THE 21 YEAR DEEMED DISPOSITION RULES AFFECTING CERTAIN TRUSTS

I. INTRODUCTION

Many Canadian trust and estate lawyers have received, or will receive, questions from settlors or trustees concerning the 21 year deemed disposition rules (“21 Year Rules”) affecting certain trusts.

The purpose of this paper is to help legal advisors better understand and advise settlors or trustees how to properly deal with the 21 Year Rules. With that purpose in mind, this paper identifies the policy underlying the 21 Year Rules, explains the operation of the 21 Year Rules, and describes some common strategies for dealing with the 21 Year Rules.

II. POLICY UNDERLYING THE 21 YEAR RULES

Pursuant to subsections 70(5) to (5.2) of the Income Tax Act (Canada),¹ when a natural person dies, he or she is deemed to have disposed of his or her capital properties, eligible capital properties, land inventories, and resource properties immediately before death and receive proceeds of disposition thereon equal to the fair market value (“FMV”) of such properties with the resulting income thereon being included in computing the income of the deceased for his or her terminal year. The estate of the individual will be deemed to have acquired these properties at the individual’s time of death at a cost generally equal to the FMV of these properties. These subsections (collectively, the “FMV Deemed Disposition on Death Rules”) were enacted in connection with Canadian tax reform in 1971-1972 (“Reform”),² which among other things, replaced inheritance taxes with capital gains taxes on death.³

Unlike natural persons, the FMV Deemed Disposition on Death Rules do not apply to properties owned by trusts, partnerships, and corporations. Therefore, a natural person could avoid the application of the FMV Deemed Disposition on Death Rules in respect of a

¹ RSC 1985, c. 1 (5th Supp.), as amended (hereinafter referred to as the “Act”). Unless otherwise stated, all statutory references in this paper are to the Act.
² Prior to the Reform capital gains were not subject to tax under the Act.
³ There are exceptions to the FMV Deemed Disposition on Death Rules. For example, if, as a consequence of the death of the deceased, the deceased’s properties are transferred or distributed to a qualifying spouse trust or common-law partner trust, then the deemed disposition immediately before death may be for proceeds equal to the deceased’s tax cost of the properties, as long as other requirements are satisfied.
particular property owned by him or her by transferring the property to a trust, partnership or corporation prior to his or her death.

In the case of a corporate or partnership transferee, a property with an accrued gain generally may be transferred by the person on a “roll over” basis by making an election under either subsection 85(1) (in the case of a transfer to a corporation) or subsection 97(2) (in the case of a transfer to a partnership). However, the FMV Deemed Disposition on Death Rules will be applicable to consideration received for the property, including, a share of a corporation or an interest in a partnership. Further, if the share is a common share or the interest is an “ordinary” partnership interest, then the FMV of the share or interest may increase as the FMV of the transferred property appreciates in the corporation or partnership. This increase in the FMV of the person’s corporate share or partnership interest will result in additional tax at the time of his or her death by virtue of the FMV Deemed Disposition on Death Rules.

However, in the case of a transfer of property to a trust, the FMV of the transferor’s interest in the trust, if any, often will not correlate with the underlying FMV of the trust’s property. If the transferor (or other person) is a beneficiary of a discretionary trust, he or she often will not have a right to receive any of the trust’s income or capital, unless and until there is an exercise of trustee discretion in favour of the beneficiary. Accordingly, the ultimate value of the beneficiary’s interest in the trust could be as low as nil or as high as the entire value of the property of the trust, or somewhere in between. As a result, courts have struggled with valuing these types of interests. For example, in Gartside v. IRC, [1968] A.C. 553, the House of Lords held that the value of an interest in a discretionary trust was unquantifiable, and as a result, was valued at nil for purposes of an English estate tax statute. The author is not

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4 If the transfer of property occurs between persons not dealing at arm’s length for purposes of the Act, FMV consideration for the property should be provided to avoid potential double tax under section 69.

5 To avoid this increase in value, a corporate transferee often will issue preferred shares, as opposed to common shares, as consideration for the property in order to, inter alia, “freeze” the value of a transferor’s interest in the corporation. Similarly, “preferred” partnership interests might be used to freeze the value of a transferor’s interest in a partnership. However, the potential application of section 103 to subsequent allocations of income of the partnership must be considered when using preferred partnership interests.

6 In many cases, a transferor of property to a trust will not be a beneficiary of the trust to avoid the application of the income attribution rule in subsection 75(2). However recently it has been held that transfers of property to a trust for FMV proceeds should not be subject to the application of this attribution rule: see inter alia Sommerer v. R., 2012 FCA 207.
aware of any Canadian case law considering the value of a discretionary interest in a trust for purposes of the Act.\(^7\)

In the context of the FMV Deemed Disposition on Death Rules, unless an interest of a deceased beneficiary of a trust is “vested indefeasibly” (discussed below), the interest of the beneficiary often ceases upon death, and as a result, neither the deceased beneficiary nor his or her estate will receive income or capital distributions from the trust at, or subsequent to, the beneficiary’s death. Therefore, for purposes of applying the FMV Deemed Disposition on Death Rules, trust interests ceasing at death should be valued at nil in such cases.

The Canada Revenue Agency (“\textit{CRA}”) does not automatically accept that the FMV of the interest in a discretionary trust is necessarily nil for purposes the Act.\(^8\) However, in the context of the Deemed Disposition on Death Rules, the provisions of the Act appear to imply a nil value because to counter the ability of natural persons to avoid taxes resulting from the FMV Deemed Disposition on Death Rules for an indefinite period (subject to applicable rules against perpetuities\(^9\)) by having property in a trust, the 21 Year Rules were enacted.\(^10\)

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\(^7\) For family law purposes, there is Canadian case law that considers the value of an interest in a discretionary trust for purposes of determining the value of a spouse’s property on the breakdown of a marriage. In \textit{Kachur v. Kachur}, 2000, A.J. No. 1180 (Alta. Q.B.), the Court valued a particular beneficiary’s interest in a discretionary trust at nil, accepting evidence that the trustees were not going to distribute any of the property of the trust to the beneficiary. On the other hand, in \textit{Sagl v Sagl} (1997), 31 RFL (4th) 405 (Ont. Gen Div.), to obtain “the fairest and most equitable result”, the Court allowed an interest in a discretionary trust to be valued as if the trustees had made a distribution of all of the trust property equally amongst all of the beneficiaries. In my view, these family law decisions should have less relevance for purposes of the Act because the contexts in those cases did not require the degree of precision and certainty in valuation that is required to subject an amount to tax under the Act. Further, the FMV standard (objective, value to a third party) applicable for purposes of the Act appears to be different than the “fair value” standard (subjective, value to a spouse) applicable to the relevant family law statutes.

\(^8\) In Technical Interpretation 2003-0181465 — “Fair market value of an interest in a discretionary trust” (April 3, 2003), the CRA, citing \textit{Sagl} as support, expressed the view that absent a term of a discretionary trust directing trustees to favor one beneficiary over another, or facts supporting a finding that one beneficiary had a lesser chance of receiving a distribution from the trust than another beneficiary, the even handed principle should be assumed to result in each beneficiary having an interest in the trust having equal value to each other beneficiary.

\(^9\) In brief, the “rule against perpetuities” is a limitation imposed by the common law to prevent property from not vesting in perpetuity. In this context, this rule provides that a trust interest is invalid if it could vest after the perpetuity period, that is, if it could vest beyond the 21st anniversary of the date of death of certain persons (lives in being) alive at the date of the trust’s creation (i.e., the relevant perpetuity period). Some provinces have modified (e.g., Alberta) or even abolished (e.g., Manitoba) this common law rule.

\(^10\) The Technical Notes in connection with the Reform legislation introducing the 21 Year Rules state that the rules are “necessary to prevent the indefinite postponement of capital gains taxes through the use of long-term trusts”.