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Winding up of a Family Trust

Carefully, now

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The first discretionary trust that I ever drafted for a client was about 21 years ago, which means that I've now gone full circle with the trust, having seen its "birth" and recent "death". And if you have been reading my articles for the last number of years, you'll immediately know why 21 years is an important anniversary date. For those of you who don't know, discretionary family trusts only have a tax life span of 21 years, as they are deemed to have sold all of their assets on each 21st anniversary. So, if the appropriate planning is not done, the family trust could potentially be subject to a deemed capital gain. In order to avoid this deemed tax hit, you may want to consider winding up the trust (hence its "death") and distributing the trust capital to the beneficiaries before the 21st anniversary. The exception to this type of planning is where the assets of the trust do not have a pregnant gain that has not yet been realized (for example, if the assets are made up of GICs or other cash equivalents, with no inherit gain, then the deemed disposition rules would not trigger any capital gain). If, however, the assets include shares of a company that might have been put in place as part of an estate freeze, then you should consider distributing those shares out to the beneficiaries (assuming of course that the underlying company has grown in value).

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Distributions

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 (i.e. the trust is deemed to have disposed of the trust assets at the trust's cost base, as opposed to the fair market value of such assets). However, there are a couple of instances in which tax could be triggered at the trust level on any such capital distribution:

1. The first is where the trust property is distributed to a non-resident beneficiary. So, if your children are beneficiaries of a trust and are resident outside of Canada, you cannot distribute tax-free to them (the trust will be subject to a deemed disposition at fair market value of the trust assets distributed out to such non-resident beneficiaries). However, if the class of beneficiaries includes a corporate beneficiary (a Canadian resident company held by such non-resident children) then the trust assets could be distributed to the Canadian resident company as opposed to the non-resident children in order to avoid the tax to the trust. If the trust does not include a corporate beneficiary, then 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.

2. A more dangerous tax trap is the application of the attribution rule common referred to as the "reversionary trust rule" under s. 75(2) of the Income Tax Act. In a nut shell, if s. 75(2) ever applied to

a trust (even for one moment in time), then you lose the ability to distribute capital out of the trust on a tax-deferred basis, even if to a Canadian resident beneficiary. So in order to avoid this trap, it is important to understand when the reversionary trust rules will apply.

Reversionary Trust Rule

This rule will apply to a trust where property contributed to a trust is held on condition that the property (or substituted property):

☛ 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 with this rule is that even if you cure the trust of this tax problem, the damage is already done. The trust will be forever tainted and it will always be subject to a deemed disposition at fair market value when distributing to a beneficiary (even if such person is a resident of Canada). The only two exceptions to such deemed disposition are:

1. If the trust distributes to the contributor or his/her spouse; or
2. After the date of death of the contributor.

The following scenarios should be kept in mind so that you don't trip over this rule, and essentially fall into a tax nightmare.

☛ You contribute property to the trust and you are a beneficiary of the trust. This includes if you are a contingent beneficiary, e.g., you are not a primary beneficiary but could benefit under the trust once the primary beneficiaries pass away. (However, there is a distinction where the trust property reverts to you by operation of law because of a failure of the trust, e.g., if the trust fails because there are no beneficiaries left to whom the property can be distributed).

☛ The trust trips over a subsection 75(2) "technicality." One example is if 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 ultimately determined by the contributor through his/her will.

☛ 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 must pay its professional fees (e.g., paying an accounting firm for preparing and filing the trust's tax returns). Suppose that the beneficiary writes out a cheque directly to the accounting firm to defray these expenses. Even though the funds are not first paid to the trust, and are paid directly to the accountant, arguably, at least, the beneficiary has effectively "contributed" to the trust.

☛ The contributor has a "veto" over the distribution of the trust property (or the power to determine who the property can pass to); for example, 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, the CRA has indicated some leniency in applying this attribution rule where the contributor is one of two trustees. So long as the acts of the contributor as trustee stem from the exercise of his or her duty as a trustee (and not under 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), then you will run afoul of the rule.

As a result of some case law, however, it is 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 (even if such loan is not at commercial terms, i.e. interest-free) without offending this rule. However, it would be prudent to document the loan as such, just in case the CRA comes knocking on your door. ❑