



Variation of Trusts:
Methods & Tax Implications

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Martin J. Rochweg & James A. Hutchinson
Miller Thomson LLP
www.millerthomson.com

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Overview



- **Reasons to Vary**

- Why vary a trust in the first place



- **Methods**

- How to vary a trust




- **Relevant Considerations**

- Considerations before varying a trust

- **Specific Tax Implications**

- Tax implications upon trust variation



Reason to Vary – Why vary a trust in the first place

- There are several reasons why a trust may require variation:
 1. Trust terms no longer consistent with needs of beneficiaries
 2. 21-year rule planning
 3. Effect certain status requirements
 4. Settle equalization claims under *FLA*
 5. Settle dependants' claims against estate
 6. Changes to law (i.e., tax law)

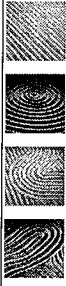
With regard to #4 above, see *Stone v. Stone*, 39 ETR (2d) 292 (Ont. CA).

With regard to #5 above, see *Mordo v. Nitting*, 2006 B.C.S.C. 1761.



Methods – How to vary a trust

1. Disclaimers, Releases or Surrenders of trust interests by beneficiaries
2. Amendment pursuant to the trust itself
3. Agreement among beneficiaries
4. Application under Trust Variation Legislation



Method 1: Disclaimers, Releases or Surrenders

- **Disclaimers**
 - Refusal to accept trust interest
 - Gift void *ab initio*
 - Beneficial interest deemed to have never been acquired
 - Thus, disposition not possible
- **Releases and Surrenders**
 - Relinquishment of entitlement or property right
 - Disposition may or may not result

Method 1: (cont'd)

Disclaimers, Releases or Surrenders



- **Releases and Surrenders**

- Beneficiary presupposed to have accepted, and enjoyed some benefit of trust interest
- Relinquishment of entitlement or property right
- Disposition may or may not result
 - Query effect of prior acceptance of funds from trust
 - Depends on whether entitlement directed or assigned



Method 2:

Amendment pursuant to the trust itself

- Discretionary trusts
 - Power to amend to add beneficiaries
 - Results in proportionate disposition of beneficial interest
 - Seemingly unfair to pre-existing beneficiaries with no say or recourse
 - Most unfair to pre-existing discretionary beneficiaries b/c may never receive any value at all

Method 3:

Application under Trust Variation Legislation



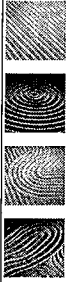
- All provinces have Trust Variation Legislation, except PQ and NFLD
 - Relatively similar from jurisdiction to jurisdiction
 - Ontario: *Variation of Trusts Act*
- Must apply to, and receive approval of proposed arrangement from Courts
- Permits variation (and even revocation), but not revocation followed by resettlement



Method 3: (cont'd)

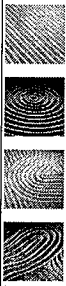
Application under Trust Variation Legislation

- **Approving a variation application:**
 1. Demonstrating a "Benefit"
 - Economic Benefits
 - Non-Economic Benefits
 2. Intention of the Testator or Settlor
 - Authorities divided as to whether intention is a relevant consideration
 - In Ontario, Courts consider intent a relevant factor
 3. Judicial Discretion
 - "if it thinks fit"
 - Courts to consider overall justice and fairness of proposed arrangement



Method 4:
Agreement among beneficiaries

- ***Saunders v. Vautier***
- Beneficiaries may vary a trust, if:
 1. All beneficiaries have a fully vested interest
 2. All beneficiaries are legally capacitated
 3. All beneficiaries agree
- Substantial variation may result in resettlement
- May affect testamentary status



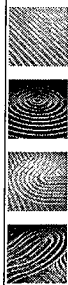
Relevant Considerations – What to consider before varying a trust

- What is the extent of the proposed variation?
 - Minor vs. Substantial change
 - Immediate or prospective effect on existing beneficiaries
 - Risk of unintended tax consequences



Relevant Considerations (cont'd)

- Varying a trust may result in the following:
 1. Re-settlement of trust
 2. Disposition of trust assets
 3. Disposition of beneficial interests
 - Income or capital
 4. Status changes
 - Loss of status as a testamentary trust



Bill C-10

- Example provided at STEP
- Referred to Senate Banking Committee
- Problem with proposed FIE rules applying to non-discretionary interests in a non-resident trust (i.e., annual payment from capital of trust)
 - where the “successor beneficiary” and “discretionary beneficiary” exceptions do not apply, therefore a specified interest
- As proposed FIE rules apply after 2006

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-Trust established by HK grandfather for benefit of 25 grandchildren and remoter issue

-- 1 of the grandchildren was born in and is resident in Canada, aged 3

-- Trust is not deemed resident in Canada

-- Trust is fully discretionary with power of encroachment

---Termination Date is Royal Lives perpetuity period

-- Trust capital to be distributed equally among beneficiaries living on Termination date

-- 3 year old Canadian beneficiary has a specified interest because of mandatory distribution scheme on termination date

-- Cost amount of Trust Property is \$100MM

-- Assume Prescribed rate of 9%

-Beneficiary will have income inclusion of \$9MM

-OPTIONS

-Can Trust be amended or resettled to fit within the discretionary beneficiary exception.?

-Renouncing interest?



Bill C-10 (cont'd)

- Income inclusion at the end of a taxation year if taxpayer is resident of Canada and has a specified interest in the trust
- Renewed consideration of the tax implications of disclaimers, releases or surrender of trust interest and variation of the trust pursuant to the terms of the trust

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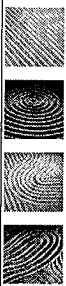
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Another example:

- Canadian beneficiary (daughter) has a capital interest in a non-resident trust.
- Assume that the trust is not subject to the NRT rules.
- Mandatory payment of \$200,000 from the trust capital on an annual basis.
- Trustees have no discretion as to the payment.
- "Successor beneficiary" and "discretionary beneficiary" exceptions do not apply

-OPTIONS

- Canadian beneficiary can renounce her future interest in the Trust?
- Trust can be amended so that discretionary beneficiary exception would apply (i.e., eliminate the mandatory annual payment)?



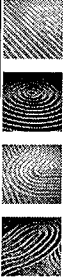
Review of tax implications on disposition of income interest

Income Tax Act:

- **S. 106(2):**
 - Requires taxpayer to include proceeds of disposition of income interest
 - treated as income
- **S. 108(1):** definition of income interest in a trust

“Income Interest” of a taxpayer means a right (whether immediate or future and whether absolute or contingent) of the taxpayer as a beneficiary under a personal trust to enforce payment of an amount to receive any part of the income of the trust.

Under proposed amendment, “income interest” will not include, at any time, a participating interest in respect of which 94.1(3) (application of FIE rules) or 94.2(9) (tracking interests) applies for the year.



Review of tax implications on disposition of income interest

- 1) Disclaimers
- 2) Releases or Surrenders
- 3) Amendments under the terms of the Trust



Tax Consequences: *Disclaimers*

- If person disclaims an income interest:
 - at time becomes aware of it (or reasonable time thereafter); and
 - not in favour of anybody,
 - then never acquires property interest, therefore no disposition, s. 106(2) does not apply

= no tax consequences

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See paragraph 7 of IT-385-R2 "Disposition of an Income Interest in a Trust" dated May 17, 1991 states the taxpayer who executes the disclaimer (not in favour of any person) of an income interest in a trust at the time the taxpayer becomes aware of it (or within a reasonable time thereafter) will be considered not to have acquired that income interest in the trust. s. 106(2) will, therefore, have no application in such a situation... A person who has accepted any funds from the trust in respect of an income interest in the trust or executes a "disclaimer" in respect of an income interest in the trust in favour of another person would be considered to have acquired the income interest and therefore would be unable to execute a valid disclaimer.

The most suitable course of action will depend upon the facts of each situation. For example, if annual income distributions had been made under provisions of the Trust, a disclaimer of the income interest by the Beneficiary will not work.

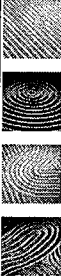


Tax Consequences: Disclaimers (*cont'd*)

- If beneficiary has already been receiving income from the trust, CRA position would be that income interest in trust cannot be disclaimed
- Distinguish between a disclaimer and a release or surrender

Tenuous argument that each annual distribution is a separate gift and therefore would be able to disclaim even after receipt of annual distributions from the Trust.

In a situation where income beneficiary has received annual distributions of income from the trust, a disclaimer is probably not a valid disclaimer therefore s. 106(2) of the ITA would apply



Tax Consequences: *Release or Surrenders*

- Release or surrender of income interest is a disposition of property
- If person
 - accepts funds from other person; or
 - executes disclaimer in favour of another= disposition of income interest,
s. 106(2) applies



Tax Consequences: *Release or Surrenders (cont'd)*

- If surrender income interest in return for payment from trust
 - = s. 106(3) applies
 - may trigger capital gain
- CRA: If validly release or surrender but do not direct who will receive future payments
 - = s. 106(2) does not apply



Tax Consequences: *Release or Surrenders (cont'd)*

- If direct interest to non-arm's length person and receive no payment
= s. 69(1)(b) deems payment at fair market value and triggers s. 106(2)
- See paragraph 8 and 9 of IT-385

Paragraph 8 of IT 385:

Where a taxpayer formally releases or surrenders all or any part of an income interest in a particular trust in respect of future payments (amounts not due and payable at the time of the release or surrender) in favour of one or more other persons, the taxpayer will be deemed, by virtue of paragraph 69(1)(b), to have received proceeds of disposition equal to the fair market value at the time of the release or surrender of the income interest released or surrendered and must include that amount in income pursuant to subsection 106(2). It should be noted that paragraph 248(8)(c) does not apply to an income interest that arises upon the death of the deceased since such an interest could not have been property of the deceased immediately before death.


Paragraph 9 of IT-385:

A taxpayer who for no consideration validly releases or surrenders an income interest in a trust in respect of future payments (not due and payable at the time the release or surrender is executed) and does not direct in any manner who is entitled to receive the benefits, will not be considered to have received any proceeds of disposition for the purposes of subsection 106(2). The result will be the same if the taxpayer designates or otherwise agrees which person or persons will benefit by reason of the release or surrender, if the same person or persons would be entitled to benefit in the same way under the trust without the taxpayer's designation or agreement. However, the attribution rules of subsections 74.1(1) and (2) are considered to apply if the person or persons who benefit under the terms of the trust as a consequence of the release or surrender are persons described in those subsections.



Tax Consequences: *Release or Surrenders (cont'd)*

- Query whether 69(1)(b) or 56(2) should apply
- 56(2) applies where a payment or transfer property is made with direction or with the concurrence of a taxpayer to some other person and the taxpayer desired to have a benefit conferred on that other person



Tax Consequences: *Release or Surrenders (cont'd)*

- If 56(2) applied the payment is included in the taxpayer's income
- Also query whether 246(1) of the ITA would apply
 - section applies where a person confers the benefit either directly or indirectly on a taxpayer
 - applies to resident and non-resident persons

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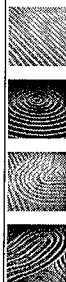
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246 (1) Benefit conferred on a person

Where at any time a person confers a benefit, either directly or indirectly, by any means whatever, on a taxpayer, the amount of the benefit shall, to the extent that it is not otherwise included in the taxpayer's income or taxable income earned in Canada under Part I and would be included in the taxpayer's income if the amount of the benefit were a payment made directly by the person to the taxpayer and if the taxpayer were resident in Canada, be

(a) included in computing the taxpayer's income or taxable income earned in Canada under Part I for the taxation year that includes that time; or

(b) where the taxpayer is a non-resident person, deemed for the purposes of Part XIII to be a payment made at that time to the taxpayer in respect of property, services or otherwise, depending on the nature of the benefit.



Tax Consequences: *Release or Surrenders (cont'd)*

- If s. 246 applies, and the taxpayer receiving the benefit is a non-resident, the benefit it is deemed to be a payment under Part XIII
- Although favourable rulings have been given in similar situations (see 2005-0113011R3) there is still some risk with this approach

Attribution Rules – s. 74.1(1) and (2)

Will apply if no consideration and no direction and result will benefit spouse or minor



Tax Consequences: *Release or Surrenders (cont'd)*

- Generally, in order to have no tax consequences:
 - Surrender income interest to trust
 - No consideration passing
 - No influence regarding future payments



Disclaimer, Surrender or Release of Capital Interest

- Tax consequences not as clear as disclaimer, surrender or release of income interest
- Capital gain may result on disposition of capital interest
- Gain will be excess of proceeds of disposition over the greater of (i) ACB and (ii) cost amount of the capital interest

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See Technical Interpretation 2004-0061841E5 where the CRA took the position that there was a capital gain on a deemed disposition under Para. 128.1(4)(b) and that such capital gain was equal to the beneficiary's share of the accrued gain on the trust property as of the date of disposition.

Consider possible application of Para 69(1)(b) on the basis that an amount has been transferred to the daughter.

56(2) should not apply as receipt of capital payment would not have been included in the Father's income; similarly subsection 246(1) should not apply – see Ruling 2005-0113011R3.



Variance of the Trust

- In our example, could the non-discretionary annual payment be made discretionary
- CRA takes a general position that a variance of a trust may have the consequences of causing the trust to be resettled if the variance is of a significant magnitude and causes a fundamental change in the trust.

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See Technical Interpretation 9209655.

“It is our opinion that, in general, a variance of a trust may have the consequence of causing the trust to be resettled if the variance is of significant magnitude to cause a fundamental change in the terms of the trust. If this occurs there would be an actual disposition of the trust's property from the "old" trust to the "resettled" trust.”

[. . .]

“With respect to a variation of a trust which would add discretionary beneficiaries, serious consideration should be given as to whether such a variation constitutes a disposition of any interests in the trust. The decision in *Murphy v. The Queen* 80 DTC 6314 (F.C.T.D.), implied that beneficiaries agreeing to a variation in the terms of the trust will have disposed of their interests in the trust by consenting to the variation. Accordingly, the Department may view such a variation as a disposition by each beneficiary of part of their interest in the trust to or for the benefit of the new discretionary beneficiary.”



Variance of the Trust (cont'd)

- If the trust is resettled there would a disposition of the trust property from the old trust to the resettled trust
- In all likelihood the change from non-discretionary to discretionary annual payments would likely constitute a material change in the terms of the trust and result in the trust being resettled



Power to Exclude Beneficiaries

- The Trust may provide that an interest of a beneficiary can be excluded
- Minimal risk of beneficiary being considered to have disposed of their income interest as there was no action on the part of the beneficiary and the exclusion was in accordance with the original terms of the trust

This would not be considered a variance of the trust as the Trustees would be merely exercising their powers they were granted under the original deed of trust.



Martin J. Rochweg
Miller Thomson LLP
mrochweg@millerthomson.com
416.596.2116

James A. Hutchinson
Miller Thomson LLP
jhutchinson@millerthomson.com
416.597.4381

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