Symposium: Problems in the Application of Tax Law to Civil Law Trusts

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ABSTRACT

Historically, federal tax legislation has been based on common law principles. The author analyzes specific elements of the Income Tax Act (ITA) that have their source in common law and create an interpretation problem when they are applied in a civil law context. The author first addresses the problem of the interaction between the new rules governing self-benefit trusts and the Civil Code of Quebec. From a civil law standpoint, the author is of the opinion that two questions arise in the context of these provisions: (1) what is beneficial ownership; and (2) what mechanism can be used to vest property after the death of the settlor? The author analyzes four methods of vesting used by civil law practitioners with the self-benefit trust and asks which is the most consistent with the intention of Parliament.

Second, the author analyzes the concept of indefeasible vesting in a trust, the interpretation of which in tax law actually refers to the common law concept of "vested." More specifically, the author describes two kinds of situations: the vesting of property in the trust patrimony, and the vesting of property in a beneficiary while the trust continues to administer the property. After discussion, she notes that the parameters for indefeasible vesting should be defined.

Third, the author demonstrates that the use in common law of constructive trusts and resulting trusts between spouses is particularly unfair in relation to the civil law, because it is assumed that there was never a transfer between spouses, and thus the attribution rules are avoided, or ITA section 160 does not apply. To mitigate the unfairness that results from these trusts, the author proposes four options and discusses their respective advantages and disadvantages.

Fourth, the author explains the concepts of income and capital, in relation to possible distortions that result from their application to tax law. To avoid such distortions with respect to trusts for the exclusive benefit of the spouse, the author prefers the solution of changing the requirement regarding the distribution of all income to the spouse, to require instead that all distributions from such trusts should be made to the benefit of the spouse, during the spouse's lifetime, without distinguishing between income and capital.

The author closes her analysis by examining other matters to be considered—specifically, the application of ITA section 43 to a usufruct or a substitution of civil law to permit the same tax benefit when a gift is made; the suggestion to revisit the concept of revocable trust in ITA subsection 75(2) to ensure that it means the same thing in civil law as in common law; and the new tax treatment of the bare trust, which deems that

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the person who created the trust continues to be the owner of the property, as is the mandator in Quebec.

In conclusion, the author observes that the harmonization of tax legislation may result in a major improvement if it enables civil law practitioners to answer some of these questions using their own tools, without having to try to determine the meaning of concepts and expressions used in the common law.

KEYWORDS: BIJURALISM ■ TRUSTS ■ FISCAL POLICY ■ QUEBEC ■ INCOME TAX ACT ■ TAX EQUITY ■ TAX LAW

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INTRODUCTION

Historically, federal tax legislation has always been based on the common law. An example is the deemed disposition of trust assets for tax purposes every 21 years, which is a direct reference to the common law rule against perpetuities for trusts.[1]

A trust established by contract in Quebec civil law corresponds broadly to the common law concept of an express trust in terms of its effects. The focus of this study is to determine whether references to the common law trust in the Income Tax Act[2] are sufficiently neutral to encompass the distinctive features of the civil law trust. Where they are not, the impact of the discrepancies will be analyzed and solutions proposed.

Before embarking on a technical discussion of dissimilarities between the common law and the civil law, some fundamental considerations will be outlined that (with some exceptions) are reflected in the detailed analysis that follows.

Respect for Provincial Private Law

The goal of the harmonization program is not to amend the federal tax laws in a way that would make Quebec residents subject to common law rules, or to amend the civil law to conform to the common law. Where the tax treatment diverges, ideally an effort should be made to respect the civil law, rather than amend it so that it operates like the common law. The principle of respecting the civil law may, in exceptional circumstances, be stretched to some extent. One example is the technique applied in ITA paragraph 248(3)(d) for the recognition of certain arrangements, such as self-directed registered retirement savings plans (RRSPs), that

1 Louise Bélanger-Hardy and Aline Grenon, *Éléments de common law et aperçu comparatif du droit civil québécois* (Scarborough, ON: Carswell, 1997), 480.

2 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the ITA").

raised some doubts in Quebec civil law but were acceptable in the other provinces. While the purpose of that paragraph is laudable, its effect nevertheless is to distort Quebec civil law insofar as it encourages recourse to the application of common law rules in Quebec, rather than making adjustments to the tax provisions so that they will work in harmony with the civil law.

Recognition of Major and Unavoidable Differences

There are differences between the common law "trust" and the civil law "fiducie" (or "trust") that cannot be resolved through tax law.

Jean-Charles Hare[3] has identified four main points of difference between these concepts:

1. the nature of the trust;
2. the plurality of the functions of settlor, trustee, and beneficiary;
3. the power to appoint beneficiaries; and
4. the variation and termination of the trust.

With respect to the nature of the trust, Hare points out the difference between the dual ownership of property held in trust at common law and the trust patrimony in civil law, which is owned by no one.

Plurality of offices or functions is not permitted by the Civil Code of Quebec,[4] since CCQ article 1275 requires the appointment of a trustee who is neither the settlor nor a beneficiary. Although this difference means that an additional trustee must be involved in the trust, a prerequisite that is unnecessary under common law, it generally does not lead to different tax treatment for Quebec trusts because of ITA subsection 75(2), among others. In addition, in civil law, one can arrive at a similar result through the use of substitution, which tax law treats as a trust. With substitution, no trustee other than the institute need be appointed to administer the property.

With respect to the power to appoint, Hare writes that in common law "[TRANSLATION] the settlor may give the trustee unlimited power to add or remove trust beneficiaries";[5] however, the granting of such power is not permitted under civil law. This appears to be a difference that does result in distinct tax treatment as between Quebec and the other provinces.

Finally, Hare addresses the difference in procedures for the variation and termination of a trust, depending on the jurisdiction. Although, in principle, variation and termination can be effected on the mere consent of the beneficiaries, such modifications are generally subject to certain requirements specified under provincial

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3 Jean-Charles Hare, "Comparaison entre fiducies de droit civil et trusts de la Common law," in *Congrès 98* (Montreal: Association de planification fiscale et financière, 1999), 7:1-17.

4 SQ 1991, c. 64, as amended (herein referred to as "the CCQ").

5 Supra note 3, at 7:9.

laws. The complexity of those requirements must therefore be considered when a comparison is made between common law and civil law; for example, the procedure in civil law necessitates an application to the court in such circumstances.

Other examples of differences in civil law include the prohibition against appointing a corporate trustee other than a trust company, the absence of a protector, the absence of extensive jurisprudence on trusts, and the impossibility of using a declaration of trust.

This study will not propose changes for most of the distinctions identified above, since they are a matter of private law and will evolve along with it. Intervention would be warranted only where a specific difference resulted in different tax treatment.

Forum Shopping

The current harmonization program, when completed, will not alter the appeal to taxpayers of finding the provincial private law system with the most advantageous trust legislation. On considering the differences between the civil law trust and the common law trust and the differences among provinces arising from their respective trust statutes, some taxpayers will still opt for the law of Quebec, which, for example, offers trustees more security in terms of their personal liability, while others will prefer the common law trust, which permits the settlor to appoint himself as trustee.[6] However, because harmonization seeks to resolve differences in tax treatment, at least at the federal level, the choice of jurisdiction should no longer be motivated by such differences.

Avoidance of Any Tax Difference?

Before amendments are proposed to standardize the federal tax treatment of trusts throughout Canada, it is essential to ascertain whether it is worthwhile to try to eliminate all of the tax advantages or disadvantages arising from different rules between jurisdictions. In my view, harmonization should be applied primarily to cases where the legal situation created is essentially the same in both jurisdictions but, because the concepts are different, the tax treatment is different. This action would then be in line with the prevailing case law favouring the uniform application of federal tax legislation notwithstanding the applicable private law.

Harmonization has its limits, however, because some tax differences are the result of specific rules that are not found in the other legal system. An example is the doctrine of constructive trust, which arose from a common law judge's interpretation of a particular situation. Although methods can be proposed to limit the tax impact of such differences, constructive trusts and the resulting tax advantages are not available

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6 Choosing another provincial jurisdiction for a trust whose beneficiaries are in Quebec is more complex since the publication by the Quebec minister of finance of *Information Bulletin* no. 2002-8, July 11, 2002.

to Quebec residents. (However, as will be discussed later, somewhat similar results may be obtained through the court's recognition of a tacit partnership.)[7]

As mentioned earlier, Quebec residents can use substitution to obtain trust tax treatment without the presence of an actual trustee. This distinctive feature is the result of the federal government's attempt to adapt its tax legislation to an institution specific to Quebec by applying the tax rules for trusts, which is a related concept. The result is interesting since the concept of substitution, which had been ignored by Quebec tax specialists, can once more be utilized. Substitution is clearly a concept specific to Quebec, however, and the concomitant tax advantages and disadvantages are not applicable anywhere else in Canada.

When the difference in tax treatment between the two legal systems arises from features specific to one of the systems, it may be impossible to achieve perfect uniformity, although efforts can be made to mitigate the differences.

Reduction of References to Concepts Foreign to Civil Law

Where federal legislation contains legal concepts that are foreign to civil law, civil law lawyers and notaries need solutions that make the application of the tax rules clearly understandable, so that they are not forced to analyze the common law in order to be able to apply the rules. For example, the ITA could be amended to provide definitions of the concepts "vested indefeasibly" in subsection 70(6) and "revert" in subsection 75(2). These definitions could be made applicable to the civil law as well as the common law, thus obviating reference to the common law as a complementary source for the provisions. That solution could lead to more differences, however, if the statutory definition of a common law concept did not correspond to the definition adopted by that jurisdiction's courts.

Avoidance of Increased Complexity in the Law

In the examination of proposed solutions, it should be a priority to avoid adding to the complexity of the law. This complexity is a source of discrepancies in tax treatment and inequities for Canadian taxpayers resulting from the means available to them to access accurate tax information. Increasing the complexity of the law in order to achieve horizontal uniformity in its application across the country would lead to greater disparities in its vertical application across various categories of taxpayers.

Impact of Taxation on the Trust Agreement

In discussing problems and solutions, and in establishing the scope of the task undertaken here, one must be aware of the extent to which tax law influences the law of trusts and the fact that the two areas of law are intrinsically related. This interconnection reinforces the need for harmonization of tax legislation, particularly

7 See the text below under the heading "Constructive and Resulting Trusts—Solutions for Quebec." The concept of a tacit or deemed partnership has been applied only to unincorporated businesses. It can also be used in common law jurisdictions.

given the lack of neutrality in existing tax policy with respect to the taxpayer's decision to set up, or not to set up, a trust.

Far from being neutral, tax rules even impose the framework by which a trust is legally constituted and in so doing occasionally misrepresent the civil law perspective on the issue. Some trusts, in fact, are directly derived from tax legislation or other public laws.

The following lists some of the elements of a trust that are for the most part derived from tax legislation, and the contexts in which they arise under the ITA:

- choice of settlor (ITA subsection 75(2); attribution rules; preferred beneficiary election);
- choice of trustees (ITA subsection 75(2); Canadian residence);
- choice of property transferred (the resulting disposition for tax purposes);
- choice of beneficiaries (benefit to shareholder; attribution rules); and
- methods for distributing income and capital (21-year rule; presence of a preferred beneficiary or a spouse in a trust exclusively for that person's benefit; requirements to render amounts payable).

Such elements are fundamental to the decision to set up a trust; however, for tax purposes, they must often be articulated differently from what the parties to the trust deed originally intended.

The influence of tax legislation on the trust agreement is not peculiar to civil law. The constitution of a common law trust is also subject to tax considerations that must be addressed in the context of the applicable legislation.

Analysis and Proposals

Taking the above into consideration, the task is now to analyze the specific aspects of federal tax law (other than the concepts of "beneficial ownership" and "legal ownership," which are addressed in another study) that raise problems of interpretation when they are applied in a civil law context. For each tax problem that is identified, one or more solutions will be proposed that could standardize the tax treatment of trusts in Canada while respecting provincial private law.

PROBLEMS ARISING FROM THE INTERACTION BETWEEN THE CIVIL CODE AND THE NEW RULES FOR SELF-BENEFIT TRUSTS

In 1994, the CCQ introduced a redefined concept of trust that allowed trusts to be used in Quebec to protect assets from creditors or from maladministration. It should be noted, however, that there is no consensus on the nature of this new form of trust in Quebec civil law.[8]

8 Jacques Beaulne, *Droit des fiducies* (Montreal: Wilson & Lafleur, 1998), 70-71. Is it a personal trust or a private utility trust? Beaulne opts for the latter.

To obtain such protection under a trust, a person need only transfer some of his property to the trust in order to take it out of his own patrimony. However, the degree of protection sought will vary depending on the terms of the trust deed. To achieve protection from creditors, the most secure trust appears to be one that allows the trustees, at their discretion, to distribute the trust income and capital among a number of beneficiaries, including the settlor, in such a manner that the settlor's interest in the trust would be of no value as long as the discretion of the trustees had not been exercised in his favour.[9] Differences between common law and civil law do not particularly affect the way in which the trust is used. The disadvantage of this kind of trust for tax purposes, however, is that a deemed disposition is triggered when the property is transferred to the trust.

The kind of trust that is discussed in this section of the paper offers less protection against creditors, but its advantage is that it can receive property without tax consequences.

Self-Benefit Trust

To avoid a disposition for tax purposes on the transfer of property to a trust, the trust must be created for the exclusive benefit of the settlor. In this study, such a trust is referred to as a "self-benefit trust" ("fiducie pour soi"). In this kind of trust, the assets are not directly available to the settlor's creditors but are sheltered in the trust patrimony. If the creditors cannot attack the transfer (which may have been made in violation of their rights) through other means available to them,[10] they cannot seize the trust assets, nor can they cause them to be sold. At most, they can seize the proceeds eventually resulting from the settlor's interest in the trust.

Quebec jurists wishing to avail themselves of the self-benefit trust for their clients face significant difficulties because the qualifying criteria, recently included in the ITA, that allow tax-free transfers to this kind of trust originate in court decisions from common law jurisdictions. Therefore, those criteria must be interpreted with the requisite adaptations if they are to be transposed to a civil law context. A jurist's comment to me illustrates the problem:

> [TRANSLATION] [I]n this context, it is not only necessary in Quebec law to imitate a transfer of legal ownership that does not involve a transfer of the beneficial ownership, but it must also be ascertained how a life interest in the trust can be disposed of while preserving a reversionary interest on death.[11]

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9 Marc Cuerrier, "L'impôt des fiducies" (1996) vol. 18, no. 4 *Revue de planification fiscale et successorale* 805-71, at 870. However, see the commentary by Jack Bernstein in "Discretionary Trust Interest" in (2003) vol. 11, no. 5 *Canadian Tax Highlights* 2.

10 For an analysis of these remedies, see, among others, Michel Legendre, "L'utilisation de la fiducie à titre de mécanisme de protection des actifs dans un contexte de difficultés financières" (1997) vol. 19, no. 1 *Revue de planification fiscale et successorale* 11-67; and Lucie Beauchemin, "Fiducies entre-vifs de protection des actifs," in *Congrès 95* (Montreal: Association de planification fiscale et financière, 1996), 12:1-47.

11 From a telephone conversation with a source that must remain confidential.

Although the criteria that Parliament has elaborated are sufficiently detailed that one can try to adapt them to the civil law context (though not without questions), any such attempt is frustrated by the fact that they derive from concepts foreign to civil law.

ITA Criteria

Two new and similar tax provisions allow for tax-free transfers to trusts by gift or by sale. The proposal is to integrate the first provision to section 73,[12] along with the new alter ego trust and the joint spousal or common law partner trust, both of which are permitted beginning at age 65. These trusts will enjoy the same rollover as that originally granted to interspousal transfers of capital property. The second provision is ITA subsection 107.4(1) and gives rise to a "qualifying disposition" for a rollover.

The two provisions have roughly the same requirements. According to the established hierarchy, ITA subsection 107.4(1) applies only if the trust does not qualify under ITA subsection 73(1)[13]—for example, in the case of a transfer of property to the trust that is not capital property. The technical criteria for the application of these rollovers are described below.

Like the spousal rollover, ITA subsection 73(1.01) requires that the following conditions be met:

- the settlor has the right to receive all of the income during his lifetime; and
- no one else may receive any capital before the settlor's death.

By comparison, the concept of a qualifying disposition in ITA subsection 107.4(1) implicitly includes the following requirements,[14] arising from the necessity that there be no change in the beneficial ownership of the property, as this condition is interpreted in the technical notes accompanying this amendment:[15]

- the settlor is the sole beneficiary of the trust;
- the settlor is entitled to receive whatever share he requests of the annual income and the capital gains realized from the trust; and
- the trust property reverts to the settlor if the trust is terminated before the settlor's death.

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12 More specifically in ITA subsection 73(1.01).

13 According to the condition in ITA paragraph 107.4(1)(i).

14 These requirements have long been applied in administrative practice to this kind of trust for the protection of assets. They are described in the Canada Customs and Revenue Agency's *Income Tax—Technical News* no. 7, February 21, 1996.

15 Canada, Department of Finance, *Explanatory Notes Relating to Income Tax* (Ottawa: Department of Finance, March 2001), clause 82.

In contrast to the treatment under ITA section 73, the concept of a qualifying disposition permits the choice as to whether the rollover will be total or partial.[16]

Two other conditions must be met in order to take advantage of the self-benefit trust of ITA section 73:

> [T]he transfer does not result in a change in beneficial ownership of the property and there is immediately after the transfer no absolute or contingent right of a person (other than the individual) or partnership as a beneficiary (determined with reference to subsection 104(1.1)) under the trust.[17]

With a few minor differences, the same criteria apply to trusts constituted under ITA subsection 107.4(1).[18]

ITA subsection 104(1.1) provides that a person is deemed not to have a beneficial right under a trust where the person is beneficially interested in the trust solely because of a right that may arise as a consequence of the law governing the intestacy of an individual (paragraph 104(1.1)(b)) or a right that may arise as a consequence of the terms of the will or other testamentary instrument of an individual (paragraph 104(1.1)(a)). The foregoing clarification seems useful given that the law forbids the presence of a contingent right to become a beneficiary. It seems appropriate that the possibility of a right of reversion to the settlor or to his heirs exists, and that heirs by intestacy be eligible to become permitted contingent beneficiaries.[19] However, the reference to the will in paragraph 104(1.1)(a) is perplexing because the testamentary dispositions will be acknowledged as valid only once the settlor is deceased. This date is quite distant from the date of the initial transfer to the trust. Is subsection 104(1.1) an indication that the property must necessarily revert to the estate of the settlor? If that is the intention of the legislator, it could have been made more explicit. To the contrary, could we not contend that if the terms of the trust give the settlor unlimited power to appoint beneficiaries, and such appointment takes effect only at the time of the settlor's death and the termination of the trust, then the condition that no person has a beneficiary right immediately after the transfer, even if this right is only a contingent right, has been fulfilled (without having to consider ITA subsection 104(1.1))? It would be difficult to uphold in these circumstances that each and every person is a contingent beneficiary. May we consider the use of a limited power given to the settlor to appoint beneficiaries, which is nevertheless broad enough to include all the people who are naturally potential heirs of the settlor? Because, in my view, the power to appoint

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16 ITA subsection 107.4(3).

17 ITA subparagraph 73(1.02)(b)(ii). It should be noted that, according to the explanatory notes, there will be no change in the beneficial ownership if the settlor reserves a general power of appointment.

18 Paragraphs 107.4(1)(a) and (e).

19 CCQ article 1297.

beneficiaries remains an option, this factor will be part of the present analysis, along with heirs under an intestacy and legatees.

Finally, new ITA paragraph 104(4)(a.4) provides that there will be a disposition of the trust property on the day on which the death of the settlor occurs, rather than every 21 years.

Problems in the Civil Law

The civil law practitioner who is informed of these technical requirements is confronted with at least two questions:

1. What is beneficial ownership?
2. In a civil law context, what is the mechanism whereby property devolves after the settlor's death?

Concept of Beneficial Ownership

The concept of beneficial ownership referred to in the ITA is addressed in the two papers that follow, by Mark Brender and Catherine Brown. Until such time as legislative amendments are introduced as a result of those studies, an interim solution might be to give a liberal interpretation to ITA paragraph 248(3)(e), which attempts to harmonize the common law concept of beneficial ownership with the civil law. Arguably, as soon as a person has a beneficiary right in a trust, that person has beneficial ownership of the trust property.[20] On the other hand, on the basis of technical interpretations of the Canada Customs and Revenue Agency (CCRA) reported by Marc Jolin,[21] as soon as a person receives a beneficiary right (even a contingent right) in a trust, that is enough to cause a change in beneficial ownership and prevent a rollover to a self-benefit trust.[22] Recent publications, however, reveal the extent to which Quebec jurists no longer know what tack to take with regard to this concept.[23] The pending clarifications to the ITA will certainly be welcome if they manage to shed light on this debate. For the time being, I will

20 Sophie Bélanger and Isabelle Gouin, "Fiducie en faveur de soi-même, fiducie mixte au profit du conjoint et autres modifications législatives" (2000-2001) vol. 22, no. 2 *Revue de planification fiscale et successorale* 467-511, at 494.

21 Marc Jolin, "Les nouveaux types de fiducies et les possibilités de planification," in *Colloque 109—Les fiducies* (Montreal: Association de planification fiscale et financière, May 2001), 37-39.

22 The second requirement, that there be no other beneficiaries, would thus be merely an expression of the retention of beneficial ownership.

23 See Richard Gauthier, "Les transferts entre fiducies et les dispositions admissibles faites à une fiducie," in *Colloque 109*, supra note 21, paper no. 4, at 2-3, where the author states that ITA subsection 248(3) no longer applies to the concept of beneficial ownership. His reasoning, however, is based on the development of this concept in relation to leasebacks. For trusts, the ITA is somewhat clearer in that it refers to a right as a beneficiary in its description of beneficial ownership. However, it is clear that in order that beneficial ownership of a property may be retained, not just any kind of interest may be held in the trust.

simply note that, as regards the self-benefit trust, the other requirements in the ITA seem to function as a description of what constitutes no change in beneficial ownership in civil law.

The Mechanism of Devolution on the Settlor's Death

A trust deed usually specifies the person to whom the property will be transmitted on the death of a beneficiary. The various possibilities open to a Quebec jurist under the ITA when drafting a self-benefit trust have been listed in the legal literature as follows:

> [TRANSLATION] To comply with the condition that no one but the settlor may be the present or future beneficiary of a self-benefit trust, regardless of age, the trust deed may provide for the happening of one of the following on the death of the settlor-beneficiary:
>
> - make no provision for a beneficiary in the event of the settlor-beneficiary's death;
> - provide for who will become the trust beneficiaries in the event of the death of the settlor-beneficiary among the persons mentioned to that effect in the will of the settlor-beneficiary;
> - provide for who will become the trust beneficiaries in the event of the death of the settlor-beneficiary among the persons who are the heirs by intestacy of the settlor-beneficiary; or
> - provide that all the property of the trust will be deemed to have been transferred to the settlor immediately before his death.
>
> The trust deed should not designate the persons who will be beneficiaries of the trust on his death, but this designation may be made in another document, the will. The connection between the two must be explicitly referred to.[24]

In the face of this array of solutions, it would be difficult to argue that a self-benefit trust cannot be used in Quebec. However, when one attempts to apply the above solutions, various difficulties are encountered, and the results vary depending on the particular solution chosen. In the other provinces, the use of such trusts does not appear to be as problematic, since the requirements seem to be directly derived from common law concepts such as beneficial ownership, discussed above, and the transfer of a life interest in trust while preserving a reversionary interest on death.

The issues that arise in civil law with regard to each of these possible solutions are discussed below:

Option 1: Remain Silent About the Identity of the Trust Beneficiary or Beneficiaries on the Death of the Settlor

CCQ article 1297 provides that, where there is no beneficiary, the property held in trust devolves to the settlor or his heirs. This article makes it possible to comply

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24 Bélanger and Gouin, supra note 20, at 487.

with the requirements of ITA subsection 104(1.1) and leaves it up to the settlor to make a will concerning the trust property, thus giving him complete freedom on the choice of the subsequent beneficiaries.

The CCQ thus provides a tool enabling Quebec jurists to draw up a self-benefit trust in full compliance with the law. However, in the application of this article, there are two civil law issues that raise the need for clarification:

1. Does the property revert to the patrimony of the deceased by virtue of this provision?
2. Can the settlor make a legacy by particular title of the trust property?

These two questions address, on the one hand, the extent of the protection obtained for the assets in this manner and, on the other hand, restrictions on testamentary freedom.

The CCQ is unclear as to whether the property reverts to the settlor and passes into his patrimony on his death by virtue of CCQ article 1297. If the answer is affirmative, the property becomes available at that time to pay creditors,[25] thus eroding the protection of the assets. In terms of the tax consequences, the property of the inter vivos trust would be subject to the deemed disposition on the settlor-beneficiary's death and consequently would not receive the spousal rollover.[26] However, if, as I believe, the property reverts to the patrimony of the deceased, it could then be used to create a testamentary trust. Is this result similar to that achieved by taxpayers in the common law provinces?

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25 There are two ways to interpret CCQ article 1297 on this point. The first interpretation is that the article merely provides for the appointment of the new trust beneficiaries, who will thus receive the property directly from the trust. The second interpretation is based on the kind of appointment that is made and claims that, since the article provides for the reversion of the property to the settlor or, failing that, its devolution to his heirs, the devolution to the heirs means in fact that the property passes through the settlor's succession. This is the opinion of Beaulne, supra note 8, at 300 (among others), who sees in CCQ article 1297 the effects of lapse, and refers to Faribault and his analysis of article 964 of the Civil Code of Lower Canada, LC 1865, c. 41, entitled An Act Respecting the Civil Code of Lower Canada (herein referred to as "the CCLC"). This position is also supported by the Quebec Ministry of Justice, which has commented that the rule is consistent with earlier law: Ministère de la Justice du Québec, *Commentaires du ministre de la Justice*, vol. I, *Le Code civil du Québec* (Quebec: Les publications du Québec, 1993), 773. CCLC article 964, the precursor of CCQ article 1297, stated that the property passes to the heir or the legatee who receives the succession in the event of lapse or impossibility of using the property for the purposes intended. On the other hand, by analogy, insurance payable to the succession or the assigns, heirs, liquidators, or other legal representatives pursuant to a stipulation in which those terms or similar terms are employed forms part of the succession of such person, pursuant to CCQ article 2456.

26 From a tax point of view, there will be a disposition of the trust property on the death of the settlor under ITA paragraph 104(4)(a.4). Even if, immediately before death, the settlor holds an interest in the capital that is also subject to a deemed disposition, the disposition will not result in tax for the deceased since a new presumption adjusts the cost of his interest in order to avoid double taxation under paragraph (a.1) of the definition of "cost amount" in ITA subsection 108(1).

On the issue of whether a legacy by particular title of the property from a self-benefit trust would be authorized in this situation, the CCQ and academic opinion unanimously agree that the statute's use of the term "heirs" ("héritiers") generally excludes a legatee by particular title.[27] On this interpretation, the settlor must take this outcome into account in planning his estate and provide that the trust patrimony will be given to those successors who receive universal legacies or legacies by general title.

In my view, however, in a trust context the term "heirs" should be understood in a broad sense as meaning all successors of the settlor, especially since if the trust property reverted to the settlor during his lifetime, it would be part of the entire estate. When this issue comes before the courts, it is inconceivable that, in circumstances where the settlor has left a will clearly providing that the inter vivos trust property is to go to a specific legatee by particular title, a judge would decide, on the basis of the wording of the CCQ, that the legacy is not valid and that the trust property should instead be distributed to the persons receiving the residue of the estate. There is an exception to the definition of "heirs" contained in another part of the CCQ, at article 2456, that specifies that when the term is used to designate the beneficiary of an insurance policy, it means generally the person's entire succession.

This limitation on the settlor's testamentary freedom does not call for a tax-specific solution, although it does clarify how a self-benefit trust fits into the Quebec context.

Option 2: Provide That on the Death of the Settlor-Beneficiary, the Beneficiaries of the Trust Will Be the Persons So Named in the Will

Insofar as the spirit of the tax measure concerning the self-benefit trust would not require that the property revert to the patrimony of the settlor on termination of the trust, the best way to constitute such a trust appears to be to include a specific provision in the trust deed that the property will be distributed to the persons chosen by the settlor under the terms of his will. The great advantage of this option is the increased protection it offers to the trust property, which at no time will pass through the settlor's patrimony and become subject to the claims of creditors. The tax aspect differs from that of the first option in that it then becomes impossible to create a testamentary trust using the property of the inter vivos trust. Indeed, it is necessary to ensure that other trusts are not tainted by that property.[28]

It should, however, be asked whether the power of appointment is enough to ensure compliance with ITA paragraph 104(1.1)(a), which, as noted above, refers to "a right that may arise as a consequence of the terms of the will or other testamentary instrument of an individual who, at the particular time, is a beneficiary under the

27 CCQ articles 619 and 739, and Germain Brière, *Le nouveau droit des successions*, 2d ed., Collection bleue (Montreal: Wilson & Lafleur, 1997), 2, at paragraph 2.

28 See, for example, the position expressed in CCRA document no. 9901435, February 16, 1999.

trust." In view of this wording and the general context of the self-benefit trust, the use of the power of appointment raises two questions:

1. Does the ITA authorize a provision in the trust deed that the settlor will appoint in his will the persons who will receive the trust property on his death without having the property pass through his patrimony?
2. In civil law, can such a power be drafted so as to make it unlimited, or should it be restricted to certain classes of persons?[29] In the latter case, the tax impact of such restriction must also be ascertained.

The government needs to explain its policy on the first issue. The second issue concerns limitations on the power to appoint under civil law. This power is the privilege of designating, after the trust has been constituted, the persons who will be the trust's beneficiaries. E.C. Brierley describes the power as a right intuitu personae (of a specific person) without patrimonial value.[30]

CCQ article 1282 appears to be favourable to the idea that there is no need to limit the power of appointment to a class of persons where it involves a power retained by the settlor, as opposed to that conferred on the trustee or a third party. If the CCQ were interpreted as a tax provision, we could be sure of this conclusion from the wording of the article:

> The settlor may reserve for himself the power to appoint the beneficiaries or determine their shares, or confer it on the trustees or a third person. . . . [T]he power to appoint may be exercised by the trustee or the third person only if the class of persons from which he may appoint the beneficiary is clearly determined in the constituting act.

At a conference of the Association de planification fiscale et financière (APFF), Richard Gauthier said that he favoured the interpretation that the article permits an unlimited power of appointment.[31] Marc Jolin, on the other hand, has expressed the view that the power to appoint must be limited:

> [TRANSLATION] The problem is that, in a trust constituted in accordance with the Civil Code of Quebec, an unlimited power of appointment is completely invalid.

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29 The article by Bélanger and Gouin, supra note 20, at 499, contains the following passage indicating the lack of certainty in the law at the present time: "[TRANSLATION] Whereas article 1282 CCQ imposes the requirement to specify the class of persons by whom the power to appoint may be exercised, the question then arises as to how the article 1282 CCQ limitation should be expressed so that subsection 104(1.1) ITA will be considered to have been complied with in that context."

30 John E.C. Brierley, "Powers of Appointment in Quebec Civil Law (first part)" (1992) vol. 95, nos. 3-4 *La Revue du notariat* 131-67.

31 Richard Gauthier, "Les nouvelles règles concernant les fiducies en faveur de soi-même et les fiducies mixtes au profit du conjoint," in *Congrès 2000* (Montreal: Association de planification fiscale et financière, 2001), 17:1-23, at 17:13, note 20.

> Moreover, according to article 1282 C.C.Q., only a trustee or a third person can be granted the power to appoint beneficiaries or determine their shares. It would appear that the Agency [the CCRA] has completely overlooked such realities in applying the federal tax system to trusts established under the Civil Code of Quebec.[32]

Since Jolin overlooks the portion of the article stating that the settlor may reserve this power for himself, I suggest that his conclusion on the requirement to limit the power of appointment might have been different if he had dealt with that possibility.

When CCQ article 1282 was introduced, the Quebec minister of justice commented briefly that the provision was consistent with the current state of the law.[33] But what was the state of the law? The case law has consistently affirmed that, in order to be valid, a power of appointment must limit the class of persons in whose favour it can be used.[34] Among these judgments, the decision of the Quebec Court of Appeal in *Brodie et Brodie* is often cited. The decision was rendered in a testamentary context.

Brierley has made a comparative study of this judgment and another Ontario decision, also in a testamentary context.[35] The common law jurisdiction had maintained the validity of a general power of appointment, which corresponds to an unlimited power of appointment, whereas the contrary result was reached in Quebec. Brierley explained these results by differences in the concept of the law of property in the two jurisdictions: the common law allowed that a "mere power" in a will to designate beneficiaries took priority over the concept of trust, which requires that beneficiaries be designated more specifically, whereas from a civil law standpoint, testamentary freedom must yield to the requirement that the persons who are to benefit from the will must "exist or be identifiable at the time of the testator's death"[36] according to former CCLC article 838. Brierley explained the result at civil law in more detail as follows:

> The general power of appointment was struck down in *Brodie*, on the other hand, because the device of a power, like the notion of a trust itself, is perceived to be no more than a modality of gratuitous dispositions of property and, in particular, dispositions by will. . . . That general law is to the effect that a disposition of ownership by one

32 Jolin, supra note 21.

33 *Commentaires du ministre de la Justice*, supra note 25, at 764.

34 *Brodie et Brodie v. Compagnie Trust Royal* (1989), 25 QAC 22; JE no. 89-1185 (CA); *Royal Trust v. SMRQ*, [1990] RDFQ 2 (CQ); *Godbout v. Godbout*, [1993] RL 414 (Que. CA); *Rodrigue v. Fiducie Desjardins Inc.*, JE no. 97-1967 (CA), rev'g. certain conclusions of the judgment of first instance, JE no. 96-966 (Sup. Ct.); *Trust La Laurentienne du Canada Inc. v. Beullac*, JE no. 98-163 (Sup. Ct.); and *Trust Général du Canada v. Poitras*, JE no. 99-30 (Sup. Ct.).

35 John E.C. Brierley, "Wills—General Powers of Appointment in Wills—Bare Powers and Trust Powers—Ontario and Quebec Compared: Re Nicholls; Royal Trust v. Brodie" (1990) vol. 69, no. 2 *Canadian Bar Review* 364-79.

36 *Brodie et Brodie*, supra note 34, at 30.

person, the owner (the person divesting), necessarily requires that there be certainty in the person to whom the ownership is transferred (the person to be vested).[37]

As indicated above, the *Brodie* decision was rendered under the former Civil Code, which provided that the constitution of a trust could exist only as a mechanism for the administration of gifts or legacies.[38] Thus, although the Supreme Court of Canada had already had occasion to rule that ownership of the trust property was vested in the trustee and not the beneficiaries,[39] this did not prevent the Quebec Court of Appeal from maintaining that in order for the power of appointment to be recognized as valid in the context of a legacy, it must at least define "[TRANSLATION] the class of beneficiaries within which the trustees or legatees will choose."[40]

CCQ article 1282 would therefore have codified that legal rule. However, it cannot be concluded from this that a power of appointment reserved by the settlor for himself should necessarily receive the same treatment, given that the CCQ draws a distinction between the two cases and the earlier case law never dealt with this situation. In fact, the traditional concept of the power of appointment is the power left to a third person, which must be supervised, whereas when the power is to be exercised by the settlor, it should instead be considered as an unlimited right that the settlor reserves for himself. Furthermore, CCQ article 1281 also provides that the settlor may reserve the right to receive the fruits and revenues or the capital of the trust; and CCQ article 1297 indirectly incorporates an unlimited power of this kind by providing that the "heirs" of the settlor receive the trust property when there is no beneficiary. In this way, the designation of the beneficiaries is left to the settlor's will, which can designate anyone. Not admitting that the settlor can reserve the power for himself without limitations would amount to denying the legality of the following clause in a self-benefit trust deed:

> On the death of the settlor, the property will be given to the persons who are designated in the settlor's will.

However, the CCQ already admits the validity of the following clause:

> On the death of the settlor, the property will be given to the heirs of the settlor in accordance with article 1297 C.C.Q.

It is true that there is a great difference between these two clauses if one accepts the thesis that the second clause triggers the reversion of the property to the settlor's

37 Brierley, supra note 35, at 373.

38 Madeleine Cantin Cumyn, *Les droits des bénéficiaires d'un usufruit, d'une substitution et d'une fiducie* (Montreal: Wilson & Lafleur, 1980), 18.

39 *Royal Trust Co. v. Tucker*, [1982] 1 SCR 250.

40 *Brodie et Brodie*, supra note 34, at 31. See also the commentary of Marcel Faribault, *La fiducie dans la province de Québec* (Montreal: Wilson & Lafleur, 1936), 197-98.

estate, while the first clause allows the trust property to pass directly to the persons designated. The two clauses are equivalent, however, in their lack of precision concerning the identity of those who will receive the property and the scope of the power left to the settlor, allowing him to choose any beneficiary.

In the context of the CCQ, Brierley—if I understand his reasoning correctly—expresses doubts about whether the settlor may reserve an unlimited power of appointment for himself, although he admits that the CCQ opens the door to this possibility by allowing the settlor to retain a general power of appointment.[41]

Furthermore, in commenting on the new articles of the CCQ in another paper,[42] Brierley explains that the CCQ repeats the main themes of the earlier case law, and he clarifies the distinction between a trust and the power to appoint. He makes the following allusion to the reservation of such power by the settlor:

> [TRANSLATION] [The power to appoint] implies the power of the holder of the power (trustee or others, even the settlor) to choose the beneficiaries within a determined class.[43]

Given the fact that a jurist as expert as Brierley has not noted any change in the law, which for years has proclaimed that the power of appointment should be limited, together with the impossibility of easily modifying a trust, it is not surprising that some Quebec jurists still do not venture to use the power of appointment without also including a determination of the class of persons in whose favour it may be exercised.

In deciding how to apply the power of appointment to a self-benefit trust, a Quebec jurist is then faced with two alternatives:

1. *To take the prudent approach under civil law and limit the power of appointment, while at the same time trying to comply with the requirements of the ITA by ensuring that the limitation is as unrestrictive as possible through an authorization to the settlor to choose among all persons with whom he has a family relationship, or a charitable organization.* This method ensures greater protection from a trustee in bankruptcy, who could be tempted to try to appropriate an unlimited power to himself. However, according to several technical interpretations by the CCRA, this kind of expanded power of appointment could be seen as an appointment of contingent beneficiaries, which would make the trust ineligible for the tax rollover.[44] Jolin recently stated, however, that he had

41 Brierley, supra note 30, at 166.

42 John E.C. Brierley, "De certains patrimoines d'affectation : Les articles 1256-1298," in *La réforme du Code Civil*, vol. 1, *Personnes, successions, biens* (Sainte-Foy, QC: Le Barreau du Québec and la Chambre des notaires du Québec and Presses de l'Université Laval, 1993), 735-82, at 766.

43 Ibid., at 766.

44 CCRA document no. 9832537, March 11, 1999; CCRA document no. 9830105, February 26, 1999; and CCRA document nos. 9701605 and 9708685, February 10, 1999, which would require a *general power of appointment*. Moreover, as Jolin reports, supra note 21, at 39, the first

secured a verbal agreement from the CCRA that such a power of appointment could be used in the context of a self-benefit trust.[45]

2. *To take the prudent approach under tax law and provide for a general and unlimited power of appointment, at the risk that the provision could be deemed null and CCQ article 1297 would be applied.* However, even if the Quebec jurist adopts this solution, he is not at the end of his troubles. If the reversion of the property to the settlor's patrimony is a key element in qualifying for the rollover to the trust, as the CCRA has stated on occasion,[46] the use of unlimited power to circumvent this rule may disqualify the property for the rollover and lead to a very costly tax result.

The following clause, which probably originates in common law, was examined by the CCRA in a technical interpretation:

> [O]n the death of the settlor ("Mr. X"), the trustees of the trust are to deal with the trust property in the same manner as if it formed part of his estate, that is, in accordance with the provisions of his last will, if any, and if none, in accordance with applicable intestacy laws. As an alternative, the trustees are given the power to transfer all or part of the trust property to Mr. X's estate.[47]

This clause is as broad as an unlimited power of appointment. However, according to the CCRA, it does not meet the conditions for rollover set out in *Income Tax—Technical News* no. 7,[48] on which the provisions in ITA section 73 were based. The following excerpts from this ruling are particularly revealing:

> The effect of the "as if" clause is to provide for other (contingent) beneficiaries of the trust. . . . [T]he power to appoint beneficiaries would have to be a general power. . . . Property over which the deceased has a general power which is exercised in the deceased's will is, however, generally available for payment of debts of the deceased.[49]

Although this opinion is based on common law principles, one cannot help being uneasy about the treatment of even an unlimited power of appointment in Quebec.

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technical notes accompanying ITA subsection 73(1.02), also referred to the requirement for an unlimited power of appointment.

45 Jolin, supra note 21, at 42-43. Jolin recommends the use of an expanded power of appointment to avoid a transfer of "beneficial ownership."

46 For example, the CCRA has stated that if a general power of appointment were exercised in the will, the property would be generally available for settlement of the decedent's debts, and the availability of the assets to pay the debts of the decedent would ensure the collection of any taxes owing: CCRA document no. 9832537, March 11, 1999.

47 CCRA document no. 9701605, February 10, 1999.

48 Supra note 14.

49 Supra note 47.

From the preceding discussion, the only conclusion to be drawn is that we do not know how to adapt a general power of appointment to a civil law context and what consequences this would have for the devolution of property.

Option 3: Provide in the Trust Deed That When the Settlor Dies, His Heirs by Intestacy Will Receive the Property

In theory, the third technique would meet the requirements of ITA paragraph 104(1.1)(b), because, in contrast to the explanatory notes accompanying ITA section 107.4,[50] this paragraph at first glance does not require that the laws of intestacy be applied only where no will exists.

If the trust deed contained a clause, as proposed in the alternatives listed above, to the effect that the heirs by intestacy are entitled to the trust property, in my view this would constitute a step backward in relation to the other options analyzed thus far, in the sense that the list of subsequent beneficiaries would be even more restricted and the settlor's discretion would be completely set aside. Although the heirs by intestacy are undefined before the settlor's death, the clause would ensure that, if the settlor had a spouse and children at the time of his death, they would share in the property in the proportions dictated by the CCQ. If there were no longer any spouse, the children would receive everything, and so on. However, if such description of the contingent beneficiaries had been made in the trust deed, the trust would undoubtedly have been disqualified for the tax rollover because of the presence of other contingent beneficiaries.

Furthermore, the proposed clause would deprive the settlor of his testamentary freedom over the trust property. This result may create an even greater distance between civil law and common law if it transpires that in the latter jurisdiction the retention of this testamentary freedom is necessary for there to be no change in beneficial ownership.

I therefore do not recommend this alternative. It is less flexible than the first and presents a much greater risk in the sense that it does not seem to respect the fiscal policy underlying self-benefit trusts. Moreover, I believe that it is an erroneous interpretation of the intent of the law, which is to provide recourse to the law of intestacy, but only where the settlor does not leave a will. In my view, this option is already covered by option 1, which relies on CCQ article 1297.

Option 4: Transfer the Trust Capital Immediately Before the Time That Is Immediately Before the Death of the Settlor

A relatively widespread practice in the context of a protective trust,[51] even before the recent amendments, is to have the trust property revert to the settlor's patrimony

50 Supra note 15.

51 Jolin, supra note 21, at 41, recommends the use of a protective trust to avoid transferring "beneficial ownership." The practice is also mentioned in note 27 of the article by Bélanger and Gouin, supra note 20, at 487.

before his death so that the property can pass with the assets of his estate. By doing this, one is not deprived of the possibility of taking advantage of the rollover of the assets to the spouse on death and the possibility of creating a testamentary trust as of that time. The effect of this practice is to advance the time when the property reverts to the settlor by the operation of CCQ article 1297.

To achieve this result, a deeming clause is included in the trust deed providing either that the reversion of the trust property takes place as a matter of law immediately before the moment immediately before the settlor's death or that the trust is terminated immediately before this time. Thus, on the death of the settlor, the deed would have one notionally return to a moment before that event for the clause to take effect, even though at that moment this effect did not exist, since the death had yet not occurred. This deeming clause is simply a contractual means of giving retroactive effect to a provision of reversion or termination. Although it may be valid as between the parties to the contract, its effect in the eyes of the tax authorities is debatable. However, in such a context, the argument that the tax authorities are a third person against whom this clause may not be set up is harder to apply than in the context of a counter letter, where at the beginning of the trust the tax authorities have received a copy of the deed and can take cognizance of the effects provided for on death.

In my view, the idea that one can cause or avoid certain tax effects through the use of such a clause is a fundamental issue. In my view, the law cannot allow this, because before the settlor's death, the delivery of the trust property or the termination of the trust has not occurred. To foresee this event is a fiction. In fact, only on death, and not before, does the obligation arise to return the property or to terminate the trust. This was the view of the Federal Court of Appeal in the context of a shareholders' agreement in its recent decision in *Nussey v. Canada*.[52] The judges unanimously refused to recognize the effectiveness of a contractual provision deeming that a share redemption by the company had taken place before the disposition on the shareholder's death when the shareholder had not benefited in his lifetime from any such redemption. In its judgment, the court held that

> the deemed redemption provision in the agreement did not effect a retroactive disposition of the shares the day before A.W. Nussey's death. By its terms, the agreement could only operate once the taxpayer had died, by which time subsection 70(5) of the Act would have applied.[53]

For the same reasons and because, by analogy with this situation, a presumption in the trust deed would make it possible to avoid the deemed disposition of the property on the beneficiary's death, this presumption could not be set up against the tax authorities, since they are not party to this fiction even if they are aware of its existence.

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52 2001 FCA 99. See the commentary of Arthur B.C. Drache, "Governments Have More 'Deeming' Powers" (2001) vol. 23, no. 11 *The Canadian Taxpayer* 85-86.

53 *Nussey*, supra note 52, at paragraph 4.

Thus, although option 4 would have the same advantages as option 1 and, moreover, would make it possible to take advantage of the spousal rollover and to create a testamentary trust on death, this option would probably not be recognized by the tax authorities. CCQ article 1297 would apply in any event, as in the case of option 1, but with the risk that the parties concerned would rely on the wording of the trust deed in planning their estates.

Use of this last option is accordingly not recommended.

Summary and Analysis of Options

Table 1 summarizes the consequences of using each option and whether it can be recommended in setting up a self-benefit trust:

Conclusion

The Department of Finance should clarify which approaches it intends to allow, taking into account the two civil law options: reversion of the property to the settlor under CCQ article 1297 or use of the power of appointment.

VESTED OR VESTED INDEFEASIBLY (DÉVOLU OU DÉVOLU IRRÉVOCABLEMENT)

In trust matters, the fact that a property has vested or vested indefeasibly is essential to meet the conditions for certain kinds of tax relief or tax treatment.[54] Although the concept of devolution is known in civil law in matters of succession,[55] the term "vested" in the ITA is translated in the French version not just by the term "dévolu" but also by the term "acquis."[56] It is interpreted through reference to the common law concept of vesting and has a broader meaning than does devolution in civil law.

The concept of indefeasible vesting also refers back to common law. While its literal meaning seems fairly obvious, its legal meaning is somewhat different, as can be seen from the various definitions for the opposing concept of "defeasible interest," which can mean an interest subject to a condition, an interest in a legacy that has not been paid (subject to being divested), or an interest subject to a power of revocation.[57] Civil law practitioners not only must understand the nuances involved in the common law concept of indefeasibly in combination with that of vested, but also must adapt these nuances to their own legal system in order to comply with the conditions prescribed by the ITA.

Since the topic of indefeasible vesting is treated in a separate study under the harmonization program, this paper will simply indicate the various difficulties of a practical nature occasioned by the use of this concept in civil law trusts.

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54 In particular, the conditions set out in ITA subsections 70(6) and 104(18), and in the definition of "trust" in subsection 108(1).

55 See CCQ article 613 and Book Three, Title Three, entitled "Legal devolution of successions."

56 ITA subsections 248(9.2) and 104(18).

57 *Canadian Common Law Dictionary: Law of Property and Estates: Standardized French Terminology*, 158.

TABLE 1 Summary and Analysis of Options

	Mechanism chosen for devolution of trust property on death			
	Option 1 Omit any mention of beneficiaries, or refer to the application of CCQ article 1297	Option 2 Provide for a power to appoint beneficiaries in the will	Option 3 Provide that the heirs by intestacy will receive the property	Option 4 Transfer the trust property immediately before the time immediately before death
Identification of beneficiaries	They are the legatees or heirs by intestacy if no will	They are the persons who are chosen among the classes of persons provided for in the deed, if any	Persons and proportions are determined by law	The property returns to the settlor during his lifetime
Freedom of choice reserved by settlor	Yes, subject to the fact that it cannot be transmitted to legatees by particular title, but only to universal legatees or legatees by general title	Complete testamentary freedom is lacking because of the need for specific classes, unless the opposing view is accepted that such classes are not necessary	No	Yes
Deemed disposition in the inter vivos trust on death: ITA paragraph 104(4)(a.4)	Yes	Yes	Yes	No, in theory; in practice, one should not be able to avoid this
Spousal rollover	No	No	No	Yes, in theory
Creation of testamentary trust using the property of the inter vivos trust on death of beneficiary	Yes, subject to the interpretation of CCQ article 1297	No	No	Yes

(The table is concluded on the next page.)

TABLE 1 Concluded

	Mechanism chosen for devolution of trust property on death			
	Option 1 Omit any mention of beneficiaries, or refer to the application of CCQ article 1297	Option 2 Provide for a power to appoint beneficiaries in the will	Option 3 Provide that the heirs by intestacy will receive the property	Option 4 Transfer the trust property immediately before the time immediately before death
Application of ITA subsection 75(2)	Yes	Yes	Yes	Yes
Property available to creditors at death	Yes, subject to the interpretation of CCQ article 1297	No	No	Yes
Certainty of qualification of the property for rollover to a self-benefit trust	Yes	Doubt: (1) No, if the property has to go through the settlor's patrimony; (2) power to appoint and compliance with ITA subsection 104(1.1)	No, because it involves appointment of beneficiaries, which removes the settlor's freedom of choice	Yes, because no other beneficiaries provided for
Is its use recommended?	Yes, although the assets are not protected at death	Hesitation: it would be the best solution for protection of assets, especially with a flexible limited power of appointment, but not in terms of tax advantages at death; uncertainty as to the CCRA's treatment	No; this use does not seem to comply with the spirit of the measure	No; even if tax law uses the fiction of disposition immediately before death, under civil law, it is doubtful whether retroactive effect could be given to a distribution of capital that at the time of death had not yet occurred—option 1 is a better alternative

There are two kinds of situations where the concept of devolution (vesting) or acquisition is used in connection with trusts: (1) the devolution of property to the trust patrimony and (2) the devolution of property to a beneficiary while the trust continues to administer it. They are both characterized by their obscurity in civil law.

Indefeasible Vesting to the Trust

In the first category is the rollover on death—for example, to a trust created for the exclusive benefit of the settlor's spouse under ITA subsection 70(6).[58] Among other things, this subsection requires that the property have vested indefeasibly in the trust. It is clear on the face of it that such vesting is specific to the settlement of an estate, since ITA subsection 73(1) deals with a similar rollover for an inter vivos transfer without requiring indefeasible vesting.

The only definition of the concept of indefeasible vesting in the ITA is in subsection 248(9.2). This definition only serves to specify that the property is deemed not to have vested indefeasibly after the death of an individual or a spouse who is a beneficiary of a trust; it does not clarify the conditions for vesting.

The main tool for the analysis of the criteria for indefeasible vesting continues to be the CCRA's position as set out in *Interpretation Bulletin* IT-449R.[59] The adaptation of these criteria to civil law has been the subject of commentary by the academic community.[60]

Under the CCQ, the effect of an inheritance is established at the time of death and acceptance of the inheritance only confirms it.[61] However, according to IT-449R, indefeasible vesting requires that the property subject to the inheritance be clearly identified and concerns the time when the spouse, spouse trust, or child of the deceased "obtains a right to absolute ownership of that property in such a manner that such right cannot be defeated by any future event, even though that person may not be entitled to the immediate enjoyment of all the benefits arising from that right."[62]

Thus, the retroactive effect of civil law or other provincial law[63] is not recognized. According to Jolin, one must wait for the heirs to accept,[64] and even for the partition

58 See also ITA subsections 70(9) and (9.1) for transfers of farm property on death.

59 *Interpretation Bulletin* IT-449R, "Meaning of 'Vested Indefeasibly,'" September 25, 1987.

60 Marc Jolin, *Les impôts sur le revenu et le décès* (Montréal: Association de planification fiscale et financière) (looseleaf service), vol. 1, I-13-1-23 to I-13-1-29.

61 CCQ articles 625, 645, 738, and 739.

62 IT-449R, supra note 59, at paragraph 1.

63 See Jolin, supra note 60, at I-13-1-9 to I-13-1-12, which reports the decision in *Hillis Estate v. The Queen*, 82 DTC 6249 (FCTD); 83 DTC 5365 (FCA). In that case, the judges were divided on the issue of whether they should recognize retroactivity on death under The Dependants' Relief Act, RSS 1978, c. D-25. A distinction was drawn between the acquisition of a right by succession and the transfer of a specific property.

64 In civil law, the acceptance may be tacit (CCQ article 637) and the fact of claiming the tax treatment that arises from that acceptance should be enough to give effect to it.

of the property, before the heir's rights in a property can be certified and it can be claimed that the property has vested indefeasibly in the heir. Even the declaratory effect of partition[65] would not suffice for the recognition of vesting for tax purposes at a date before that of the agreement. However, publication of the declaration of transmission, which renders the liquidator's divestiture official and releases the property for the benefit of the legatees and heirs at the end of his administration,[66] is not required for vesting.[67]

IT-449R contains additional qualifications concerning the indefeasible vesting of shares subject to a buy-sell agreement among shareholders.[68]

As can be seen, although the interpretation of indefeasible vesting in a testamentary trust context demonstrates a number of differences arising in civil law, enough information is available permitting a civil law practitioner to be aware of the limits, even if they have been dictated by a common law environment. In the context of harmonization of the ITA with private law, it would be appropriate to redefine these limits to make them more inclusive of civil law. Study of the feasibility of this adaptation could be linked to a review of retroactivity since, among other things, it must be determined whether in this context the declaratory effect of the vesting should be recognized or whether the ITA should explicitly reject it.

Vesting in the Trust Beneficiary

The concept of vested, which, as noted above, is translated by "dévolu" or "acquis," and is used with regard to the beneficiary of a trust, is far more nebulous in civil law. It refers to a situation where an interest in a trust is acquired by a beneficiary without the property's having been distributed to the latter. The vesting must sometimes be indefeasible.

Indefeasible Vesting in a Beneficiary

Paragraph (g) of the definition of "trust" in ITA subsection 108(1) includes an exception for a trust in which all beneficiaries have indefeasibly vested rights. This trust escapes the 21-year deemed disposition rule, but is still subject to the other tax rules for trusts, with the exception of the preferred beneficiary election and ITA section 106.

The technical notes offer the following brief explanation of the former version of paragraph (g) of the definition:

> This definition is amended for 1993 and subsequent taxation years so that the exclusion with respect to unit trusts also applies to trusts under which all interests in which have vested indefeasibly and in which no interest may become effective in the future.

65 CCQ article 884.

66 CCQ article 822.

67 IT-449R, supra note 59, at paragraph 1.

68 Ibid., at paragraph 8(d); and Jolin, supra note 60, I-13-1-23, at I-13-1-30.

> The ability of a trust beneficiary to sell his or her interest in the trust or gift the interest during his or her lifetime or on death through the terms of a will is not intended to bring a trust outside the terms of this exclusion. . . . This amendment is relevant primarily for those commercial trusts which do not qualify as unit trusts.[69]

Apart from indicating that the beneficiary implicitly receives an interest that he may dispose of, these notes are not very helpful in understanding the meaning of indefeasible vesting.

In the context of loans to non-residents, ITA subsection 17(15) specifies that a trust in which all of the interests have indefeasibly vested is synonymous with a "non-discretionary trust." However, the scope of this definition is limited to this section.

Returning to IT-449R, indefeasible vesting to a beneficiary is explained as follows:

> where . . . the individual's ownership rights cannot be defeated by any future event and no other person has any right whatsoever to an immediate or future benefit from that property or that trust, the property will be considered to vest indefeasibly in that individual.[70]

Paragraph 8(c) of the bulletin explains that if, under the terms of a will, farm land is directed to be held in a trust for the benefit of the taxpayer's child, to be distributed to the child when the child reaches a specified age, or, if the child should die before that age, to be distributed to the child's estate, the property is considered to vest indefeasibly in the child. If, however, the will provides that the land would be distributed to other persons—for example, the taxpayer's grandchildren—if the child should die before attaining the specified age, the land would not vest indefeasibly in the child until the child attained the specified age.

This interpretation seems to be in line with subparagraph (g)(v) of the definition of "trust" in new ITA subsection 108(1), which permits exemption from the 21-year rule only if the indefeasibly vested interest of a beneficiary terminates in the anticipated manner, namely, "as a consequence of a distribution to the person (or the person's estate) of property of the trust."

This reference to the person's estate, however, creates a problem in civil law with respect to personal trusts, at least where the specified age of distribution is later than the date on which the child reaches the age of majority and acquires the capacity to make a will. In fact, under civil law, one cannot generally leave to a beneficiary, by means of a reference to his succession, the freedom to designate replacement beneficiaries.[71] As explained in the discussion above on the power of appointment, it is necessary to specify the classes of persons among whom the

69 Canada, Department of Finance, *Amendments to the Income Tax Act and Related Statutes: Explanatory Notes* (Ottawa: Department of Finance, June 1992), clauses 44(4) to (6).

70 Supra note 59, at paragraph 1.

71 See, for example, *Darling v. Quebec*, [1996] RDFQ 28 (QAC).

power may be exercised.[72] Although the classes may be broad enough to encompass family members, they cannot be equivalent to testamentary freedom, since they must usually exclude “friends” and other persons who can only be described as members of a class so broad and imprecise that it could include anyone.

Moreover, the power of appointment must be differentiated from the rights flowing from ownership. In this respect, it might be thought that, if an amount became payable to a beneficiary, the beneficiary would act as a creditor of the trust for this amount. This debt would then belong to the beneficiary’s patrimony and would therefore on his death automatically be part of his testamentary succession or succession by intestacy, as the case may be, without passing through the provisions of the trust deed. However, it seems to me that the notion of indefeasible vesting does not go so far.

Could a simple reference to the persons who would have received the succession by intestacy of the beneficiary without regard to the latter’s will be valid from a tax point of view? To answer this question, it is first necessary to determine whether indefeasible vesting in a beneficiary involves a tax requirement that the beneficiary have the same testamentary freedom as if he had been the owner of the property.

In view of all this lack of precision, the first step would be to define the conditions of indefeasible vesting in favour of a trust beneficiary. They seem to be well known in common law, but for a civil law practitioner, that is of no assistance. Specifically, answers are needed to the following questions:

1. Must the beneficiary have unlimited testamentary freedom over his share of the trust?

   Example
   Three children are each entitled to a third of a trust patrimony. The patrimony will be divided into three separate portions; the capital and income from these portions will be appropriated to the exclusive needs of the child for whom each portion is intended; and, if the child dies, his portion will be distributed to his heirs. (Note that this power of appointment could be illegal under civil law.)

2. Is indefeasible vesting equivalent to granting the beneficiary a financial claim on the trust property that he may transmit to his heirs?

   Example
   A trustee makes a third of the property of the trust patrimony payable, and the trust becomes the debtor, in favour of a child beneficiary, and the property that is to be used to pay the debt is placed in a separate account. No other beneficiary is stipulated for this share. The trustee can distribute all or part of this property at his discretion. On the death of the child, the trustee will distribute the property to the child’s succession.

72 CCQ article 1282 does not provide that the power to appoint may be exercised by the beneficiary, although the term “third person” could be broad enough to include the beneficiary.

There is only a slight difference between these two situations. It is not even certain that they are really different, since in fact the creditor relationship seems unworkable in the context of a personal trust. One can certainly imagine that a trust could become indebted in favour of a beneficiary if an amount became payable to him—for example, when the beneficiary reached the age of distribution, or when the trustee exercised his discretion to distribute some income or capital. The writing of a note could then testify to a creditor/debtor relationship for this amount. That debt or note would certainly be part of the property in the beneficiary's estate on his death and would be distributed according to his will or the rules of intestacy.

Except for these circumstances, I do not think that the trust is the debtor of the beneficiary's entire share while it retains ownership and administration of the property. Under the CCQ, the right of the beneficiary in the trust is conditional with respect to the terms prescribed by the settlor. On the death of the beneficiary, if his right to receive the capital has not yet commenced,[73] I believe that his succession will have no grounds for a claim against the trust. The right of the deceased will pass to other beneficiaries according to the trust deed. Furthermore, the case law holds that the "succession" could not qualify as a replacement beneficiary because this designation would constitute an illegal unlimited power of appointment.

Thus, in civil law, a relation comparable to that of debtor/creditor for the entire participation of a beneficiary would go beyond the concept of a personal trust. The trustee would no longer be administering the trust patrimony but rather the patrimony of the beneficiaries.

Once the answers to the above questions have been clarified and the other criteria for indefeasible vesting have been made clearer, if possible, the second step would be to ensure that the criteria are consistent with civil law, particularly with respect to the power of appointment, which cannot usually be unlimited. If the criteria were found to be inconsistent, they would have to be reviewed and adapted to this system of law—for example, by allowing on the death of a beneficiary the use of a general but limited power of appointment, or the designation of individuals who would be heirs by intestacy without insisting upon full testamentary freedom.

It should be noted that the preceding comments do not necessarily apply to commercial trusts. It appears that in such a trust, the right of a beneficiary does not terminate upon his death since his participation does not result from a gift or a will.[74] It would therefore be easier to meet the requirements of an indefeasibly vested right through the creation of a commercial trust.

Non-Indefeasible Vesting

In other contexts, the law disregards the indefeasibility requirement and retains only the vesting requirement. Thus, ITA subsection 104(18) provides for the taxation of

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73 CCQ article 1279 provides that the beneficiary must not be deceased at the commencement of his right.

74 CCQ article 1279.

income in the hands of a child even when the income is not paid or made payable to him, as long as the right to the income has been vested ("acquis") to the child.

In light of the technical interpretations on this subject referring to the common law definition of "vested," at first glance there is no apparent difference between vesting and indefeasible vesting. Both seem to require a certain right in the trust that can be transferred by the beneficiary himself.[75]

From these interpretations, it appears that the CCRA relies on two common law decisions for its interpretation of the concept of vested—*Hashman Trust v. MNR*[76] and *Cole Trusts v. MNR*.[77] These decisions, however, do not offer much enlightenment about the meaning of "vested," since they do not provide a definition but rather apply the concept to specific situations.

Another example adds to the debate: a legacy of an RRSP to a trust for a child under 18 years of age as contemplated by ITA clause 60(l)(ii)(B). In this situation, the ITA requires that the child be the "sole person beneficially interested in amounts payable under the annuity" acquired from the RRSP. Although the English version uses the expression "sole person beneficially interested" and not "vested," the former could perhaps be considered to be equivalent to vesting; or at least, one could consider that the fact that an interest is "acquis" could be enough to ensure that the requirement of this provision is met. There is, however, some confusion in Quebec about how the statute is to be interpreted. For example, it is asserted that this provision requires a trust whose sole beneficiary is the child.[78] All that the ITA requires, however, is payment to the child of the annuity amount, not of the entire trust property. Having just one child as the beneficiary can definitely facilitate taxation of the trust income, but it does not resolve the question whether the child's interest can terminate, for example, on his death and be given to his brothers and sisters.

Civil law practitioners would welcome clarification of this concept of vested. Perhaps its meaning is not much clearer in common law, and this discomfort arises from Quebec's lack of experience with trusts. Nevertheless, the government should

75 CCRA document no. 9901375, January 12, 1999; CCRA document no. 9807495, March 12, 1999; CCRA document no. 9702825, June 23, 1997; and CCRA document no. 9633875, March 25, 1997. It should be noted that the latter two interpretations state that, to comply with ITA subsection 104(18), it may be provided that the beneficiary's vested rights to the property may be extinguished if the beneficiary dies before attaining 40 years of age since this condition is specifically provided for by the Act. This position confirms that the concept of "vested" implies that the beneficiary's interest would normally not be extinguished on his death. Another condition, it is indicated, is that the trustee may have a discretionary power regarding the timing of the distribution of the income or the capital; however, the exercise of a discretionary power should not affect the share intended for the beneficiary. The shares, as well as the persons who are the beneficiaries of them, must be specified.

76 72 DTC 1191 (TRB).

77 81 DTC 8 (TRB).

78 Marc Jolin, *Examen testamentaire*, brochure distributed by the Association de planification fiscale et financière, 1998, question 17, at 11.

explain this important concept, using uniform language when it is appropriate and clarifying the differences, if any, that it sees in a right vested in a beneficiary, a right vested indefeasibly, and a trust of which one is the sole beneficiary in respect of a certain amount.

Such explanations should, of course, take into consideration the limitations imposed by civil law on the application of these definitions.

CONSTRUCTIVE AND RESULTING TRUSTS[79]

The CCQ does not recognize any trusts other than those that are expressly created. The associate deputy minister of the ministry of justice has also made it clear that the common law concepts of resulting trust and constructive trust have not been introduced in Quebec.[80]

Tax jurisprudence involving litigation arising in Quebec has no choice other than to refuse to apply these common law concepts.[81] Nevertheless, reliance on the doctrines of resulting trusts and constructive trusts seems to be on the rise in the common law jurisdictions, and such trusts are increasingly used to obtain tax results to the taxpayer's advantage. As part of this study, it is worth taking a closer look at these doctrines.

Constructive Trusts

As noted earlier, a constructive trust (trust by interpretation) arises from the interpretation of a particular situation by a common law judge. The doctrine of constructive trust is used in two circumstances:

1. *As a restitutionary mechanism developed by US and Canadian courts.* It corresponds to the civil law doctrine of unjust enrichment. This kind of remedy is often sought in a matrimonial situation.
2. *As a presumption for the protection of the victim in the context of fraud or misconduct.* This use of the constructive trust originated in Great Britain.

Canadian case law has applied the doctrine in these two sets of circumstances. In either case, the court's decision to recognize a trust, rather than make an order transferring the property to the victim on some other basis, may give rise to some interesting tax consequences, because the trust so created predates the judgment recognizing the trust. When the existence of a constructive trust is directly argued

79 For the common law analysis, I have essentially relied on the article by Catherine Brown and Cindy L. Rajan, "Constructive and Resulting Trusts: Challenging Tax Boundaries" (1997) vol. 45, no. 4 *Canadian Tax Journal* 659-89. I have not taken into account more recent common law cases, since my research has focused on how these doctrines have been applied in tax litigation.

80 Lise Morency, "La fiducie (*trust*): Une institution de *Common Law* dans un contexte de droit civil," in *Conférences sur le nouveau Civil Code du Québec—Actes des Journées louisianaises* (Cowansville, QC: Yvon Blais, 1991), 7.

81 *Drapeau v. The Queen*, 99 DTC 763 (TCC).

in a tax case and not in the context of a claim against the person who has been enriched, judges often feel justified in recognizing its effects, even though the actual creation of the trust falls outside their jurisdiction. Some in fact believe that where the taxpayer's situation is such that the existence of a constructive trust could be successfully argued in court, the tax consequences should be defined accordingly.

Let us consider a few examples from the tax case law.

In *Karavos v. The Queen*,[82] the judge refused to apply the concept of constructive trust in a tax case involving restitution. The taxpayer argued that a constructive trust was created by the sale of a building so that part of the gain could be taxed in the hands of her spouse. After analyzing the doctrine and decisions of the Supreme Court of Canada, the judge made the following comments:

> A constructive trust is a mechanism by virtue of which a court with equitable jurisdiction can grant redress to an unjustly deprived person. In determining whether unjust enrichment exists and restitution through the invocation of a constructive trust is appropriate a court may take into account the deprived person's actual financial contributions, (which may properly include the contribution of earnings towards household bills and maintenance), all work performed in relation to the property, both physical and otherwise, and other factors as the performance of housekeeping duties, the raising of children etc. The result is that effectively a court is required to embark on an examination of the totality of a marital relationship extending over a period of 30 years to determine whether an unjust enrichment occurred and whether it would be appropriately remedied by a declaratory order vesting the claimant with title to property or by granting a monetary award. In my view such an inquiry is inappropriate in an income tax context. The use of a restitutory device to remedy situations of unjust enrichment should not be equated with the determination of a collateral issue necessary in order for this Court to carry out its statutory function, that is, to dismiss or allow an appeal or vacate or vary an assessment. . . .
>
> Even if the Appellant had established the prerequisites which would enable this Court to find that unjust enrichment existed this appeal could not succeed. In order to determine whether it is appropriate in a given case to invoke the remedy, the Supreme Court proposed a "causal connection" test. This test was considered by Dickson, C.J.C. in Sorochan v. Sorochan where he said:
>
>> . . . It is suggested simply that there should be a "clear link between the contribution and the disputed assets." The question of a connection between the deprivation and the property is further explained as "an issue of fact." That is, courts must ask whether the contribution is "sufficiently substantial and direct" to entitle the plaintiff to an interest in the property in question [note omitted].
>
> For this appeal the question may be stated as follows: Were Mrs. Karavos' contributions, in a broad sense, sufficiently substantial and direct so as to entitle her to a portion of the profits realized upon the sale of the property? There must be a clear causal connection between the spousal contribution founding the unjust enrichment

82 96 DTC 1001 (TCC).

> and the property which is alleged to [be] the subject of the constructive trust. In my view there is no reasonable connection between the contribution or alleged deprivation and the property.[83]

Although the facts in this case did not allow the judge to find a trust, it is interesting to note the definition that is given, which is directly linked to a balance in the economic relations of a couple.

The other component of the constructive trust, the "protective" aspect, is not so well established in Canadian case law, according to Catherine Brown and Cindy Rajan:

> The history of the constructive trust has created uncertainty about its current doctrinal basis. Although it has been argued that the current position in Canada is that the constructive trust is to be regarded as a remedy and not a substantive institution, it is not clear that a court would refuse to impose a non-remedial constructive trust on the basis of the British institutional notion of the trust as a cause of action in appropriate circumstances. . . . [T]he specific nature of the constructive trust may have important tax consequences since at least one Tax Court decision appears to have distinguished between the remedial and non-remedial constructive trust when providing tax relief.[84]

The decision referred to is *Fletcher v. MNR*.[85] In that case, the Tax Court of Canada expressed the opinion that the term "trust" in the ITA includes all kinds of trusts, even a constructive trust arising from the misconduct of a person acting under a power of attorney.[86] In the result, this case allowed Mr. Fletcher, a non-resident, to successfully plead that he had realized a capital loss under ITA section 115 as a result of the disposition of his interest in a Canadian trust,[87] which was a constructive trust created by his agent's misconduct.

Thus, although it did not have the jurisdiction to declare the existence of a constructive trust and require the payment of compensation, the Tax Court did not deprive itself of the power to recognize the tax consequences of such a trust. The court based its intervention on the need to identify the owner of the beneficial ownership in a property in order to assess the taxes correctly.[88]

The CCRA recognized that a constructive trust is a trust in a tax context at a round table held after the *Fletcher* decision. In response to several questions—in particular, whether the trust was a bare trust that should be disregarded from a taxation point of view—the CCRA replied:

> It is our view that a constructive trust will be a trust that is subject to the application of all relevant provisions of the Act. In these trusts, the constructive trustee usually

83 Ibid., at 1006-7.

84 Brown and Rajan, supra note 79, at 663.

85 87 DTC 624 (TCC).

86 In civil law, it would be a mandate.

87 As reported by Brown and Rajan, supra note 79, at 665-66.

88 Ibid., at 675.

> has the control of the trust property within the meaning of subsection 104(1) of the Act. Such a trust would be deemed to have been created at the time the property or control thereof is acquired by the ultimate constructive trustee, or later on, as the circumstances may require. Normally, the time of the court judgment would not be relevant to this determination. In our opinion, a constructive trust would be a personal trust within the meaning of the definition contained in subsection 248(1) of the Act.[89]

Another example of the application of the constructive trust doctrine for tax purposes can be found in *Anderson Estate v. The Queen*.[90] A property of the deceased had escaped the deemed disposition rules on his death on the basis that, at that time, he no longer held the beneficial ownership of it, even though the title was in his name. After his death, it was recognized that the property belonged to his sister-in-law, who had lived with him for 57 years and had never been paid for her work. This finding made it unnecessary to consider whether a trust existed since the court relied on her beneficial ownership of the property. From a civil law viewpoint, it is difficult to understand the nuance between recognizing a constructive trust of the remedial kind and deeming the beneficial ownership to have already been transferred because of the work performed by a family member; however, the result seems to be the same, a result that is not available in Quebec.

Liability for tax under ITA section 160 was also avoided in *Savoie v. The Queen*[91] on the basis of a constructive trust, which was argued along with a resulting trust. The judge held that it was legitimate to argue the existence of these types of trusts for the first time in the context of a tax case, when it was necessary to determine who had the ownership of a property; therefore, the recognition of such trusts is not exclusively reserved to courts addressing a dispute between ex-spouses.[92]

Resulting Trusts

A resulting trust ("fiducie par déduction") is concisely described by D.W.M. Waters as follows:

> [A] resulting trust arises whenever legal or equitable title to property is in one party's name, but that party, because he is a fiduciary or gave no value for the property, is under an obligation to return it to the original title owner, or to the person who *did* give the value for it.[93]

89 "Revenue Canada Round Table," in *Report of Proceedings of the Fortieth Tax Conference*, 1988 Conference Report (Toronto: Canadian Tax Foundation, 1989), 53:1-90, question 31, at 53:47.

90 95 DTC 758 (TCC), commented on by Robert Jarman at 95 DTC 6039 and by Brown and Rajan, supra note 79, at 667-68.

91 93 DTC 552 (TCC), commented on by Brown and Rajan, supra note 79, at 667-68.

92 In this case, since the deemed trustee had died leaving his property to his wife, who was also a beneficiary of the trust, the recognition of this trust could not have had any financial impact other than the tax advantage it provided.

93 D.W.M. Waters, *Law of Trusts in Canada*, 2d ed. (Toronto: Carswell, 1984), 299.

A resulting trust requires at least two elements: a common intention, expressed or not, that the property be held in trust; and facts supporting this intention or from which this intention may be deduced.[94]

Like the constructive trust and often in conjunction with it, a resulting trust has been argued on a number of occasions in tax cases from common law jurisdictions.

One example is *A.G. of Canada v. Holizki*,[95] in which the Federal Court of Appeal confirmed the finding of the trial judge that the husband, who owned 99 percent of the shares of the family business, had always held a part in a resulting trust for the benefit of his wife. The facts that led to this result were the usual situation where a couple pools their property, the husband is in business, and he subsequently incorporates his business in his own name. His wife's involvement had consisted in, among other things, guaranteeing loans for the business, working in it, and making up any cash shortfalls from her nursing income. It should be noted that during the years the business was in operation, all of the income was taxed in the husband's hands.

The trial judge summarized their situation as follows:

> There was no express trust agreement and no discussion between Mervin and Maureen that he was holding any property in trust for her. Both Mervin and Maureen testified that it was just "understood" that the business belonged to both of them.[96]

The understanding between the spouses regarding their common property, despite the fact that the title to the shares was in the husband's name alone, allowed the couple to claim that, although the husband had subsequently transferred 49 percent of the shares to his wife, the transfer should escape the attribution rules since the ownership had never been transferred. By the application of the doctrine of resulting trust, the wife had always been the owner of the shares. The court found in the taxpayers' favour.

A similar decision was rendered in *Disbrowe v. The Queen*.[97]

A Quebec jurist might be somewhat sceptical about this line of cases after the considerable efforts of the Department of Finance to prevent spouses under a community of property regime in Quebec from using their co-ownership under that regime to split income.[98]

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94 Brown and Rajan, supra note 79, at 668-69.

95 98 DTC 6530 (FCA), aff'g. 95 DTC 5591 (FCTD).

96 Ibid., at 5593 (FCTD).

97 2000 DTC 2587 (TCC), summarized in "Half of Capital Gain Held in Trust for Taxpayer's Wife," *Tax Topics*, no. 1508 (North York, ON: CCH Canadian, February 1, 2001), 5-6; and "Existence d'une fiducie malgré l'absence de document écrit" (2000) vol. 9, no. 4 *Flash Fiscal* 2.

98 They include, among others, *Sura v. MNR*, 62 DTC 1005 (SCC); *MNR v. Faure Estate*, 77 DTC 5228 (SCC); and *Laporte v. MNR*, 84 DTC 1208 (TCC). The problem of taxing income and capital gains in relation to matrimonial regimes has been analyzed in André Dionne and Michel Turcot, "Aspects fiscaux des diverses étapes de la vie conjugale selon le nouveau droit familial" [1981] *Cours de Perfectionnement du Notariat* 393-444, and a historical note is contained

I still recall the words of Judge Dubé in a 1989 decision of the Federal Court Trial Division refusing to recognize a capital gain split between spouses married under Quebec's community of property regime, despite the spouses' co-ownership of the property:

> [TRANSLATION] [I]t would be quite unfair for taxpayers in one province to be favoured by provincial legislation dealing with the application of the Act, which should affect all Canadian taxpayers equally.[99]

Why Such Trusts Are Attractive from a Tax Standpoint

The majority of the decisions involving resulting or constructing trusts and taxation are concerned with transactions between spouses or other related persons. The consequences vary and can include avoidance of the attribution rules, of the deemed disposition on death, or of the application of ITA section 160. When such trusts are found to exist, the result is that the property in question has not in fact been transferred, since it is deemed to have always been held in trust for the benefit of the person who suffered the impoverishment resulting from the established relationship, whether conjugal or other.

As stated earlier, other situations between unrelated persons involving misconduct or unjust enrichment also can give rise to such trusts.[100] These situations, however, appear less problematic; they do not open the door to abuse, owing to the opposing interests of the persons involved. From a tax perspective, however, if it must be considered that a trust existed in a tax context, as in the *Fletcher* decision,[101] it would be normal to reassess years that were not statute-barred and, among other things, take into account the 21-year deemed disposition rule. Curiously, as Brown and Rajan have noted, those decisions in which tax relief was claimed in this context have not reconsidered the taxpayer's entire tax file on the basis of the existence of the trust.[102]

Opinion on the issue of the retroactive tax impact of resulting or constructive trusts is divided.[103] There is disagreement as to whether the existence of such trusts, and thus the beneficial ownership of the person claiming the gain, begins at the time of the event giving rise to that person's entitlement, on the acquisition of the property related to the trust, in the course of the events giving rise to an unjust

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in Jolin, supra note 60, at 1.13.1-1-1. The legal battle ultimately led to the inclusion in the ITA of specific dispositions to eliminate the advantage that some spouses united under a community matrimonial regime might enjoy in Quebec: ITA subsections 248(22) to (23.1).

99 *The Queen v. Dumais*, 89 DTC 5543, at 5548 (FCTD).

100 See, for example, the decision in *Fletcher*, supra note 85.

101 Ibid.

102 Brown and Rajan, supra note 79, at 682.

103 Ibid., at 680.

enrichment, at the time a claim was instituted on this basis, or when the judgment recognizing the trust is rendered.[104]

It is nonetheless interesting to note that, in the tax context, once the existence of a constructive or resulting trust was recognized, none of the recent decisions was decided on the basis that the trust did not exist until judgment had been rendered by the court.

Solutions for Quebec

In view of all this fiscal uncertainty, what changes should be made to ensure equity for Quebec?

The differences in the tax treatment accorded in civil law and common law jurisdictions begin to be significant in the context of unjust enrichment claims involving a constructive or resulting trust,[105] particularly in matrimonial matters. Civil law also offers a remedy based on enrichment in the same circumstances[106] or on the compensatory allowance between married persons;[107] however, to my knowledge, the compensation that has been obtained has never had a retroactive tax impact.

One author has summarized the treatment of unjust enrichment as follows:

> [TRANSLATION] Arising from the same equitable principle and applying the same conditions for its exercise, Quebec jurisprudence and the jurisprudence of the common law provinces have evolved through reciprocity, with the common law provinces incorporating principles taken from Quebec law and vice versa. . . .
>
> It must be emphasized, however, that in terms of compensation, common law solutions could not be fully incorporated into Quebec law, which does not recognize trusts by interpretation [constructive trusts] that are relied on by the common law courts in some cases in awarding ownership of the other spouse's property.[108]

The only Quebec cases that admit a retroactive tax effect are those involving claims for restitution based on a tacit partnership. In *Beaudoin-Daigneault v. Richard*,[109] the Supreme Court of Canada recognized that there could have been a tacit partnership between common law spouses who were partners in a farm and, accordingly, that the husband's signature on the initial contract of purchase was merely

104 In this regard, a judgment of a tax court should be distinguished from a judgment of a court settling a dispute between private parties.

105 As discussed earlier, the two doctrines are often pleaded in the alternative.

106 CCQ articles 1493 to 1496.

107 CCQ articles 427 to 430.

108 Violaine Belzile, "Recours entre conjoints de fait: enrichissement injustifié et action de in rem verso," in *Développements récents sur l'union de fait*, Service de la formation permanente, Barreau du Québec (Montreal: Yvon Blais, 2000), 125-73, at 139.

109 [1984] 1 SCR 2, at 9.

that of a mandatary of the partnership. In *Savoy v. SMRQ*,[110] the Quebec ministry of revenue, in disallowing certain losses, pleaded the existence of a tacit partnership between spouses. The remedy is not confined to civil law; taxpayers in common law provinces have also pleaded the partnership concept.[111] However, a number of factors limit the use of this remedy and make it less popular in Quebec than constructive or resulting trusts appear to be in common law jurisdictions.[112]

It should be pointed out that, although the use of the common law constructive or resulting trust, or even of beneficial ownership,[113] has been developed in tax jurisprudence over the last decade with advantageous consequences in matrimonial cases, these remedies are still not applicable in Quebec.

The following solutions could be considered to deal with this inequity:

- refuse to recognize such trusts as trusts for tax purposes;
- recognize the family, or at least the couple, as a tax unit;
- prevent a resulting or a constructive trust from having a retroactive tax effect by enacting measures similar to those adopted for Quebec's community property regime; and
- recognize throughout Canada that reasonable consideration, corresponding to the payment of a spouse's entitlement on the basis of enrichment, constitutes valuable consideration.

Each of these alternatives is discussed below. Note that throughout this discussion, the term "spouse" ("conjoint") is used to refer to a person who is either married or in a common law relationship.

Refuse To Recognize Such Trusts as Trusts for Tax Purposes

The government could reverse its position of recognizing the existence of a constructive trust or even a resulting trust as a trust for tax purposes. As in the case of a

110 [1996] RDFQ 316 (CQ).

111 See, for example, *Desrochers v. The Queen*, 99 DTC 962 (TCC); and *Graves v. The Queen*, 90 DTC 6300 (FCTD).

112 In Quebec, the existence of a tacit partnership between spouses (which is generally restricted to a context involving the operation of an unincorporated business) involves evidence of a common intention by the partners (affectio societatis) that is not always present when the services rendered correspond to those resulting from a matrimonial situation. Furthermore, since the tax authorities are a third person with respect to the taxpayers, the partnership could not be set up against them as long as the partnership declaration had not been published and the partnership was an undeclared partnership: CCQ articles 2189, 2195, and 2252.

113 *MacDougall v. The Queen*, 98 DTC 2180 (TCC). In a Quebec case, the taxpayer argued that he held the beneficial ownership of a property so that he would not be subject to the application of ITA section 160 with respect to a transfer without consideration to which he was party. The judge rejected this claim because the principle is unknown in Quebec, even taking ITA subsection 248(3) into account, and because the facts would not have permitted a different conclusion at common law.

bare trust,[114] which is deemed not to be a trust, it could be provided that this kind of trust also is not recognized for tax purposes.[115]

If this draconian solution is not suitable in circumstances where such trusts result from the misconduct or fraud of an unrelated person, it is possible that an exception could be made for those cases, and even that the trust could be recognized as dating from the commission of the wrongful act, provided that taxation of the act is not statute-barred. Since this kind of situation is relatively uncommon in Quebec, such an exception may have no tax impact. Although in some cases—for example, given the facts in *Fletcher*[116]—the tax result might be advantageous, the victim could also find that he is held responsible for taxes on income from a property that he did not own at the time.

It seems to me, however, that this solution would not fully cover matrimonial cases, since common law courts sometimes base their decisions on the concept of beneficial ownership without it always being necessary to refer to the doctrine of constructive or resulting trust.[117] Thus, it is not so much the tax status of the trust that matters as the fact that there is no transfer by the spouse who pays the claim resulting from a situation of unjust enrichment.

Recognize the Family, or At Least the Couple, as a Tax Unit (or Eliminate Attribution Rules Between Spouses)

The main inequities resulting from the inapplicability of resulting and constructive trusts in Quebec are that Quebec residents are not allowed to split capital gains or investment income from the portion of the property that is intended to redress the financial imbalance between the spouses, and that sufficient consideration cannot be argued in the context of ITA section 160 in relation to the settlement of rights arising from the spouses' communal relationship.

This is only the tip of the iceberg for family tax policy. The Department of Finance still refuses to recognize the family as a single tax entity; yet there are more and more limitations that reduce the deductions and tax credits that are based on the income of the entire family.

Tax policy thus favours recognition of the family unit when tax expenditures can be reduced. For example, two persons who work for an equivalent income and manage their wealth independently but live together as a couple will have to share the principal residence exemption if each owns a residence. Furthermore, a mother who earns a modest income because of her family responsibilities will have her

114 ITA subsection 104(1) and the definition of "disposition" in subsection 248(1), which provide that a bare trust is not a trust for the purpose of the application of tax rules. The settlor continues to pay tax since he did not actually transfer the ownership of his property to the trust acting as an agent for him.

115 This proposal is taken from Brown and Rajan, supra note 79, at 668-69.

116 Supra note 85.

117 *Anderson Estate*, supra note 90.

child tax benefits reduced if her common law partner ("conjoint de fait") has a high income. Since it is implicitly assumed that this mother has access to her partner's property in the raising of her children, it would be logical to encourage the legal transfer of that property to her name without the application of the attribution rules. Even with this tax advantage, such transfers would likely enjoy limited popularity.

Recognition of the family, or at least the couple, as the tax unit would, moreover, give a nod to family unity by eliminating the attribution rules between spouses and reducing tax complexity, since the attribution rules are both difficult to monitor and poorly understood.[118]

This solution would curtail tax cases based on the effects of a constructive or resulting trust, beneficial ownership, or a tacit partnership as they relate to the attribution rules. Thus, it would help to make the tax system more neutral as regards the choice of the most appropriate remedy. It might also promote the division of ownership of property between couples during their union rather than on the breakdown of their relationship, when such discussions typically become very painful.[119] To obtain the tax split, title would have to be transferred to the spouse.

This solution would also have the advantage of placing all spouses on an equal footing—those who equalize their property throughout their relationship, and those who refuse or neglect to do so and find themselves at the end of their relationship having to make court-ordered adjustments.

It would not, however, solve the thorny issue of ITA section 160. In this regard, an exception could be added to the ITA similar to the one granted on marriage breakdown for cases where a reasonable division of property is made during the union. Otherwise, the ITA could be seen as favouring marriage breakdown when the couple is in financial difficulty.

On the other hand, if the couple were recognized as the tax unit for all purposes of the ITA, all of the property belonging to the couple might be viewed as a way to guarantee payment of taxes.

Prevent a Resulting or a Constructive Trust from Having a Retroactive Tax Effect by Enacting Measures Similar to Those Adopted for Quebec's Community Property Regime

Like denying the existence of a trust for tax purposes, this solution is very simple to implement in that it does not require extensive legislative amendment and would not generate additional tax costs. On reflection, however, it might provide only a superficial remedy to a deep and pervasive problem.

In my view, the adoption of such a presumption would lead to increased reliance on another argument, having more or less the same effect but this time across

118 Experience shows that the attribution rules and their exceptions require at least three hours of instruction for third-year law students.

119 Despite the constructive and resulting trust doctrines, the split will be more certain with a transfer.

Canada, to circumvent the attribution rules and ITA section 160[120]—namely, that of sufficient consideration. In an appropriate context, the argument would consist in claiming that the interspousal transfer was made for equivalent value—that is, in settlement of all or part of the debt pursuant to the spousal relationship.

In my view, litigation involving constructive and resulting trusts cannot find a fair solution applicable throughout Canada unless such situations are viewed in their entirety. Merely adding a presumption to the ITA that these particular kinds of trust do not exist or are of no effect for tax purposes, in order to prevent the income splitting that might be achieved through their use, could open the door to arguments about the fair market value of the consideration. It would be better to articulate the use of such trusts in a way that encompasses and clarifies their application throughout Canada, and in the same process, to address questions concerning the payment of household expenses and spousal compensation.

Recognize Throughout Canada That Reasonable Consideration, Corresponding to the Payment of a Spouse's Entitlement on the Basis of Enrichment, Constitutes Valuable Consideration

Instead of revising the tax system as it relates to resulting or constructive trusts, tax policy could solve the issue of fairness between Quebec and the other provinces by clearly establishing the principle that the payment of marriage debts is a transfer for consideration everywhere in Canada, provided that the transfer is genuine and reasonable in the circumstances. This solution is similar to the elimination of the attribution rules between spouses, with the difference that the amendment would be restricted to transfers resulting from situations involving financial adjustments.

It should be noted in this respect that, even without such official recognition, the reasonable consideration argument is quietly making inroads. In an earlier article,[121] Richard Chagnon and I proposed that this argument could be used in the settlement of the compensatory allowance during marriage. Our position was that the debt owned by the creditor-spouse in respect of this allowance could, if it were settled on the occasion of a transfer of a property, constitute sufficient consideration so that the exception in ITA subsection 74.5(1) could be used—to the extent that the ITA subsection 73(1) rollover was not used. This solution was also argued to avoid the application of ITA section 160 in *Savoie*. The judge in that case found sufficient consideration, in view of the wife's rights, as follows:

> Her relinquishment, upon the transfer of the property, of her inchoate right to apply in a provincial superior court for a declaration that she held a 50% beneficial interest in the property would have a value equal to the 50% interest in the property and

120 By application of ITA subsections 74.5(1) and 160(1).

121 Diane Bruneau and Richard Chagnon, "Aspects fiscaux de la loi 146 du Québec" (1990) vol. 38, no. 1 *Canadian Tax Journal* 21-47, at 45-46.

> would constitute the consideration that paragraph 160(1)(e) requires be taken into account in determining her liability under that paragraph.[122]

Brown and Rajan, in their analysis, take the position that the application of the constructive trust and resulting trust could have been avoided by using this approach.[123]

I am still convinced that, if this argument were well planned and well documented,[124] it could succeed when pleaded in court. Thus, where one spouse pays the other an amount of money in settlement of the debt resulting from the recipient's work in the house for a specific number of years, which the spouses have determined to be a specific amount, it would be surprising if the court refused to recognize the existence of consideration, especially in the current environment, where compensatory allowances and unjust enrichment are used, among other things, to compensate housework.[125]

In *Barroso v. The Queen*,[126] where this argument was raised, Judge Dusseault indicated in obiter that the renunciation of the family patrimony could have constituted consideration if the value of the family patrimony had been put in evidence. However, use of this argument, particularly in Quebec, is weakened by the CCRA's position, taken early in the 1990s, that it does not recognize that a transfer of property made in consideration of a renunciation to the family patrimony or in payment of a compensatory allowance[127] can be considered to include sufficient consideration that the attribution rules would not apply.[128]

Furthermore, with respect to the case law, there is currently a divergence of opinion in the Tax Court of Canada regarding this issue in the context of ITA section 160. Certain payments to the spouse or on her behalf are sometimes not even considered transfers but rather are treated as a payment of an obligation of the taxpayer to participate in household expenses. Thus, in *Dupuis v. The Queen*,[129] the transfer of several small amounts used, among other things, by the husband as his contribution to household expenses was not recognized as a transfer for the purposes of the application of section 160, and the exact amount of the expenses did

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122 Supra note 91, at 555, note 2.

123 Brown and Rajan, supra note 79, at 684.

124 See, to the same effect, Jean-Marie Fortin, "Transferts de biens entre personnes liées et conséquences fiscales," in *Congrès 91* (Montreal: Association de planification fiscale et financière, 1992), 639-67, at 666-67.

125 Belzile, supra note 108.

126 97 DTC 338 (TCC). See also *MacDougall*, supra note 113.

127 CCQ articles 427 and 430 expressly provide that the allowance may be payable or paid voluntarily during the marriage.

128 Benoit Mandeville, "Revenu Canada et le Code civil," in *Congrès 93* (Montreal: Association de planification fiscale et financière, 1994), 18:1-54, at 18:17-19.

129 93 DTC 723 (TCC).

not have to be proved. Instead, the transfers constituted a payment of the debt incurred by him during his marriage.[130]

In *Raphael v. The Queen*,[131] on the other hand, the judge was not satisfied that the transfer of several amounts to the benefit of the taxpayer's wife was consideration at fair market value.

This discussion has led us far from the subject of trust; however, I believe that it was necessary in order to provide a wide perspective on the problem, so that the solution that is ultimately adopted will be neither superficial nor ineffectual.

Conclusion

The common law remedies of constructive or resulting trust are particularly inequitable between Quebec and the other provinces where they are applied in family matters deeming that an interspousal transfer never took place, so that the attribution rules or liability for tax under ITA section 160 can be avoided. Although the common law cases of this kind are not consistent, there are enough examples to justify the demand by Quebec jurists for legislative intervention.

THE CONCEPTS OF INCOME AND CAPITAL

An income interest in a personal trust[132] is defined in the ITA as "a right (whether immediate or future and whether absolute or contingent) of the taxpayer as a beneficiary under a personal trust to, or to receive, all or any part of the income of the trust."[133] Furthermore, the meaning of "income" in the context of that interest refers to income "computed without reference to the provisions of this Act."[134] Accordingly, the ITA recognizes that the tax impact of the rights of the beneficiaries of a personal trust must take into account the trust relationships established under private law—that is, the CCQ in Quebec and the common law in the other provinces. It follows that the distinction between the beneficiary of the income and the beneficiary of the capital of such a trust arises outside the purview of the ITA.

Nevertheless, the nature of the interest held by the beneficiary of a personal trust is a fundamental element in the application of a number of tax provisions. For example, the treatment provided for a disposition of an income interest differs from that accorded to a disposition of a capital interest.[135] It is therefore of interest to consider whether reliance on private law to define the nature of such interests is

130 Other judgments favourable to the taxpayer were rendered in *Ferracuti v. The Queen*, 99 DTC 194 (TCC); and *Michaud v. The Queen*, 99 DTC 43 (TCC).

131 2000 DTC 2434 (TCC).

132 Only personal trusts involve income interests that are separate from capital interests.

133 The definition of "income interest" in ITA subsection 108(1).

134 ITA subsection 108(3). The same concept is found in ITA subsection 104(13.1). The minister of revenue refers to private law in order to define income of a trust: see CCRA document no. 2001-0076895, April 26, 2001.

135 ITA sections 106 and 107.

a source of difference in tax consequences for a Quebec personal trust and a common law personal trust.[136]

Spousal and Similar Trusts

The difference between an income interest and a capital interest in a trust may have significant consequences where the trust is created for the exclusive benefit of a spouse pursuant to ITA subsection 70(6) or 73(1.01). The ITA requires that all the income be allocated and paid to the spouse by the trust, whereas the capital, depending on the settlor's wishes, may be either paid to the spouse or retained for the benefit of other beneficiaries (although the latter could receive it only after the death of the spouse beneficiary). Since the other types of trust referred to in ITA subsection 73(1.01) are subject to the same requirement regarding the income from the trust, the comments below will apply to them as well.

Income of a trust is defined in the ITA as having the meaning it has in private law,[137] but it does not include a dividend from a capital dividend account.[138]

Whether a trust for the exclusive benefit of a spouse qualifies for a tax rollover is described as a question of law and not as a question of fact.[139] In other words, what counts are the provisions of the trust deed and the rights it creates for each beneficiary, not whether the administration of the trust complies with the deed.

For example, when a testamentary trust provides that all the income must be paid to the surviving spouse with encroachment upon the capital in the latter's favour only if necessary, a rollover is allowed in the terminal year. After that, the trustee should question himself every year as to whether he has an obligation to pay a certain element to the spouse. If he mistakenly characterized an income element and concluded that it came from capital, or vice versa, there would be no effect on the tax rollover previously obtained. At most, the trustee might incur a liability relating to the beneficiary.

To make the trustee's task easier, there is no reason why the trust deed cannot provide that the trustee will have the power to decide that doubtful elements will be considered to be income. This in effect complies with the obligation to pay at least all the income to the spouse. A clause providing for the opposite, permitting the trustee to deem that an income element constitutes capital, should be avoided, however, because of the risk that the rollover will be denied—although according to the case law, when such a clause cannot be invoked in an arbitrary way and cannot have the effect of reducing the amount of income to be paid to the spouse, it will

136 My description of the situation in the common law provinces is limited to reporting the analyses made by other authors. Furthermore, it does not take into account specific trust legislation that may have been enacted in those jurisdictions.

137 A rollover would not be granted if the deed provided for giving the taxable income to the spouse. See Jolin, supra note 60, at I-13-2-7.

138 ITA subsection 108(3).

139 Jolin, supra note 60, at I-13-2-7.

not prevent the rollover.[140] It must be noted that if it can be anticipated that such a clause will have so little effect, there is no reason to add it to the trust deed.

The real difficulty in the reliance of the ITA on private law to determine the nature of income and capital in this context[141] arises from situations where the settlor does not want to limit himself to stating a general principle to the effect that the spouse is entitled to all of the income, or does not want to give the trustee the discretion to distinguish between income and capital because of the size of the particular element to be characterized. In these circumstances, the settlor insists on including in the deed detailed descriptions of the elements that must go to the spouse. Since grey areas are encountered when determining the nature of certain elements, the inclusion of such particulars may endanger the status of a spousal trust, not because they are visibly at odds with tax policy, but because of the difficulty of properly identifying what constitutes all of the income of the trust. It is clear that uncertainty about the distinction between income and capital is not confined to civil law. Since, however, the process of characterization is approached differently in the civil law system, it is easy to imagine that the same particulars in a trust deed would prevent a rollover in a civil law jurisdiction but not in a common law jurisdiction, and vice versa.

I will illustrate the problem with an example in which the possibility of using a shareholders' agreement or other solution to achieve the desired result is not considered. I have set aside those solutions in order to focus solely on the difference in meaning between a requirement to distribute all the income to a spouse under common law and the same requirement in civil law. The following example is drawn from a consultation with one of my clients.

The principal shareholder of a private company (Opco), whose shares are held by a holding company (Holdco), wants to make a will and take advantage of the spousal rollover. He would like to safeguard his second wife's standard of living by giving her the income received by the spousal trust; at the same time, he would like the Opco shares, or the proceeds of disposition, to be preserved so that they may be given to his children on the death of his wife. The problem is to draft a clause that will meet the requirements for a spousal trust while respecting the client's desire to preserve the shares for his children.

Two choices are available to the person drafting the will: safeguard the rollover by providing that nothing is to deprive the spouse of her right to the income, thus reducing the chances that the shares will be handed over to the children; or safeguard the transmission of the shares to the children and increase the risk that the rollover will not be permitted.

If the second option is chosen, a clause in the spousal trust could state that, notwithstanding any other provisions in the deed, the Opco shares, as well as any property acquired by reinvestment, are to be preserved for the children. Even if, on

140 *Terrill Estate v. MNR*, 87 DTC 504 (TCC).

141 ITA subsection 108(3).

the face of it, those elements are capital, the use of such a clause could raise a doubt as to whether some of the income would reach the spouse because of the various forms in which the proceeds of disposition of the Opco shares could be distributed to the trust. In short, could the eventual distribution of the Opco shares to the trust be considered to be in the nature of income and so endanger the rollover?

It will become clear that the problem is real, and that the situation can vary from province to province, as a result of the definition of income in private law, discussed below.

Distinction Between Income and Capital

Civil law classifies as income[142] the product of agriculture and raising of animals, rents, interest, and dividends, except those representing the distribution of capital of a legal person. Also defined as income are "sums received by reason of the resiliation or renewal of a lease or of prepayment, or sums allotted or collected in similar circumstances."[143]

According to the CCQ, capital, apart from its indisputable elements, includes the reinvestment of the fruits and revenues, the price for any disposal of capital or its reinvestment, and expropriation or insurance indemnities in replacement of capital, as well as rights of intellectual or industrial property and rights the exercise of which tends to increase the capital, such as the rights of subscription for securities.[144]

The nature of dividends is especially important in our example. According to the above-mentioned articles, dividends in principle constitute income, except those representing the distribution of capital of a legal person. However, since the reinvestment of revenues is capital in nature, would the nature of the revenue from a dividend be limited to the profits, interest, and dividends earned in the year?[145]

The CCQ articles could be viewed as a reflection of earlier case law since they do not specify the situations in which the distribution of a dividend becomes capital. Before the CCQ came into force, the Quebec Superior Court, in *Munro v. Common*,[146] had had occasion to decide that the proceeds from the sale of a building earned by a corporation that had subsequently distributed the proceeds to a trust were in the nature of income. The dividend had been paid in cash and did not

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142 The CCQ uses the terms "fruits and revenues," thus distinguishing corporeal fruits from economic revenues. The concept of income referred to in the ITA probably corresponds to the civil concept of fruits and revenues.

143 This list is found in CCQ article 910.

144 CCQ article 909.

145 This question is raised in Guy Fortin, "Concepts de revenu et de capital d'une fiducie : Importance de l'interaction en droit civil et en droit fiscal" (1994) vol. 42, no. 5 *Canadian Tax Journal* 1236-62, at 1251.

146 JE no. 92-1230; (July 1992), Montréal 500-05-005322-894 (Sup. Ct.). For comments on this decision, see Fred Purkey, "Les concepts de capital et de revenu à l'égard des fiducies dans un contexte de planification fiscale," in *Colloque 109*, supra note 21, paper no. 1, at section V (Jurisprudence).

constitute proceeds of liquidation, nor did it alter the corporation's capital account, since the sale of the building had been accounted for as retained earnings. In reaching this conclusion, the judge relied on arguments imported from the common law. In another decision based on the common law, *Trust Général du Canada v. Maillet*,[147] it was held that a stock dividend followed by a share redemption in the same year was a capital dividend.

Although a number of CCQ articles were intended to codify the earlier law, the definitions of fruits and revenues and of capital are qualified as new articles.[148] Accordingly, earlier cases may not necessarily be of much use. If the new articles had been applied in those cases, the results might have been different. We could argue that the distribution of the proceeds from the sale of a building is capital and that the stock dividend is if it was paid for the purpose of distributing the earnings for the year.

With regard to common law jurisdictions, Waters reported in 1984 that the Supreme Court of Canada had established that the factor that determined the nature of a dividend was the form chosen for payment of the dividend (the form rule) and not the intentions of the corporation. Waters commented on the form rule as follows:

> It is not a matter of real character and substance. Whether a distribution is income or capital is determined by the company's mode of doing things, for whatever reason it chose that mode. As Rand J. said in *Re Waters*, "Here form is substance."[149]

According to this test, dividends in cash or in kind are income, even if the dividend was extraordinary and resulted from the distribution of a capital gain, whereas what constitutes capital are capital reductions, share redemptions, and stock dividends, except in the case where an option to receive an equivalent amount of money has been offered.[150]

The difficulty of deciding whether the CCQ codified the form test or has basically distanced itself from that test arises, as noted above, from the fact that it offers no examples of what it considers to be a dividend from the distribution of capital.

By grouping the opinions of some of the civil law authors who have written on this subject together with Waters' description of the form rule, table 2 shows how the various kinds of dividends might be classified depending on the jurisdiction.

It must be remembered that legal doctrine is still far from consensus on this issue, as shown in the following two opinions, and there are as yet no cases clarifying the meaning of the new CCQ articles. Accordingly, it is difficult to determine whether they are really different from the common law.

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147 [1972] CS 342.

148 *Commentaires du ministre de la Justice*, supra note 25, at 532-33. This wording differs from the comments on CCQ article 1413, for example, stating, at 858, that although new, the article is nonetheless consistent with the previous law.

149 Waters, supra note 93, at 837.

150 Ibid., at 838.

TABLE 2

Elements	Civil law	Common law
Cash dividend	Income, *unless there is a disposition of capital* (does this then go into the capital reduction category?)	Income (the form of the dividend determines its nature even if it comes from the sale of a capital property)
Dividend in kind	Income a priori	Income
Capital reduction dividend or winding-up dividend	Capital[a]	Capital[b]
Stock dividend	Income a priori?[c]	Capital a priori[d]
Deemed dividend (ITA section 84)	Capital[e]	Capital

a However, see Guy Fortin, "Concepts de revenu et de capital d'une fudicie : Importance de l'interaction en droit civil et en droit fiscal" (1994) vol. 42, no. 5 *Canadian Tax Journal* 1236-62, at 1253. Fortin is of the opinion that the proceeds of the redemption that would correspond to the profits of the year in progress would be income. However, it is not clear whether this conclusion flows from the articles establishing a distinction between income and capital, or from the fact that the trustee must act equitably in accordance with CCQ article 1345.

b Ibid.

c However, see Marc Jolin, *Les impôts sur le revenu et le décès* (Montreal: Association de planification fiscale et financière) (looseleaf service), vol. 1, at I-13-2-8. Jolin maintains that a stock dividend constitutes capital first and cites the divergent opinions of other authors. The situation is summarized by Pierre Lessard and André Morrissette, "The New Civil Code of Quebec," in *Report of Proceedings of the Forty-Fifth Tax Conference*, 1993 Conference Report (Toronto: Canadian Tax Foundation, 1994), 51:1-90, at 51:31-32, as follows: "As well, there will undoubtedly be some confusion over the classification of dividends payable as capital stock, since such a dividend could conceivably fall under both headings. One author [note omitted] has concluded that the courts will simply look carefully at whether the dividend was paid out as a distribution of surplus capital or as a true dividend from profits."

d Fortin, supra note a, at 1249.

e Jolin, supra note c, at I-13-2-9.

Dominique Lafleur analyzed these articles and reached the following conclusion:

> [TRANSLATION] In our opinion, the C.C.Q. has only resolved the classification of cash dividends and winding-up dividends, and not all the other kinds of dividends. The latter should be the subject of an examination on the part of the trustee.
>
> In examining the said dividends, will the trustee have to consider the form test as was done under the C.C.L.C.? We believe that this question should be answered in the affirmative.[151]

151 Dominique Lafleur, "Quelques problèmes d'interaction entre le Code civil du Québec et la planification fiscale," in *Congrès 94* (Montreal: Association de planification fiscale et financière, 1995), 23:1-76, at 23:74.

Taking a different position, Guy Fortin is of the opinion that the common law form test should no longer be used to decide whether a dividend represents a distribution of capital.[152] He offers examples in which the distribution of dividends to the trust from elements that would constitute capital of the corporation—for example, a contributed surplus from a rollover with low paid-up capital, or a step-by-step liquidation—would be capital. He also questions whether retained earnings that are not distributed in the year in which they are earned would become capital.

Although the CCQ seems to have adopted a test that is more substantive than the form test, I do not think that Quebec courts will go as far as Fortin suggests in differentiating civil law from common law. Otherwise, only the dividends from the earnings of the year would be characterized as income, whereas the CCQ actually appears to treat dividends first and foremost as income, with capital being the exception.

To return to the Opco example, in view of the various forms that the distribution of an affiliate's shares or the proceeds of its disposition to the shareholders of the parent company may take, the settlor of a common law trust cannot claim that the trust is in a position to distribute all of the income to the spouse if he prohibits the distribution of the Opco proceeds of disposition. However, the development of the Quebec jurisprudence[153] might allow such a clause. On the other hand, a clause in a trust deed that applied to stock dividends could affect the capital under the common law and the income under Quebec law.

Solution for Spousal Trusts

As discussed earlier, the requirement for spousal trusts that all the income must be payable to the spouse leads to discrepancies and should be revisited in the tax treatment of such trusts, because of the varying definitions of income in civil law and common law. In our example, for instance, the common law may find it more difficult to accept that a restriction on the business distribution is not equivalent to limiting the spouse's income. If at least it could be specified that certain elements are to be considered as capital by the trustee, it would be possible in both civil law and common law jurisdictions to alleviate the uncertainties in each legal system and, in our example, to respond better to the testator's desire to protect the value of his business for his children without endangering the rollover.

I make this suggestion because I realize that, in any case, the requirement to pay all the income to the spouse does not ensure that the income will be taxed in the hands of the spouse, given the tax options[154] now available to the trustee; nor does it ensure a minimum income for the spouse, since the income depends on the kind of property owned by the trust. In a trust that holds shares of private companies or a portfolio of securities, it is obvious that the income does not represent all the

152 Fortin, supra note 145, at 1250-51.

153 I have not identified any cases since 1994 that deal with CCQ articles 909 and 910.

154 ITA subsection 104(13.1).

earnings. One only has to realize that the capital gain is unquestionably capital to understand that an important part of the increase in value is withheld from the spouse. For this reason, encroachment upon the capital is usually necessary to ensure a minimum return to the spouse.

I see no harm, in terms of tax policy, in incorporating the principle in a spousal trust that the capital, as of the time the trust was constituted, plus property acquired by reinvestment, could be preserved for the children. At the present time, if this principle were included, in order to allow the rollover it would be necessary to stipulate that such a clause should not have the effect of depriving the spouse of income. That would not be very reassuring for the testator.

In view of the flexibility of the taxing provisions that allow the income to be taxed either at the level of the trust or in the hands of the spouse, in my view the requirement to pay all of the income to the spouse has become obsolete. It should be replaced by a requirement providing that "any payment" from the spousal trust must be made to the spouse during the spouse's lifetime and that no one else may receive anything whatsoever before the spouse's death. This change would solve two problems that arise in drafting and administering the trust. First, it would remove the difficulty of establishing whether certain elements are income, and thereby decrease the level of the trustee's liability; and second, it would alleviate the differences that will apparently continue to exist between civil law and common law in interpreting the concepts of capital and income.

As another way to address the latter issue, consideration might be given to defining all the elements that are to be regarded as income for the purposes of obtaining the benefit of the rollover. This solution would allow the drafters to include the specific requirements in the tax legislation, although it might further widen the gap between private law and tax law.

Income Versus Capital: Other Aspects

Income Payable

A precise definition of income and capital is also necessary for the computation of the annual tax liability of the trust. Once it has been determined to which beneficiary each element of the taxable income is payable,[155] because the beneficiary is entitled to enforce payment of the amount, the effect of the determination is to make it possible to tax the beneficiary on these amounts while allowing the trust an equivalent reduction in the taxes it owes.[156]

Pursuant to ITA subsection 104(13.1), however, the tax reduction given to the trust cannot exceed the beneficiary's share of the taxable income of the trust computed without reference to the ITA. The purpose of this reduction is to allow income to be retained in the trust so that non-capital losses of the trust, which are

155 ITA subsection 104(24).

156 ITA subsections 104(6) and (13).

locked in, can be used. Subsection 104(13.2) provides a similar rule permitting the use of capital losses of the trust against its taxable capital gains.

The problem relating to the definition of income and capital here lies in the difference between income for tax purposes and income as defined in private law. Once the difference has been identified (which is not always easy to do), the distortions it causes in terms of the overall taxation of the trust and its beneficiaries become apparent.

Example
The taxable income of a trust is $150,000, but its civil income is $140,000. If all of the income is payable to a beneficiary, the beneficiary can claim $140,000 and pay taxes on that amount. The deduction allowed at the level of the trust will also be $140,000, but the trust will have to pay taxes on the $10,000 difference between the civil income and the income for tax purposes, and it may be taxed on this amount at a higher rate.

If the trust wanted to pay taxes on this income, it could elect to do so only in respect of $140,000, which is the amount that must be paid to the beneficiary. At the civil level, the taxes not related to the income would have to be paid out of capital.

Example
In this case, the civil income of the trust is $150,000, and the income for tax purposes is $140,000. Since the beneficiary is entitled to $150,000, $140,000 can be deducted from the income of the trust and taxed in the hands of the trust as an amount payable; however, the $10,000 difference will be taxable as a benefit under the trust pursuant to ITA subsection 105(1). Therefore, there will be no double taxation in respect of the $10,000, which came from the trust, even though the trust can deduct only $140,000 from its income under ITA subsection 104(6).

The difference in these concepts does not create any serious problems here. While an argument may arise among the beneficiaries regarding recognition of their right to a particular element of income, this is a private law problem. Since, generally speaking, the trust deed may provide that a specific element will go to a specific beneficiary, even if there are differences between the two jurisdictions, this will not in itself cause significant inconvenience. If a cash dividend from the distribution of a capital element is income under common law and capital under civil law, the discrepancy will cause difficulties for the CCRA as well as the trustees, since the level of taxation will have to respect this characterization. However, it will not necessarily lead to inequity, because the level at which the taxes are assessed will be a direct consequence of the respective rights established between the beneficiaries.

Losses

When the ITA deals with income, losses are also involved. Fortin has pointed out a double taxation situation that could occur in civil law in respect of the use of losses, as a result of the difference between income and capital.[157]

157 Fortin, supra note 145, at 1254-55.

In Fortin's view, since a business loss would, under civil law, be in the nature of a capital loss,[158] its application against other trust income could mean that the income for tax purposes would be not as high as the civil income. The beneficiary would pay tax on the excess received by virtue of ITA subsection 105(1). Thus, the loss would only serve to reduce income at the level of the trust, but the beneficiary would be taxed on the distribution of that income.

Example
Assuming income for tax purposes of $50,000 reduced by a business loss carryover of $30,000, the recipient of the income would receive $50,000 and would pay tax, on the one hand, under ITA subsection 104(13) on $20,000 and, on the other hand, under ITA subsection 105(1) on $30,000.[159] Given the conduit role played by the trust, there would be double taxation for the income amount representing the loss used.

In common law, under the normal operating circumstances of a business, the business loss would instead be a loss chargeable against income.[160] The amount distributed to the beneficiary would be reduced to $20,000, and the loss would reduce the overall tax burden.

The solution considered earlier in this section—identifying precisely the elements that constitute income and those that constitute capital for tax purposes—would not help matters, since the question here is to reconcile the level of taxation with the rights of each beneficiary under private law. Thus, in our example, the tax law cannot change the civil law beneficiary's right to income and reduce it to $20,000, as at common law (assuming that Fortin's thesis is accepted). The tax law can, however, alter the negative consequences of the difference by easing the loss utilization rules. In particular, the rules could be made more flexible by extension of the period during which the losses can be used, so that civil law trusts could apply them against capital gains (to avoid putting the capital beneficiary at too great a disadvantage).

Nature of Expenses

Analysis of the attribution of expenses to income or capital is complementary to the discussion of the concept of income. CCQ article 1345 provides that the trust deed takes precedence in this regard if it contains clauses specifying how the apportionment is to be made. In the absence of sufficient indication, the apportionment is to be made equitably, taking into account the object of the administration, the

158 This is because of CCQ article 909, which prescribes that retained income is added to capital. This position could be strongly criticized. Why would an income beneficiary only receive profits and not be affected by losses?

159 For other similar examples, see Lafleur, supra note 151, at 23:20, and Fortin, supra note 145, at 1254.

160 Waters, supra note 93, at 857.

circumstances, and generally accepted accounting principles. After expressing these principles, the CCQ provides examples reflecting their application.[161]

At this point, it should be asked whether the apportionment provided for in the trust deed would be valid from a tax standpoint. Although the CCQ refers to the trust deed in order to establish the apportionment of benefits as well as expenditures,[162] I believe that a distinction should be made here between the two cases. In contrast to the apportioning of expenses between capital and income, I do not think that under civil law the trust deed can change what is represented by income, since that term is defined elsewhere in the CCQ. Thus, even if the settlor is allowed to specify or modify in the deed who will receive a particular benefit, the intrinsic nature of this benefit as income or capital is determined by the CCQ. That reasoning seems not to apply to the apportionment of expenditures, according to the wording of CCQ articles 1346 and 1347.[163] In this regard, the CCQ does not provide a definition but does reflect generally accepted accounting principles.[164] However, recourse to those principles seems to be secondary to the provisions of the trust deed prescribing the apportionment.

The situation seems fairly similar in common law. On this subject, Waters wrote:

> Nevertheless, it is always open to the testator or settlor to say how burdens are to be borne, and his intentions will govern. It is only where he says nothing on the matter that the general rule takes effect.[165]

Thus, it is only where there are no indications in the deed that the nature of the expense will determine whether it should be charged against income or capital.

A number of the distortions between civil income and taxable income result from the differences in the kinds of expenses allowed by each. The distortions may lead to unwanted results, such as taxation at the level of the trust without a possibility of transferring the additional taxable income resulting from a lower depreciation expense to the income beneficiary.[166]

To avoid inequity between the recipients of income and the recipients of capital with regard to the cost of depreciation, Lafleur offers the following recommendation:

161 CCQ articles 1346 and 1347. According to the Quebec minister of justice, these examples are intended to guide the trustee: *Commentaires du ministre de la Justice*, supra note 25, at 811.

162 CCQ article 1345.

163 CCQ article 1346: "[t]he revenue account is generally debited for the following expenditures." CCQ article 1347: "the capital account is generally debited."

164 *Commentaires du ministre de la Justice*, supra note 25, CCQ articles 1346 and 1347, at 810-11.

165 Waters, supra note 93, at 845.

166 In this regard, see the example provided by Lafleur, supra note 151, at 23:25 and 23:26.

> [TRANSLATION] [I]n order to simplify the administration of the trust, it would be helpful to provide that the civil depreciation to be deducted from the civil income must be equal to the tax depreciation claimed under the Act.[167]

Such apportionment of expenses will have to be respected by the tax authorities since, in referring to the private law concept of income, the ITA indirectly introduces the possibility of reliance on the trust deed for clarification regarding apportionment. Obviously, this cannot be done where the trust is not created by a legal document, as in a succession by intestacy, or when the deed is silent on the question of expenses. However, taking these possibilities into account, although the same expense can receive different treatment under private law, comparing the case law from the common law provinces with that of a civil law province, I do not think that changes in tax law are warranted since the trust deeds themselves can resolve the issue.

Thus, if the principle is to be followed that the terms of the trust deed take precedence in characterizing an expense, I even think that the above clause proposed by Lafleur could find a place in a trust deed for the exclusive benefit of a spouse, without having the effect of limiting the latter's right to the income of the trust, either in civil law or in common law. However, to translate this remark into a recommendation is another matter.

To ensure this result and to avoid having to deal with an opinion to the contrary, the government should make it clear that it will respect the primacy of the trust deed with respect to the apportionment of expenses.

Concluding Comments

Since the tax system is only accessory to the transactions and the rights of parties, it is perfectly legitimate to use private law to determine what proportion of the trust property is to be distributed to the income beneficiary and what proportion to the capital beneficiary. However, if private law is ambiguous, there are necessarily repercussions on the application of the tax legislation. Provision for a parallel system that defines income and capital for tax purposes could have the effect of usurping provincial jurisdiction in this area since, for the sake of simplicity, the drafters of trust deeds will take the prudent course of shaping the deed in accordance with the tax definition, thereby displacing the private law definition. This phenomenon can be verified particularly with the concept of foundation recently developed in the civil law,[168] the utility of which is limited since the criteria for a foundation under the ITA are specific and cannot be circumvented.

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167 Ibid., at 23:26.

168 CCQ articles 1256 to 1259.

It is clear that the differences between civil income and tax income create difficulties of application and double taxation. However, these problems are as widespread in common law as they are in civil law. A more annoying difference between the two jurisdictions is the different treatment that the same element of taxable income may receive; but since that difference generally translates into different rights for the beneficiaries, a solution is very difficult to find.

The situation with a spousal trust is somewhat different in that the discrepancies in the definitions of income and capital can endanger the rollover of property to the trust. In this regard, I prefer the solution of amending the requirement that all the income be distributed to the spouse and replacing it with a more flexible requirement that all distributions by the trustee be made to the spouse during the spouse's lifetime, without the need to distinguish between income and capital.

Another alternative would be to revise the definition of income in the ITA to specify how the various dividends are to be characterized. This approach is not without interest. I discussed at the beginning of this section differences in tax treatment on a distribution of property to a beneficiary in payment of the beneficiary's interest in the income or the capital of the trust. The former constitutes taxable income while the latter benefits from a rollover.[169] One could imagine a family trust deed providing that a beneficiary would receive one element of the trust's assets (for example, all stock dividends), which, in one jurisdiction, would be considered income and, in another, capital. The tax treatment resulting from this difference would vary significantly. Under this option, if a definition of the nature of dividends were added to the ITA, it could resolve these differences, since basically this is the kind of element that poses the most problems.

It should be noted that both alternatives could be applied.

MORE FOOD FOR THOUGHT

In addition to the illegality of an unlimited power of appointment, the mysteries of indefeasible vesting, the impossibility of constituting resulting and constructive trusts, and the distinctions between income and capital, the ITA contains many other obstacles related to trusts for taxpayers in a civil law jurisdiction. I have chosen to make a few comments on the application of ITA section 43.1, on trusts with a reversionary interest, and on bare trusts. These points are not documented to the same extent as the issues discussed above; what follows is only an overview of the problems associated with these topics, along with some suggested solutions that could prove interesting to pursue.

ITA Section 43.1

In common law, it appears that only real property can be subject to successive interests, such as a life estate and a remainder interest. Thus, it is permissible to

169 ITA subsections 106(2) and 107(1).

give a charitable trust a remainder interest in a real property, while retaining a life estate in it so that the property can continue to be used by the donor during his lifetime. ITA subsection 43.1(1) makes it possible in such a case to avoid a deemed disposition of the life estate retained by the donor. Accordingly, the donor will be taxed only on the fraction of the value of the property that corresponds to his gift and is the subject of the charitable donations credit.

Since these concepts do not exist in Quebec, it would be hard to apply them, especially since ITA subsection 248(3) has now clarified the tax treatment to be given to dismemberments of the right of ownership specific to the CCQ.

The effect of ITA subsection 248(3), however, is to provide for the deemed disposition not just of the value of what is given, but of what is retained as well, since the creation of a substitution or a usufruct, or even a mere possessory right, involves the deemed disposition of the entire property that is its subject.

At an APFF round table, I asked whether in Quebec it was possible to use the exception in ITA subsection 43.1(1) to avoid taxes on the interest retained when a gift over was made. The answer of the Department of Finance was favourable,[170] but so far there has been no amendment.

I believe that this significant difference should be corrected as soon as possible.

Trust with a Reversionary Interest

I admit to having some hesitation in introducing this topic. The ITA is fairly specific in its definition of criteria for evaluating whether or not a trust complies with subsection 75(2), whether the trust is governed by common law or by civil law. However, civil law practitioners have the clear impression that the common law concept of a revocable trust transcends this provision and should be a very important element in its interpretation. An example will illustrate my thinking on this issue.

To repeat the wording of the ITA, subsection 75(2) applies, according to the first test, if

> property is held on condition
> (a) that it or property substituted therefor may
> (i) revert to the person from whom the property or property for which it was substituted was directly or indirectly received.

The restrictive interpretation provided by the CCRA could lead us to conclude that the key words are "revert to the person," so that subsection 75(2) will apply as soon as there is a possibility that the trust property will revert to the settlor. This reasoning has led to concerns that CCQ article 1297, which provides for automatic reversion to the settlor when there is no beneficiary, would trigger the application of ITA subsection 75(2). Accordingly, it has been recommended that the trust deed

170 "Table ronde sur la fiscalité fédérale," in *Congrès 98*, supra note 3, 43:13-60, question 8.1, at 43:57-58.

should provide that a charitable organization will be the beneficiary if all the other beneficiaries are dead, as in the following passage:

> [TRANSLATION] Finally, we should note that Revenue Canada takes the position in Interpretation Bulletin IT-369R that subsection 75(2) I.T.A. can also apply in cases where the property may revert to the transferor as a consequence of the death of the last of all other beneficiaries under the trust. Thus, the settlor's residual right to receive the trust capital under article 1297 C.C.Q. could, according to the tax authorities, trigger the application of subsection 75(2) I.T.A. Therefore, in order to prevent this, it is recommended that it be provided that the trust residue will be distributed to a charitable organization in the event that no beneficiary is able to receive the capital.[171]

Why has the CCRA not accepted this reasoning, but stated instead that CCQ article 1297 does not trigger the application of ITA subsection 75(2)?[172] The reason is that the initial phrase, "on condition," takes precedence over the rest. In my view, the settlor must have explicitly included in the deed a condition that, notwithstanding the transfer to the trust, he personally reserves the right to revoke the trust[173] by taking back his property or, on its distribution, to act as if he had not ceased to be the owner, thus reserving the right to take back the property at his discretion or to exercise an unlimited power of appointment, or reserving the power to dispose of the property as if the trust were only his agent.

The deed of trust should thus be the sole element to consider when determining whether the settlor imposed conditions on the trust in such a way that it would correspond to a revocable trust.

The absence of this concept in civil law and misunderstanding of the case law behind the concept constitute a major handicap for civil law practitioners attempting to interpret its true meaning.

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171 André Morrissette, "Fiducies," in *Colloque 63—La réforme du Civil Code et son impact sur l'impôt sur le revenu*, paper no. 3 (Montreal: Association de planification fiscale et financière, 1993), 10. See the section entitled "La désignation du bénéficiaire et ses droits."

172 See, for example, CCRA document no. 2001-0096935, November 8, 2001. The conclusion of this discussion is reported by Marc Jolin, "Le fractionnement du revenu et les pièges insoupçonnées des règles d'attribution," in *Colloque 88—La fiducie: le véhicule fiscal du nouveau millénaire* (Montreal: Association de planification fiscale et financière, 1999), section 2.2 (trust with right of reversion).

173 See Waters, supra note 93, at 291: "A settlor cannot revoke his trust unless he has expressly reserved the power to do so. This is a cardinal rule . . . the trust is a mode of disposition. . . . [I]t is sometimes said that the trust is a mode of 'restricted transfer.' So indeed it is, but the restriction does not mean that by employing the trust the settlor inherently retains a right or power to intervene once the trust has taken effect, whether to set the trust aside, change the beneficiaries, name other beneficiaries, take back part of the trust property, or do anything else to amend or change the trust." This description of a revocable trust conjures up the possibility that the settlor could change his mind with respect to the provisions of the trust, which under the civil law would be a kind of conditional transfer, rarely used in practice.

It is strange that a few years ago the presence of subsection 75(2) in the ITA did not trouble tax professionals in Quebec, whereas it has now become a spectre hovering over every trust deed.[174]

This provision should be rethought, at least to verify whether the terms it uses have the same meaning and the same impact in the two legal systems.

Bare Trust ("Simple Fiducie")

The bare trust was criticized, in a report submitted in the harmonization process by the APFF, as a common law concept at variance with civil law.

It is clear that in civil law, a bare trust may not be constituted as a trust. The legal nature of a bare trust is similar to a type of "mandate" or agency, in which the trustee, like an agent, cannot act except in accordance with the settlor's instructions and must return the property to the settlor on demand.

At this time, however, the difference between the two legal systems seems to have no tax consequences because a bare trust is no longer treated as a trust for tax purposes. By the amendment of ITA subsection 104(1), the settlor, like a mandator in Quebec, is deemed to remain the owner of the property.[175]

Accordingly, I have no recommendations to make on this subject, except perhaps that Quebec law should be taken into account in the wording of ITA subsection 104(1), as Maurice Régnier has proposed:

> [TRANSLATION] As an additional condition to avoid any disposition, it is added that the trustee must be an agent in respect of the property received by him. This condition may be explained by the ambivalence recognized in the English case law about the possibility that a person might combine the dual attributes of trustee and agent. In the context of the Civil Code of Québec, this situation makes no sense. A person can be either a trustee or an agent of a third person, but not both. The property of the principal does not belong to his agent, whereas the property of the trust may belong only to the trust.[176]

CONCLUSION

The harmonization of tax law in order to make it applicable to two fundamentally different legal systems, so that each is independent of the other, would be a truly remarkable achievement. In fact, insofar as Quebec legal doctrine respecting taxation is not even accessible to the majority of tax professionals in the common law provinces because of language, it is understandable that, although the task is certainly a laudable one, it will require a significant and continuing effort.

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174 For instance, the doctrinal discussion of the possibility that ITA subsection 75(2) applies if a loan to the trust is not considered genuine: Jolin, supra note 172.

175 See the technical notes concerning the introduction of ITA section 107.4, supra note 15, at clause 82.

176 Maurice Régnier, "De la morosité!" (1998) vol. 20, no. 1 *Revue de planification fiscale et successorale* 7-12, at 9.

Many of the differences noted in this paper depend on the result of the evolution of private law, including the power of appointment, the conditions for applying the resulting trust, and the definition of income. Tax law must adapt to these changes as well.

Trusts are still an area of expertise in Quebec. Curiously, it is the tax professionals who have taken over this area of the law. In one sense, this is fortunate because it means that only trusts that do not cause too many tax problems are currently being created. By requesting technical interpretations and discussions, tax professionals have more or less managed to demarcate the clauses needed to accommodate provisions of the ITA that are difficult to interpret. They have done so well, in fact, that nothing more resembles a trust deed in Quebec than another trust deed.

However, as soon as an attempt is made to go beyond the predetermined framework—as illustrated by the example where the client wants to preserve the business for his children using a spousal trust—unanswerable questions arise.

If the harmonization project allowed civil law practitioners to use their own tools to answer some of these questions, without having first to ascertain the meaning of terms used in the common law system, which is uncodified and difficult to access, this would already be an enormous improvement.