Using a Trust as a Unilateral Marriage Contract [1]

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An increasingly common problem facing planners is how to deal with the conflict between family law and income tax. In many cases, the tax tail wags the personal planning dog, producing acceptable tax results but at some cost to personal planning. In other situations, personal wishes prevail, resulting in potentially adverse tax consequences for the beneficiaries of the planning. A recent Ontario Court of Appeal decision may provide some relief for the fortunate few with valuable homes.

For those individuals who are contemplating a second marriage (and a second family) an important consideration is how to protect original family assets for the benefit of family members of the first marriage (the “first family”). One solution may be a pre-nuptial agreement; but this may become an emotional and political minefield. However, we may now be able to use a trust to effectively create a “unilateral pre-nup” or one-sided marriage contract to limit the application of family law rules on marriage breakdown, and also limit adverse tax consequences, all for the benefit of the first family.

In *Spencer v. Riesberry*[2] the Court of Appeal was asked to consider whether a property owned by a family trust, in which one of the trust beneficiaries (“Sandra”) resided, was a “matrimonial home” for the purposes of the Ontario *Family Law Act* (FLA). By concluding it was not, the Court of Appeal opened the doors for planning for second (or subsequent) marriages. The effect of the Court of Appeal´s decision is to exempt the property from the equalization regime in the FLA; however, the interest in the trust still has to be valued, and any appreciation in value during the marriage will be included. In other words, if the property was worth $1,500,000 at the time of marriage but was worth $2,200,000 at the date of separation, the latter value would be excluded from the calculation of family property, and only the beneficiary´s interest in the trust (which would generally include a pro rata portion of the $700,000 appreciation in value, based on the number of beneficiaries) would be caught.

In this case, the mother (“Linda”) purchased a property in 1993. On the same day, she executed a trust agreement in which she established the Spencer Family Realty Trust (SFRT) in favour of herself and her four children. Linda was the trustee. The preamble to the SFRT stated that Linda had purchased the property in trust for the benefit of herself and her four children. The SFRT defined the trust property as the original property plus any additional property that might be contributed. It also provided that any distribution pursuant to the trust agreement was not to form part of the recipient´s net family property (the “Proviso”). Linda retained a life interest in the trust property during her lifetime, and on her death the trust property was to be divided into equal shares for the children alive at her death.

The first property was purchased for Sandra who married Derek Riesberry (“Derek”) in 1994. They did not pay rent but did pay taxes, insurance, utilities and maintenance.

In December 2005 the trust agreement was amended to change the trustee from Linda to her three daughters (including Sandra).

At various times Linda purchased three other properties and contributed them to the SFRT. Just as Sandra and her family were permitted to live in “their” property, so too each of Linda´s other three children and their families were permitted to live in one of the other trust properties.

Sandra and Derek separated in August 2010, and Linda gave them notice to vacate their home, as she intended to take possession. Derek and one child vacated, but Sandra and the other child remained in the home.

Derek raised questions about Sandra´s interest in the home in the course of their divorce proceedings. After some procedural wrangling, the matter came to trial, and the trial judge made four findings:

1. The property was not a matrimonial home for the purposes of the FLA;
2. The Proviso was a condition subsequent that was void for uncertainty (and so ineffective in excluding the value of any trust property from the calculation of net family property). This finding was not appealed by Sandra; the Court of Appeal commented "nothing in these reasons is to be taken as approving this aspect of the decision" – which may leave the interpretation of such a clause for another case;
3. Sandra´s interest in the SFRT was an asset for the purposes of the FLA; and
4. An evaluation of that interest was required for the purposes of the equalization calculation under the FLA.

Derek appealed only the first finding above (since the other three were to his benefit). The trial judge concluded that Sandra had a contingent beneficial interest in the SFRT "whatever that might be on the death of Linda." Therefore, he concluded, she did not have an "interest" in the property within the meaning of the FLA, so that it could not be a "matrimonial home" and hence its value was excluded from the equalization calculation. However, she still had an interest in the SFRT which had to be valued. The Court of Appeal agreed with the Trial Court decision and dismissed Derek´s appeal.

So how can planners use this case? Consider the situation where Mother has inherited a property which has been in her family for generations. She wants the property to go to the children of her first marriage on her death. She is now contemplating a second marriage, to a man with substantially fewer assets. She wants to ensure her family property is protected and cannot be exposed to claims of her future husband´s family. She also wants to avoid the conflict inherent in a pre-nup. In such circumstances, Mother´s advisers might suggest that she create a "First Family Trust," the beneficiaries of which are one or more of her children from her first marriage (depending largely on their ability to claim a principal residence exemption, and the availability of other assets to equalize an ultimate distribution of her estate), and their issue (to create a contingency). Mother would shelter the gain on the disposition of the property to the trust with her principal residence exemption. She and her children could be the trustees and could allow Mother to occupy the property (so Mother would have no "interest" in the property for FLA purposes). So long as Mother does this before her marriage, her future husband has no right to prevent this planning and the property will be safely beyond the reach of her new husband and his family (or creditors). Her personal planning goal has been realized.

Trusts similar to that created in the *Spencer* case can be used to protect interests of children from FLA claims of their spouses.

Careful drafting of the trust documents will be required. In addition, a number of tax issues will have to be discussed, including use of the principal residence exemption by beneficiaries of the trust and the attribution/roll-out rules. However, we may finally have a solution to allow the personal planning dog to stop the tax tail from wagging.

About the Author

Robin MacKnight, LLB, TEP, is a Partner with Wilson Vukelich LLP and has practised tax for over 30 years. He has advised clients in most sectors of the economy, from small start-ups to established family firms to multinational public companies. He has been actively involved in the resource sector, and in employee buyout and business
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Endnotes

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