In my article on Discretionary Family Trusts in last month’s TaxLetter, I noted that family trusts only have a tax life span of 21 years. This is because they are deemed to have sold all of their assets by their 21st anniversary.

So if the appropriate planning is not done, the family trust could potentially be subject to a deemed capital gain. Some thought should be given to ensure that the trust capital is distributed out of the family trust to the beneficiaries in order to avoid this capital gains hit.

However, there may be some potential tax problems that could jeopardize the ability to distribute tax-free.

The general rule regarding distributions out of a trust is that trust capital (not income) can be distributed out of a discretionary family trust on a tax-deferred basis to a beneficiary.

However, there are a couple of instances in which tax could be triggered at the trust level on any such capital distribution.

The first is where the trust property is distributed to a non-resident beneficiary. If your children are resident outside of Canada, you cannot distribute to them tax-free. However, if the class of beneficiaries includes a corporate beneficiary (a Canadian company held by such non-resident children), this provides some tax planning opportunities.

If the trust does not include a corporate beneficiary, possible alternatives could include varying the trust to add corporate beneficiaries, or having the non-resident beneficiary assign his or her interest in the trust to a Canadian company.

But there are certain tax issues that may prevent these options unless properly addressed with your advisor.

Reversionary trust rules

A more dangerous tax trap is the application of the attribution rule commonly referred to as the “reversionary trust rules.”

In a nutshell, if this rule is ever applied to a trust (even for one moment in time), then you lose the ability to distribute capital out of the trust tax-free, even if it is to a Canadian beneficiary.

In order to avoid this trap, it is important to understand when the reversionary trust rules will apply. Specifically, they will apply if property contributed to a trust (or substituted property) is held on condition that it:

☛ may revert to the person from whom the property was directly or indirectly received (i.e. the contributor);

☛ may pass to persons determined by the contributor after the creation of the trust; or

☛ may not be disposed of during the contributor’s life/existence without his or her consent/direction. (For example, the contributor has a veto power over how the property is distributed.)

The danger is that even if you are able to cure the trust of this tax problem, the damage is
already done.  

Best to keep the following scenarios in mind as they are examples of when you can trip over this rule inadvertently, and essentially falling into a tax nightmare.

✓ You contribute property to the trust, and are a beneficiary of said trust. This may be the case if you are designated as a contingent beneficiary, e.g., if other beneficiaries pass away.

(Note: there is a distinction where the trust property reverts to you by operation of law because of a failure of the trust. For example, if the trust fails because there are no beneficiaries left to whom the property can be distributed.)

✓ The trust trips over a tax “technicality” in which the trust contains 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.

✓ A beneficiary pays expenses on behalf of the trust or contributes cash to allow it to do so. One possible example is where a trust incurs accounting fees (e.g., to file tax returns).

Suppose the beneficiary writes out a cheque to defray these expenses. Even if the cheque is made out directly to the accountant, the beneficiary has effectively “contributed” to the trust.

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**It is now possible for a beneficiary to sell property to the trust, as long as it is for fair market value**

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You may be able to avoid this problem by structuring this as a true loan by the beneficiary to the trust (see below).

✓ The contributor has a “veto” over the distribution of the trust property, or has the power to determine who the property can pass to. An example of this scenario is where 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.

With respect to the last point (where the contributor is one of two trustees), CanRev has indicated some leniency in applying this attribution rule. As long as the acts of the contributor as trustee stem from the exercise of his or her duty as a trustee (and not from a greater power), then the CRA has stated that it won’t apply the attribution rule.

But the moment you give the contributor extra powers (i.e., veto power on distribution decisions), you’re in hot water.

As a result of some recent case law, however, it is now possible for a beneficiary to sell property to the trust, as long as it is for fair market value.

A beneficiary can also loan money to a trust, as long as it is a true loan (although it appears that the loan does not need to be interest-bearing, it certainly is more helpful if it is).

What is of interest in the last few years is that a growing number of trusts that are currently approaching or have approached their 21st anniversary may find themselves running afoul of these reversionary rules.

This is because the actual rule preventing the tax-free roll-out of the trust property in this context did not come into play until the late 80’s, and the consequences of tripping over these rules was not always fully appreciated by practitioners into the early 90’s.

**Use an advisor**

So if you’re sitting on an old trust that may be approaching its 21st anniversary, you may want to consult with your tax advisor.

And for those of you who still have the clock running on the first 21 years, make sure you consult with your advisor to ensure that you don’t fall into any of these tax traps.