

# Financial Advisor

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## The 21-year rule and insured variations of trusts

### Protect minor beneficiaries and increase the likelihood of Court consent

Changes to trusts (known as "variations of trusts") are sometimes needed to save taxes however, Court orders may be required. Life insurance can play a significant role in protecting the interests of minor beneficiaries and in gaining the Court's consent. However, special advance planning is a must.

## The 21-year deemed disposition

It is a common misconception that family trusts last for only twenty years. In fact, trusts may last for a lifetime – or sometimes, several lifetimes. Business owners often use a family trust to hold company shares for both tax and non-tax reasons. But trustees can face a special problem if the trust owns illiquid assets, such as land or the shares of a private company.

The problem, known as the "21-year deemed disposition rule", arises because every 21 years, the trust is taxed as if it had disposed of all its capital property at fair market value. The trust may owe significant capital gains tax, but may not have enough cash to pay it. Finding a way to defer the tax or to use effective tax planning to reduce or eliminate tax payable in this situation may be critical to keeping the business or assets in the family.

One way the trust can avoid the capital gains tax is to avoid owning the assets on the twenty-first anniversary. Assets can be distributed to capital beneficiaries in partial satisfaction of their trust rights without triggering tax. This practice is so common that many clients think family trusts last for only 20 years.

While distributing assets may avoid a crippling tax bill, it can create other problems. For example, the distribution may violate the intent of the trust and may even expose the trustee to lawsuits from beneficiaries whose interests may be impaired by the transfer.

## Case study

In the mid to late 1980s, Alma Smith implemented an estate freeze of her company, Appelcore Manufacturing, and created a family trust in favour of her two grandchildren, Duncan and Eric. They were ages five and seven respectively at the time.

She named her brother Cedric as the trustee. Alma owns all the preferred shares and super voting shares in Appelcore while the trust owns all the common shares. The preferred shares have a fixed redemption value to the common shares.

The arrangement lets Alma control the company, but transfers future company growth to her grandchildren. That's exactly what has happened during the past eighteen to nineteen years as Appelcore Manufacturing has soared in value.

The trust was intended to run until Duncan and Eric were forty years old, at which point the trust would transfer its shares to them and terminate. The trust contains no language that allows Cedric to give Duncan and Eric their shares before age forty. The terms of the trust also say that if either Duncan or Eric dies before age 40, their children (including children not born when the trust was created) will take their deceased parent's shares. As a result, the trust beneficiaries include not only Duncan and Eric, but also any children they have, and any children they may yet have before they turn age forty.

The 21-year deemed disposition will occur in two and a half years. Cedric could solve the trust's tax problem by simply distributing the Appelcore shares to Duncan and Eric. Assuming that Cedric had the power under the trust to do so, a distribution of trust capital to the trust beneficiaries will not trigger any immediate tax consequences, and will stop the 21-year deemed disposition clock. Although Duncan and Eric are still in their twenties, and in Cedric's view not yet old enough to become significant shareholders in a multi million-dollar enterprise, Alma would still control the company through her preferred voting shares even if Duncan and Eric owned their shares outright.

One big problem with this strategy, however, is that Cedric could face lawsuits from Duncan and Eric's children (both children alive now and those who may be born before Duncan and Eric turn age forty). Duncan has one child (and may have more) Eric has no children though he may have them in the future. If, for example, Cedric transferred trust shares in Appelcore to Duncan, and Duncan died, Duncan's son could sue Cedric for his shares or the cash equivalent of those shares' value at the date of death. If Cedric does nothing, however, Duncan and Eric may suffer severe financial damage from a deemed disposition and subsequent capital gains tax on shares owned by the trust.

Cedric seems to be caught. What can he do? Realistically, the only way out for Cedric is to get a court order changing the terms of the trust to allow an early disposition of the shares to Duncan and Eric without exposing Cedric to liability from existing and future trust beneficiaries.

## **What will the Court require? How does life insurance help?**

A Court must balance and protect the interests of all beneficiaries. Adult beneficiaries can consent to a variation, however, minors and future unborn beneficiaries cannot. As a result, steps must be taken to get a legal consent on their behalf and protect their interests as necessary. **Getting that consent is where life insurance can play a valuable role.** Depending on where the minor lives, the consent may come from a parent, a Court-appointed guardian of the minor's property or from a public official. (e.g. the Official Guardian or the Children's Lawyer - in Quebec, the Public Curator.)

In exchange for the minor's consent, the usual solution is to turn the mere possibility of a future trust inheritance of uncertain size into a smaller but guaranteed inheritance, through the use of life insurance. Although Appelcore Manufacturing has performed well in the past, it may not in the future. If it fails, none of the trust beneficiaries, Duncan, Eric or their children, will get anything. Further, if Duncan and Eric both live to age forty, their children will get nothing from the trust. A life insurance policy, however, provides a guaranteed inheritance for all of Duncan and Eric's children born before Duncan and Eric reach age 40, if Duncan and Eric should die on or before reaching this age.

For the new life insurance policy to be acceptable and provide more certainty, it must be issued without the usual suicide exclusion and without a contestability period – something that is not readily available. The good news is that arranging for the new policy at least two years in advance of the twenty-first anniversary deadline is an easy way to ensure that even ordinary policies with these exclusions can meet these requirements. Once the incontestability period is past, those policy concerns are more easily satisfied.

In this case, Cedric would obtain insurance on Duncan and Eric's lives in amounts that Cedric and his legal advisors believe are reasonable and that a court would find acceptable. After the two-year incontestability period expires, Cedric's legal advisors would apply to a judge for an order varying the terms of the trust in such a way as to allow Cedric to distribute Duncan and Eric's shares to them, and to maintain life insurance on their lives so that if they died before age 40, the death benefits would substitute for the shares that Cedric could no longer give them. Term insurance lasting at least until Duncan and Eric's fortieth birthdays would probably be the best choice since Cedric could let it lapse when Duncan

and Eric reached age 40 or transfer the policies to them for them to own, pay premiums on and convert to permanent insurance if they chose to do so.

## Advising clients

- Court-ordered variations of trust can be expensive and time consuming. That means they only occur in substantial cases such as family business situations. They must also be planned well in advance. Chances are the insurance needs will also be substantial.
- A distribution of assets from the trust may create other problems.
  - The trust will lose control of the assets.
  - Trust assets may become subject to claims of the trust beneficiaries' creditors' (whereas they could be sheltered from those claims if they stayed in the trust). In most provinces, life insurance policies can benefit from creditor protection if the requirements of the applicable provincial insurance act are respected.
- Trust assets may become marital property and subject to the claims of a spouse in the event of a separation or divorce.
- Life insurance policies are not subject to the deemed disposition rule. If a life insurance policy is to be owned by a trust for more than 21 years it will not be deemed to have been disposed of at the end of each 21-year period.
- A trustee should be able to transfer a life insurance policy to a trust beneficiary who is also the insured under the policy without triggering immediate income tax consequences.<sup>1</sup>
- The 21-year deemed disposition date is known years in advance. By investigating the client's situation early, you can help ensure the insurance is available when it's required.

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<sup>1</sup> There is a conflict between ss. 107(2) and 148(7) of the Income Tax Act. S. 107(2) permits a rollout of trust capital to a trust beneficiary on a tax-deferred basis. However, s. 148(7) treats a transfer of ownership as a taxable disposition. The Canada Revenue Agency has confirmed that a life insurance policy is eligible for a tax-deferred rollover from a trust to the trust beneficiary whose life is insured under the policy (Conference For Advanced Life Underwriting ("CALU") Conference May 1999, CRA document 9908430, dated June 30, 1999).