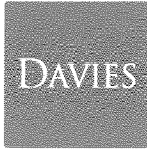

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PRE-BUDGET 2015 SUBMISSION TO THE HOUSE OF COMMONS STANDING COMMITTEE ON FINANCE

Improving Canada's Taxation And Regulatory Regimes

EXECUTIVE SUMMARY

In this submission, we offer a recommendation that we believe will help improve Canada's Taxation and Regulatory Regimes while supporting the objective of a balanced budget.

Trusts are an important vehicle of personal and estate planning. In recent years, the taxation of trusts has been amended so as to reduce the benefits available to trusts in an effort to eliminate perceived unfair tax advantages. For example, the recent proposed amendments to s.122(1) of the *Income Tax Act* (the "**Act**") will eliminate the graduated rate of taxation for grandfathered *inter vivos* trusts and testamentary trusts and establish a flat top-rate taxation (subject to certain exceptions). In addition, other "special treatment" for such trusts will be eliminated, such as the exemption from instalment rules, the exemption from a December 31 year end, and the basic exemption from alternative minimal tax.

The 21-year rule in s. 104(4) of the Act, which causes trusts to have a deemed disposition of their capital property every 21 years, was introduced in 1971 at the time of the introduction of the capital gains tax. However, in today's society, we submit that the implications are too severe and do not reflect the planning needs of today's taxpayers.

In light of this, we recommend the following change to the Act.

Reform to the 21-year deemed disposition rule

The 21-year deemed disposition rule applicable to trusts by virtue of s. 104(4) of the Act should be amended in two ways:

1. The period should be changed from 21 years to 50 years, and

2. The period should only commence on the death of the settlor or contributor.

EXPLANATION

1. The choice of 21 years was arbitrary

The need for a deemed disposition of trust property is generally understood as a basic corollary of the introduction of capital gains tax. Capital gains tax was first introduced in 1971 by Bill C-259, and the government wanted to prevent taxpayers from using trusts to defer indefinitely realization of gains and payment of capital gains tax.

However, the choice of 21-years as the cut-off point was not explained in the Summary of 1971 Tax Reform Legislation, nor does it seem to have been explained by any other government document.

There seems to be a general consensus among legal scholars that the number was inspired by the 21-year component of the Rule Against Perpetuities, which provides that no legal interest in property is valid unless it is certain, at the time when the disposition takes effect, that the interest must vest within a life or lives in being (i.e. the lifetime of the beneficiaries alive at the time of the creation of the trust) plus 21 years.

However, it is clear that this is no more than an inspiration. In most cases the Rule Against Perpetuities allows trusts (or similar interests) to be created for far longer than a simple 21 years, while the deemed disposition rule establishes an absolute ceiling (but for certain exemptions and exceptions) of 21 years[1].

Thus legal scholars generally agree that the choice of 21 years was ultimately an arbitrary one, and many have argued that in fact other periods may be more appropriate.

Jason M. Stephan:[2]

> The choice of 21 years for triggering the Trust Deemed Disposition as opposed to say, 25 or 50 years, is unclear. While the common law perpetuity period is measured with reference to 21 years, this period bears little relation to determining the appropriate period for requiring a Trust Deemed Disposition. Assuming the objective of the 21 Year Rules is to prevent a natural person from avoiding tax otherwise arising under the FMV Deemed Disposition on Death Rules, it is apparent that the 21 year period could pass significantly sooner than the person's death.

As the first 21-year anniversary of 1993 approached, the government itself acknowledged that the rule, as it was, was problematic for several reasons, including the arbitrariness of the 21-year period, which was not directly tied to any substantial change in the trust structure itself.

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[1] Manitoba has abolished the Rule Against Perpetuities (*The Perpetuities and Accumulations Act*, CCSM c P 33, s.3) while British Columbia has replaced the period with a fixed term of 80 years (*Perpetuity Act*, RSBC 1996 c 358, s.7).

[2] "*Understanding And Dealing With The 21-Year Deemed Disposition Rules Affecting Certain Trusts*", 2008 PPC p.14:1.

As a result of these problems, in 1991 the government proposed and introduced several amendments to the rules, most notably s. 104(5.3) which provided for the possibility of an election to delay the deemed disposition.

Draft legislation 1991, explanatory notes:[3]

> Third, the existing rule is arbitrary. While other rules in the Income Tax Act deem realizations in the event of death. emigration from Canada or change in property use, such deemed realizations are seen as necessary ways in which the Canadian tax system recognizes real events. By contrast, the 21-year deemed realizations occur on dates that are of relevance solely for tax purposes.

This amendment was repealed however in 1995, and today no such election is available.

2. A different period is more appropriate

Taxpayers who wish to arrange their affairs for the benefit of their children should be encouraged to do so as early as possible. For example, on the birth of a child, a parent may wish to put $50,000 in trust for such child and future children to be disbursed as needed for the benefit of such children (i.e. for the purchase of a home or for continuing education) in the discretion of the trustees, who invest same in growth assets. However, when such children are 21 years old or less, it may not be apparent what their needs are or that they are ready to handle the management of such assets and thus the trustees may be reluctant to transfer such assets to the beneficiaries notwithstanding that they may generally do so on a tax-deferred basis under s. 107(2) of the Act. Similarly, the trustees may be reluctant to fix the interest of each beneficiary at such time, eventhough they may generally do so in order to avoid the 21-year rule.

Further, the entire purpose of utilizing a trust is to ensure that assets are distributed to the beneficiary when appropriate, but not before. While in earlier times, 21 years may have been considered an appropriate age at which a young adult could be expected to act maturely and responsibly with distributed assets, that is simply not the case today.

As a general indicator of how the age of maturity has gradually risen over the past 40 years, consider the average age at first childbirth of mothers in 1971 and in 2011. According to Statistics Canada, in 1971 the mean age of mothers giving birth to their first child was 23.3,[4] while by 2011 the mean age had jumped to 29.7.[5]

Given that the purpose of trust and estate planning is to provide for one's heirs in the future, the rule should be reformed as recommended. Several legal scholars have written on this subject:

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3 Department of Finance release, 91-018 , Ottawa, February 11, 1991.

4 *Selected Birth and Fertility Statistics,* Canada 1921-1990, Catalogue 82-553, p. 41.

5 Statistics Canada, Table 102-4504- Mean age of mother at time of delivery (live births), Canada, provinces and territories, annual (years), CANSIM (database).

Craig M. Jones:[6]

> It has been suggested that the selection of 21 years as the period for revaluation is inappropriate. If the rules are intended to prevent tax avoidance through intergenerational transfers, then revaluation at intervals somewhat longer than 21 years would have been more appropriate.

F. Douglas Gibson:[7]

> The second inequity is the selection of 21 years. It seems obvious that the intention is to prevent trusts from skipping generations and the realization tax that will be charged at the dates of normal deaths. A 35- or 40-year period would be much more appropriate for that purpose, and the Department is simply endeavouring to take an extra advantage in collecting tax early. The selection of 21 years is most unfortunate for normal administration considerations. Even 25 would have been much preferable.
>
> ...Even though the age of majority is now 18 in many provinces and nowhere higher than 21, normal common sense would suggest disadvantages that militate against distributions of capital sums to 21-year-old beneficiaries in many cases.

W. M. Carlyle:[8]

> The period of 21 years appears to be unreasonably short for imposing a deemed realization on a trust. The magic of "21" no longer exists. The age of majority in British Columbia, for example, is 19. Bill C-259 now recognizes age 18 as an appropriate time for terminating the attribution rule in respect to transfers to minors. Furthermore, very few trusts in respect to settlements between parents and the first generation provide for a full distribution of capital at age 21. The minimum age is usually 25 and quite often is extended to 40.

Maurice C. Cullity:[9]

> Although the justification for the provisions that give rise to a deemed realization at periodic intervals is reasonably clear, the generally applicable period of 21 years is arguably too short. Testamentary trusts are most commonly created for the benefit of minors and it is often thought desirable to postpone vesting in whole or in part until each beneficiary attains the age of 30, 35 or 40 years or even longer.
>
> The tax consequences of a deemed realization of capital gains every 21 years may induce testators to provide for vesting to occur at times earlier than they believe to be in the best interests of their children or grandchildren or at least, by conferring powers of encroachment, to place upon their trustees the responsibility of deciding whether to distribute assets to beneficiaries under the specified ages or to retain the assets and pay tax. Both the general principle of treating an estate or trust as an individual and the policy of realizing capital gains at least once in each generation could accommodate a significantly longer period than 21 years.

In addition, the 21-year rule will often cause a disposition earlier than would be the case if the taxpayer simply held onto such assets personally. It is difficult to see the policy rationale for such earlier disposition.

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6 "*Inter Vivos Trusts and the 21-Year Deemed Realization Rules*", 1984 CR p.352.

7 "*Trusts and Estates,*" in Report of Proceedings of the Twenty-Third Tax Conference, 1971 Conference Report (Toronto, Canadian Tax Foundation, 1972), pp. 354-368, at pp. 362-3.

[8 ***Ibid*** **at p.351.]**

9 "*Using Trusts in Estate and Tax Planning*", 591 OC p.5:191.

3. Conclusion

The perceived unfair tax advantages associated with trusts have arguably been eliminated with the changes set out in proposed s. 122(1) of the Act. Given that the original choice of 21 years was essentially arbitrary, in that it did not actually mirror the functioning of the Rule Against Perpetuities, and given that in today's society taxpayers need to be able to make use of estate planning is such a way as will benefit their future generations by giving them access to assets when needed and by restricting access to those assets before appropriate, we propose that the deemed disposition rule be reformed so that the period is extended from 21 to 50 years, and that the period only commences upon the death of the settlor or contributor.

We believe these proposals fit within the broader context of improving Canada's taxation and regulatory regime, by ensuring that that tax law evolves with society.

We would be pleased to discuss the foregoing further.

Yours very truly,

DAVIES WARD PHILLIPS & VINEBERG LLP

Per: Rhonda Rudick