Proactive Drafting Tips for Trusts in Family Law[1]

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This paper considers the use of trusts and particularly discretionary trusts, in estate planning with a particular focus on the challenges of sections 83 to 85 of the *Family Law Act*, S.B.C. 2011, c. 25 (the “FLA”), as they relate to trusts.

Trusts are settled by clients for the benefit of their family members with a number of planning goals in mind including: tax planning, deferring a beneficiary’s inheritance until those family members have matured and protecting the assets from the claims of third parties, including current or future spouses of the beneficiaries.

For years, estate planning lawyers have extolled the virtues of testamentary trusts and their graduated tax rates as a useful planning tool. However, the 2014 federal budget made it clear that as of the commencement of the 2016 tax year, income earned in testamentary trusts will be taxed at the top marginal tax rate, excepting (1) the first 36 months of an estate (where such estate qualifies as a “Graduated Rate Estate”) in which case graduated tax rates will be applied to give reasonable time for the estate to be administered and (2) testamentary trusts that are set up for disabled beneficiaries who are eligible for the federal Disability Tax Credit if the trust qualifies as a “Qualified Disability Trust”. This loss of testamentary trust benefits will be significant for many estate plans; however, tax planning is often not the governing reason for providing testamentary trusts. Reasons to continue to plan testamentary trusts in wills include providing for minor or vulnerable beneficiaries, management of assets for aging spouses, limited income splitting opportunities, protection of inheritance for children of a first relationship upon the death of the second spouse and control of funds for spendthrift or irresponsible beneficiaries. They also continue to be useful matrimonial planning tools.

A. Nature of A Discretionary Trust

Before embarking on an analysis of the FLA’s application to trust planning it is helpful to have in mind the nature of a discretionary trust. Under a fully discretionary trust, members of the class of potential beneficiaries have no right or entitlement to call for payments from the trust; they have no property interest in the trust[2]. Whatever interest the members of the class of beneficiaries have in the trust is no more than an “expectancy” or a “mere hope” that the trustee will consider in good faith, taking into account proper considerations and factors, whether to benefit each member of the class when the trustee exercises his or her discretionary powers.

[1] This paper is based in part on “Trusts Under the *Family Law Act*” prepared by Andrea E. Frisby for PBLI *Family Law: Challenging Issues and Emerging Trends* held on April 28, 2015
[2] See Donovan Waters Q.C., “The Power in a Trust Instrument to Add and Delete Beneficiaries”, (2012 31:2) Estate, Trusts and Pension Journal at page 188 and Waters, Gillen & Smith, Waters Trust Law of Trusts in Canada, 4th (Toronto: Carswell, 2012) at pages 1202-1204 and footnote 155.

Even though the members of the class of potential beneficiaries have no proprietary interest in the trust property, a trustee may still owe such individual a fiduciary duty and such individual may have sufficient "chose in action" to approach the court to ensure that the trust is duly administered: ***Schmidt v. Rosewood Trust Ltd.,*** [2003] UKPC 26. The New Zealand Court of appeal case in ***Johns v. Johns,*** [2004] 3 NZLR, reinforced this view that a member a class of potential beneficiaries has standing to sue in order to have a trustee's duties performed.

B. FLA Property Division Basics Applied to Trusts

The FLA has only beein in force since the Spring of 2013. Under the former legislation, the *Family Relations Act (*"FRA"), the theory of property division was that property "ordinarily used" for a "family purpose" was subject to division on marital breakdown. Under the FRA, trust property used for a family purpose was caught by the property division regime where (1) a spouse settled the property on a trust and retained some control of the disposition, (2) a trust was settled by another but the spouse was in a position to appoint the trust property to himself or herself or (3) the trust property was used for "family purposes". Fixed interests in either the income or the capital of the trust were therefore, in the correct circumstances, exposed to division or reapportionment. Also, anything deemed to be a family asset was divisible. Depending on the circumstances, family assets could include business assets that a spouse had directly or indirectly contributed to or an asset that was controlled by a spouse but not technically owned by that spouse. For example, where one spouse was the beneficiary of a trust fund, received distributions from the trust which he or she used ordinarily for a family purpose or was a trustee and beneficiary of the trust with the power to appoint the distribution of the trust funds, the court could determine that the trust fund or a portion thereof was a family asset to be divisible amongst the spouses. However, where the spouse has only an interest in a discretionary trust, such interest was not a property interest for the discretionary beneficiary. Accordingly, if the spouse, was not the trustee who was capable of exercising the discretion or the trust property was not clearly linked to the "family purpose", then technically the trust property was immune from division.[3]

The property division regime under the FLA does not rely on the "family purpose" test. Property division under the FLA applies to both marriages and common law relationships where the unmarried couple has lived in a marriage-like relationship for at least two years. The property division scheme is based on an excluded property model. Under this model, the court no longer has to decide as a first step whether a certain piece of property was "ordinarily used for a family purpose". Rather any property owned by one or both spouses will be considered to be "family property" (subsection 84(1)(a)(ii)), subject to equal division between the spouses, unless that property is part of a class of property that is by its nature excluded from division ("Excluded Property"). Similar rules apply to debts. Part 5, Division 2, sections 81-109 of the FLA provide the rules for determining what constitutes family property, Excluded Property, family debt and how to determine the value for the purposes of the division.

[3] See *Delesalle v. Delesalle*, 2006 BCCA 445 (BCCA) where the court considered a spouse's contingent interest in a discretionary trust and determined that he did not at the time of the triggering event "own an interest" in the trust fund.

In addition to generic rule as to what comprises family property in s. 84(1) of the FLA, subsection 84(3) expressly provides that where property is "contributed" to a trust by a spouse the trust property itself can be deemed to be family property if (1) the spouse is a beneficiary and has a vested interest in that part of the trust property that is not subject to divestment, (2) the spouse has a power to transfer the trust property to him or herself or (3) the spouse has the power to terminate the trust and the property would revert to the spouse. There is no definition of "contributed" in the FLA.

Additionally, this section is expressly subject to s. 85(1)(e) and so appears to exclude property which would be excluded property if not held in a trust (for example, property that is gifted or inherited). This section would not catch property where the spouse has retained control but has no ability to receive a distribution of trust property. However, s. 84(2)(f) treats as family property, "property" that is not caught by s. 84(3) which a spouses disposes of after the relationship began but over which the spouse retains authority "either alone or with another person" to require its return or direct its use or disposition.

Section 85 establishes the Excluded Property. Excluded Property includes any property that each spouse owned before the relationship started and certain property acquired post-relationship, such as gifts and inheritances given to only one spouse during the relationship, compensation payments made to one spouse only for personal injury or loss (unless it was meant to compensate both spouses or involves income that was lost during the relationship), insurance payments made to one spouse only for personal injury or loss (unless it was meant to compensate both spouses or involves income that was lost during the relationship), property bought during the relationship with Excluded Property and some kinds of trust property.[4] Section 96 prohibits the court from dividing Excluded Property unless it would be "significantly unfair" not to do so. The Excluded Property belongs to the spouse who owned, bought, or received it but the spouse claiming the exclusion must demonstrate that it is Excluded Property. However, if the Excluded Property becomes more valuable during the relationship, that increase in value is considered family property and is divisible between the separated spouses.

There has been much confusion and debate about the FLA provisions dealing with trusts and trust assets on spousal separations. Under the FRA, it was the spouse's interest in the trust that was capable of being a family asset. However, under the initial version of subsections 85(1)(e) and 85(1)(b) of the FLA there was some concern that the definition of Excluded Property included property held in a discretionary trust where the spouse did not contribute to the trust, and was named as only a potential beneficiary. The initial language in subsection 85(1)(f) read as follows:

> The following is excluded from family property…
> (f) property held in a discretionary trust
>> (i) to which the spouse did not contribute,
>> (ii) of which the spouse is a beneficiary, and
>> (iii) that is settled by a person other than the spouse.

[4] See *Dhillon v. Gaba*, 2014 BCSC 1474; *Asselin v. Roy*, 2013 BCSC 1681; *Remmen v. Remmen*, 2014 BCSC 1552, *Wells v. Campbell*, 2015 BCSC 3, *V.J.F. v. S.K.W.,* 2015 BCSC 727 for early cases exploring the boundaries of Excluded Property, the relationship between Excluded Property, joint tenancy and valuation issues.

This section was read in conjunction with subsection 84(2)(g):

> …family property is all real and personal property as follows:
> (g) the amount by which the value of excluded property has increased since the later of the date [the relationship between the spouses began or the excluded property was acquired].

Since the growth in value of Excluded Property is divisible between separated spouses, there was significant concern that the growth in value of the underlying trust property during the relationship could be divisible despite the fact the beneficiary spouse has no automatic claim to the trust property and there could be a number of potential beneficiaries to the trust (some of whom could be unconnected to the marriage).

The general consensus was that this effect was not intended by the drafters and amendments were made which came into force on May 26, 2014. Subsection 85(1) was amended, *inter alia*, to the following:

> The following is excluded from family property…
> (f) a spouse's beneficial interest in property held in a discretionary trust
>> (i) to which the spouse did not contribute, and
>> (ii) that is settled by a person other than the spouse.

In the case of a discretionary trust, as previously discussed, the property position at trust law is that the spouse does not have a beneficial interest in a discretionary trust but rather is one of a class of potential beneficiaries. Despite this position at trust law, we do not know how the courts will interpret these sections nor do we know if a family law court will be prepared to step outside trust law and ascribe value to a "beneficial interest" in a discretionary trust.

Section 84 was also amended in 2014 by the addition of subsection 84(2.1) which provides:

> For the purposes of subsection 2(g), any increase in value of a beneficial interest in property held in a discretionary trust does not include the value of any property received from the trust.

This amendment appears to protect distributions that have been made to a spouse from a discretionary trust during the relationship from subsequently being added back to the increased value in growth of the spouse's beneficial interest in the property when it is valued upon separation.

C. Valuing a beneficial interest in a discretionary interest[5]

The writer is unaware of any British Columbia case law addressing the value of a beneficial interest in a discretionary trust under the FLA. However, if a British Columbia court is prepared to step beyond the constraints of property and trust law to declare that a mere object (one of a class of potential beneficiaries) has a "property interest" in a discretionary trust such that it is captured by subsection

[5] This section of the paper is based in part on the papers of Genevieve N. Taylor of Legacy Tax + Trust Lawyers prepared for the PBLI *Advanced Tax and Estate Planning for the Family Business* held on May 21, 2014 and also Estate Planning – 2014, *Trusts and the Family Law Act* for CLE, October 2014.

85(1)(f) of the FLA, then the live issue will become how to value this unrealized “beneficial interest”; the further conundrum will be how the growth in this “interest” can be valued for purposes of dividing the same pursuant to subsection 84(2)(g) of the FLA. Options for division may include some imposed pro-rata scheme, distribution based on a pattern of previous distributions or valuation based on a “wait and see” strategy.

The issue of valuing interest in discretionary trusts has been explored elsewhere in Canada under the differing provincial legislation. In Alberta, the governing property division regime under the *Matrimonial Property Act*, R.S.A., c. M-8, though silent on trust interests, permits the court to divide “property owned by one or more spouses” and similar to the FLA, certain exemptions apply for property received by gift or inheritance. Several cases have considered whether an interest in a discretionary trust could be property for the purposes of division between spouses and different valuation approaches have been taken.

In ***Kachur v. Kachur***, 2000 ABQB 709, a family trust was settled in the context of an estate freeze by the husband. The husband’s mother was the initial settlor of the trust, the husband and two of his close friends were the trustees and the husband and his children and grandchildren were named as the class of beneficiaries. The vesting date of the trust was 21 years after the death of the last surviving child of the husband or an earlier date as determined by the trustees. Pursuant to the terms of the trust, the trustees had absolute discretion regarding distributions of income and capital and also had the power to pay trust funds to charity. In the family law action, the wife argued that the trust property was wholly owned by the husband and the children had no quantifiable interest whereas the husband argued that the children had 100% of the interest and should be deemed to own a notional one-third of the trust fund each. At an early stage of the litigation, the husband also signed a renunciation of his interest in the trust. In that case, the decision of the judge turned on the evidence of the intentions of the settlor at the time the trust was created, which was to benefit the children and grandchildren with the future growth in the trust fund. The court also looked at the historic distribution patterns which had benefitted the children not the husband, and the absolute discretionary power of the trustees to exclude the husband from all distributions. The court held that based on these particular circumstances the value of the husband’s interest was nil and the children held 100% (despite their interest also being contingent on the discretion of the trustees).

Similarly, in ***Horne v. Horne***, 2010 ABQB 32, the Alberta Court of Queen’s Bench considered whether a contingent remainder interest was property. In that case, the wife had a contingent remainder interest in a testamentary trust that was established by her father and this interest was subject to divestment if the trustees of the testamentary trust encroached upon or exhausted the capital of the trust fund for the benefit of the father’s surviving spouse. The husband claimed that the wife’s contingent remainder interest was property within the meaning of the *Matrimonial Property Act* and its increased value during the span of the relationship was divisible. On the facts, the judge determined that it was just and equitable for the entire contingent interest, including any increased value, to be retained by the wife. However, the judge stated that in the event that the determination was wrong, the interest should be valued on a “wait and see” basis; if the wife received a quantifiable interest once the contingency was met then, and only then, the husband would be entitled to his appropriate share of that interest.

In ***Shopik v. Shopik***, 2014 ABQB 41, the husband had settled a discretionary silver coin family trust approximately 12 years prior to the matrimonial proceeding. The husband was the sole trustee and the beneficiaries were the husband, all of the husband's children and the husband's spouse. "Spouse" was a defined term in the trust and excluded a person living separate and apart by reason of marital breakdown. The trustee had absolute discretion regarding distributions of income and capital to any one or more of the beneficiaries. Although the historical distribution pattern had only befitted the children, the court found that the husband, as the sole trustee, had the clear ability to appoint some or all of the property to himself as a beneficiary and therefore had an interest in the trust property. In that case, the court ordered that the trust fund property be split into two discretionary funds, one for the benefit of the husband and children and one for the benefit of the wife and children. The husband and wife were both named as the trustee of their respective fund and in the event that either of them exercised their discretion to encroach on the capital of the trust fund for his or her benefit, one-half of the value of such encroachment would be payable to the other as marital property. This is structurally a combination of the ***Kachur*** *and the* ***Horne*** approach.

Under the Ontario *Family Law Act*, R.S.O. 1990, c. F.3, subsection 4(1), "property" is stated to include "any interest, present or future, vested or contingent, in real or personal property" and has been held to include an interest through a discretionary trust. In ***Sagl v. Sagl,*** 1997 CanLii 11248 (ONSC), the court referred to what was in fact a discretionary interest as being a "contingent capital interest". The court did not deal with the threshold issue of whether an interest in a discretionary trust can be property. However, on a careful reading of the case, it appears that the parties may have agreed to this position so the threshold analysis was unnecessary; therefore, the case is only of limited utility. In ***Sagl***, the court valued the husband's interest by taking the deemed realization of the trust as of the valuation date and then allocating the value between all potential capital beneficiaries equally. There were five potential capital beneficiaries at the date of marriage and seven potential capital beneficiaries at the date of separation. The judge included the value of one-fifth of the trust in the husband's assets as of the date of marriage and one-seventh as of the date of separation.

In ***Dillon v. Dillon***, 2014 ONSC 2236, the husband was named as a potential beneficiary of a freeze family trust established by his parents. The judge in that case was considering the validity of a marriage contact but made a number of useful comments in regard to the freeze family trust. The trust was fully discretionary and the parents were the initial trustees; the husband did not have control. At the time of the husband's marriage breakdown, his mother was the sole trustee though he had received several distributions from the trust. He gave evidence that he had never been informed of the value of the trust property and was only aware that he might receive an inheritance from the trust upon the death of both of his parents. Additionally, the husband and wife had entered into an agreement prior to their marriage which expressly excluded any interest in the family trust from division. The judge stated at paragraph 283 that "the interest in a discretionary trust cannot be valued" and cited *Waters Laws of Trusts in Canada*, 4th ed. (Carswell, 2012) at paragraphs 1202-1204; he concluded at paragraph 293 that the husband's potential interest in the trust was "incapable of valuation". The judge went on to distinguish ***Sagl*** as being unique on its facts (at paragraph 288-289) and cautioned against relying on ***Sagl*** for new principles in trust law.

The ***Dillon*** case is similar to the analysis in ***Durakovic v. Durakovic,*** (2008) CarwswellOnt 5329 (ONSC), where the wife's residual interest in a family trust was not included in her net family property statement. The court reviewed the disability benefit case of ***Ontario (Director of Income Maintenance, Ministry of Community and Social Services) v. Henson,*** [1987] 2 E.T.R. 121 (Ont. Div. Ct.), in which the court determined that a discretionary trust in which the mere object did not have the right to compel the trustees to make payments to such object did not give that object a "beneficial interest" in the trust property. The court held that in order to have a beneficial interest, the beneficiary must have "either control or an ability to fall within the criteria that would require a trustee to provide funds in certain exigent circumstances" (at 162). The ***Durakovic*** court found that in order to have an interest, the spouse must have some degree of control over the contingency.

A similar theory that the beneficiary must be in a position of some control over the discretion in order to have a beneficial interest was applied in ***Grosse v. Grosse***, 2012 SKQB 424, where the Saskatchewan Court of Queen's Bench characterized the husband's interest in a discretionary trust as "contingent". The court held that since the husband was the sole trustee and had sufficient control of the trust to influence the distributions, he had an interest in the trust for the purposes of the Saskatchewan *Family Law Act* (at 56-58).

There is also a growing body of other common law jurisdictions where the courts have been faced with family law property decisions involving discretionary trusts. These decisions appear to focus on whether the spouse has some sort of direct or indirect control of the trust in the particular circumstances. The courts have considered the purpose of the trust, the members of the class of beneficiaries, the historical distribution pattern and who is exercising the discretion when deciding if the discretionary trust falls under the particular family law regime.[6]

The United Kingdom case of, ***Charman v. Charman***, 17 EWCA Civ. 503, is considered something of a seminal case in the development of the U.K. position. The ***Charman*** parties were married in 1976 and neither brought any capital into the marriage. The husband worked in insurance and the wife gave up work when she was expecting their first child. Ultimately the marriage broke down and divorce proceedings were commenced. The wife's assets were valued in the proceeding at £8 million and the husband's assets were valued at £123 million. In 1987, the husband settled an off-shore discretionary trust (the "Dragon Trust") with an expression of wishes to the trustee that during his lifetime he should be its primary beneficiary. Mr. Charman also retained the power as "protector" to replace the trustees. The Dragon Trust class of beneficiaries were Mr. and Mrs. Charman, their children and remoter issue. Although the Dragon Trust initially funded with $10,000., the trustees exercised an option to subscribe for shares in the Charman business which at the time of the divorce were valued at £68 million. On appeal, Mr. Charman challenged the trial judgment that had included Dragon Trust property as his property subject to marital division. Mr. Charman argued that the Dragon Trust was dynastic in nature

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[6] The writer recommends the recent article by Margaret O'Sullivan, *When Trust Law Meets Family Law: A Comparative Review of Discretionary Trusts and Marital Property Division*, published in <u>ICLG To: Private Client 2014</u>, 4th Ed.

and had been established with the intention to provide wealth for the benefit of his issue (at that time unborn).

The Court of Appeal upheld the trial judge decision to attribute all the assets of the Dragon Trust to Mr. Charman despite its discretionary nature based on the following factors:

(i) Mr. Charman was the settlor of the Dragon Trust;
(ii) He retained the power to remove the trustee;
(iii) The growth in trust wealth represented the fruits of investment at his request (and relied on his business success);
(iv) Until the breakdown of the marriage, he had a Letter of Wishes in place which wished that he should have the "fullest possible access to the capital and income of the settlement"; and
(v) Even after the breakdown, a fresh Letter of Wishes expressed the wish that he would be treated as the primary beneficiary.

Similarly, in ***Kan Lai Kwan v. Poon Lot To Otto and HSBC International Trustee Ltd***., 17 July 2014, FACV20/2013) (CFA judgment) ("Poon"),[7] the highest court of Hong Kong held that the assets of a discretionary trust will be a "resource" available for division upon divorce if factors similar to the ***Charman*** factors exist. In the ***Poon*** case, the husband was the settlor, protector and beneficiary of the trust that was established in 1995 and comprised the 84.63% shareholding in the holding company of his business (the business was valued at HKD1.56 billion at the time of the divorce trial). The trustee had absolute discretion to appoint capital and income to any one member of a class of beneficiaries, which included the husband, the wife, their adult daughter and a university, and to remove or add beneficiaries to the class with the consent of the husband as the protector. The protector also had the power to remove and appoint trustees. At trial, the wife sought to have the entire trust property included as a "resource" whereas the husband argued for a pro-rata approach under which the daughter ought to be considered to hold a one-third interest which he argued should be immune from the wife's claims. The trial judge was swayed by the husband's argument. On final appeal, the Court of Final Appeal reapplied the ***Charman*** factors and considered the hypothetical scenario where the husband were to request the trustee to advance the whole or part of the capital or income, and whether the trustee would "acting in accordance with its duties, would on the balance of probabilities be likely to accede to that request" (CFA, paragraph 60). The Court of Final Appeal determined that (i) in making himself protector, the husband had reserved significant powers, including the power to remove the trustee and intending to retain importance to the administration of the trust; (ii) in making himself a potential beneficiary, he intended to benefit from distributions of capital and income; (iii) he intended the trustees to have only the passive role of a shareholder; (iv) the daughter was one of the members of the class of potential beneficiaries and had no vested beneficial interest in the trust fund; and (v) the trust was discretionary and one member of the class of beneficiaries could benefit to the exclusion of the others. The Court of Final Appeal also looked at the Letters of Wishes accompanying the settlement deed and historical distributions which completely relied on a dividend being declared by the husband's company. Historically, when a dividend had been declared by the company, the trustee had

[7] http://mediation.judiciary.gov.hk/lrs/common/ju/ju_frame.jsp?DIS=93918&currpage=T)

immediately issued a letter of instruction to the company directing that the dividend should be paid directly to the husband's bank account. The Court of Final Appeal found that there was "an overwhelming likelihood" that the trustee would if requested by the husband during his lifetime have appointed the entirety of the income and capital to the husband and therefore held that the trust fund property should be characterized as a "resource" available for consideration in the marital property division process.

Although the application law varies from the law in British Columbia both ***Charman*** and ***Poon*** are chilling reminders that discretionary trusts are not necessarily immune in family law situations based on the trust law position that a member of a class of beneficiaries does not have a property interest. However, both are examples of discretionary trusts settled by a spouse with assets that were acquired during the marriage and where the settlor has reserved significant controlling powers (as protector) and remains a beneficiary. It is possible that attempts will be made to import the ***Charman*** and ***Poon*** principles to British Columbia cases considering the scope of s. 84(2)(f) of the FLA (making family property out of property that a spouse disposes of after the relationship between the spouses began, but over which the spouse retains authority, to be exercised alone or with another person, to require its return or to direct its use or further disposition in any way). It may, however, be more difficult to make these cases apply to a third-party settled trust comprising of assets not acquired during the relationship where the spouse is one of the class of potential beneficiaries (situations which would presumably be exploring the boundaries of s. 85(1)(f)).

D. Examples of the application of the FLA to common trust structures[8]

(i) Example of trusts settled by a spouse

Section 84(3) of the FLA provides:

> Despite subsection (1) of this section and subject to section 85 (1) (e), family property includes that part of trust property contributed by a spouse to a trust in which (a) the spouse is a beneficiary, and has a vested interest in that part of the trust property that is not subject to divestment, (b) the spouse has a power to transfer to himself or herself that part of the trust property, or (c) the spouse has a power to terminate the trust and, on termination, that part of the trust property reverts to the spouse.

The Excluded Property definition in subsection 85(1)(e) appears to include, property held in trust for the benefit of a spouse if such property would be excluded if it were not held in the trust. For example, if the property held in the trust was property acquired before the relationship began, a gift to the spouse or an inheritance.

If Spouse A settled an Alter Ego Trust before commencing a spousal relationship with Spouse B or using only assets which qualified as Excluded Property (e.g. an inheritance or gift from a third party), the assets in Spouse A's Alter Ego Trust would fall into the definition of Excluded Property and, subject to

[8] The writers recommend "Trusts and Family Law" prepared by Gordon B. MacRae, Q.C., and Andrea E. Frisby for PBLI *Trusts: Challenging Issues and Emerging Planning Techniques*, June 18, 2013, for a more detailed application.

subsection 84(2)(g), only the growth in the value of the trust property during the spousal relationship would be divisible. However, if Spouse A settled an Alter Ego Trust during the spousal relationship with assets that were not qualified as Excluded Property, the trust property would be subject to the provisions of subsection 84(3) and would be included in the definition of family property and would be divisible between the spouses unless Spouse A and Spouse B had entered into a binding agreement regarding their property division that the court was prepared to uphold.

If Spouse A and Spouse B settle the Joint Partner Trust, when Spouse A dies Spouse B will be the income beneficiary and the only person entitled to benefit from an advancement of the capital of the trust fund (this right can be limited at the planning stage if desirable). Upon Spouse B's death, the distributive provisions of the Joint Partner Trust could distribute the remaining trust property to Spouse A's two adult children (from Spouse A's earlier marriage to a different spouse). If following the death of Spouse A, Spouse B marries a new partner, Spouse C, from whom he later separates, Spouse C may claim an interest from the Joint Partner Trust in the following manner:

1. During Spouse B's lifetime, the income interest from the Joint Partner Trust is property owned by Spouse B (subsection 84(1)(a)(i)) but is likely excluded under subsection 85(1)(a), (b) and (e) since it was acquired before the relationship began and also any portion of the trust fund which was gifted by Spouse A. However, the growth on the value of the life estate during the relationship between Spouse B and Spouse C would be divisible upon the separation.
2. Spouse B has the right to be considered by the trustee of the Joint Partner Trust as an object of the discretionary power to advance the capital of the trust fund during his lifetime (he is the only person entitled to the capital during his lifetime). While the capital property is likely excluded under subsection 85(1)(a), (b) and (e), unlike the income which has to be paid to Spouse B during his lifetime, the encroachment on the capital is subject to the exercise of the discretionary power. As such, Spouse B is not an owner of the capital property, regardless of its qualification as Excluded Property, and from a trust law perspective the growth in the value of the capital during the relationship between Spouse B and Spouse C should not be divisible upon the separation of Spouse B and Spouse C.

During Spouse B's lifetime, Spouse A's children ("Child A and Child B") own contingent interests in the remainder of the trust fund which is subject to divestment in the form of the advances in favour of Spouse B. If Child A has separated from her spouse, it is possible that her spouse may bring a claim that Child A's interest in the trust fund is property owned by Child A pursuant to subsection 84(1)(a)(i) and though acknowledging that the trust fund qualifies as an inheritance and is therefore Excluded Property (subsection 85(b)), Child A's spouse could seek to divide the growth in value of Child A's interest in the capital of the trust fund during the relationship. Valuing Child A's contingent interest to determine if there has been any growth during the span of Child A's spousal relationship is difficult since capital advances in favour of Spouse B could decrease or completely eliminate the capital. Further, if discretionary trusts are created in the Joint Partner Trust for the benefit of Child A and Child B and their respective issue rather than outright distributions upon the surviving spouse's death, Child A would have no more than a contingent interest to be considered as one of the class of beneficiaries of a discretionary trust and arguably would not have an interest which could be valued with any reliability.

(ii) <u>Example of trusts settled by a third party in the context of an estate freeze</u>

For the purposes of this example, the structure of the particular estate freeze can be summarized as follows:

(a) The original owner (Spouse A) holds the common shares of the operating company;
(b) These shares are exchanged for either preferred shares of the original company or of a new holding company into which the shares of the original company have been rolled;
(c) The preferred shares have a value equal to the current fair market value of the original shares, effectively resulting in no taxable capital gain on the disposition of the original shares;
(d) The future growth, representing the new common shares, can be subscribed for by individual family members or settled into a new discretionary Freeze Trust. The Freeze Trust can benefit the original owner (Spouse A), his or her spouse (Spouse B), his or her children (Child A and Child B), remoter issue (Grandchild A and Grandchild B) or other parties; and
(e) At the Freeze Trust's distribution date (at the end of the common law perpetuity period) the remaining trust fund is appointed to the issue of Spouse A who are then living in equal shares.

Holding the growth shares in a Freeze Trust where Spouse A is likely the trustee or a co-trustee and maintains control of the distributions of both income and capital will often provide comfort for the owner who wants to utilize the flexibility of the tax planning, but is not yet ready to give up control of running the business. Often voting control is retained by Spouse A with a separate class of voting shares held personally or in a separate trust. Spouse A can name anyone as a beneficiary of the trust. In the discretionary Freeze Trust, the income and the capital interests of a beneficiary are contingent on the discretion of the trustee to allocate income or capital to the beneficiary. Thus, Spouse A can ostensibly maintain control over the underlying shares held by the trust and the income attributable to it. In many situations, to avoid undesirable income tax issues, it is recommended that a Freeze Trust has several trustees so that the Canada Revenue Agency does not find that Spouse A has retained sole ownership and control of the trust property.

Spouse A will want to ensure that the Freeze Trust structure is created with a mind to the provisions of s. 84(2)(f), s. 84(3) and also s. 85(f) of the FLA to ensure that the trust property cannot be characterized as property of Spouse A.

Child A is named in the class of potential beneficiaries as one of the objects of the power to advance income and capital from the trust. Therefore, from a trust law perspective, Child A does not own the property in the trust nor does she arguably have a "beneficial interest" in the property. Subsection 85(1)(f) would not capture Child A's interest in the trust fund unless the court dealing with a property division situation for Child A and Spouse D is prepared to find that Child A has some sort of property interest that can be quantified. Based on the cases from other jurisdictions, the court would likely review the intention of the settlor when creating the trust, look to the control and management of the trust, see whether Child A had any control or influence of the discretion of the trustee or trustees and consider the historical distributions made by the trustee or trustees when exercising his or her discretion. The court may also consider the number of potential beneficiaries if the judge was attracted to the pro-rata analysis which has led some planners to consider including large pools of potential beneficiaries when designing discretionary trusts.

The remainder beneficiaries of the trust (potentially Child A and Child B, Grandchild A and Grandchild B and other remoter issue including unborn issue) own either an interest in the remainder contingent on each being alive at the distribution date (possibly property for the purposes of subparagraph 84(1)(a)(i)) but subject to divestment as a consequence of advances being paid to others of the class of potential beneficiaries prior to the distribution date; the property value of each remainder beneficiary's interest is likely excluded under subparagraphs 85(1)(a), (b) and (c) of the FLA as being acquired before the relationship began and being a gift or inheritance. The quantification of any growth in the value of such Excluded Property is likely impossible to calculate from a practical perspective.

E. Conclusion

As previously noted, until we have our own decisions in British Columbia applying the trust provisions of the FLA, planners will need to advise clients of the various potential approaches that the courts may take when faced with property division decisions in British Columbia and the valuation of these "beneficial interests".

Subsections 84(2)(f) and 84(3) of the FLA should be discussed and carefully considered where a client is the settlor of the trust. Where such settlor is also to be a beneficiary, the only way for the trust property not to be exposed is where the underlying property is excluded at the outset (e.g. it exists prior to the relationship or is a gift or inheritance) or if the spouse has no vested interest and is not permitted to act as a trustee or revoke the trust.

If the trust is settled after the commencement of the relationship, with non-Excluded Property, the settlor-spouse should have no control as trustee (even with another) as to the disposition of the funds even if the settlor-spouse is not a possible beneficiary.

Transparency and approval of the spouse is also key.[9] If the settlor retains dispositive control, the property may be exposed pursuant to subsection 84(2)(f) of the FLA. A marriage agreement could be of critical use in any plan as the settlor's spouse can agree to the terms of the trust. The operation of subsection 84(2)(g) of the FLA could result in the division of any increase in the value of Excluded Property unless the spouses have agreed otherwise in their marriage agreement.

The underlying trust property of a trust settled by a third party, is excluded in its initial value as a gift or inheritance pursuant to section 85. Where the trust structure is fully discretionary, there is a strong argument that the potential beneficiaries do not have a property interest but merely a hope that the trustee will consider them; a hope which cannot be quantified until actual property is received. Evidence of the settlor's intention, such as a Letter of Wishes, may also be relevant in these

[9] See *Mawdsley v. Meshen*, 2012 BCCA 91, for a consideration of trust planning where the spouse settled an *inter vivos* trust which effectively depleted her estate for her spouse. A key finding at the trial level involved an analysis of the spouse's involvement and awareness of the planning.

circumstances along with the level of control that a potential beneficiary exercises over the disposition of the trust fund. To bolster protection, the settlor may wish to limit which of the beneficiaries may be named as trustees or prohibit a potential beneficiary from acting as a trustee. Planners may want to consider whether the particular powers reserved for the protector add support to an argument that the protector is controlling the trust funds.

When acting, the trustees may wish to consider using an erratic pattern of distribution where there is concern that the history of past distributions will be considered for family law property division purposes.

While it remains somewhat unknown as to how the judicial application of subsections 84(2)(f) and 84(3) of the FLA will evolve as the cases come before the judges, planners and clients alike should remain positive in regard to the benefits of prudent trust planning. To the extent possible a balance should be struck between planning for marital breakdown and flexibility for use by the client's intended beneficiaries.