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Preston Family Trust II: The 21-Year Rule and Non-Resident Beneficiaries

The recent decisions in the Preston cases—*The Preston Family Trust II v. The Queen* (docket no. 2020-641(IT)G), *John Preston v. The Queen* (docket no. 2020-642(IT)G), and *Monika Preston v. The Queen* (docket no. 2020-643(IT)G)—dealt directly with a question of litigation procedure. Specifically, the Preston cases addressed whether certain statements included in the "assumptions of fact" section in the minister of national revenue's reply to the notice of appeal were conclusions of mixed fact and law, not statements of fact, and therefore should be struck. This article will not focus on the direct issue being litigated in the Preston cases but, instead, will discuss the minister's assessing position with respect to some of the planning undertaken to deal with the "21-year rule" under the ITA in respect of the Preston family trust.

According to the Preston cases, two non-resident beneficiaries of the Preston trust became the only shareholders of an Alberta unlimited liability corporation (ULC) just before the trust's 21st anniversary, and assigned their capital interests in the trust to the Alberta ULC pursuant to subsection 85(1) of the ITA. The Preston trust proceeded to transfer all of its capital property, consisting of shares of a holding corporation ("Holdco") and a partnership interest, to the Alberta ULC.

The purpose of these steps is explained by M. Elena Hoffstein and Corina S. Weigl in a paper that was given at the Canadian Tax Foundation's 2014 Ontario Tax Conference and cited by Spiro J in his decision, which lays out the rationale for the steps undertaken. By way of background, the general planning to address the deemed disposition of trust assets resulting from the 21-year rule would be a tax-deferred rollout to beneficiaries pursuant to subsection 107(2) of the ITA. However, pursuant to subsection 107(5) of the ITA, such a rollout is not available to non-resident beneficiaries for most types of property. The exceptions include property described in subparagraphs 128.1(4)(b)(i) to (b)(iii) of the ITA—most typically, "real or immovable property situated in Canada."

The 2014 paper by Hoffstein and Weigl offers as a planning option a distribution of the relevant property to a Canadian-resident corporation of which a non-resident individual beneficiary is directly or indirectly a shareholder. The paper also contemplates situations where the terms of the relevant trust do not expressly provide for a corporate beneficiary within the class of beneficiaries of the trust, and it contemplates mechanisms for making use of the rollout provided for in subsection 107(2) despite that lack.

In the Preston cases, there appears to have been no direct provision for corporate beneficiaries under the trust deed itself. Therefore, in order to achieve a tax-deferred rollout of the Preston trust property, two individual non-resident beneficiaries of the Preston trust assigned their capital interest in the trust to the Alberta ULC, and then the property was distributed from the trust to the Alberta ULC. An unlimited liability company may have been used to mitigate adverse US tax consequences.

The minister assessed on the basis that the Alberta ULC never became a beneficiary of the Preston trust and that those two individual non-resident beneficiaries continued as beneficiaries after the assignment of their capital interests. Accordingly, the minister assessed the relevant parties as if the Preston trust effectively distributed the relevant assets directly to the two individual non-resident beneficiaries.

On that basis, the minister assessed approximately $12 million in tax to the Preston trust pursuant to part I and part XII.2 of the ITA on the theory that the Preston trust had been deemed to have disposed of its capital property as a result of its distribution to the two non-resident individual beneficiaries. This article will not address the mechanics of part XII.2—a regime that, in general terms, is intended to ensure that one cannot avoid the tax that would be payable by a trust on certain types of income by allocating the income to non-resident beneficiaries.

The minister's theory of the case is consistent with CRA document no. 2017-0683021I7 (June 8, 2018) ("the TI"), which directly addressed planning virtually identical to the planning undertaken in the Preston cases (that is, planning that involved the assignment of capital interests in a trust held by non-residents to a Canadian-resident corporation in order to secure a tax-deferred rollout of trust assets). The trust identified in the TI did not directly provide for a corporate beneficiary in the trust deed.

In the TI, the CRA noted that the definition of "beneficiary" in subsection 108(1), which applies for the purposes of subdivision k and section 107, includes a person "beneficially interested in a trust," which is defined in paragraph 248(25)(a) to include

> any person . . . that has any right (whether immediate or future, whether absolute or contingent or whether conditional on or subject to the exercise of any discretion by any person . . .) as a

> beneficiary under a trust to receive any of the income or capital of the particular trust either directly from the particular trust or indirectly through one or more trusts.

In the TI, however, the CRA takes the position that the meaning of "beneficiary," as expanded by paragraph 248(25)(a), refers to "a person who can be identified as a beneficiary of a trust in the ordinary sense." The CRA took the same position more recently in document no. 2021-0879021C6 (June 15, 2021).

On the basis of this interpretation of "beneficiary," the TI takes the position that the Canadian-resident corporation "is not a beneficiary with a capital interest in the Trust following the assignment" and that the individuals remained beneficiaries of the relevant trust. As a result, the CRA took the view that "the transfer of the Trust's assets to [the Canadian-resident corporation] subsequent to the assignment was for the benefit of" the individual non-resident beneficiaries. On that basis, the CRA took the position that (1) subsection 107(5) applied, (2) the rollover provided for in subsection 107(2) would not be applicable, and (3) a deemed disposition of the assets ultimately transferred to the Canadian-resident corporation by the relevant trust would occur pursuant to subsection 107(2.1).

The CRA has also stated that planning of this type (that is, planning that uses a tax-deferred rollout to a Canadian-resident corporation owned by a non-resident) raises significant concerns and that the CRA would "consider the application of GAAR when faced with a similar set of transactions unless substantial evidence supporting its non-application is provided" (CRA document no. 2017-0724301C6, November 21, 2017). Of interest in this regard is the recent designation of this type of planning—that is, planning designed to avoid the application of subsection 107(5) pursuant to section 237.4 of the ITA—under the new "notifiable transaction" regime (see draft legislation released on February 4, 2022).

It will be interesting to see how the substantive question raised by the assessment in this case is dealt with. We note that the language in paragraph 248(25)(a) is quite broad, and the result of the litigation may hinge on whether that language is broad enough to capture an interest acquired from an existing beneficiary and the nature of the interest acquired under the relevant trust law. The text of the Preston cases does not indicate whether the relevant taxpayers were also assessed under GAAR.

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