Variations of Trusts: An Analysis of the Effects of Variations of Trusts Under the Provisions of the Income Tax Act

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PRÉCIS

Avant l'adoption de la législation sur la modification des fiducies, les fiduciaires étaient en général tenus par leurs devoirs fiduciaires d'administrer la fiducie selon les modalités. À moins qu'aux termes de l'acte de fiducie, les fiduciaires n'aient été spécifiquement habilités à changer les modalités de la fiducie, ils ne pouvaient pas mettre en oeuvre même la plus simple des modifications administratives aux modalités de la fiducie, peu importe les avantages qu'en auraient tiré les bénéficiaires. L'effet punitif de cette règle fondamentale de la législation régissant les fiducies a été atténué par suite de l'adoption relativement récente de la législation sur la modification des fiducies dans la plupart des provinces canadiennes.

Malgré l'intérêt grandissant pour les modifications des fiducies et le nombre croissant de demandes à cet effet, les incidences fiscales précises de ces modifications sont encore peu connues. À la lumière des changements proposés à la disposition réputée aux termes de la règle de 21 ans annoncée dans le budget fédéral de février 1995, il est encore plus urgent de mieux comprendre les incidences fiscales des modifications des fiducies. Les préoccupations possibles du point de vue fiscal découlant des modifications des fiducies comprennent les suivantes : la modification constitue-t-elle une aliénation de biens; la modification donne-t-elle lieu à l'établissement d'une nouvelle fiducie; et les règles d'attribution du revenu peuvent-elles s'appliquer. Ces diverses questions n'ont pas encore été examinées en détail dans la jurisprudence canadienne en matière de fiscalité, ni n'ont-elles été analysées de façon critique par Revenu Canada ou les experts en fiscalité. Le planificateur prudent en matière de successions doit évaluer avec soin les incidences fiscales possibles de la modification d'une fiducie. Dans cet article, les

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auteurs examinent la notion des modifications des fiducies et certaines questions d'ordre pratique que soulèvent les demandes de modifications des fiducies. Ils discutent des incidences fiscales connues, et point peut-être encore plus important, des incidences inconnues de ces modifications.

ABSTRACT

Before the enactment of variation of trusts legislation, trustees were generally bound by their fiduciary duties to administer the trust according to its terms. Unless the trust deed specifically empowered the trustees to vary the terms of the trust, trustees could not implement even the simplest administrative alteration to the terms of a trust, irrespective of the benefits that would accrue to the beneficiaries as a result of such a change. The punitive effect of this basic rule of trust law has been alleviated by the relatively recent passage of variation of trusts legislation in most Canadian provinces.

Despite growing interest in variations of trusts and increasing numbers of such applications, very little is known of the precise consequences of trust variations for income tax purposes. In the light of the proposed changes to the 21-year deemed disposition rule announced in the February 1995 federal budget, the need to gain a clearer understanding of the tax consequences of variations of trusts has taken on an even greater urgency. The possible tax concerns resulting from a variation of trust include whether the variation constitutes a disposition of property, whether the variation establishes a new trust, and the possible application of the income attribution rules. These various concerns have not, to date, been considered in any detail in Canadian income tax jurisprudence, nor have they been subject to much critical analysis by Revenue Canada or tax practitioners. The prudent estate planner must carefully evaluate the potential tax consequences of a variation of trust. In this article, the authors explore the concept of trust variations, review some practical considerations involved in the variation application, and discuss what is known and (perhaps more important) what is not known about the income tax consequences of such variations.

INTRODUCTION

Since the concept of trust variations sanctioned by statute was introduced in Canada in the late 1950s, the variation of trust has become an indispensable tool in the estate planner's workbox. In recent years, both the interest in variations of trusts and the number of such applications have been increasing. Nevertheless, little consideration has been given to the consequences of trust variations for income tax purposes.

The federal budget speech of February 22, 1994 focused new attention on the tax implications of variations of trust. In a brief statement, Minister of Finance Paul Martin commented that

> many Canadians including Members of this House, have expressed the view that the taxation of family trusts should be examined. This issue will be referred to the House of Commons Finance Committee for review.[1]

This statement was widely perceived to be a response to criticisms levelled against 1993 amendments to the Income Tax Act[2] that had the effect of adding flexibility to the rules respecting 21-year deemed dispositions by trusts.[3] The February 1995 federal budget proposes to repeal the election mechanism currently available under subsection 104(5.3), which permits a trust to defer the 21-year deemed disposition so long as there is an "exempt beneficiary" as defined in subsection 104(5.4). This proposal will establish December 31, 1998 as the first critical deadline for dealing with trusts that would otherwise face potentially ruinous levels of taxation under the deemed disposition rule. Variations of trust could become important as a means of responding to these proposed changes. Accordingly, it is timely to examine the use of this estate-planning tool in the specific context of income taxation. In this article, we explore the concept of trust variations, review some practical considerations involved in the variation application, and discuss what we know and (perhaps more important) do not know about the income tax consequences of such variations.

THE CONCEPT OF VARIATIONS OF TRUSTS

At the time of settlement, the settlor likely has a clear idea of the purpose of the trust and its mode of operation. Often, however, as a result of a change in the circumstances of the beneficiaries or a change in law (particularly tax law), it may be desirable to vary the trust. Innumerable contingencies could occur that would make a variation of trust attractive. Ideally, the trustees will have been granted sufficient powers to be able to react to unanticipated events and to implement the necessary changes. Circumstances may arise, however, where the trustees do not have the powers or the flexibility to effect the desired variations. In such circumstances, there are a limited number of options available by which to implement a trust variation. Those options include, inter alia,[4] an

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[1] Canada, Department of Finance, 1994 Budget, Budget Speech, February 22, 1994, 17.

[2] RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

[3] In particular, new subsections 104(5.3) to (5.8) introduced by SC 1993, c. 24, section 42(3), applicable after February 11, 1991, with the exception of a grandfathering rule for subsection 104(5.8) insofar as it extends to property transferred before December 21, 1991.

[4] In this article, we will confine the discussion to the variation of trusts under provincial variation of trusts legislation. Other methods that could be used to vary a trust in appropriate circumstances include disclaimers, renunciation, and surrender (see Maria Elena Hoffstein and Julie Y. Lee, "Restructuring the Will and the Testamentary Trust: Methods, Underlying Legal Principles and Tax Considerations" (September 1993), 13 *Estates and Trusts Journal* 42-99); appealing to the "inherent jurisdiction" of the court (see A.J. McClean, "Variation of Trusts in England and Canada" (May 1965), 43 *The Canadian Bar Review* 181-261); and application of the rule in *Saunders v. Vautier* (1841), 4 Beav 115, 49 ER 282 (Rolls Ct.), aff'd. (1841) Cr. & Ph. 240, 41 ER 482 (Ch. D.), discussed in footnote 7, infra.

application to court for a variation of trust under provincial variation of trusts legislation.[5]

In the absence of a variation of trust, the trustees are required to fulfil their fiduciary obligations according to the original trust terms unless the trust deed empowers them to depart from those terms. In the words of Donovan Waters:

> It is the first duty of the trustees to preserve the trust property and to carry out the trust terms. Unless the settlor chooses to give them such a power, they have no authority to vary the terms of the trust, any more than they can neglect their duty to preserve the trust property. Nor does it matter whether the term which the trustees would like to vary is concerned with the beneficial interests created by the trust or the powers of themselves as trustees. It follows that, even if the trustees honestly and reasonably believe that it would be for the benefit of the beneficiaries were the trustees to depart in any way from any term of the trust, nevertheless they would be in breach of trust were they to do so.[6]

Thus, before the enactment of variation of trusts legislation, unless the rule in *Saunders v. Vautier*[7] could be applied, the trustees were bound by their fiduciary duties to administer the trust strictly according to its terms. They could not implement even the simplest administrative alteration, notwithstanding the benefit that would accrue to the beneficiaries as a result of such a change. The punitive effect of this basic rule of trust law was alleviated in England with the passage of the Variation of Trusts Act of 1958. Soon after, The Variation of Trusts Act, 1959 was passed in Ontario.[8]

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[5] The discussion of variation of trusts legislation will focus on the Variation of Trusts Act, RSO 1990, c. V.1 (herein referred to as "the VTA"). The statutes in all the Canadian common law provinces that have enacted such legislation are substantively similar.

[6] D.W.M. Waters, *Law of Trusts in Canada*, 2d ed. (Toronto: Carswell, 1984), 1055.

[7] Supra footnote 4. Technically speaking, this rule provides that where all of the interests in a trust are currently vested and all of the beneficiaries of the trust are ascertained, adult, and otherwise sui juris (that is, not suffering from any legal incapacity), they may, acting together, bring a trust to an end by requiring the trustees to deliver the trust property to them in accordance with their interests, notwithstanding any provision of the trust permitting or requiring a later distribution. See, for example, Philip H. Pettit, *Equity and the Law of Trusts*, 7th ed. (London: Butterworths, 1993), 367 et seq. The rule does not permit a variation of trust terms or a reallocation of beneficial interests, as such. As a practical matter, however, the result of the rule is that those individual beneficiaries are the only ones who can object if the trustees depart from the strict terms of the trust. If they are prepared to condone conduct on the part of the trustees that varies from the terms of the trust, this can amount to a de facto variation. Where variation initiatives arise from the beneficiaries of what might be termed a *Saunders v. Vautier* trust, although the trustees are not, strictly speaking, obliged to accede to the wishes of the trust beneficiaries in such a circumstance, it is not uncommon for them to do so in practice. We will not speculate on the tax consequences of such a de facto variation under the *Saunders v. Vautier* principle, although many of the same issues that are discussed in this article in the context of formal variation of trust applications would undoubtedly arise.

[8] SO 1959, c. 104.

THE VTA APPLICATION

The current Ontario VTA is a brief statute, which reads, in its entirety, as follows:

> 1.—(1) Where any property is held on trusts arising under any will, settlement or other disposition, the Ontario Court (General Division) may, if it thinks fit, by order approve on behalf of,
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> (a) any person having, directly or indirectly, an interest, whether vested or contingent, under the trusts who by reason of infancy or other incapacity is incapable of assenting,
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> (b) any person, whether ascertained or not, who may become entitled, directly or indirectly, to an interest under the trusts as being at a future date or on the happening of a future event a person of any specified description or a member of any specified class of persons;
>
> (c) any person unborn; or
>
> (d) any person in respect of any interest of the person that may arise by reason of any discretionary power given to anyone on the failure or determination of any existing interest that has not failed or determined,
>
> any arrangement, by whomsoever proposed and whether or not there is any other person beneficially interested who is capable of assenting thereto, varying or revoking all or any of the trusts or enlarging the powers of the trustees of managing or administering any of the property subject to the trusts.
>
> (2) The court shall not approve an arrangement on behalf of any person coming within clause (1) (a), (b) or (c) unless the carrying out thereof appears to be for the benefit of that person.

In effect, the VTA permits, in specific circumstances, a *Saunders v. Vautier* type of application in situations where the rule in *Saunders v. Vautier* would not otherwise be available. However, whereas the rule in *Saunders v. Vautier* allows capacitated beneficiaries to implement any variation they wish, for whatever reason they wish, and even permits them to wind up the trust, approval of a variation under the VTA is subject to compliance with the requirements of the legislation and is also subject to the discretion of the court.

For the estate planner, two issues must be evaluated in the context of a proposed application under the VTA. First, the proposed variation must comply with the requirements of the VTA. That is, there must appear to be a benefit for the beneficiaries contemplated by sections 1(1)(a), (b), and (c) of the VTA ("the VTA beneficiaries"). Second, the tax consequences of the proposed variation must be considered. Of course, the "benefit" motivating the proposed variation could be a tax benefit itself. However, whether or not a tax benefit motivates the application, it is possible that the variation could trigger certain adverse tax consequences.

One of the leading Ontario cases on the requirements for approval of a variation of trust under the VTA is *Re Irving*.[9] The purpose of the proposed

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[9] (1975), 66 DLR (3d) 387 (Ont. HC).

variation in that case was to realize significant savings in succession duties, which would have resulted in a substantial benefit to the beneficiaries of the trust as a whole. In the course of judgment, Pennell J laid down certain guidelines that, in his view, should be considered by the court in the context of a VTA application. Those guidelines have generally been favourably referred to and followed by judges in subsequent cases. The guidelines may be summarized as follows:

1) The court must, to the extent possible, keep alive the basic intention of the settlor. The "substratum" of the trust must be maintained. As stated by Pennell J, the VTA "permits pruning of the trust in order to promote fruitfulness, but the root is to be preserved."[10]

2) A sufficient benefit must be realized by all VTA beneficiaries. It is not acceptable for the beneficiaries as a whole to benefit from the variation or for all classes to benefit. Each *individual* VTA beneficiary must benefit.

3) The benefits realized by the variation must be of a sufficient magnitude and certainty. The sufficiency of the benefit may be determined by asking whether a reasonable person in the shoes of the beneficiary would agree to the proposed variation. Or, in the words of Pennell J,

> [I]s the benefit to be obtained on behalf of those for whom the Court is acting such that a prudent adult motivated by intelligent self-interest and sustained consideration of the expectancies and risks and the proposal made, would be likely to accept?[11]

4) A court is limited to approving or rejecting the proposal before it. The court cannot substitute its views on what would constitute a "beneficial" variation. If the court rejects the application, the parties are free to amend the proposal and return to court to seek approval.

Ultimately, Pennell J rejected the application before him in *Re Irving*. In his view, the proposed variation resulted in a disproportionate benefit for the capacitated beneficiaries and did not provide for sufficient benefit to the VTA beneficiaries.

In *Re Zekelman*,[12] the court held that in determining the sufficiency of a "benefit" for purposes of the VTA, the court could also consider a non-financial benefit.[13] The benefit approved by the court in that case included certain tax savings and "family harmony." The avoidance of family dissension was also recognized as a benefit for VTA purposes in *Lafortune v.*

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[10] Ibid., at 399. Subsequent case law has suggested that this wording may be overly restrictive; see, for example, *Lafortune v. Lafortune Estate* (1990), 40 ETR 299 (Ont. HC).

[11] *Irving*, supra footnote 9, at 394.

[12] [1971] 3 OR 156 (HC).

[13] In *Re Weston's Settlements*, [1968] 3 All ER 338 (CA), the court considered a variation of trust that would have seen the property from two English trusts transferred to Jersey. Lord Denning, at 342, stated that the non-financial detriment to the infant beneficiaries of being uprooted from England outweighed the financial benefits of the proposed variation.

Lafortune Estate.[14] The weight of jurisprudence suggests, however, that although the court may consider non-financial benefits, financial considerations should be the court's primary concern. Non-financial benefits, by themselves, are not sufficient.

In *Finnell v. Schumacher Estate*,[15] the court was asked to consider an arrangement involving a variation of a testamentary trust. The dominant purpose of the proposed variation was tax saving. The trust assets in that case included nearly 200 mining properties in northern Ontario. The estate earned mining revenues of approximately $800,000 per annum. For trust purposes, these revenues were treated as capital; for tax purposes, they were treated as regular income. Since the revenues were capital for trust purposes, they had to be retained until the division date; yet, for tax purposes, they were subject to immediate taxation. The objective of the proposed variation was, in part, to distribute the mining revenues in the year of receipt to the income beneficiaries to be taxed at their individual rates. The variation would have also effected a deferral of the 21-year deemed disposition rule. The Court of Appeal indicated that the applicants had received an advance tax ruling approving the variation. The applicants had been successful at trial; however, the official guardian (representing the infant, unborn, and unascertained VTA beneficiaries) and the public trustee (representing an Ontario charity that was a beneficiary under the estate) appealed the decision. The appeal was allowed. Although the court held that "the effort of the trustees to save taxes was worthwhile"[16] and that saving taxes "makes good business sense and should be encouraged,"[17] it also found that the tax savings would accrue disproportionately to the capacitated beneficiaries and the quantum of the benefit to be realized by the VTA beneficiaries was not sufficient. The court approved the holding in *Re Irving* that an application under the VTA would not be accepted unless all the VTA beneficiaries received sufficient benefits.

It should be noted that the Court of Appeal recognized in *Finnell v. Schumacher Estate* that after the advance tax ruling had been obtained, the Income Tax Act had been amended such that it would be unlikely for the applicants to obtain as beneficial a ruling on a new application. Nevertheless, the court refused to consent to the proposal, even though the benefits that could have been realized by the beneficiaries as a whole were substantial.

In Ontario, the infant, unborn, and unascertained VTA beneficiaries are represented by the official guardian. Clearly, it would be beneficial to obtain the prior approval of the official guardian when an application is intended to be made under the VTA. Unfortunately, however, the official guardian has taken the position that a tax benefit is insufficient justification,

[14] Supra footnote 10.

[15] (1990), 37 ETR 170 (Ont. CA).

[16] Ibid., at 184.

[17] Ibid., at 182.

by itself, for approval of a variation of trust under the VTA. The official guardian has expressed the following view:

> Now that 1993 is fast approaching and some tax relief is being eagerly anticipated by some trusts and their beneficiaries through variation, it is our view that tax relief by itself is not a sufficient "benefit" at law, though very compelling. There must be some further "benefit" for the wonderful interests we represent. They deserve it. They are the future generations of our great province which is substantially driven by the trusts which hold corporate empires and large assets. We believe that it is not much to ask today's beneficiaries to dig into their pockets and benefit their future sons, daughters and their issue.[18]

On the other hand, it has been argued that the case law supports a liberal interpretation of the term "benefit."[19] Such a liberal interpretation should logically include a tax benefit. While there are cases where a VTA application to achieve a tax benefit has been denied, the basis of the denial was either that the benefit accruing to the VTA beneficiaries was not sufficient or that not all of the VTA beneficiaries obtained a benefit. Contrary to the official guardian's position, the case law suggests that tax benefits may be proper benefits for VTA purposes provided that sufficient benefits accrue to all the VTA beneficiaries.[20] Although criticism of the official guardian's position is well supported by the case law, the official guardian's opposition, or potential opposition, to a tax-motivated variation represents an additional hurdle for tax advisers to overcome in obtaining a tax-effective variation of trust.

INCOME TAX CONSIDERATIONS

Assuming that a variation of trust is acceptable for purposes of the VTA, it is necessary to consider the tax consequences of the variation. However, the impact of a variation of trust upon the taxation of the trust and its beneficiaries is far from clear. Revenue Canada does not seem to have publicly expressed[21] any firm views on most of the major issues presented by trust variations. Similarly, there has been a surprising lack of commentary on the point by the tax community.[22]

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[18] Willson A. McTavish and Ronald R. Anger, "Variation of Trusts: The Official Guardian's View" (March 1989), 9 *Estates and Trusts Journal* 133-63, at 133-34.

[19] Strachan Heighington, "Variations of Trust and Tax Avoidance" (July 1990), 10 *Estates and Trusts Journal* 30-36.

[20] *Re Zekelman*, supra footnote 12, *Finnell v. Schumacher*, supra footnote 15, *Re Irving*, supra footnote 9, and other cases suggest that tax saving is a reasonable objective for trustees and beneficiaries to pursue. The only issue for VTA purposes is whether the quantum of the benefit realized by all the VTA beneficiaries is sufficient.

[21] The issue has been considered in some technical interpretations and private rulings, a sampling of which is discussed below.

[22] Although a number of commentators have referred to these issues, they have normally done so briefly in the context of a broader discussion: see, for example, John M. Fuke, "Post-Mortem Estate Planning," in *Report of Proceedings of the Twenty-Fourth Tax*

(The footnote is continued on the next page.)

Specific areas of concern for tax purposes include

- the possible application of the attribution rules;
- the possibility that the variation will constitute a resettlement of the trust;
- the possibility that the variation will trigger a disposition of property, either by the trust or by the beneficiaries;
- the possibility that the variation will taint the status of the trust (for example, causing a trust that formerly qualified for graduated tax rates to be taxed at the top marginal rate);
- the impact on various tax pools, including loss carryforwards; and
- the possible application of certain benefit conferral provisions (such as subsection 56(2) or 105(1)).

As a result of these tax concerns, applicants under the VTA should almost invariably seek the comfort of an advance tax ruling before implementing a trust variation. However, persons seeking approval of an application for a variation of trust often find themselves confronted with a chicken and egg dilemma. Specifically, should the applicants first obtain court approval of the application and subsequently apply for the advance tax ruling; or, alternatively, should they appear at the variation of trust application armed with Revenue Canada's approval of the transaction in the form of an advance tax ruling. Unfortunately, case law suggests that obtaining an advance tax ruling is of no assistance for purposes of the VTA,[23] and a successful application under the VTA is no assurance that adverse tax consequences can be avoided.[24]

What We Know

What we know about the tax consequences of a variation of trust is limited:

[22] Continued . . .
Conference, 1972 Conference Report (Toronto: Canadian Tax Foundation, 1971), 263-77, at 275-76; John M. Fuke, "A Lecture on Trust Law for Tax Practitioners," in *Report of Proceedings of the Twenty-Seventh Tax Conference*, 1975 Conference Report (Toronto: Canadian Tax Foundation, 1976), 459-78, at 477-78; Maurice C. Cullity, "Unplanning an Estate—Part 3," Estate Planning in Canada feature (1977), vol. 25, no. 2 *Canadian Tax Journal* 180-87, at 183; T.E. McDonnell, "Attribution Rules—Whether Variation of Testamentary Trust a Transfer of Property to Spouse," Current Cases feature (1980), vol. 28, no. 6 *Canadian Tax Journal* 783-88; Douglas P. Hayhurst, "Transactions in Income and Capital Interests in Trusts," in *Report of Proceedings of the Fortieth Tax Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 38:1-24, at 38:20-22; and Maurice C. Cullity, "Trusts: Deferring the Deemed Realization," in *Report of Proceedings of the Forty-Third Tax Conference*, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), 36:1-23, at 36:19. See also Heighington, supra footnote 19; and Lloyd F. Raphael, *Canadian Income Taxation of Trusts*, 2d ed. (Don Mills, Ont.: CCH Canadian, 1982), 337-44.

[23] See, for example, *Finnell v. Schumacher Estate*, supra footnote 15.

[24] See, for example, *Murphy v. The Queen*, 80 DTC 6314; [1980] CTC 38 (FCTD), discussed below.

• In Revenue Canada's view, a variation cannot be used to purify a tainted spousal trust so as to fall within the rollover provisions of subsection 70(6) of the Act.[25]

• In Revenue Canada's view, a variation could cause a pre-June 18, 1971 inter vivos trust to lose the benefit of graduated marginal rates under subsection 122(2). The department's comments, however, are not very instructive: "Variations in the terms of the trust must be examined to determine if a particular change is of such a nature as to constitute the establishment of a new, successor trust."[26] There is no direct or implicit indication of what types of trust variation, apart from the purely administrative, would result in the "tainting" of such a trust.

• In some circumstances, a variation of trust can give rise to income attribution where one beneficiary is seen to be transferring rights to another.[27]

• Subsection 108(6) of the Act provides that, for the purposes of subsections 104(4), (5), and (5.2), in the case of variations occurring after February 11, 1991, the trust shall be deemed to be the same trust as, and a continuation of, the trust before its variation.[28]

Some guidance on Revenue Canada's views can be gleaned from the few advance rulings that have been issued, some technical interpretations, and passing references to favourable advance tax rulings in certain VTA court applications:

• In a private ruling letter issued in May 1980, Revenue Canada considered a trust in which several individuals held contingent interests pending the arrival of the distribution date, at which time all interests would vest. At a particular time when only one individual had a vested capital interest, all the beneficiaries consented to a variation of trust so as to defer the distribution date. The department expressed the view that the varied trust would have been "established" after June 17, 1971 for purposes of determining whether it qualified for graduated tax rates but was not prepared to offer an opinion on whether the trust would be considered to have been "created" at the time of the variation for purposes of subparagraph 104(4)(a)(ii). The department considered that the determination of this issue required a detailed review of the trust document and the specific circumstances. The department further expressed the view that although the variation would not result in a disposition of trust property by the trust, there may be a disposition and reacquisition by the beneficiaries of their interests in the trust.

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[25] *Interpretation Bulletin* IT-305R3, "Establishment of Testamentary Spouse Trust," June 29, 1987, paragraph 5. Presumably this interpretation would also extend to such provisions as paragraphs 70(5.2)(d) and (f), dealing with resource properties and land inventory, respectively.

[26] *Interpretation Bulletin* IT-406R2, "Tax Payable by an Inter Vivos Trust," May 11, 1990, paragraph 3.

[27] *Murphy*, supra footnote 24.

[28] The application of subsection 108(6) will be discussed in greater detail below.

• In a technical interpretation dated July 24, 1992,[29] Revenue Canada expressed the view that it would be a question of law whether or not a testamentary trust whose terms were varied with the agreement of its beneficiaries constituted a new trust. Thus, it would be a question of law whether subsequent distributions could be said to have been made under the terms of the testator's will or another trust for the purposes of the meaning of the terms "testamentary trust" and "personal trust" and for purposes of paragraph 248(8)(a)[30] of the Act.

• In a technical interpretation dated July 22, 1992,[31] Revenue Canada indicated that a variation of trust may result in resettlement of the original trust if the variation is of significant magnitude to cause a fundamental change in the terms of the trust. However, a variation affecting only administrative, investment, or ancillary powers would not normally, in and of itself, cause a taxable event. If the variation added discretionary beneficiaries, the department would consider whether such a variation constituted a disposition of interest.

• In *Hunter Estate v. Holton*,[32] the Ontario Court of Justice (General Division) considered whether the trustees were empowered to transfer the assets held in a testamentary trust fund into two new funds that would have the same terms as the original trust, except that the primary beneficiaries of one of the new trusts would be the testator's daughter and her issue and the other trust would be for the benefit of the testator's son and his issue. Although the case is not a tax case,[33] in the course of judgment Steele J noted that an advance tax ruling had been received which confirmed that there would be no adverse tax consequences as a result of dividing the fund into the two new trusts.

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[29] Technical interpretation of the Manufacturing Industries, Partnerships and Trusts Division of Revenue Canada, July 24, 1992, available from Canadian Tax On-Line electronic database.

[30] Subsection 248(8) reads in part as follows:

For the purpose of this Act,

> (a) a transfer, distribution or acquisition of property under or as a consequence of the terms of the will or other testamentary instrument of a taxpayer or the taxpayer's spouse or as a consequence of the law governing the intestacy of a taxpayer or the taxpayer's spouse shall be considered to be a transfer, distribution or acquisition of the property as a consequence of the death of the taxpayer or the taxpayer's spouse, as the case may be.

[31] Technical interpretation of the Manufacturing Industries, Partnerships and Trusts Division of Revenue Canada, July 22, 1992, available from Canadian Tax Online electronic database.

[32] (1992), 46 ETR 178 (Ont. Gen. Div.).

[33] It should be noted that the *Hunter* decision involved a variation under the terms of a will but was not an application under the VTA. Nevertheless, the decision does provide additional guidance on the scope of trust variations that will not constitute a disposition for tax purposes.

Further guidance on Revenue Canada's views may also be obtained, by way of analogy, from *Interpretation Bulletin* IT-448.[34] IT-448 discusses whether certain changes in the terms of debt and equity securities would constitute dispositions within the meaning of the definition of that term in section 54 of the Act. Paragraph 14 of the bulletin lists examples of changes that would normally be considered to be of sufficient substance to be regarded as dispositions. Paragraph 15 lists examples of changes that, taken by themselves, would not be considered to be dispositions:[35]

> 14. Following are examples of changes that are normally considered to be of sufficient substance to be regarded as dispositions:
>
> (a) a change in voting rights attached to shares that effects a change in the voting control of the corporation;
>
> (b) a change in a defined entitlement (e.g. a change in par value) to share in the assets of a corporation upon dissolution (preferred shares only);
>
> (c) the giving up or the addition of a priority right to share in the distribution of assets of the corporation upon dissolution;
>
> (d) the addition or deletion of a right attaching to a class of share that provides for participation in dividend entitlements beyond a fixed preferential rate or amount;
>
> (e) a change from a cumulative to a non-cumulative right to dividends or vice versa.
>
> 15. Following are examples of changes that taken singly are not considered to be dispositions:
>
> (a) the addition of the right to elect a majority of the directors of the corporation if, at that time, the shareholders of that class are already in a position to control the election of directors;
>
> (b) a change in the number of votes per share if the ability of any one shareholder to influence the day-to-day affairs of the corporation is neither enhanced nor impaired thereby;
>
> (c) the giving up of contingent voting rights which, in the event they were exercised, would not be of sufficient number to control the affairs of the corporation;
>
> (d) restrictions added or removed concerning transfer of shares;
>
> (e) the addition of a right of redemption in favour of the corporation;
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> (f) stocks splits or consolidations (see IT-65);

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[34] *Interpretation Bulletin* IT-448, "Dispositions—Changes in Terms of Securities," June 6, 1980.

[35] For a critique of Revenue Canada's position as set out in IT-448, see Brian J. Arnold and David A. Ward, "Dispositions—A Critique of Revenue Canada's Interpretation" (1980), vol. 28, no. 5 *Canadian Tax Journal* 559-84. For judicial consideration of the meaning of the term "disposition," see *Victory Hotels Ltd. v. MNR*, 62 DTC 1378; [1962] CTC 6 (Ex. Ct.); and *The Queen v. Compagnie Immobilière BCN Ltée*, 79 DTC 5068; [1979] CTC 71 (SCC).

(g) a change of shares with par value to shares without par value or vice versa, provided that there is no change in any pre-set entitlements to dividends and/or distributions of assets upon dissolution;

(h) a change in ranking concerning preference features, (e.g. 1st preference to 2nd preference);

(i) an increase or decrease in the amount or rate of a fixed dividend entitlement.

Unfortunately, Revenue Canada has not provided any similar guidelines pertaining to the types of variations of trust that would and would not constitute dispositions of property.

Terra Incognita

In contrast to the bits and pieces that we know about the treatment of trust variations under the Act, the unresolved questions are quite fundamental:

- When, if at all, does a variation of a trust give rise to a disposition of assets by the trust?
- Does the consent of a beneficiary to a variation of trust give rise to a disposition or partial disposition of his or her interest in the trust?
- After a variation, is the varied trust the same taxpayer as previously?[36]
- Could the variation constitute a conferral of a benefit upon a person for purposes of subsection 56(2) or 105(1)?

These issues are discussed below.

Does the Variation Create a New Trust?

If a variation of trust were to give rise to a new trust, this would normally result in a disposition of all of the capital property of the trust by virtue of the definition of "disposition" contained in section 54,[37] unless it could

[36] This presents the various questions of continuity of tax accounts such as losses, tax credits, etc., that have given rise to repeated amendments to section 87 dealing with amalgamations.

[37] Section 54:

In this subdivision, . . .

"*disposition*"—"disposition" of any property, except as expressly otherwise provided, includes

(a) any transaction or event entitling a taxpayer to proceeds of disposition of property,

(b) any transaction or event by which

(i) any property of a taxpayer that is a share, bond, debenture, note, certificate, mortgage, agreement of sale or similar property, or an interest therein, is redeemed in whole or in part or is cancelled,

(ii) any debt owing to a taxpayer or any other right of a taxpayer to receive an amount is settled or cancelled,

(The footnote is continued on the next page.)

be ascertained that there was no change in the beneficial ownership of the property within the provision of paragraph 54(e) of the Act and the exclusion in the definition of "disposition." Generally speaking, with the exception of trust variations that involve purely administrative provisions, the purpose of most variations is to change the scheme of the underlying beneficial interests in the trust. Thus, for the purposes of determining whether there has been a disposition of the capital property of a trust upon a variation, the fundamental question appears to be whether the post-variation trust is a different trust such that there can be said to be a "transfer of property" to a trust within the meaning of the definition of "disposition" in section 54.

There is English case law that suggests that a variation of a trust does not necessarily create a new trust.[38] It is not clear, however, whether this judgment is based on the facts of that particular variation, nor is it clear whether Canadian courts would follow this decision in an income tax appeal.[39] The result may well depend on the facts of each particular case—

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[37] Continued . . .

(iii) any share owned by a taxpayer is converted by virtue of an amalgamation or merger, or

(iv) any option held by a taxpayer to acquire or dispose of property expires, and

(c) any transfer of property to a trust, or any transfer of property of a trust to any beneficiary under the trust, except as provided in paragraph (e),

but, for greater certainty, does not include

(d) any transfer of property for the purpose only of securing a debt or a loan, or any transfer by a creditor for the purpose only of returning property that had been used as security for a debt or a loan,

(e) any transfer of property by virtue of which there is a change in the legal ownership of the property without any change in the beneficial ownership thereof, other than a transfer by a trust resident in Canada to a trust not resident in Canada or a transfer to a trust governed by

(i) a registered retirement savings plan,

(ii) a deferred profit sharing plan,

(iii) an employees profit sharing plan, or

(iv) a registered retirement income fund

by a person who is, immediately after the transfer, a beneficiary under the plan or fund, or a transfer by any such trust governed by a plan or fund to a beneficiary thereunder,

(f) any issue by a corporation of a bond, debenture, note, certificate or mortgage of the corporation, or

(g) any issue by a corporation of a share of its capital stock, or any other transaction that, but for this paragraph, would be a disposition by a corporation of a share of its capital stock.

[38] *Holmden's Settlement Trusts, In re*, [1968] AC 685, at 703-10 (HL). See, however, the minority opinion that a new trust was created.

[39] The *Holmden* case was cited in *Murphy v. MNR*, 79 DTC 785, at 788; [1979] CTC 2921, at 2925 (TRB); however, the board did not otherwise comment upon the decision.

that is, the scope of the variation; the degree to which beneficial interests are altered, increased, or removed; and the degree of continuity between the original trust and the post-variation trust. As a practical matter, it would be prudent to obtain an advance ruling before varying any trust with significant unrealized capital appreciation.[40]

As a related matter, there is the question whether the post-variation trust is the same taxpayer as the original trust and can, for example, carry forward losses, tax credits, and so forth. The answer to this issue probably turns to some extent on the same factors that will determine whether the variation has given rise to a disposition of the assets of the trust—that is, the scope of the variation; the degree to which beneficial interests are altered, increased, or removed; and the degree of continuity between the original trust and the post-variation trust. It is possible that the minister could invoke subsection 104(2)[41] to ensure that the post-variation trust was treated as the same taxpayer, but it seems questionable whether the minister's power under this provision would extend to a case where one trust (that is, the pre-variation trust) had, in effect, ceased to exist. It may, however, be possible to draw some comfort from the analogy of the decision of the Federal Court of Appeal in *The Queen v. Guaranty Properties Limited et al.*,[42] dealing with the continuity of amalgamated corporations for the general purposes of the Act.

As a practical matter, until Revenue Canada issues clear guidelines on how it will treat trust variations for the purposes of the Act, it is

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[40] It would also be prudent to obtain a ruling on the continuity of the various tax accounts referred to previously. This would presumably involve a ruling that the post-variation trust was the same taxpayer as the original trust for the purposes of subsection 104(4). Subsection 104(1) reads as follows:

> In this Act, a reference to a trust or estate (in this subdivision referred to as a "trust") shall be read as a reference to the trustee or the executor, administrator, heir or other legal representative having ownership or control of the trust property.

Hayhurst, supra footnote 22, indicates that the department has given private rulings on these points in the past.

[41] Subsection 104(2):

> A trust shall, for the purposes of this Act, and without affecting the liability of the trustee or legal representative for that person's own income tax, be deemed to be in respect of the trust property an individual; but where there is more than one trust and
>
> (a) substantially all of the property of the various trusts has been received from one person, and
>
> (b) the various trusts are conditioned so that the income thereof accrues or will ultimately accrue to the same beneficiary, or group or class of beneficiaries,
>
> such of the trustees as the Minister may designate shall, for the purposes of this Act, be deemed to be in respect of all the trusts an individual whose property is the property of all the trusts and whose income is the income of all the trusts.

[42] 90 DTC 6363; [1990] 2 CTC 94 (FCA), rev'g. 87 DTC 5124; [1987] 1 CTC 24 (FCTD). Application for leave to appeal to the Supreme Court of Canada dismissed, January 1991, but see the more recent decision of *The Queen v. Pan Ocean Oil Ltd.*, 94 DTC 6412; [1994] 2 CTC 143 (FCA).

recommended that an advance ruling on these points be obtained as a necessary part of the variation process.

Does the Variation Give Rise to a Disposition of the Beneficiaries' Interests in the Trust?

The question whether a variation of trust gives rise to a taxable disposition of all or some portion of the interests of the beneficiaries consenting to the variation (arguably, however, only those whose prior interests under the trust are diminished by the variation)[43] has been raised by a number of commentators.[44] In the first place, it is not clear whether such a disposition, or partial disposition,[45] occurs upon a variation of a trust. If such a disposition does occur, there are no proceeds of disposition as such. Presumably then, the argument is that subparagraph 69(1)(b)(i) or (ii) would apply[46]—that is, that there had been a transfer by the beneficiary to a non-arm's-length party[47] for no proceeds or as a gift inter vivos.

The critical, unresolved issue regarding a possible disposition of property by the existing beneficiaries is whether the diminution of the rights of existing beneficiaries results from a disposition of existing rights to other beneficiaries or, rather, results in a transfer of those rights back to the trust. If the former were the case, it seems that the existing beneficiaries

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[43] While the position is not free from doubt, it may be argued that where a variation of trust results in a diminution of interest of a beneficiary of the trust, the beneficiary has disposed of a part interest only in the trust rather than having disposed of the entire interest and reacquiring a new interest. By corollary, a person whose interest in a trust is augmented as a result of a variation should not be seen as having disposed of the prior interest and receiving the new interest.

[44] See, in particular, Cullity, "Unplanning an Estate," supra footnote 22, at 183.

[45] It appears that, in most variations, the rights of some classes of existing trust beneficiaries are diluted, delayed, or restricted, but not normally extinguished. This seems to indicate that section 43 of the Act, dealing with partial dispositions of capital property, would apply if it were concluded that a variation of trust gave rise to any form of disposition of interests in the trust by the existing beneficiaries.

[46] Subsection 69(1):

> Except as expressly otherwise provided in this Act, . . .
>
> (b) where a taxpayer has disposed of anything
>
> (i) to a person with whom the taxpayer was not dealing at arm's length for no proceeds or for proceeds less than the fair market value thereof at the time the taxpayer so disposed of it, or
>
> (ii) to any person by way of gift *inter vivos*,
>
> the taxpayer shall be deemed to have received proceeds of disposition therefor equal to that fair market value.

[47] This would assume that the beneficiary transferring property to another was related by blood, marriage, or adoption within the provisions of section 251 of the Act or that the beneficiaries were, in fact, dealing at less than arm's length. While family relationships among beneficiaries may be such that the beneficiaries are "related" for the purposes of the Act, that is not always the case. Cousins, for example, are not necessarily related for the purposes of the Act.

would have a taxable disposition of a partial interest in the trust at the then fair market value of that partial interest if

- they dealt at less than arm's length with the beneficiaries whose interests were augmented; or
- the consent to the variation of trust were construed as an inter vivos gift.

Although the consent to the variation may result in a partial disposition of the interests of existing beneficiaries, it is arguable whether they can be said to have disposed of those interests "to" other beneficiaries. While the *Murphy* decision, discussed in greater detail below, concluded that in some circumstances a consent to a variation may amount to a "transfer, directly or indirectly" to another beneficiary, that does not appear to amount to the same thing as a "disposition to" that beneficiary. It is more likely that those interests are, in effect, surrendered to the trust.

Paragraph 69(1)(b) would apply only if such action constituted an inter vivos gift to the trust or if the beneficiary and the trust were not dealing at arm's length. With respect to the issue of arm's-length dealing, Revenue Canada has expressed the view that a trust and its beneficiaries normally deal with each other at less than arm's length "[u]nless the facts indicate the contrary."[48] However, the determination of arm's-length dealing is more complex in the context of an application under the VTA. In order to determine whether the applicants/beneficiaries are dealing at arm's length from the trust for purposes of a variation of trust application, two separate questions must be considered. First, as a factual matter, do the beneficiaries and the trust, generally, deal with each other at arm's length. If the answer to this question is no, it must subsequently be determined whether the parties are at arm's length for purposes of the variation of trust application. In this regard, it must be remembered that the applicants will be negotiating with the official guardian, who will be seeking the best possible result for the infant, unborn, and unascertained VTA beneficiaries. Further, the court, in evaluating the proposed variation, will consider whether a reasonable individual (not a reasonable non-arm's-length individual) would consent to the variation. It may be argued that the procedural requirements for a variation under the VTA should often be sufficient to dispel Revenue Canada's administrative presumption of less than arm's-length dealing between a trust and its beneficiaries.

Alternatively, a variation of trust might give rise to a capital gain (or an income inclusion in the case of an income interest)[49] on the partial disposition of the interests of the existing beneficiaries. In the case of a capital beneficiary of a personal trust, however, whether this would give rise to a capital gain would depend in part on the application of paragraph

[48] *Interpretation Bulletin* IT-419, "Meaning of Arm's Length," July 10, 1978, paragraph 17(b). See, however, paragraph 84.1(2)(d) which would seem to be largely unnecessary if the department's administrative position were correct.

[49] There is also a remote possibility that a capital interest in a trust may be acquired and held as a trading asset.

107(1)(a),[50] which provides that in computing the capital gain on a disposition, or part disposition, of such interest, the adjusted cost base is deemed to be the greater of the adjusted cost base otherwise determined[51] and the "cost amount"[52] of such interest. Since the capital beneficiary's cost amount would normally be equal to his or her proportionate share in the "tax values" of the assets of the trust, the potential for gain would depend on the accrued but unrealized gains or profits in the assets of the trust.[53]

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[50] Subsection 107(1):

Where a taxpayer has disposed of all or any part of the taxpayer's capital interest in a trust,

(a) where the trust is a personal trust or a prescribed trust, for the purposes of computing the taxpayer's taxable capital gain, if any, from the disposition of the interest or part thereof, as the case may be, the adjusted cost base to the taxpayer thereof immediately before the disposition shall be deemed to be an amount equal to the greater of the adjusted cost base to the taxpayer thereof otherwise determined immediately before that time and the cost amount to the taxpayer thereof immediately before that time,

(b) for greater certainty, for the purposes of computing the taxpayer's allowable capital loss, if any, from the disposition of the interest or part thereof, as the case may be, the adjusted cost base to the taxpayer of the interest or part thereof immediately before the disposition is the adjusted cost base to the taxpayer thereof immediately before that time as determined under this Act without reference to paragraph (a), and

(c) where the taxpayer is a corporation and the interest is not an interest in a prescribed trust, its capital loss from the disposition at any time of the interest or part thereof shall be deemed to be the amount, if any, by which the amount of its loss otherwise determined exceeds the amount, if any, by which:

(i) the total of all amounts each of which was received by the trust before that time (and, where the trust is a unit trust, after 1987) and designated by it under subsection 104(19) or (20) in respect of the corporation

exceeds

(ii) such portion of the total referred to in subparagraph (i) as can reasonably be considered to have resulted in a reduction under this paragraph of its capital loss otherwise determined from the disposition before that time of an interest in the trust,

except that where the interest was an interest in an *inter vivos* trust not resident in Canada that was purchased by the taxpayer, paragraph (a) does not apply in respect of the disposition of all or any part thereof except where subsection (2) is applicable in respect of any distribution of property by the trust to the taxpayer in satisfaction of that interest or that part thereof, as the case may be.

[51] Generally nil, by virtue of the application of subsection 107(1.1):

For the purposes of subsection (1) and notwithstanding paragraph 69(1)(c), the cost to a taxpayer of a capital interest in a trust, other than an interest acquired by the taxpayer from a person who was the beneficiary in respect of the interest immediately before the acquisition thereof by the taxpayer or an interest issued to the taxpayer for consideration paid by the taxpayer that is equal to the fair market value thereof at the time of issuance, shall be deemed to be nil.

[52] See subsection 108(1) for the definition of "cost amount" for these purposes.

[53] In the case of income interests in personal trusts, the provisions of section 106 would apply; in the case of income or capital interests in trusts other than personal trusts or prescribed trusts (regulation 4800.1), paragraph 107(1)(a) would have no application and the normal rules respecting the computation of capital gains would apply.

Valuing Discretionary Interests

Additional confusion in determining the tax liability that may result from a variation of trust arises out of the difficulty in valuing discretionary and/or contingent interests in trusts.[54] Assuming, without conceding the point, that subparagraph 69(1)(b)(i) or (ii) would deem a beneficiary to dispose of his or her interest, in whole or in part, at its then fair market value, how can one realistically come to a determination of that value when, for example, the beneficiary's entitlement was solely in the discretion of the trustee before (and, quite likely, after) the variation? It may well be that in such cases the answer to the partial disposition issue is that, in any event, the interest disposed of has no appreciable (or, at least, no determinable) fair market value.[55] This would, nevertheless, depend on the facts of the particular case and the realistic expectations of the existing beneficiaries, particularly in the light of their past experience in receiving distributions from the trust.

Benefits Under Subsection 105(1) and Trust Variations

Whether or not there is a disposition of property, it must be determined whether a "benefit" has been conferred on a person within the meaning of subsection 56(2) or 105(1).[56] In circumstances where those provisions apply, the value of the benefit will be included either in the income of the beneficiary enjoying the benefit or, if the attribution rules apply, in the income of the person who conferred the benefit on the beneficiary.

The leading case on the interpretation of subsection 105(1) is *Cooper v. The Queen*.[57] The issue in *Cooper* was whether an interest-free loan

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[54] By way of analogy, it may be noted that the issue of valuing discretionary and/or contingent interests for purposes of the debt forgiveness provisions of the Act is addressed by draft subparagraph 80(2)(j)(iii). That subparagraph provides that

> where a beneficiary's share of the income or capital of a trust depends upon the exercise by any person of, or the failure by any person to exercise, any discretionary power, the fair market value at any time of the beneficiary's interest in the trust is equal to
>
> (A) where the beneficiary is not entitled to receive or otherwise obtain the use of any of the income or capital of the trust before the death after that time of one or more beneficiaries under the trust, nil, and
>
> (B) in any other case, the total fair market value at that time of all beneficiaries' interests under the trust.

Canada, Department of Finance, Draft Legislation on Debt Forgiveness and Foreclosures, July 12, 1994, subclause 28(1).

[55] In "Revenue Canada Round Table," in *1992 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 1992), question 31, Revenue Canada indicated that the fair market value of a discretionary interest in a trust is indeterminable.

[56] The possible application of subsection 56(2) was considered in *Murphy*, supra footnote 24. The court did not, however, determine whether subsection 56(2) applied in the circumstances and thus has left open the question of the application of subsection 56(2) in a variation of trust context.

[57] 88 DTC 6525; [1989] 1 CTC 66 (FCTD).

from a trust constituted a taxable benefit within the meaning of subsection 105(1). The plaintiff argued that, in the absence of a provision analogous to section 80.4 that would explicitly provide for taxation of low-interest or interest-free loans from a trust, subsection 105(1) should not, by itself, treat such a loan as a taxable benefit. The Federal Court—Trial Division recognized in *Cooper* that the word "benefit" did not necessarily convey the identical meaning everywhere in the Act. Further, although a taxpayer may enter into an arrangement with a trust that would commonly be viewed as a benefit, not all "benefits" from a trust are taxable under subsection 105(1). In the result, the court accepted the plaintiff's argument that the fact that a provision analogous to section 80.4 did not specifically apply to interest-free or low-interest loans from a trust militated in favour of finding that such loans did not constitute taxable benefits within the meaning of subsection 105(1).

In considering the application of subsection 105(1) in the context of a VTA application, it should be noted that often the benefit justifying a variation of trust is not realized by the VTA beneficiary until a future time. The Act will not tax such a benefit until it is realized. However, if the VTA benefit is realized contemporaneously with the court's approval, there is a risk of current taxation under subsection 105(1).

Subsection 108(6)

Subsection 108(6)[58] is the first provision of the Act to deal directly with any aspect of the question of trust variations. Unfortunately, it is essentially an anti-avoidance rule with a very narrow ambit. The rule provides that, for the purposes of the three 21-year deemed disposition provisions—subsections 104(4) (capital property), 104(5) (depreciable property of a prescribed class), and 104(5.2) (resource properties)—where the terms of a trust are varied, the trust will be deemed to be the same trust as, and a continuation of, the trust immediately before that time. An exception is made in the case of pre-1972 spousal trusts. Where a trust was varied before January 1, 1993 in order to give persons other than the spouse a right to the income of the trust, the trust will be deemed to have disposed of its properties on January 1, 1993 (rather than on the later date upon which the spouse dies).

Notwithstanding the narrow ambit of this rule, it may be possible to use it constructively in planning for the use of an election under new subsection 104(5.3). Where an existing trust is, for example, potentially unable to use the election because overly broad powers of encroachment deprive it of any exempt beneficiaries, it may be possible to vary the trust

[58] Subsection 108(6):

For the purposes of subsections 104(4), (5) and (5.2), where at any time the terms of a trust are varied, the trust shall at and after that time be deemed to be the same trust as, and a continuation of, the trust immediately before that time, but, for greater certainty, nothing in this subsection affects the application of paragraph 104(4)(a.1).

to limit those encroachment powers and rely on subsection 108(6) to ensure the availability of a subsection 104(5.3) election to the varied trust. Such a transaction, however, should probably be undertaken only after an advance ruling on the point has been obtained.

Attribution Concerns

The decision of the Federal Court—Trial Division in *Murphy v. The Queen*[59] raises some potentially troubling issues in the context of variations of trusts. The facts of the *Murphy* case are quite simple. Mr. Murphy's father died in 1936, leaving his wife an annuity of $20,000 and stipulating that the balance of the income of the estate was to be split equally between his two children. By 1967, Mr. Murphy and his sister, Mrs. Rhodes, who were the sole executors and trustees of the estate, were entitled to a one-half share each of the annual income generated by the estate after the payment of the annuity to their mother. On September 27, 1967, the family obtained an order under The Variation of Trusts Act,[60] which had the effect of replacing the vested income interests of Mr. Murphy and Mrs. Rhodes with discretionary interests, for them and their respective spouses, in the income earned by the estate after the payment of the annuity to their mother. During the years under appeal, 1974 to 1976, Mr. Murphy and his sister, in their capacity as co-executors and co-trustees of the estate, paid part of the income earned by the estate to their respective spouses. This presumably had the effect of achieving an income split through use of the lower marginal rates of the spouses, although this is not entirely clear from the case. The minister assessed Mr. Murphy on the ground that the income paid to his wife during the years in question was taxable in his hands, either on the basis of subsection 56(2) dealing with the conferral of indirect benefits or on the basis of former subsection 74(1) dealing with the transfer of property to a spouse "directly or indirectly by means of a trust or by any other means whatever" and the attribution of income from such property back to the transferor spouse.[61]

Cattanach J found that former subsection 74(1) applied to the variation of trust in 1967, holding that property had been transferred "to a discretionary trust for the potential benefit to the object of the trust"[62] and that this was sufficient to bring the transaction within the broad language of that provision.[63] He did not decide whether subsection 56(2) applied on the facts of the case, but he expressed the reservation that, although he agreed that a transfer of property had occurred, it was not clear to whom

[59] Supra footnote 24.

[60] RSO 1960, c. 413.

[61] The same language is now used in subsections 74.1(1) and (2) and subsection 74.2(1).

[62] Supra footnote 24, at 6321; 393.

[63] In so holding, he relied upon the earlier decision of the Federal Court of Appeal in *Sachs v. The Queen*, 80 DTC 6291; [1980] CTC 358, dealing with attribution under former subsection 75(1) in the case of preferred beneficiary elections.

the property was transferred.[64] Thus, the potential application of subsections 56(2) and 105(1) remains open.

The decision in *Murphy* rested heavily upon the fact that, before the variation, Mr. Murphy had a present vested right to one-half of the net income of the estate. Cattanach J summarized the post-variation trust as follows:

> Under the discretionary trust so created none of the individual objects thereof is entitled to any part of the property, income or capital. A beneficiary is entitled to only what the trustees, in their discretion, elect to bestow. Until that is done the beneficiary has no vested interest therein.[65]

He also cited the following passage from the decision of Walton J in *Thorn v. IRC*:[66]

> In the context of a family arrangement of this nature, I think the proper way to regard the actions of a person who gives up a *fixed and certain interest* in exchange for the somewhat spectral interest of being included in a class of discretionary beneficiaries is that the interest has been given up for the benefit of those who obtain the benefit of it under the scheme, the benefit conferred by the discretionary trust being much more in the nature of a long stop, in case anything should go seriously wrong with the finances of the person giving up the interest thereafter, rather than as a seriously intended quid pro quo [emphasis added].

In the view of Cattanach J, Mr. Murphy clearly surrendered his fixed and certain entitlement under the trust in favour of a "spectral" discretionary interest. In addition, it must be borne in mind that Mr. Murphy and his sister had complete control over the discretionary distribution of income by the post-variation trust. However, the court did not indicate to what extent this fact influenced the decision.

The *Murphy* decision appears to stand for the proposition that where a person gives up a fixed and certain entitlement to income (or, possibly, capital) under the terms of a variation of trust, this constitutes a transfer of property "directly or indirectly, by means of a trust or by any other means whatever." Under the current provisions of the Act, this may result in attribution under subsection 74.1(1) or (2) or subsection 74.2(1) if the transferee of that property is a person referred to within those attribution rules. Where the interest is the "spectral" interest of a discretionary beneficiary (whether to income or capital or both), it is not clear that the *Murphy* decision would extend so far as to hold that there had been a transfer of property in such a case and, hence, potential attribution to the transferor. Strong arguments can be made that a consent given by a discretionary beneficiary of a trust to the variation of that trust does not

[64] Supra footnote 24, at 6320; 393.

[65] Ibid., at 6319; 391. Quaere whether the comment about vesting is correct as a matter of trust law. Unfortunately, the precise terms of the varied trust are not set out in the reasons for judgment.

[66] [1976] 2 All ER 622, at 632-33 (Ch. D.).

amount to a transfer to any other person for the purposes of the attribution rules. In the light of the many uncertainties in this area, however, the prudent course, once again, would likely be to obtain an advance ruling on the point.

CONCLUSION

Our review of what is known of the income tax consequences of variations of trusts will undoubtedly have left the reader with two clear impressions:

1) The little that we do know about the tax consequences of trust variations is sadly outweighed by the terra incognita.

2) The prudent estate planner should not embark on a variation of trust without giving very serious consideration to the tax consequences and, if possible, obtaining some comfort from Revenue Canada in the form of an advance tax ruling.

If, as we believe will be the case, variations of trust become more common in the future in response, at least in part, to the minister of finance's proposed changes to the rules governing the taxation of trusts, it will be incumbent on Revenue Canada to provide taxpayers with more guidance in this area. We hope that this will ultimately lead to a set of reasonable and flexible guidelines that will allow trust variations to continue to be a vital part of estate planning in Canada, without being unduly constrained by an overly rigid or complex tax regime.