



VALUATION ISSUES IN ESTATE PLANNING AND FAMILY LAW

DISCRETIONARY TRUSTS

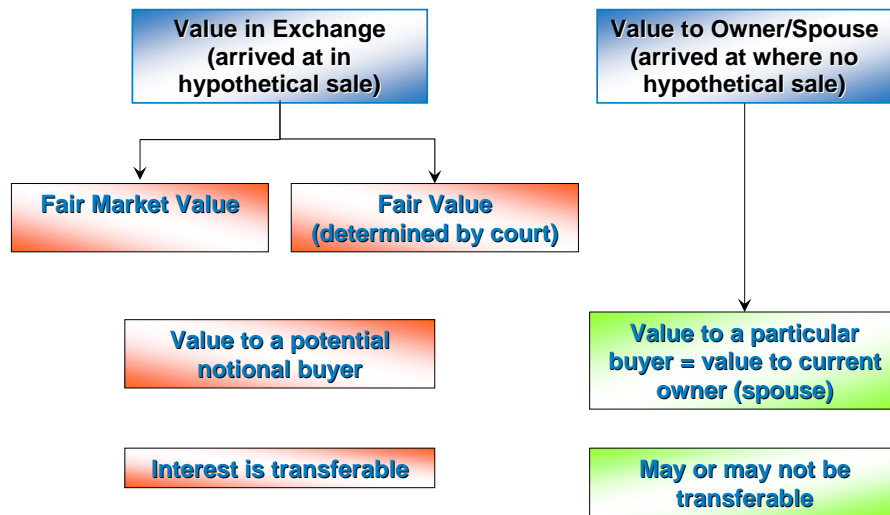
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STANDARDS OF VALUE — MATRIMONIAL



STANDARDS OF VALUE

Income Tax Act: Fair Market Value “Objective” Standard

- “The highest price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm’s length in an open and unrestricted market, when both have reasonable knowledge of the relevant facts”
- Value in Exchange

Matrimonial: Value-to-Owner “Subjective” Standard

- Value to a particular owner or beneficiary (e.g., spouse)
- The price that an owner of an asset (spouse) would pay not to be deprived of it (e.g., amount beneficiary of trust interest would pay not to be deprived of it)

Value-to-Owner

“ ... what would [the owner], as a prudent man at that moment pay for the property rather than be ejected from it?”

Diggon-Hibben v. King (1949) SCR 712

■ ■ ■ □ RISK

“Degree of uncertainty as to realization of expected future economic benefits (e.g., cash flow).”



■ ■ ■ □ PRESENT VALUE CALCULATION

- **Identifiable income stream with scheduled payment dates and entitlement to capital at future point can be quantified**
- **Discounts/risk factors are applied for contingencies and/or uncertainties**
- **Judgment: Appropriate rate of return applied and actuarial evidence re contingencies**

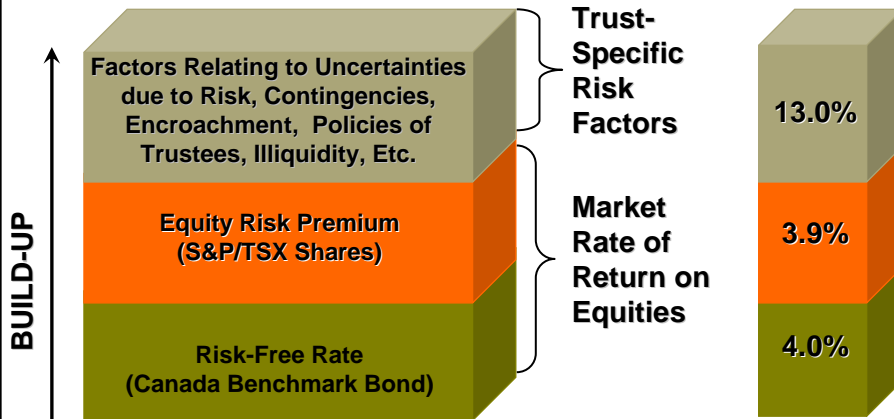


DEVELOPMENT OF DISCOUNT RATE (RATE OF RETURN)

(TRUST OWNING STOCK PORTFOLIO)

Required Return to
Capital Beneficiary

BUILD-UP METHOD

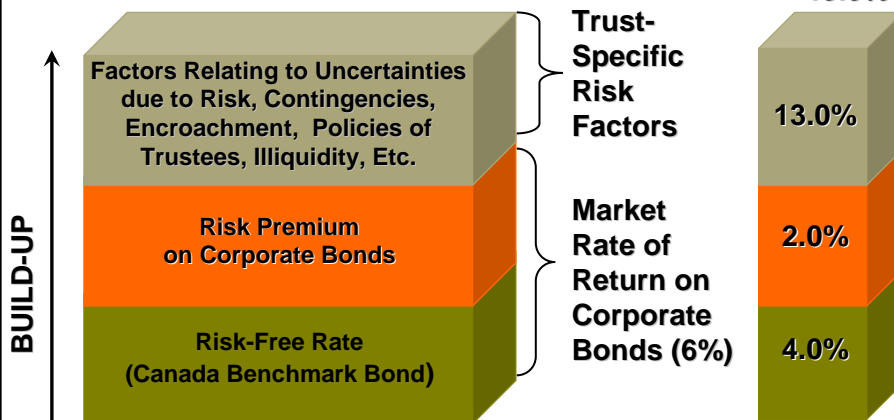


DEVELOPMENT OF DISCOUNT RATE (RATE OF RETURN)

(TRUST OWNING BOND PORTFOLIO)

Required Return to
Capital Beneficiary

BUILD-UP METHOD





CAPITAL INTEREST vs INCOME INTEREST

- **Income Interest**
 - Entitled to all or a portion of income generated periodically by assets of trust
- **Capital Interest**
 - Entitled to all or a portion of trust assets, but amount(s) and timing of distribution may not be readily determinable; does not include an income interest



TRUST INTERESTS

VESTED vs UNVESTED

- **Vested**
 - Interest no longer dependent on satisfying specified requirement (e.g., reaching certain age or surviving another beneficiary)
- **Unvested**
 - Dependent on satisfying a specified requirement (e.g., reaching certain age or surviving another beneficiary)

■ ■ ■ □ TRUST INTERESTS (CONT'D)

**ENCROACHMENT RIGHTS OF
INCOME BENEFICIARY**

- Right to receive capital based on income beneficiary's needs and judgment of trustee(s)
- Such encroachment rights
 - a. Increase value of income beneficiary's interest in trust; and
 - b. Decrease value of capital beneficiaries' interests

■ ■ ■ □ ENCROACHMENT RIGHTS
EXAMPLE

- Surviving spouse may:
 - a. Receive assets bequeathed on a tax-deferred basis
 - b. Live off income generated by trust's assets (with capital enuring to next generation); and
 - c. Have ability to encroach on capital in case of family emergency, economic difficulties, health care



CONTINGENT BENEFICIARIES (EXAMPLE)

- **Inter-vivos trust**
 - **Settled by parents**
 - **Beneficiaries: children**
 - **Grandchildren become beneficiaries if child pre-deceases both parents**
 - **Contingent beneficiaries:**
 - a. **Unborn children**
 - b. **Grandchildren**
 - c. **Unborn grandchildren**



VALUATION ISSUES CONTINGENT BENEFICIARIES (CONT'D)

- **Dependent on future event**
- **Valuation (present value) of respective interests of beneficiaries:**
 - **Present value of potential “entitlement” of contingent beneficiaries based upon actuarial input (and actuarial reserve)**
 - **After-tax value in case of “21-year rule” (deemed disposition)**

■ ■ ■ □ TRUST INTERESTS

DISCRETIONARY vs NON-DISCRETIONARY

- If only one beneficiary entitled to all income, valuation must nonetheless consider how assets are invested
- If investments in government and corporate bonds and publicly-traded shares: amount and timing of future income might be unclear

■ ■ ■ □ VALUATION OF INTERESTS IN NON-DISCRETIONARY TRUST

- Value of income beneficiary's interest = present value of future income stream, discounted for time-value, contingencies, risks and taxes
- Value of capital beneficiary's interest = total value of trust less *income* beneficiaries' interests, adjusted for risks, contingencies, illiquidity, etc.



VALUATION OF INCOME INTEREST IN NON-DISCRETIONARY TRUST (CONT'D)

- **More difficult if trust's assets include portfolio of cash, fixed income securities, public and private equity shares, rental property (and asset-mix varies)**
- **Relationship between/among income beneficiaries and capital beneficiaries (and trustee) can present difficulties. Possible bias of trustee(s) toward investing in capital (growth assets)?**



VALUATION OF INCOME INTEREST IN NON-DISCRETIONARY TRUST (CONT'D)

FACTORS TO CONSIDER

- **Beneficiary's life expectancy**
- **Composition of trust's assets**
- **Estimate of rate at which income will be generated by trust capital**
- **Estimate of timing of income distributions/receipts**
- **Estimate of quantum of income distributions**
- **Rate of return required to present-value future after-tax cash generated**



VALUATION OF INCOME INTEREST IN NON-DISCRETIONARY TRUST (CONT'D)

FACTORS TO CONSIDER (CONT'D)

- **Income taxes beneficiary must pay on trust income**
- **Contingencies (surviving relative(s))**
- **Financial resources of beneficiary**
- **Encroachment rights of other beneficiaries (income and capital) and history of encroachments**



VALUATION OF CAPITAL INTEREST IN NON-DISCRETIONARY TRUST (CONT'D)

- **Starting point: Future value of capital, determined as function of**
 - **Asset mix**
 - **Expected appreciation rate(s)**
 - **Expected annual rate(s) of return**
 - **Expected total capital to be distributed to beneficiaries**
 - **Expected date(s) of distribution**
 - **Expected capital distributions to other beneficiaries**
- **PV = lump sum amount that beneficiary would accept as of valuation date rather than await future receipt of funds**
- **Apply (as appropriate) discounts for:**
 - **Contingencies (e.g., surviving relative)/actuarial data**
 - **Legal costs, etc.**
 - **Lack of marketability**



CASE LAW — MATRIMONIAL

(EXAMPLES)

<i>Case</i>	<i>Type of Trust</i>	<i>Valuation</i>	<i>Type of Interest</i>	<i>Valuation</i>
<i>Brinkos</i> (Ont.)	Non-discretionary	Fair Value	Income	PV of future cash flows to owner for relevant period
<i>DaCosta</i> (Ont.)	Non-discretionary	Fair Value	Capital	Beneficiary's interest in future value of trust capital
<i>Sagl</i> (Ont.)	Discretionary	Fair Value	Contingent Capital and Income	Deemed realization pro-rata on relevant dates



VALUATION OF INTEREST IN DISCRETIONARY TRUST

- **Family law courts have used:**
 - “if-and-when” approach
 - **deemed realization at V-day (i.e., full value)**
 - **present value of future cash flows to beneficiary and/or capital distributions**



VALUATION OF INTEREST IN DISCRETIONARY TRUST (CONT'D)

FACTORS CONSIDERED (CONT'D)

- **Fiduciary powers of trustee(s)**
 - **General power**
 - **Special power**
 - **Intermediate/hybrid power**
 - **Mere power**
 - **Trust power**
- } Valuator will often consult with counsel



VALUATION OF INTEREST IN DISCRETIONARY TRUST (CONT'D)

FACTORS CONSIDERED

- **Settlor's overall intentions/income tax or estate plan**
- **Composition of trust capital**
- **Value of trust capital**
- **Assumed rates of return on trust capital**
- **Trustee(s)**
- **Obligations of trustee(s) as specified by settlor/testator**
- **Possibility of change of trustee(s)**
- **Relationship between beneficiary(ies) and trustee(s)**



VALUATION OF INTEREST IN DISCRETIONARY TRUST (CONT'D)

FACTORS CONSIDERED (CONT'D)

- **Likelihood of trustee(s) exercising power in favour of certain beneficiaries**
- **Obligation of trustee(s) to maintain even hand *vis-à-vis* all beneficiaries**
- **Number of beneficiaries**
- **Rights of other beneficiaries**
- **Age, health and needs of the other beneficiaries**
- **Life expectancies of other beneficiaries**



VALUATION OF INTEREST IN DISCRETIONARY TRUST (CONT'D)

FACTORS CONSIDERED (CONT'D)

- **Letter of Wishes, if any, and possible access thereto**
- **Legitimate expectations of other beneficiaries**
- **Contingent taxes**
- **Degree of control by one particular beneficiary (as trustee or through relationship to trustees) *vis-à-vis* other beneficiaries**
- **History of distributions to beneficiaries**
- **Willingness of trustee(s) to provide beneficiaries with documents, information or reasons regarding exercise of discretion, etc.**



“It would be unreasonable to conclude that the FMV of an interest [in] a discretionary trust holding property with significant value has no value simply because it is difficult to measure. In absence of any term of the trust that would direct the trustees to favour one beneficiary over another, the even handed principle would suggest that value of each beneficiary's interest was approximately equal. Where the facts support a finding that one beneficiary has a lesser chance of receiving a distribution from the trust than another beneficiary, it may be appropriate to discount the value of one interest and increase the value of another.”



“In [Sag], it was held that a reasonable approach would be to value the interest as if the trust assets were fully distributed equally among all the contingent beneficiaries on the valuation date. In our view, this would be a reasonable approach to take in many cases involving the valuation of an interest in a discretionary trust. However, where the terms and conditions of the trust are such that this approach does not yield an appropriate result, it may be necessary to apply a discount factor in recognition of the uncertainty caused by any condition precedent or condition subsequent that could affect the value of the beneficiary's interest in the trust. As with business equity valuations, the valuator must use reasonable judgment and objectivity in the selection and analysis of the relevant facts of each valuation.”



VALUATION OF INTEREST IN DISCRETIONARY TRUST (CONT'D)

“The factors which a court would consider ... would include: the size of the distributable fund, the size of the range of objects, the nature of any criteria provided by the settlor by way of guidance to the trustees in the exercise of their discretion, the number and nature of any takers in default of appointment, the nature of the trustees’ power – is it necessary that the trustees distribute the fund among the objects? – and the existence of any power vested in a third party (particularly the spouse) to nominate extra objects or to remove existing objects or to revoke appointments made by the trustees. The relationship of the objects to the settlor, a contributor, or a trustee, should be considered as should the practice of the trustees between the time of the creation of the trust and the time of valuation.”

Hardingham & Baxt, *Discretionary Trusts*, 2nd ed (1984), at 151 (Australia).