STEP TECHNICAL COMMITTEE

Society of Trust and
Estate Practitioners

Please reply to:
Paul R. LeBreux
Harris & Harris - 180 Attwell Drive, Suite 400
Toronto, Ontario, M9W 6H8
Tel. (416) 798-2722 Fax (416) 798-2715
E-mail: paullebreux@harrisandharris.com

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DELIVERED BY TELECOPIER AND BY COURIER

TAX LEGISLATION DIVISION
Department of Finance
140 O'Connor St.
Ottawa, Ontario
K1A 0G5

Attention: Mr. Len Farber

Dear Mr. Farber:

SOCIETY OF TRUST AND ESTATE PRACTITIONERS
COMMENTS AND SUBMISSIONS
DECEMBER 23, 1998 LEGISLATIVE PROPOSALS

By way of introduction, the Society of Trust and Estate Practitioners ("STEP") is the professional body for the trust and estate profession world-wide. The Society was formed six years ago, and now has over 7,500 members world-wide. In Canada, there are currently about 200 STEP members from the legal, accountancy, corporate, trust, banking, insurance and related professions, involved at a senior level in the planning, creation, management of and accounting for trust and estates and related matters. Members of STEP include the most experienced and senior practitioners in the fields of trusts, estates and taxation. STEP's mission statement is "to be recognized and accepted as the principal professional body for trust and estate practitioners world-wide". The STEP Technical Committee has been recently organized to comment and provide

submissions on legislative proposals that impact, either directly or indirectly, upon trusts and their beneficiaries as well as related trust, estate and tax matters. Attached as Schedule "A" is a list of the members of the STEP Technical Committee.

The purpose of this letter is to comment on the legislative proposals released on December 23, 1998. Although a significant portion of the proposals pertain to the "Taxpayer Migration" rules, the following comments and submissions are limited to the amendments affecting the taxation of trusts and their beneficiaries.

The following comments are of a general nature only with specific submissions immediately following:

1. Overall, we found the legislation well conceived and well drafted. Many of the amendments are welcome additions that add clarity or introduce relieving provisions. We are pleased to see administrative practice being codified in legislation. We believe this should be done wherever possible to introduce more certainty into the tax laws.

2. There is a concern with the overall complexity with certain of the legislative proposals. It is our understanding that the main purpose of the draft legislation is "administrative" in nature and designed to respond to gaps, inconsistencies and uncertainties in the existing law. However, the extensive nature of the proposed legislation, combined with the fact that certain amendments alter tax policy, makes understanding the purpose and effect of the proposals extremely difficult even for experienced practitioners. Furthermore, the fact that certain amendments apply specifically to commercial trusts, other amendments are directed to personal trusts, while other amendments have implications for both personal and commercial trusts makes it difficult to evaluate the impact of the changes in any given area. Any method to simplify the legislation or to introduce it in a more understandable way, would be greatly appreciated. For example, it might be possible to draft the legislation in segments, rather than by section, so that related amendments are all in one place. Also, it would aid in the clarity if certain sections that are being amended were reproduced in full.

3. It is not appropriate to release extensive legislation at year end. For many practitioners significant tax planning is conducted at year end making the review of extensive legislation often impossible. In addition, a number of the proposed amendments have an effective date of December 23, 1998 (the "Announcement Date") which further complicates year end tax planning, especially in light of the fact that distributions from many trusts (pre-1978 trusts) were anticipated. There is concern that introducing legislation at year end and establishing the Announcement Date as the effective date may result in negligence claims if practitioners were unable to review and formulate an opinion as to the purpose and effect of the

legislative proposals prior to finalizing year end tax planning. Of further concern is the fact that certain amendments are deemed effective as at January 1, 1999, which would seem to provide possible planning opportunities between the Announcement Date and the year end. This has the potential to create disparity in the advice provided by practitioners who were unable to review the legislative proposals in the allotted time frame. Finally, from a practical point of view, many practitioners take time off between Christmas and New Years leaving escrowed transactions to close for convenience effective at year end. Such timing issues may have an even greater detrimental impact for practitioners dealing with commercial trusts.

4. In certain cases the explanatory notes were slightly misleading in their reinforcement of the fact that the proposed changes did nothing to alter tax policy and were "administrative" in nature only. There is a concern that such general comments may create a false sense that the proposed amendments are inconsequential. Despite this, for the most part the explanatory notes were very helpful and much appreciated. In some cases though, the explanatory notes just restate the legislation. More details, interpretation and examples would be most welcome.

5. Although this was not raised in the legislative proposals, it is unclear whether the 21-year deemed disposition rule applies in the case of "protective trusts" or trusts of a similar nature. For such trusts the property is deemed to be returned to the settlor either on termination of the trust or to the estate of the settlor upon the settlor's demise. We would suggest that the 21-year deemed disposition rule should not apply to protective trusts or trusts of a similar nature.

6. Given Revenue Canada's position that a bare trust is to be ignored for tax purposes and that the transferor/settlor is considered to remain the owner of the property for all purposes of the Act, it is not clear why a transfer to a non-resident bare trust would now be considered a disposition. Although it would seem that the rationale for this change concerns the ability to collect the tax in Canada, we would be interested in your comments as to whether there are any other factors which led to this policy change. Furthermore, we would appreciate your comments as to what would be considered the appropriate circumstances whereby the Minister would permit the transfer of property to a non-resident bare trust without there being a disposition as per condition (iii) in paragraph (e) of the new definition of disposition. Obviously this issue speaks to the use of offshore asset protection trusts.

7. As you are aware, prior to the 1995 Annual Conference of the Canadian Tax Foundation, Revenue Canada's expressed position was that a transfer of property to a revocable living trust resident in Canada would not be

considered a disposition of property pursuant to paragraph (e) of the definition "disposition" in section 54. At the 1995 Annual Conference, Revenue Canada adopted a new position that a revocable living trust should be recognized for income tax purposes at the time that legal title to property is transferred to it and that the transfer of the property should be deemed to have occurred at fair market value and not at the value of the remainder interest only. The reason for this position seems to be that other beneficiaries named under the trust will have rights under the terms of the trust provided the transferor/settlor does not revoke the trust before his or her death. As a result of the introduction of a "qualifying disposition", we would recommend that the transfer of property to a revocable living trust be treated as a "qualifying disposition" as opposed to a "disposition" at fair market value. Although we would agree that such a transfer should not be treated in a similar fashion to a transfer to a bare trust, which is in accordance with the revised position of Revenue Canada as stated above, it is more appropriate to treat such a disposition in the same manner as the transfer of property to a protective trust. In the case of a revocable living trust, the fact that the transferor/settlor is the sole income and capital beneficiary during his or her lifetime and furthermore retains the right to revoke the trust at any time, makes such a trust virtually identical to a protective trust other than the fact that the revocable living trust may provide for beneficiaries, other than the estate of the transferor/settlor, on the death of the transferor/settlor. In the event that the transferor/settlor does not revoke the trust, the property that was subject to the rollover should be taxable when it is disposed of in fact by the trust and be subject to a deemed realization together with all the property of the trust when the transferor/settlor dies. This would not only be the most practical way to treat transfers of property to a revocable living trust, but the most equitable.

8. We very much welcome the rollover from a trust to separate trusts where a beneficiary's interest remains unchanged.

9. We do not understand why the amendments to paragraph 94(1)(c) were released in a way that allowed this supposed loophole to be utilized prior to 1999. Surely this tax plan, which we believe was rarely used, cannot be considered to be government sanctioned tax planning. Thus, we do not understand why a window of opportunity (albeit brief) was provided for its possible further exploitation.

The following specific submissions are dealt with in the order that they appear in the legislative proposals. Our comments are limited to the taxation of personal trusts and their beneficiaries.

Clause 11

Subsection 104(1)

It is not clear as to the purpose for amending subsection 104(1) in order to add the wording “unless the context otherwise requires” and “to include”. We wonder if there is a specific example in the Act of the use of the word trust or estate whereby the existing section would lead to confusion or an improper result.

Subsection 104(13)

Subsection 104(13) is amended in order to require a beneficiary to include in income only the current income payable from a non-resident trust. It would seem that the income of the non-resident trust is to be calculated in accordance with Canadian law as opposed to the law of the jurisdiction in which the trust is resident. Perhaps this should be clarified.

We do not understand the rationale for eliminating paragraph 104(13)(c) and incorporating this provision in amended paragraph 104(13)(b) since the requirement to distinguish between the capital account and the income account will still be present.

Clause 13

Dispositions of Capital Interests in Trusts

The proposed amendments in relation to the disposition of a capital interest in a trust provide that a capital distribution to a beneficiary will be deemed to be a disposition. It is not clear whether the current provisions contained in the Act would also deem a capital distribution to be a disposition. There is concern that a capital distribution from a trust resident in Canada to a non-resident beneficiary may result in the non-resident beneficiary being obligated to notify the Minister of the disposition pursuant to the provisions of subsection 116(3) of the Act. Since a capital interest in a Canadian resident trust would be considered “taxable Canadian property” a corresponding disposition may create this obligation. If our understanding of the effect of the proposed amendment is accurate, it would seem overly cumbersome to require the non-resident beneficiary to notify the Minister each time a capital distribution is made. Finally, if notification is required and not given, there is concern that the non-resident beneficiary would be subject to the penalty provisions contained in subsection 238(1) of the Act.

Clause 14

Qualifying Dispositions (ITA 107.4(1) – (3))

Given the close connection between the new definition of "disposition" in subsection 248(1) and the new concept of a "qualifying disposition", our comments are included under Clause 18 immediately below.

Clause 18

"Disposition"

There is concern that the proposed definition of "disposition" is quite complex and possibly overly restrictive in terms of what will now be classified as a disposition for the purposes of the Act. We are aware of the existing confusion in relation to whether a transfer to certain trusts would or would not be classified as a "disposition". Furthermore, it is our understanding that one of the main reasons for establishing this new regime is to ensure that there is certainty in determining the "cost base" of property being transferred to a trust. Under the existing law, although most practitioners were of the opinion that a transfer to a trust would be deemed to have occurred at the "adjusted cost base" even in the case where the transfer was deemed not to be a transfer as a result of the effect of paragraph (e) of the definition "disposition" in section 54 of the Act, the current provisions of the Act do not provide for this. Therefore we welcome the new amendments that explicitly provide for this.

With respect to the conditions in new paragraph (f) of the definition of "disposition" in subsection 248(1), there is concern that the conditions are exhaustive in nature and, therefore, certain types of transfers may result in dispositions that would otherwise have not been "dispositions" pursuant to the existing legislation. Although such transfers would generally be "qualifying dispositions" and would not therefore result in any tax liability, it may not be practical to require the reporting of a disposition in all cases where the conditions in paragraph (f) are not met. For example, if a trustee is replaced either due to death, resignation, bankruptcy, etc., this event would result in a change in legal ownership, however, it would not result in the creation of a new trust and would, therefore, not be sheltered under the trust-to-trust transfer rules in paragraph (f). Provided the trust in question was not a bare trust, thereby precluding the operation of paragraph (e), this event would seem to result in a disposition. We believe it is impractical that such an occurrence result in a "qualifying disposition". Perhaps a reference to a regulation could be added, so that exceptions to having a disposition could be prescribed as anomalies surface.

The fourth condition enumerated under paragraph (f) provides that the transferee trust must not have any property immediately prior to the transfer. We understand the reasoning for this condition, however, we are concerned that in order to comply with this condition the transferor trust will have to be the settlor of the transferee trust, which may create other problems. It is common practice to create the transferee trust with a nominal settlement (i.e. a "silver dollar") made by a third party and then have the transferor trust transfer all of its assets to the new trust. This, however, would breach the condition since arguably the transferee trust would have held property immediately prior to the transfer.

We do not believe that this is what the Department was guarding against and therefore believe that some further thought may be needed on refining this amendment. Otherwise, the only possible way for the rule to operate is where the transferor trust creates the transferee trust.

It is not clear as to the purpose of subsection 248(25.2) in providing that the transferee trust be deemed to be the same trust as, and a continuation of the transferor trust.

It is not clear as to the purpose and effect of subsection 248(25.1). In addition, the drafting of the subsection using negative language makes the subsection very difficult to understand.

Clause 19

Arm's Length (ITA 251(1))

Revenue Canada's position as to whether a settlor deals at arm's length or not with a trust was to be determined based on the facts. This created uncertainty. Some of our committee members believe it is not appropriate to amend subsection 251(1) of the Act to deem all relationships between a taxpayer and a trust to be non-arm's length, solely as a consequence of the taxpayer, or any person not dealing at arm's length with the taxpayer, being beneficially interested in the trust. This amendment seems to be overly restrictive, especially in light of the 1998 amendments to the definition "beneficially interested". Amended subsection 251(1) may have the effect of deeming a taxpayer not to be dealing with the trust at arm's length even in a case where neither the taxpayer nor any person not dealing at arm's length with the taxpayer are named beneficiaries in the Trust Indenture, if the Trust Indenture permits additional beneficiaries to be appointed in the future. In such a case, it would seem impractical to define the relationship as non-arm's length at the outset of the establishment of the trust. Although this relationship may often be non-arm's length, this should not be the default. There is concern that precluding the ability for the taxpayer to establish the relationship as arm's length could result in the improper application of other sections of the Act.

If there is a concern that it is often not possible for the Minister to establish that the relationship is non-arm's length, we would recommend that the subsection be amended to place the onus on the taxpayer to prove that the relationship is arm's length. We believe this would address the Department's concerns without creating an impractical result.

Other committee members are of the view that this change is appropriate and that generally trusts, settlors and beneficiaries deal non-arm's length factually in most cases. If the legislation is to stay as amended, we would recommend that a transitional rule be included to exempt the application of the amended subsection with respect to any events that have occurred prior to the Announcement Date. Otherwise a trust which acquired

property that was not taxable Canadian property from a person related to a beneficiary might now have the property revert to taxable Canadian property. Due to the "25% of a share class in the past 5 years ownership rule" applicable to shares of Canadian corporations, this amendment may now cause the property to revert to being taxable Canadian property, assuming the trust relationship would otherwise have been considered to be arm's length.

There may be other similar unforeseen consequences to this amendment.

In conclusion, we found the legislative proposals to be very extensive, well drafted although complex, and we do agree that for the most part the proposed changes do not alter tax policy and do provide a great degree of assistance in clarifying the provisions of the Act. The new initiatives, especially the trust to trust rollovers, are most welcome.

Should you have any questions or concerns with respect to any of our comments or submissions, you may direct them to the undersigned. We appreciate your consideration of our thoughts and suggestions and hope that they are useful to you.

Yours very truly,

STEP TECHNICAL COMMITTEE

Paul R. LeBreux
Chair

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