

One Generation of Deferral; The Purpose and Managing of the 21-Year Rule
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The scenario may sound familiar; a 65-year old wealthy gentleman with grown children from one or more previous marriages meets, is smitten with and marries a much younger woman. In an attempt to provide for her beyond his death yet hopefully abate the expected disappointment of his adult children, he wisely establishes a will which creates a trust providing for his new wife during her lifetime, with his children as remainder beneficiaries. Upon his death, he is deemed to dispose of his assets for tax purposes and they transfer into the trust. There the assets sit earning marginally-taxed income with no capital appreciation taxed until his spouse passes away, sixty years later. We see another familiar tax strategy; an estate freeze scenario where common shares are issued to or transferred to a family trust of which the business owner's minor children are beneficiaries. Tax to the transferor is shielded by the enhanced gains exemption and/or a roll-over provision. The business expands and enjoys great success. The owner has long passed away, however the common shares held in the trust continue to appreciate without attracting tax, over the life of the children and possibly their heirs indefinitely. These are both dream tax deferral scenarios for the settlors, residual beneficiaries and professional advisors but nightmare scenarios for the Canada Revenue Agency (CRA) who cannot access the tax liability on the appreciated assets for many years. In an attempt to ensure that capital gains are not left untaxed for inordinate amounts of time in a trust vehicle, the 21-year rule was introduced. Its background, technical parameters and the methods of effectively managing the issues it creates, are worth exploration due to the extent of legislation afforded to this tax concept.

Why twenty-one? While the figure seems arbitrary, the number twenty-one is a recognized figure in statutory law. In Ontario, the Perpetuities Act¹ refers to a period of twenty-one years when referring to interest in land and vesting of trust entitlements. This timeframe is also referred to in the Accumulations Act² and the Settled Estates Act³ as it relates to lease terms. The period was introduced to trust tax law subsequent to the introduction of the capital gains tax in 1972 by the Trudeau government. Until this time, there were no particular evils with indefinite trusts as capital gains were not an issue and on-going income was already taxed as it was earned on an on-going basis. The period of twenty-one years was thought to be “roughly the span of a generation”⁴ which matched individual taxation theory, thereby establishing a reasonable period of time for which gains could accrue before a life event (i.e. death) would otherwise cause taxation under the new regime. Surprisingly (or perhaps, not so surprisingly), as the January 1, 1993 significant date loomed for all capital gains stemming from the original introduction of the tax, heavy lobbying of the Mulroney government resulted in a saving provision⁵ whereby the 21-year rule was effectively eliminated in most cases through an election outlined in the Income Tax Act (ITA) subsection 104(5.3)⁶ thanks to wealthy Canadian families such as the Montreal Bronfmans with millions of trust dollars at stake⁷. The rule was once again reintroduced by the Chrétien Liberal government in the 1995 Budget⁸. Effective again for the first time on January 1, 1999⁹, a technical change to ITA subsection 104(5.3) clarified that deferrals beyond 1998 were not permitted. Therefore, while this concept has been in place since 1972 and has had a tumultuous and politically-fueled past, its application is actually fairly recent.

The rule warrants examination of the technical parameters as they are both specific and direct. ITA subsections 104(4) and 104(5) provide the underlying legislation as it relates to the 21-year rule. Effectively, the trust is deemed to dispose of its capital (non-depreciable and depreciable) and resource assets 21 years from the creation date of the trust unless another triggering date occurs first¹⁰. The deemed realizations are reported on form T1055, the mechanics of which resemble a T1 Schedule 3 or a T3 Schedule 1 for reporting capital gains and losses. Calculation of the income inclusion is also based on general capital gains legislation. ITA subsection 104(4) relates to the deemed disposition of non-depreciable capital property such as shares or land whereas 104(5) requires deeming rules to apply to depreciable property¹¹ however the calculations mirror actual disposition rules inasmuch as they relate to the determination of fair market value, adjusted cost base, V-day values, the requirement to recognize recapture and reallocate proceeds to limit terminal losses. Allocation and designation of the income to beneficiaries may then be made; designation will ensure that the income maintains its characteristics during the flow-through to beneficiaries. Once the deemed dispositions have applied, the trust is also deemed to have required the assets at fair value to prevent future double taxation. For any income retained in the trust, minimum tax could apply as calculated on Schedule 12. Relief for the liability created is available through ITA subsections 159(6.1) and 159(7) through form T2223 which provide for an election to pay the resultant tax in ten annual installments provided acceptable security is provided¹².

CRA's application of these rules beyond reliance on taxpayer disclosure, was evident in the 2003 appeal heard in the Tax Court of Canada case, *Estate of the Late Cléophas Saint-Aubin v. The Queen*¹³. In this instance, the CRA had assessed the trust a taxable capital gain of \$640,200 on its 1993 T3 trust return under the 21-year deeming rule for an estate that had been in existence prior to V-day. In this particular case, the saving provisions were not in effect as there were no exempt beneficiaries. The appeal related to the legitimacy of a claim based on its timing, however it is clear that the CRA uses the information in the question area of the T3 return to verify whether the 21-year rule might apply even though the trustee had not made the appropriate disclosures and had not reported the deemed dispositions. The Court agreed that the 21-year would apply. There have been very few cases relating to this legislation in the last ten years and it appears as though the legislation is sufficiently specific, and the CRA sufficiently intent on applying it, preventing misinterpretations requiring legal intervention.

A multitude of exceptions to the 21-year rule exist and for various reasons. The more common trusts which are exempt from the deeming rules are inter vivos spouse, alter ego, joint spousal (common-law) and testamentary partner trusts¹⁴. In all of these cases, the establishment of such trusts does not result in any tax preferable treatment beyond what would have been afforded an individual from a deeming perspective since their life does not span beyond the life of a second surviving spouse or individual. For instance, property transferred between spouses upon death or otherwise would be afforded tax-preferential roll-over treatment in terms of capital gains recognition. Alter ego trusts do not hold any particular tax benefits with gains recognized upon the settlor's death,

therefore no deferral of gains beyond the individual's death would otherwise be recognized.

Other exceptions to the 21-year rule are also outlined in the Act. Amateur athlete, employee, master, DPSP, EPSP, segregated fund, RCA, unit, cemetery and communal organization trusts¹⁵ are all examples of excepted trusts but are also all types of trust which tend to be established in the name of societal interest versus tax deferral and wealth protection. In addition to the trusts excluded by virtue of their nature, certain assets or properties held are also excepted regardless of what type of trust in which they are held. For instance, certain farm and fishing related properties are exempt as well as non-land inventories, eligible capital property and prepaid expenses used in unincorporated businesses held in trusts¹⁶. Again, these properties tend to carry more preferable tax treatment in a non-trust environment and these preferences simply extend to the trust application as they relate to the deeming rules.

As quickly as legislation is introduced and executed, prudent taxpayers and their professionals attempt to find ways to avoid application of the legislation. The evolution of this legislation has extended beyond the original sections to include the saving provisions and their subsequent withdrawal (104(5.3), (5.31), (5.4), (5.5), (5.6) and (5.7)) and the limitation on trust transfers as a means to avoid the deeming rule (104(5.8))¹⁷. Pending/recently confirmed legislation is also proposed as it relates to foreign investment entities and non-resident trusts. Despite the Department of Finance's attempts to refine the wording of the legislation, several legitimate tax planning opportunities exist in order

to prevent the huge high-bracket lump sum tax liability that could result should the 21-year provisions take effect.

Perhaps the most common practice is to roll capital out of the trust in kind prior to the twenty-one year mark under ITA subsection 107(2)¹⁸. Capital distributions to beneficiaries can be made on a tax-deferred basis. In fact, many trusts will implicitly state that capital distributions are to be made prior to this date. For instance, the practice was confirmed via some prior year Advance Tax Rulings (1999-0013143 and 2000-0022483), the latter of which involved minor and unborn contingent beneficiaries. In both cases, CRA ruled favourably, providing a means upon which taxpayers and their professional advisors can obtain some comfort in planning for their own unique cases¹⁹.

Unfortunately, distributions may not be possible or restrictive due to the non-transferability/liquidity of assets, restrictions in the trust document itself, the age/ability of the beneficiary or the inaccessibility or inability to even identify certain recipient beneficiaries. In the case of a non-discretionary trust, the trustees may not have the ability to make capital distributions, potentially requiring the variation of trust terms to allow for advance capital distribution or the involvement of a public trustee in the case of minor beneficiaries. New beneficiaries via a Nova Scotia or Alberta unlimited liability corporation (ULC)²⁰ may also be considered in order to prevent the 104(5.7) anti-avoidance rule whereby property is transferred to another trust to re-start the twenty-one year “clock”²¹. This strategy is likely to be costly in its establishment and maintenance and would only be considered by very high-wealth trusts.

The 107(2) roll-out provisions can also be tainted by non-resident beneficiaries (107(5)) and/or the transfer of property from a spousal trust to a non-spouse beneficiary (107(4))²². The problem associated with a non-resident beneficiary could be managed by earmarking gain-poor assets to the non-resident and gain-rich assets to remaining domestic beneficiaries. In all of these cases, it is imperative that the trust document provide some discretion to the trustee in the initial drafting to prevent the expense or inability to perform future trust indenture variations. Further prohibitions are discussed in the Act's ITA subsection 75(2) whereby a revocable trust is involved. In these cases, trust property may revert back to the settlor at their approval which results in the distribution occurring at fair market value under 107(4.1)²³.

With advance planning, it may be beneficial to purposely trigger part or all of the appreciation in a year(s) prior to the twenty firstst year, via a capital distribution in order to utilize other non/net-capital losses in the trust or lower trust tax brackets which might not otherwise be available to the individual beneficiaries. Alternatively, in the case where there are very few beneficial situations to manage or similar tax circumstances, it might be beneficial to trigger gains in advance and to allocate/designate so that the beneficiary might make use of personal losses, gains exemptions or to exploit low brackets/unused personal credits. An aging trust with accrued capital losses may also have an incentive to distribute assets to its beneficiaries prior to the deeming rules as capital losses cannot be designated to beneficiaries as is the case with capital gains²⁴. If these losses are incurred

personally after the roll-out, they might be useable to the individual beneficiary immediately or at least upon death.

A trust owning shares of a private corporation (which is a common purpose for the establishment of a family trust) could face particularly onerous tax results through the triggering of the 21-year rule. In this scenario, tax would be paid at the time of the deemed disposition and yet again when the corporation sells the underlying assets²⁵. If the ownership of an investment holding company or partnership interest is involved, the effects of double taxation could also be realized at the twenty-one year mark as well as at the time of wind-up and ultimate asset distribution.

If the asset subject to deemed disposition in a principal residence held within a trust, it is possible for the trust itself to claim the principal residence exemption if one of the beneficiaries of that trust ordinarily inhabits the home²⁶. Because the exemption will apply to the beneficiary, their spouse and minor children, consideration of the effect of the tax election must be taken into account prior to making the designation.

Clearly, there are valid mechanisms under which the 21-year rule can be managed. In all of these cases, however, planning and consideration is essential meaning that the professional advisor and trustee(s) must be cognizant on an on-going basis as to the potential un-taxed capital appreciation of trust assets, whether those assets may be exempt but most importantly, at what point in the life of the trust they find themselves as the years pass. Specific consideration of these issues should probably be made in years 10-

15 of the trust's life in order to properly take advantage of the various methods of mitigating or avoiding the 21-year rule and its potentially tenuous tax results.

Despite the wealth of legislation and commentary on the issue, the 2005 Report of the Auditor General of Canada noted severe deficiencies in CRA's assessment of this legislation²⁷. For instance, of eight 2004 returns examined in which the 21-year rule applied, only three included the necessary information to adequately determine the validity of the figures reported. In response, the CRA acknowledged that the nature of trusts was "dynamic" and "evolving"²⁸ but that it was continuing to enhance its Quality Evaluation Program as it related to trusts. As a result, this area is likely to be subject to further examination as the rule is exercised and reported in trust returns more frequently.

Though potentially not of primary consideration at the formation of a trust indenture, the professional advisors, trustee and/or settler must be cognizant and considerate of the 104(4) and 105(5) 21-year deemed realization rules. This could mean an examination of the extent of discretion that the trustees might be provided to select particular assets for distribution and to allow the ability to encroach of capital prior to the wind-up of the trust which may otherwise occur beyond twenty-one years. Similarly, during the life of the trust, the un-taxed appreciated gains should be monitored vis-à-vis potential tax shield situations that might provide a timely opportunity to prematurely recognize gains in a tax-preferable environment. Nearer to the 21-year mark, consideration of an exit strategy or a way to mitigate the potential tax liability should be paramount. The inability of the professional advisor to track and advise the trustee of the impending implications of

an aged trust could lead to litigation. Therefore, it is in everyone's best interests to monitor this legislation and its application to trusts and their interested parties.

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