

Family Law and the Treatment of Discretionary Trust Interests on Marital Breakdown

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Discretionary trusts are common estate planning tools used for various reasons such as tax minimization (e.g., as part of an estate freeze and for income-splitting) and general wealth protection, including creditor protection.

The trustees of a fully discretionary trust generally decide whether or not to pay trust income or capital to any or all beneficiaries, as well as when and in what amounts. Traditional trust law holds that a person named as the object of a trustee's discretion—to whom the trustee can choose to make distributions but is under no obligation to do so—has only an “expectancy” and a right to be considered as a potential beneficiary when the trustee exercises discretion in making distributions. An expectancy is not considered an existing property interest under trust law.

Nevertheless, matrimonial courts in recent years in certain Canadian jurisdictions have not only held that an interest in a discretionary trust is property for the purpose of dividing assets between spouses on matrimonial breakdown, but have also in some cases attached significant value to these interests.

For example, in several cases Ontario family law courts have found that a spouse's interest in a discretionary trust is “property” under the *Family Law Act* (FLA), and have included the value of the interest in the beneficiary spouse's net family property (NFP) when calculating each spouse's NFP and determining the amount of an equalization payment. While this conclusion may be questionable based on the definition of property under the FLA, it appears to align with the overall objectives of the FLA.

Recent British Columbia legislation now expressly includes certain discretionary trust interests among the

pool of assets subject to division on marriage breakdown. Similar shifts in courts' treatment of discretionary interests have occurred in other common law countries such as the UK and Australia, while other jurisdictions (including many U.S. states) generally tend to continue to take a more conservative stance and exclude discretionary trust interests, including by statute, from matrimonial property division.

In the Canadian context to date, no formal methodology has been developed in the case law or by statute to reliably calculate the value of a discretionary interest. Courts typically rely on the valuation concept of “value to owner” as a more equitable approach than “fair market value”. Value to owner focuses on what a spouse would pay to not lose his or her discretionary interest

in the trust rather than what an arm's length third party would pay to acquire the interest.

This approach is not easy to apply because there are many factors to consider, including the extent of control the spouse exercises over the trust, whether distributions to the spouse would be contrary to the purpose of the trust, and the past history of trust distributions to the spouse and other beneficiaries.

Moreover, if a significant value is assigned to a spouse's discretionary trust interest, he or she may be unable to make a monetary payment without receiving a distribution from the trust. If the spouse does not control the trust, hardship could ensue if the spouse has to use all of his or her other assets to make the payment. Conversely, hardship may result for the other spouse as he or she may have a right without a remedy if the beneficiary spouse does not have sufficient other assets to make a monetary payment.

These issues are emerging but not well developed in Canadian case law, creating sometimes unexpected and undesired results on marriage breakdown. Given the complexity and uncertainty of discretionary trust interests' treatment in the matrimonial setting, three considerations come to mind:

Proper trust law advice is necessary during the planning and drafting stage of a discretionary trust agreement in light of recent case law and statutory developments with regard to property division on matrimonial breakdown.

Treatment of discretionary interests during marital breakdown should involve expert family law and trust law advice, and where required, professional valuations based on actuarial evidence to employ a sound methodology and set of guidelines in responding to the valuation question.

Discretionary trust beneficiaries should consider domestic contracts to deal with their trust interests, including where appropriate excluding them from property division.

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