Dynastic dynamism

Richard Niedermayer addresses the tax and non-tax considerations for dynastic trusts established under the law of Nova Scotia, Canada

> **KEY POINTS**
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> **WHAT IS THE ISSUE?**
> Drafters of dynastic trusts must consider various tax and non-tax issues, and provide flexibility for future trustees and beneficiaries.
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> **WHAT DOES IT MEAN FOR ME?**
> Abolishment of the rule against perpetuities in Nova Scotia creates opportunities for multigenerational dynastic trusts governed by Canadian law.
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> **WHAT CAN I TAKE AWAY?**
> Clients in jurisdictions that still have the rule can consider using Nova Scotia law to create dynastic trusts without Canadian taxation.

In July 2013, the Nova Scotia *Perpetuities Act* abolished the rule against perpetuities in the Canadian province. This was not merely a change to the 'wait and see' approach that exists in other jurisdictions, but a true abolishment of the rule, subject to the overriding discretion of the court to supervise trusts on the application by interested parties under the Nova Scotia *Variation of Trusts Act*, as amended in 2013.

Multigenerational, non-charitable trusts are now possible in Nova Scotia, and can last an indefinite number of generations, as long as there is a bloodline or other class of beneficiaries that is discernible with certainty. This means that a broad and diverse group of beneficiaries could benefit from trusts established hundreds of years earlier by predecessor family members, creating planning and drafting challenges today.

Though the cost of operating such a trust over many generations means that the starting capital of that trust must be relatively high, the amount required to make such a trust economically viable may not be as large as many might believe. The fees and expenses charged against the trust property should be weighed against the expected rate of return on invested capital and tax leakage.

A FLEXIBLE TOOL

The primary drivers of trust planning include both tax and non-tax reasons. However, in the multigenerational 'dynastic' trust realm, tax is something to be mitigated, not enhanced.

A dynastic-type trust brings a number of advantages:

- preservation of capital over generations – this is the primary, overarching goal of such planning;
- protection for beneficiaries from creditor claims, including matrimonial creditors (a trust structure often provides better protection than prenuptial agreements);
- avoidance of probate and land-transfer taxes on assets that pass from generation to generation;
- privacy for beneficiaries; and
- ease of administration when assets pass from one generation to the next.

One significant drawback to such trusts is the 21-year rule applicable to Canadian resident trusts, which deems a disposition of trust property every 21 years, thereby triggering capital gains tax. In a dynastic trust context, the trust property would generally

comprise some combination of liquid and illiquid assets. To the extent that there is sufficient liquidity in the trust to pay the capital gains on the illiquid assets, those assets need not be sold, and can be held for generations. This may apply to the family estate or summer home, other real estate holdings, private company shares or public company shares of a family-controlled business. If the trust comprises solely liquid assets in the form of marketable securities, the 21-year rule can be managed by an actively traded portfolio that spreads out capital gains over each 21-year period, rather than having a tax crunch occur at the 21-year mark.

Though the annual income of the trust would be taxable at the high Canadian tax rate (approximately 50 per cent, depending on the province) in the province of residence of the trust, if it is paid or payable to beneficiaries (a typical hallmark of a generational dynastic trust), the trust would obtain a deduction for that amount.

DRAFTING CHALLENGES

A client interested in setting up such a trust must consider carefully many planning points, and the drafter must capture those points properly. What about children conceived by artificial means through egg donors, sperm banks or frozen embryos – are they in the class? A related issue is adopted children. Given the prevalence of divorce and subsequent remarriage (and adoption), does the settlor wish to include or exclude adopted children from second or third marriages? The choices in crafting the class of beneficiaries are, if not limitless, profound.

Will the trustees have flexibility to adapt to changing circumstances in law and society, without the need to resort to the courts? Should spouses of family members be included?

A well-drafted amendment clause in the trust can address many of these challenges, but Canadian tax concerns for a Canadian-resident trust arise if the amendment power includes the ability to change beneficial interests. Additional powers in respect of change of jurisdiction and even full trust distribution may be appropriate. Is there a role for a trust protector in this context, and, if so, how would protectorship be transferred over time? Do you draft squarely into the even-handed rule or give flexibility to the trustees to ignore it? Presumably, even-handedness is exactly what is required in a dynastic trust, perhaps with a bias toward capital preservation instead of income distributions.

Another major issue is choice of trustee. A professional trust company provides continuity and a degree of permanence in trusteeship. The trust should provide that the majority of the adult, competent beneficiaries can change the corporate trustee, should that be warranted. Alternatively, a process for the beneficiaries to nominate family members to act as trustees may be workable, provided investment management services are delegated to an independent professional.

Bespoke dispute-resolution mechanisms may also be appropriate in such a trust. Although Canadian domestic trusts do not typically have private arbitration or mediation provisions for disputes that arise among the trustees, or between the beneficiaries and the trustees, given the nature of a dynastic trust, they may be appropriate.

A non-binding letter of wishes to the trustee from the settlor will also be of assistance; but, given the expected lengthy lifespan of the trust, the letter must, by necessity, be broad. Future tax law, family dynamics, and global geopolitical and societal situations will be difficult to predict on settlement. However, broad concepts, such as favouring capital preservation over all else, will be helpful to future trustees.

JURISDICTIONAL OPPORTUNITIES

Does the abolishment of the rule against perpetuities in Nova Scotia provide opportunities for non-Nova Scotia residents to implement a dynastic trust in Nova Scotia? A properly drafted choice-of-law and forum clause should work to have Nova Scotia law apply to a trust of personalty with a non-Nova Scotia settlor, trustee and/or beneficiaries.

The *Hague Convention of 1 July 1985 on the Law Applicable to Trusts and on their Recognition* (the Convention) has been enacted by statute in Nova Scotia's *International Trusts Act*. The Act deals with both interprovincial and international conflict-of-laws situations. If a conflict of laws arises from a jurisdiction outside Canada, a Nova Scotia court will typically defer to Nova Scotia law under art.6 of the Convention. Likewise, Nova Scotia law and the abolition of the rule against perpetuities can apply in other jurisdictions where the Convention is in force, even if the rule against perpetuities has not yet been abolished in that particular jurisdiction.

This can allow Canadians not resident in Nova Scotia and non-residents of Canada opportunities for dynastic planning that may not exist in their own jurisdictions. For example, an 'offshore' trust administered outside Canada, with a Canadian transnational trust company as trustee, may choose Nova Scotia law to apply even if the trustee is incorporated in a different Canadian province. Further, as long as 'central management and control' of the trust is exercised outside Canada and the trust is not otherwise deemed a Canadian-resident trust under the *Income Tax Act*, the trust will not be subject to tax in Canada on its non-Canadian income. This may be attractive to clients who want the protection of a Canadian trust, but without taxation in Canada.

Though a dynastic multigenerational trust would not be appropriate for most clients, many are now considering the extent to which they wish to preserve a family legacy for the future. The issues (tax and non-tax) are complex, but a creative planner and a motivated client have the opportunity to create a customised solution.

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