Planning to Deal with the 21-year Deemed Disposition Rule

Timothy Youdan
tyoudan@dwpv.com
PLANNING TO DEAL WITH THE 21-YEAR DEEMED DISPOSITION RULE*

Timothy G. Youdan**

Background

The General Rule

Most personal trusts are deemed to dispose "of each property of the trust (other than exempt property)\(^1\) that was capital property (other than excluded property\(^2\) or depreciable property\(^3\) or land included in the inventory of a business of the trust" at the end of the day which is 21 years after the day on which the trust was created and on each 21\(^{st}\) anniversary thereafter.\(^4\) I shall refer to this as the 21-year rule.

Some Trusts not Subject to Deemed Disposition

Certain trusts are excluded from the application of the 21-year rule.\(^5\) These excluded trusts include:

"(f) a trust that, at that time, is a unit trust, or

(g) a trust all interest in which, at that time, have vested indefeasibly, other than

---

* This paper was previously presented at Ontario Tax Foundation Conference, Mississauga, October 20, 2008.

** Partner, Davies Ward Phillips & Vineberg LLP.

1 Exempt property is defined in s.108(1) of the Income Tax Act (Canada) (the "Act") [subsequent references to provisions of an Act are references to this Act unless otherwise stated] as property the income or gain from the disposition of which by a taxpayer is exempt from Canadian taxation either because the taxpayer is not resident in Canada or because of a tax treaty. The purpose of this exception is not to provide relief to taxpayers; the purpose is to prevent the deemed realization rules from being used to increase the cost of such property. The increased cost might be relevant in the event that a non-resident trust distributes such property to Canadian beneficiaries.

2 Excluded property is defined in s.108(1) as "a share of the capital stock of a non-resident-owned investment corporation that is not taxable Canadian property". Non-resident-owned investment corporations ("NROs") have been phased out of the Act and existing NROs lost their status as such by the end of 2003. See paragraph (i) of the definition of NRO in s.133(8).

3 Depreciable property is dealt with by s.104(5).

4 S.104(4)(b), (c).

5 See definition of "trust" in s.108(1).
(i) an *alter ego* trust, a joint spousal or common-law partner trust, a post-1971 spousal or common law partner trust or a trust to which paragraph 104(4)(a.4) applies,

(ii) a trust that has elected under subsection 104(5.3), 6

(iii) a trust that has, in its return of income under this Part for its first taxation year that ends after 1992, elected that this paragraph not apply,

(iv) a trust that is at that time resident in Canada where the total fair market value at that time of all interests in the trust held at that time by beneficiaries under the trust who at that time are non-resident is more than 20% of the total fair market value at that time of all interests in the trust held at that time by beneficiaries under the trust,

(v) a trust under the terms of which, at that time, all or part of a person's interest in the trust is to be terminated with reference to a period of time (including a period of time, determined with reference to the person's death), otherwise than as a consequence of terms of the trust under which an interest in the trust is to be terminated as a consequence of a distribution to the person (or the person's estate) of property of the trust if the fair market value of the property to be distributed is required to be commensurate with the fair market value of that interest immediately before the distribution, or

(vi) a trust that, before that time and after December 17, 1999, has made a distribution to a beneficiary in respect of the beneficiary's capital interest in the trust, if the distribution can reasonably be considered to have been financed by a liability of the trust and one of the purposes of incurring the liability was to avoid taxes otherwise payable under this Part as a consequence of the death of any individual."7

---

6 This was a one-time election to defer a deemed disposition to January 1, 1999, that would otherwise have occurred at an earlier date.

7 *Cf.* s.104(4)(a.2).
These rules determine whether the trust is excluded from the 21-year rule at any particular time. Therefore, a trust may be subject to the rule at its inception but then, prior to the applicable deemed disposition date, circumstances may have occurred which cause the trust to be excluded. Consider, for example, a trust which provides for beneficiary A to receive income during his or her lifetime and then on the death of A the capital is held in trust for B, C and D. During the lifetime of A, the trust will come within exception (v) to paragraph (g) above and so will be a trust subject to the 21-year rule. On the death of A, paragraph (v) will cease to apply and the trust will be excluded from the rule from then on. It should be noted that when A dies, each of B, C and D will have an indefeasibly vested interest that will be realized on an actual disposition, on the death of the person holding it, or on such person ceasing to be a Canadian resident.

The Deemed Disposition Date

As stated above, ordinarily trusts subject to the 21-year rule will have a deemed disposition on the 21st anniversary of the creation of the trust and each succeeding 21st anniversary. Certain trusts, however, have a different initial deemed disposition date. In particular, a spouse trust, a joint partner trust, an alter ego trust (unless an election is made) or a so-called self-benefit trust will have a deemed disposition on the date of the death of the spouse in the case of a spouse trust, on the death of the survivor of the settlor and his or her spouse in the case of a joint partner trust or the date of death of the settlor in the case of an alter ego or self-benefit trust.

---

8 The defined term in s.248(1) is "post-1971 spousal or common-law partner trust".

9 The defined term in s.248(1) is "joint spousal or common-law partner trust".

10 S.248(1) "alter ego trust".

11 An alter ego trust can make an election under s.104(4)(a)(ii.1), in its income tax return for its first taxation year, not to have a deemed disposition on the death of the settlor. If this election is made, the 21-year rule will apply and also, pursuant to s.73(1.02)(c), there will be no rollover with respect to the transfer of property into the trust.

12 This is not a defined term. The requirements are derived from ss.73(1.01)(c)(ii) and 73(1.02)(b)(ii).

13 S.104(4)(a), (a.4). Cf. the provisions dealing with a pre-1972 spousal trust which have the effect that in certain circumstances the initial deemed disposition date is the later of the date of death of the spouse and January 1, 1993: ss.104(4)(a.1), 108(1) "pre-1972 spousal trust".
**Date of Creation of a Trust**

Since a trust is not, under the general law, a legal person and its creation does not depend on any government act, the date of its creation, for the purposes of the operation of the 21-year rule, has to be determined in accordance with the general principles of trust law, unless otherwise modified by provisions of the *Income Tax Act*.

Under general principles, the existence of a trust requires the satisfaction of the so-called three certainties of words, subject and objects. Certainty of words means that there must be sufficient expression of intention to create a trust. Certainty of subject has two aspects. First, it must be sufficiently certain what is the property subject to the trust (so that a trust purportedly created by will of "the bulk of my estate" would most probably be held not to create a valid trust). Second, the benefit to be obtained from the property by each beneficiary must be defined so as to enable it to be ascertained (so that a purported trust of $100,000 "mainly to be held for the benefit of John with the rest for Mary" would likely fail). Certainty of subject can be satisfied where a person is given a discretion to determine the quantum of the beneficiaries' interests or where a formula is provided by reference to which the quantum can be determined. Certainty of objects requires that the persons (or, exceptionally, the purposes) benefited by a trust must be sufficiently ascertainable. In addition to satisfaction of the three certainties, in order that a valid trust can come into existence there must be property held by the trustee(s) subject to the terms of the trust.

Ordinarily, therefore, there is no difficulty in determining when an *inter vivos* trust is created: it will occur when the initial settled property is transferred to the trustees to hold on the terms of a trust instrument signed by the settlor and the trustee (or when the settlor has declared himself or herself to be trustee of particular property on particular terms).\(^{14}\) However, if the trust document is signed on a particular date but no property is transferred to the trustee until the later date, there is no trust until such later date and consequently the 21-year period should not begin to run until such later date.

In the case of a trust created pursuant to the terms of a Will the position may be more difficult. Consider the following example. The Will of the testator appoints X and Y as his

---

\(^{14}\) No particular formalities, such as writing and signature, are required for the creation of an *inter vivos* trust of property other than land. Ordinarily, however, such trusts will be created by signed written documents.
executors and trustees; it provides for the transfer of certain particular properties to named individuals; it provides for legacies of money to named individuals; and it provides that the residue is to be held on certain trusts by the executors and trustees. Under the terms of these trusts, income is paid to the testator's wife, W, and there is a power to transfer capital to W or to the children of the testator and W (so, in this example, it is not a qualified spouse trust) and on the death of W, the property is divided into as many equal shares as equal the number of children alive at that time. Each such share is required to be held as a separate trust on certain terms for the benefit of each child and his or her issue.

Although the position is not completely clear, it seems to be as follows:

- The position could be taken that, during the period from the death of the testator until the completion of the administration of the estate and the establishment of the trust of residue, the estate constitutes a testamentary trust. On this basis, the trust for the benefit of W would only come into being on the completion of the administration of the estate. The problem with this position is that, subject to particular terms of the Will, it should be held that W is entitled to the income of the residue of the estate from the date of death of the testator and it will often, in any event, be difficult to determine a precise date when the administration of the estate is concluded. Whether or not this position is correct, if the testator died after the coming into force of section 104(5.8) on February 11, 1991, section 104(5.8) will have the effect that the twenty-one year period will run from the date of death of the testator.

- Each separate trust coming into effect on the death of A should be considered a separate trust, and a separate taxpayer for the purposes of the ITA. There are two possible positions on when, for the purposes of the ITA, these trusts were created. The first is that they were created on the death of the testator. The second position is that they were created on the death of W. If W died after the coming into force of section 104(5.8) on February 11, 1991, it should not make any difference which position is correct since even if the second position is correct section 104(5.8) will have the effect that the deemed disposition date of each separate child's trust will be the same as that applicable to the trust during the life of A.\textsuperscript{15}

Ways to Deal with 21-Year rule

Do Nothing

One possibility, which seems facile but in appropriate cases should be seriously considered, is to do nothing and to permit the deemed disposition to occur and to pay any tax payable in respect of it.\textsuperscript{16} This decision has the obvious attraction that it enables the trust to continue in accordance with its terms, so that the objectives envisaged for the trust (such as the holding of property in trust for the benefit of young children) can continue to be achieved. If there will not be significant gains at the deemed disposition date, it will usually be easy to make this decision. This may often be applicable where the trust property consists of a portfolio of marketable securities which are traded from time to time. Even if there are significant gains in respect of such a portfolio, realizing the gains on the deemed disposition with the resulting tax but also increased cost base may still be the right decision. Where there is a gain on a particular investment, consideration should be given to the sale of the investment and the actual realization of such gain. From an investment policy perspective, this may be the right thing to do. For example, I remember when Nortel was trading at over $100 per share, and trustees were seeking advice about how they could defer a deemed disposition of the shares. At least with hindsight, we know that they should have sold the shares, taken the gain and paid the tax.

A variant on doing nothing is to take steps to reduce the value of property owned by the trust – where the trust owns shares of a corporation controlled by it – by the payment of dividends and the utilization of any RDTOH and any capital dividend account. Wolfe Goodman dealt with this strategy in an interesting way. He was considering a trust with an income beneficiary where there was no power to distribute appreciated property out of the trust; nor could it be varied. He then continued as follows:

"In that case, we concluded that we would simply have to face deemed realization of the trust during the lifetime of the original income beneficiary. We had to concentrate on reducing the potential tax liability. The trust held all the shares of an investment company which owned various securities, some of which were highly appreciated. It also had a substantial capital dividend account and a large amount of refundable dividend tax on

\textsuperscript{16} Pursuant to s.159(6.1) the tax may be paid in 10 annual instalments subject to payment of interest and the providing of security.
hand. In these circumstances, it clearly made sense for the company to pay out its whole capital dividend account to the trust, since this would reduce the value of the shares but without creating any tax liability for the trust. In addition, since payment of taxable dividends would result in refund of the company's RDTOH, it also made sense for it to pay sufficient dividends to exhaust its RDTOH, giving the company a large tax refund. Even though the trust would have to pay tax on this dividend, this would not involve any significant net tax liability. Because we did not want these large distributions by the company to be treated as income payable to the income beneficiary, the company was advised to issue stock dividends for these distributions, which would be treated as capital receipts under trust law and therefore would be retained in the trust.

The really difficult problem concerned the large amount of unrealized appreciation in the securities portfolio of the company, which obviously increased the value of the shares in the hands of the trust and affected their tax liability. We therefore recommended that the trustees form a new company to which they would transfer all of the present company's portfolio at fair market values, and that the present company would then be wound up. This would, of course, accelerate the company's tax liability in respect of these appreciated securities. The resulting addition to the company's capital dividend account could be distributed as a tax-free capital dividend, and while the taxable portion of the capital gains could be distributed as a taxable dividend, this would reduce the total tax liability only slightly. The main reason for transferring these securities to a new company at their fair market value was to ensure that they would have a stepped-up adjusted cost base in its hands. If the trustees did not make this transfer, the adjusted cost base of the securities would be unaffected by the fact that its shares had been revalued to their fair market value, which would have been a very serious situation.17

Additionally, it may be appropriate to utilize any remaining capital gains deductions.

Transfer to Another Trust No Longer Available

Prior to February 11, 1991, one possible way to avoid the effects of the 21-year rule was to transfer property of the trust to a new trust in circumstances in which there was no change of beneficial ownership so that there would not be a disposition by the original trust.18

---

With effect from February 11, 1991, section 104(5.8) precluded this possible method of dealing with the 21-year rule. It applies where property is transferred by a trust to another trust "in circumstances in which subsection 107(2) or 107.4(3) or paragraph (f) in the definition "disposition" in subsection 248(1) apply." These are all circumstances in which either there is no disposition or there is a disposition on a rollover basis. Broadly speaking, the effect of section 104(5.8) is that the deemed disposition date of the transferee trust will be no later than the date that would have been applicable to the transferor trust.19

Distribution to Beneficiaries

General

The 21-year rule can be avoided by the distribution of property on a rollover basis from the trust to one or more beneficiaries so that when the 21st anniversary occurs the trust does not hold any property with accrued gains. A very simple example of this would occur when trustees have an express power to distribute capital to beneficiaries (for example, where the trust is a discretionary trust or, even where the trust is a fixed trust, there is a power of encroachment over capital) and the trust holds some property with accrued gains. The trustees can exercise their discretionary power to transfer such appreciated property out of the trust before the 21st anniversary.

Section 107(2) applies to a distribution in satisfaction of a capital interest20 of a personal trust. If the recipient beneficiary is resident in Canada, the provision will have the effect that the transfer will be on a rollover basis.21 Of course, this does not avoid tax on the accrued gain for all time. It defers it until there is an actual disposition of the property, there is a deemed disposition on the death of the person owning the property or there is a deemed disposition under s.128.1(4) on the person ceasing to be a Canadian resident.

Where the recipient beneficiary is a non-resident of Canada, section 107(5) applies in place of section 107(2), and in combination with section 107(2.1) has the effect that there will be no rollover; instead, the trust will be deemed to have disposed of the property for proceeds equal to its fair market value, unless the property comes within certain particular

19 See also s.248(25.1).
categories, the most important of which are real property situated in Canada and property used in a business carried on through a permanent establishment in Canada. 

Distribution to Corporation

The general inability to distribute to a non-resident beneficiary on a tax-deferred basis may in particular circumstances be a considerable problem. One possible way of dealing

---

20 There is no rollover where property is distributed in satisfaction of an income interest. As stated by Stevens, in "The New 'Split-Income' Tax and the 21-Year Rule: Planning Possibilities" [2000] Ontario Tax Conference, p.4.25:

"Rollouts are not available in respect of the satisfaction of income interests in trusts (subsection 106(3)). Therefore, the trustees should generally be careful to satisfy these with cash and not with assets since a transfer of assets will result in a deemed disposition of the assets. There are various techniques for dealing with this difficulty. In the list of possibilities that follows, advantageous tax consequences will depend significantly on particular circumstances. (1) There can be a distribution of the assets to the capital beneficiary (with roll out treatment) subject to a charge on the assets in favour of the trust which would use the payments to pay to the income interest. (2) If there is a power of encroachment, the income beneficiary could receive a capital distribution in lieu of a distribution of the income interest. (3) If there is no power of encroachment, and the beneficiaries are sui juris, the trust might be varied to convert the income interest into a capital interest, and to allow the trust to distribute in satisfaction of the capital interest. (4) A further alternative: the trust could borrow sufficient funds to distribute in favour of the life tenant, distribute to him or her, then distribute the assets, subject to a charge to pay the loan, to the capital beneficiary. The life tenant could then lend the funds back in exchange for an interest bearing promissory note. (Note that the draft legislation deals with a variation of this approach but only where the intention is to avoid taxes arising on a death (see paragraph 104(4)(a.2)). (5) Two classes of shares could be created on a subsection 85(1) roll over of the assets to a corporation, dividend shares with low redemption value and redeemable at the death of the life tenant, and capital shares. The former could be retained (and therefore be subject to the deemed disposition) and the latter rolled-out. (6) In one ruling, CCRA denied that a trust can avoid the 21-year rule of subsection 104(4) by distributing property to the life tenant while retaining the remainder interest in the trust since on the 21st anniversary the trust would still own the remainder interest which would then be deemed to have been disposed of at fair market value. However, CCRA stated that where the property is real property, it might be feasible to distribute the real property to the holder of the remainder interest if known (not to the life tenant), and to register the non-capital life interest against the title. If the distribution resulted in all of the capital of the trust being distributed before the earliest time referred to in subsection 104(4) of the Act, subsection 104(4) would have no effect, although other provisions of the Act would have to be considered. The trust and the capital beneficiaries may be able to rely on subsection 107(2) of the Act which provides for the property being disposed of at its cost amount where the property is distributed to the beneficiaries in satisfaction of their capital interests."

21 It is possible to elect out of the rollover, pursuant to s.107(2.001).

22 S.107(5). The rollover rule in s.107(2) also does not apply to distributions on the premature termination of a spousal trust, an alter ego trust or a joint spousal trust to persons other than the settlor or spouse, as the case may be: ss.107(4), 107(5), 107(2.1). In addition, s.107(4.1) will ordinarily have the effect that, where s.75(2) ever applied to the trust property, the trust property can only be distributed on a rollover basis to the contributor to the trust or his or her spouse during the lifetime of the contributor. See Youdan, "Income Tax Consequences of Trust Variation, Revocable Trusts and Power of Appointment" (2005), 24 ETPJ 141 at 154-155.
with this may be to distribute to a Canadian corporation the shareholders of which are individual beneficiaries. This possibility gives rise however to various issues. In particular, section 107(2) will only apply if property of the trust "is distributed by the trust to a taxpayer who was a beneficiary under the trust". The trust may not expressly include the proposed recipient corporation as a beneficiary and this will give rise to the question whether or not section 107(2) may be satisfied in such circumstances. One possibility is that the trust may contain general language, such as a power to distribute "for the benefit of" one or more individual beneficiaries, which may be considered to permit a distribution to a corporation the shareholders of which are such individuals. In such circumstances, it may be considered that the corporation is itself "a taxpayer who was a beneficiary under the trust". However, it is not clear what would be the position of the Canada Revenue Agency ("CRA") regarding this and therefore it will ordinarily be prudent to seek a ruling.

An alternative may be to seek a variation of the trust to include provisions expressly providing for the proposed corporation to be a beneficiary of the trust. I shall discuss below more generally the variation of trusts.

Another way in which the distribution may possibly be made to a Canadian corporation even though it is not itself originally a beneficiary of the trust is for the non-resident beneficiary to assign his or her interest to such corporation. This strategy is suggested as follows in Brown et al, Taxation and Estate Planning, at section 5.4.8(4):

"Any non-resident beneficiaries would transfer to a newly formed Canadian corporation ("New Can Co") their entitlement to receive capital distributions from the trust in return for shares in New Can Co; this transfer can occur under subsection 85(1). The trust would distribute the appreciated property to New Can Co before the deemed disposition date. When the non-resident beneficiary later disposes of their shares of New Can Co, they will be taxable in Canada and section 116 certificates will be required."

However, there are possible disadvantages to this strategy which are suggested, as follows, by the authors of Taxation and Estate Planning:

---
23 Note, in this context, the extended meaning of beneficially interested provided in s.248(25) which is made applicable to the definition of beneficiary in s.108(1).
"Disadvantages

- Would require the cooperation of non-resident beneficiaries;

- More complicated;

- The general anti-avoidance rule must be considered;

- An advance tax ruling is recommended which is expensive, time consuming and may give rise to other concerns; and

- Tax implications in the non-resident jurisdictions must be considered."

More generally, the position of a non-resident beneficiary may be affected by the tax laws of his or her place of residence (or citizenship in the case of the USA). It may, for example, be considered appropriate for a person subject to the tax laws of the USA if the corporation is capable of being treated as a "look through" entity such as a Nova Scotia or Alberta unlimited liability corporation.

Termination of Trust

An obvious way to avoid the 21-year rule is to terminate the trust prior to the 21st anniversary and, to the extent possible, distribute the remaining property of the trust to beneficiaries on a rollover basis. This may be done pursuant to powers provided by the terms of the trust. Alternatively, in particular circumstances, the rule known as the rule in Saunders v. Vautier may permit the premature termination of the trust. This rule applies when all of the persons with any possible interest in the trust are in existence, legally capable (i.e., assuming human beneficiaries, they are over the age of majority and mentally capable) and in agreement. In these circumstances, they can direct the trustees to convey the trust property in accordance with their directions. As a practical matter, they can also vary the terms of the trust in accordance with their agreement. It should be noted that in the case of trusts governed by

---

24 Actions by beneficiaries, such as disclaimers, surrenders, and renunciations, may also facilitate the termination or variation of the trust. Care must be taken to ensure that such actions do not have adverse tax consequences. See s.248(8); Interpretation Bulletin, "Disposition of an Income Interest in a Trust" IT-385R2; Cullity, "Post Mortem Tax Planning: Renunciations, Disclaimers, Surrenders and Elections" (1998), 18 E.T.P.J. 3.
Alberta\textsuperscript{25} or Manitoba\textsuperscript{26} law the approval of the court is required even where the rule in \textit{Saunders v. Vautier} would be applicable.

\textit{Variation of Trust}

Where the trust does not contain terms appropriate for avoiding the 21-year rule (for example, where there is no applicable power to distribute property out of the trust; there is no power to terminate the trust; and the rule in \textit{Saunders v. Vautier} does not apply) it may be possible to obtain an order of the court approving a variation of the trust in order to provide for such appropriate terms. Under the variation of trusts legislation (which in Ontario is the \textit{Variation of Trusts Act}),\textsuperscript{27} it will be necessary to obtain the agreement of all of the adult, mentally capable beneficiaries, and the court then has authority to approve the variation on behalf of certain beneficiaries or potential beneficiaries who are not capable of consenting themselves (such as unborn, minor and unascertained beneficiaries). Subject to a generally inapplicable exception, the court's power to approve depends on it being established that the variation is for the benefit of the persons on whose behalf the court's approval is required. In Ontario, the Children's Lawyer ordinarily represents the interests of such beneficiaries and, as a practical matter, it is important to obtain the support of the Children's Lawyer. Consequently, the Children's Lawyer should ordinarily be consulted before an application is made and draft proposed documentation provided to her. In this way, her position on the proposed application can be discussed and possibly negotiated.

It is obviously important that the attempt to avoid a tax problem by arrangements to deal with the 21-year rule should not cause a tax problem by the making of the variation. The main concerns here are that, first, the varied trust should not be considered a new trust so that the variation is treated as causing a disposition of property from the old trust to such new trust,\textsuperscript{28} and, second, the beneficiaries of the trust prior to the variation should not be considered to have disposed of their interests in the trust pursuant to the variation. The CRA's position has been

\textsuperscript{25} Trustee Act, RSA 2000, c. T-8, s.42(7).
\textsuperscript{26} Trustee Act, CCSM, c. T160, s.59(2).
\textsuperscript{27} RSO 1990, c. V.1.
\textsuperscript{28} S.108(6) deems the varied trust to be the same trust as the original trust for the purposes, \textit{inter alia}, of s.104(4), (5) and (5.2). The point of this is to ensure that the varying of a trust does not create a new 21 years period.
expressed in various published statements, including various rulings. \textsuperscript{29} Generally, the CRA's position has been that it is a matter of fact whether or not a variation will involve the disposition of beneficiaries' interests or the creation of a new trust. The CRA will consider whether the variation has caused a fundamental change in the terms of the trust such that there has been a disposition of the trust's property from the old trust to a new trust. Where the variation affects only the administration of the trust there is likely to be little danger that the variation will have adverse tax consequences. Even where the variations involved changes to beneficial interests, the CRA has given many favourable rulings. In particular, it has typically ruled favourably with respect to changes involving: acceleration of interests; deferral of vesting date; the inclusion of encroachment powers over capital; and the creation of new trusts to hold the funds set aside for the benefit of minor or unascertained beneficiaries. The situation where there may be more of a concern on the part of the CRA is where the variation involves the addition of new beneficiaries.

\textit{Non-Tax Considerations}

It is important that planning to avoid the 21-year rule be carried out in ways that are consistent with the trustees' obligations and general trust law and do not interfere with the applicable non-tax objectives.

The typical concern is that the distribution to beneficiaries may be made prior to the time when it is considered appropriate for particular beneficiaries to have control over the property distributed. For example, the trust may be a discretionary trust for the benefit of the children and grandchildren of a family. A distribution is being considered prior to the 21\textsuperscript{st} anniversary of the trust. But for such tax considerations, the trust would continue for many years. The children are in their early twenties and there are presently no grandchildren. Consider also a different example giving rise to similar concerns. Property is held in trust for the benefit of A. The interest will vest in A when he or she attains the age of 30 years. However, the trustees have power to advance any or all of the capital to or for the benefit of A prior to the attainment of that age. The 21\textsuperscript{st} anniversary is approaching and A is aged 20 years. In these situations, the trustees must balance the tax objective of deferring the payment of tax on accrued

\textsuperscript{29} See Youdan, "Income Tax Consequences of Trust Variations, Revocable Trusts and Powers of Appointment" (2005) 24 ETPJ 141 at 141-150.
capital gains with the non-tax objective of making distributions to beneficiaries as and when appropriate in the circumstances of the particular beneficiaries.

It may be possible to balance these objectives by arrangements, putting it broadly, under which the property representing the accrued gain is distributed to the beneficiary or beneficiaries and property representing control and future growth is retained in the trust.

Assume that the trust holds property directly with accrued gains (although the equivalent arrangements can be made when the property already exists in the form of shares of a corporation). The desired balancing may be achieved if the property of the trust is transferred on a tax-deferred basis pursuant to section 85 to a corporation, Holdco, so that prior to the 21st anniversary the trust holds the following shares of Holdco:

- one class of redeemable and retractable preference shares with a redemption amount equal to the adjusted cost base of the property which was transferred to the corporation ("Class A shares");

- one class of redeemable and retractable preference shares with a redemption amount equal to the difference between the adjusted cost base of the property transferred to the corporation and the fair market value of the property transferred at the date of the transfer ("Class B shares");

- one class of redeemable and retractable preference shares with no dividend entitlement and a nominal redemption amount but with sufficient votes attached to them to control Holdco ("Class X shares"); and

- one class of common shares which will be issued for nominal consideration ("Class C shares").

Shortly before the 21st anniversary, the trustees would distribute out of the trust the Class B shares to one or more beneficiaries. The Class A, Class X and Class C shares can all be retained in the trust or transferred to a new trust – since the disposition of them should not trigger any realization of capital gains. In this way, there should be no tax triggered on the

---

30 Initially, Holdco would issue a note to the trust equal to the adjusted cost base of the transferred property, which note would, by its terms, be convertible into Class A shares. Subsequently, the note would be converted to Class A shares.
21st anniversary and the trustees will have retained shares, the Class C shares, representing the future growth as well as shares, the Class X shares, carrying sufficient votes to provide control even if the Class A and Class C shares are subsequently redeemed or distributed to beneficiaries. This will enable the trustees to control the declaration of dividends of Holdco and thus the flow of income to the Class B shareholders.

One further point, however, needs to be considered. In order for the reorganization to take place on a tax-deferred basis it is necessary that the holder of the Class B shares be entitled to require the redemption of those shares by Holdco. This right of the Class B shareholders is likely to be inconsistent with the non-tax objective of not providing control over significant wealth passing prematurely to A or to the children in the discretionary trust example. In order to deal with this, the following may be considered:

- prior to the distribution out of the trust, the Class B shares will be transferred on a tax-deferred basis to another corporation ("Newco") in exchange for special voting shares with no dividend entitlement and a nominal redemption amount (the "Control Shares") and non-voting common shares; and

- prior to the 21st anniversary, the trustees will distribute the common shares of Newco to the beneficiary or beneficiaries but will retain the Control Shares.

Freeze Alternative

In some circumstances, the trustees may determine that, despite the possible arrangements to minimize the control of the transferee discussed above, they do not wish to distribute the appreciated value of the trust property out of the trust to one or more beneficiaries. For example, there might be concern about significant value being placed in the hands of a Canadian resident but US citizen individual, because of potential US estate tax. In such circumstances, if there is the possibility of significant gain from the present until the 21st anniversary (for example, the 21st anniversary is still several years away) the trustees may consider a reorganization under which the trust retains preference shares with a redemption amount equal to the current value of the assets held by the corporation and new common shares (with a nominal value at the date of issue) are issued to a new discretionary trust (which should
have a new starting-date for the purposes of the 21-year rule.\textsuperscript{31} The amount of gain triggered on the 21\textsuperscript{st} anniversary of the original trust will have been frozen (and the amount of potential tax reasonably predictable) and the anticipated gain on the new common shares will not be subject to a deemed realization until the 21\textsuperscript{st} anniversary of the new trust.

\textsuperscript{31} Of course, it will be necessary for the trustees to be able to conclude that the issue of such common shares to the new trust is consistent with their obligations as trustees of the original trust.