joint and several liability of the transferee for the transferor's tax under the attribution rules (per paragraph 160(1)(d)) was an "even stronger reason, as between the parties, for not visiting liability for the tax on Mrs. Zeitler."

[17] In this respect, the court cited *Reigate* v. *Union Manufacturing (Ramsbottom)* [1918] 1 K.B. 592 at 605 (C.A.), where Scrutton L.J. said:

> A term can only be implied if it is necessary in the business sense to give efficacy to the contract; that is, if it is such a term that it can confidently be said that if at the time the contract was being negotiated some one had said to the parties, "What will happen in such a case," they would both have replied, "Of course, so and so will happen; we did not trouble to say that; it is too clear."

[18] Paragraph 35.

[19] In a second marriage scenario, it is possible that such a transfer could be subject to a formal agreement between the spouses so as to bring into consideration the case law on contracts as considered in *Zeitler*. In Ontario at least, it is also quite possible that the provisions of a marriage contract may be applicable, e.g., entered into in order to prevent the surviving spouse from opting for an equalization in *lieu* of the provisions of the will; for example, there could be a separate property regime.

[20] If the husband predeceases the wife, the attribution rules would cease to apply and the wife/wife's estate must pay tax on the gain.

[21] Paragraph 37 of the judgment indicates:

> I do not consider that the implied term I would find to be present in this case must be found to be present in every transfer of real property between spouses. Whether there is such an implied term will depend on the circumstances in each case.

[22] See subsection 74.5(3).