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Marmer Penner Inc. Newsletter

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TRUST VALUATION ISSUES: A PRIMER

For most of our readers, it is not news that an interest in a trust is property for the purposes of determining net family property ("NFP") in Ontario. Decisions by Ontario courts have confirmed that property includes contingent assets such as trust interests. It is commonly accepted that the valuation basis for most components of NFP is "fair market value". However, as trust interests cannot be sold, they cannot have a *fair market value*, per se, because the definition of fair market value is "the highest price available in an open and unrestricted market between informed and prudent parties, acting at arm's length and under no compulsion to transact, expressed in terms of cash".

One cannot easily envision a Bronfman family member trying to sell a discretionary interest in a family trust on the open market. Accordingly, in these cases, the courts have relied on *value-to-owner* instead of fair market value as the appropriate definition of value. Value-to-owner is defined as the value of an asset to its owner, that is, the amount an owner would pay not to lose the asset. While the young Bronfman family member could not sell his discretionary interest in his family's trust to you, he would certainly pay quite a bit to avoid being cut out of the family's fortune.

When valuing a trust interest, or the en bloc value of a trust, it is imperative to remember that a trust is taxed as an individual and may have contingent income tax liabilities on its accrued but unrealized income.

A trust can hold many different types of assets, such as incorporated and unincorporated business interests or marketable securities. In this sense, a trust is similar to an individual or a corporation. Virtually anything a spouse can hold at V-Day as indicated on a Form 13.1 can also be found held by a trust including the requirement to calculate the present value of contingent income tax and other disposition costs. If a trust has only one beneficiary, there would not be any difference between the trust valuation and any other type of valuation.

In most cases, the beneficiaries of a trust are not clearly laid out and various rights and interests complicate matters. Some variables that impact the value of a trust interest include the following:

a) Vested interest versus unvested interest;

b) Sole interest versus joint interests;

c) Capital interest versus income interest; and

d) Discretionary interest versus non-discretionary interest.

Interests in a trust can be vested or unvested. For example, Thurston Howell II can settle a trust for the benefit of his son, Thurston Howell III. If there are no other beneficiaries, the trust interest has vested immediately after settlement. Conversely, if young Thurston is entitled to the trust interest only if he survives his father, then the interest does not vest until that expected date in the future. As a result, an actuarial adjustment may be required when determining the value of this contingent interest.

Interests in a trust can be sole or joint. If Thurston and his brother, Harry, were both discretionary beneficiaries of their father's trust, each one's interest could be worth anywhere from effectively 0% to 100% of the trust's total value. The only certainty is that their combined interests are worth 100% of the trust value.

Interests in a trust can be restricted to a capital or income interest. It is common to see a trust where a widowed spouse is entitled to its income but the children are the capital beneficiaries. In valuing an income entitlement, one must estimate the income stream and the life expectancy of the recipient. In valuing the capital beneficiaries' interests, one must remember that the aggregate of the values of the capital and income interests cannot exceed the value of the trust at V-Day. One must also review encroachment rights of an income beneficiary as this reduces the value of a capital beneficiary's interest.

The terms of a trust may spell out specifically to what each beneficiary is entitled or it may be left to the discretion of the trustee(s). If it is a discretionary trust interest, the determination of value becomes more complex.

Trusts have offered tax and estate lawyers a host of flexibilities to achieve client goals. Now they offer matrimonial lawyers and accountants a host of difficult issues with which to contend.