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Issues in Law You Need To Know

Trusts and the 21-Year Rule

Trusts, once considered a tool exclusively for the wealthy, have become enormously popular in the last ten years for middle income persons and for good reasons: trusts provide great flexibility in tax planning strategies and estate planning.

Trusts are subject to specific tax rules that ought to be fully understood and complied with. One of those is the “21-year deemed disposition” rule where, for tax purposes, a trust is deemed to dispose of certain types of property for fair market value proceeds. Failing to acknowledge this rule may result in the trust realizing capital gains, ordinary income or recapture without receiving actual proceeds of disposition.

This newsletter will review the 21-year deemed disposition rules and some tax strategies to help avoid or defer the tax implications.

21 Year Deemed Disposition Rule

The 21-year deemed disposition

rule exists in order to prevent property held by a trust from being passed from generation to generation on a tax-free basis.

The 21-year deemed disposition rule does not apply to all trusts or all types of assets held in a trust. Indeed, the rule applies to trusts which hold depreciable property, non-depreciable capital property, Canadian and foreign resource properties, land inventory and NISA funds No. 2. More specifically, the deemed disposition rule applies to:

- Qualified small business corporation shares
- Qualified farm property and qualified fishing property
- Mutual funds and other shares
- Real estate and depreciable property, bonds, debentures, promissory notes and other properties
- Personal-use property
- Listed personal property (as defined by the ITA)
- Land held as inventory



Interestingly, for estate planning purposes, life insurance does not fall into any of the above classifications and therefore is not subject to the deemed disposition rule.

Strategies For Dealing With the 21-Year Rule

For obvious reasons, trustees and beneficiaries want to avoid the 21-year deemed disposition rule as no

one wants to pay taxes if they can be avoided. Happily, there exists several strategies allowing for the deferral or avoidance of the 21-year rule.

The easiest way to avoid the 21-year deemed disposition rule is to simply have the trust property distributed to the Canadian resident beneficiary on a tax-free basis (the Income Tax Act allows such tax-free distribution). One of the drawbacks of this option is that the beneficiaries lose their opportunity for income splitting and other tax planning strategies and the trustees lose control of the assets.

Depending on the assets held by the trust, another option is to distribute only a portion of the trust's assets to the capital beneficiaries. Essentially, all assets with accrued gains would be distributed to capital beneficiaries on a tax free basis while the assets that do not have a component capital gains could be retained by the trust.

If a trust holds shares of a private corporation the trustees must consider the 21-year deemed disposition rule because failure to do so could result in double taxation; indeed the trust would realize a capital gain on the deemed disposition of the shares and, if the shares were later redeemed, the

trust would also realize a deemed dividend.

To avoid any double taxation, one strategy is to incorporate a new company (Newco) which shares will be owned by a new trust (most likely with the same trustees and beneficiaries as the first trust). The trustees of the first trust would then make Newco a beneficiary of the first trust (if there is a power to appoint new beneficiaries). Then, the first trust would distribute the Oldco shares to Newco prior to the 21-year deemed disposition date.

There are other very similar strategies, to the one above, when dealing with a trust holding shares of a private corporation and the 21-year deemed disposition rule and the trustee(s) should consult with his or her tax advisors as to which strategy might be best. The trustees must also be aware of the uncertain nature of the GAAR (General Anti-Avoidance Rules under the Income Tax Act) when implementing a 21-year deemed disposition strategies.

[Estate Planning, the Use of Trusts and the 21-Year Deemed Disposition Rule](#)

In estate planning, it is common to establish a trust under the Last

Will and Testament and fund such trust with assets flowing through the estate of the deceased. Such trusts are referred to as a "testamentary trust:" a trust that arose as a consequence of the death of a testator. Testamentary trusts provide a unique opportunity as they pay tax on a graduated basis allowing for a variety of tax savings and income splitting.

In estate planning, the 21-year deemed disposition rule is often misunderstood and too often we have advisors recommending that the testator or the estate trustee avoid the 21-year rule "at all costs." As a result, the Will may have a clause requiring the trustee of the testamentary trust (or the estate trustee) to distribute the capital of the trust to the beneficiary before the 21-year deemed disposition in order to avoid a capital gain.

Although such advice is not technically wrong, it is often given without an adequate explanation or understanding of the 21-year deemed disposition rule and may not realize the maximum benefit from the trust. For instance, what if the assets of the trust do not have a capital gain component, i.e., no capital gain is arising at 21 year limit? What if the tax savings of a testamentary trust in the long run are far greater than the capital gain



to be realized on the 21 year deemed disposition? In these two examples, why would someone want to lose the tax savings and income splitting opportunity simply to avoid a small capital gain, if any?

As an aside for estate matters, it is important to know that the 21-year deemed disposition timeline commences at the death of the testator/settlor and not on the day the residual beneficiary receives his or her

share in a testamentary trust.

Conclusion

We can see that a trust may be viewed as a vehicle that provides a 21-year window of tax opportunities. The 21-year deemed disposition rule ought to be reviewed and fully understood by any trustee of a trust; whether a family trust, a testamentary trust, an alter ego

trust, a spousal trust, etc., in order to take advantage of those opportunities and realize the maximum benefit from a trust.

If you have any questions concerning the 21-year deemed disposition rule or concerning trusts in general, please do not hesitate to contact me directly 613.288.3220 or by email at sdesmarais@tslawyers.ca

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CALL TO THE BAR

Law Society of Upper Canada, 2007

EDUCATIONAL BACKGROUND

- University of Ottawa, LL.L., 2007
- University of Ottawa, LL.B., 2005
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PRACTICE SUMMARY:

Sébastien joined Tierney Stauffer LLP as an Associate in the Wills, Estates & Trusts Planning & Administrative Practice Group in 2009. His practise focuses on estate planning, will drafting and personal and corporate taxation. Sébastien has experience in resolving disputes with the Canada Revenue Agency (CRA), filing voluntary disclosures, assisting individuals with their tax related issues and tax planning for families and businesses. Sébastien is bilingual and practices in both official languages.

He has spoken at various seminars on estate, trust and tax matters. Sébastien has also appeared on radio and television discussing legal issues. He is a tutor for the Law Society of Upper Canada for the Estate Practice section.

Prior to joining Tierney Stauffer LLP, Sébastien practiced with another Ottawa law firm where he gained experience in tax law, charity law, estate planning and will drafting.

