



DANIEL FRAJMAN EXAMINES THE MAJOR PRIVATE- AND TAX-LAW ASPECTS OF THE THREE VEHICLES OF TRUST, SUBSTITUTION AND USUFRUCT IN QUEBEC

➔ KEY POINTS

WHAT IS THE ISSUE?

Quebec's civil-law system does not recognise a division between legal and beneficial ownership, but allows for various restrictions on the right of ownership, such as usufruct and substitution, and for a trust without legal-beneficial ownership.

WHAT DOES IT MEAN FOR ME?

Practitioners should consider whether it is appropriate to use a trust, usufruct or substitution, based on the differentiating features of each.

WHAT CAN I TAKE AWAY?

How the three vehicles of trust, usufruct and substitution are handled by Quebec's civil-law system.

UNLIKE ALMOST ALL of North America, Quebec has a predominantly civil-law system. Although, it appears, non-Quebec trusts from a common-law jurisdiction generally can own property and operate in the province free of its internal law on trusts,¹ the *Civil Code of Quebec* (CCQ) does not recognise a division between legal and beneficial ownership for trusts governed by internal Quebec law. Rather, it defines 'ownership' as 'the right to use, enjoy and dispose of property fully and freely', and 'trust' as a 'patrimony by appropriation, autonomous and distinct from that of the settlor, trustee or beneficiary and in which none of them has any real right' or right *in rem*. Indeed, other 'dismemberments' and restrictions to the right of ownership, such as usufruct and substitution, were included in the first CCQ in 1866, with trusts added 20 years later. I will examine the respective features of each vehicle under the CCQ.

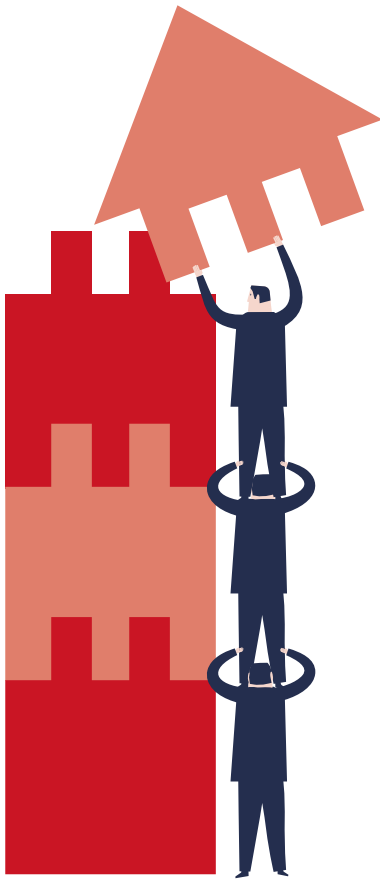
Each of the three vehicles is, in many situations, neutral from an income tax point of view; the Canadian federal *Income Tax Act* (ITA) and its Quebec equivalent provide that the taxation rules for trusts are applied to usufructs and substitutions as if they were trusts.

Since 1994, the CCQ has obliged trusts to have at least one trustee who is not a settlor or beneficiary of the trust (essentially, an independent trustee) – an uncommon requirement in North America. This has led to interpretative difficulties as to whether trustee independence is determined objectively (that at least one trustee must not be a present or future beneficiary) or subjectively (that at least one trustee must not be related to the beneficiaries),² and the penalty for breach of this requirement. The general view is that the lack of an independent trustee does not nullify the trust itself, but rather actions undertaken by the trust until a suitable appointment is made.

To avoid such difficulties, can a usufruct or substitution sometimes be used instead of a trust?

USUFRUCT

Like a trust, a usufruct can be established either by onerous (with 'cause', similar to consideration) or gratuitous (*inter vivos* gift) contract, or by will. The essence of usufruct is that it provides the usufructuary with a right of use and enjoyment for a certain time over



property (including a right to the fruits and revenues produced) owned by another (the bare owner), who has – subject to the usufructuary's rights – the power to sell the property. No trustee is required, obviating any interpretative question of independence.

Usufruct is, in fact, often called a right of use, such as when used to allow the enjoyment and use of a family home. Here, the user is required to maintain the property and is responsible for the other usual charges, such as insurance. A prime use of usufruct is when residential real estate is to be in the hands of a user for a period of time.

If creditor protection is relevant, a usufruct may be problematic, as the usufructuary holds rights seizable by creditors, subject to the right of the bare owner. The Supreme Court of Canada has, however, observed that the rights of a trust beneficiary similarly are not always entirely shielded from creditors.³

SUBSTITUTION

In a substitution, ownership lies with a first rank of beneficiary (the 'institute') and then with one or two ranks of 'substitutes'. Like with a usufruct, no trustee – let alone an independent one – is required. Unlike a trust or usufruct, a substitution can be established only by *inter vivos* gift or by will.

Under the CCQ, the institute must 'act with prudence and diligence, having regard to the rights of the substitute'. The institute will have a right to income (unless stipulated otherwise) and must preserve the capital, not encroaching on it or disposing of the property for less than fair market value, unless these are specifically provided for. Substitution with encroachment is called a residual substitution, and was recognised recently by the Quebec Court of Appeal.⁴ The institute may change the substance of the capital, unless provided otherwise.

As with a usufruct, creditor protection under a substitution may be an issue, given that the institute, while its right is in effect, is seen as the owner of the property. Another downside is that, although it is possible to have several institutes or substitutes in a particular rank, there is no power to appoint the institutes – i.e. no discretion to choose who will benefit (though there is a power to appoint at the substitute rank from a list of possible substitutes). This can hinder the use of substitution in estate planning (for example, in 'estate freezes'), but should not affect frequent situations such as the typical 'spousal trust', where a power to appoint in the first rank is not relevant. Therefore, an important use of substitution is when investment assets (including securities, real estate, etc) are to pass among ranks of users, but there is no need for a power of appointment in the first rank.

A substitution is a deemed trust under the ITA, and so several basic trust tax concepts apply:

- The institute is deemed to be both a trustee and beneficiary under the tax trust.⁵
- Revenues paid or payable to the institute are taxed in the hands of the institute.
- Trust tax returns are due by the substitution within 90 days of year-end.
- Unless an exemption is provided for (such as for 'spousal substitutions'), there is a deemed disposition of capital assets in the substitution every 21 years.
- The institute or the institute's estate should obtain tax clearance

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or distribution certificates before transmitting property to substitutes.⁶

- The spousal trust (in which the spouse is entitled to all income and, while alive, alone has a right to income or capital), with its tax deferral, appears to fit with the substitution.⁷
- Real estate in the substitution is subject to the same Quebec provincial land-transfer tax rules as real estate held in trust.⁸

CONCLUSION

Practitioners should note that in at least one North American jurisdiction, Quebec, the civil-law vehicles of usufruct and substitution are alive and well, and ready to be used in appropriate circumstances instead of a trust – especially if the independent trustee rule of the Quebec trust is meant to be avoided. This is a good example of how different legal systems can work together with a large degree of coherence.

¹ Although Quebec has not ratified the *Hague Trust Convention*, that treaty's conflict rules are essentially included in the CCQ ² *CT v D.J.*, 2009 QCCA 2460 for the objective view, and *Graham v Boyer-Richard*, 2004 CanLII 20712 (QSC) for the subjective view ³ 'The trust argument [regarding creditor protection] is, to a certain extent, a mirage. The [property on trust] may not be seized to pay the debts of... the beneficiary because the property does not belong to [the beneficiary]. However, the patrimonial rights of the beneficiary... under the trust contract, like any personal patrimonial right, are seizable' (*Bank of Nova Scotia v Thibault*, 2004 SCC 29) ⁴ *Boudreault v Boudreault*, 2015 QCCA 1781 ⁵ CRA Technical Interpretation 9709555F (1997) ⁶ ITA, s159(2); *Quebec Tax Administration Act*, s14 ⁷ CRA Technical Interpretation 0432201E5 (2012) ⁸ *Quebec Act Respecting Duties on Transfers of Immovables*, s20



DANIEL FRAJMAN TEP IS A PARTNER AT SPIEGEL SOHMER ATTORNEYS, AND BRANCH CHAIR OF STEP MONTREAL