

# Using a Usufruct or Substitution Instead of a Trust

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Unlike almost all other jurisdictions in North America, Quebec has a predominantly civil law system. The *Civil Code of Quebec* (CCQ) does not recognize a distinction between legal and beneficial ownership for trusts governed by Quebec law, although non-Quebec trusts from a common law jurisdiction can generally own property and operate in Quebec free of the law governing Quebec trusts. (Quebec has not ratified the *Hague Convention on the Law Applicable to Trusts and on Their Recognition*; however, this treaty’s conflict rules are essentially included in the CCQ.) The CCQ defines “ownership” as “the right to use, enjoy and dispose of property fully and freely,” and defines “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 a right in rem. Other dismemberments and restrictions on the right of ownership, such as usufruct and substitution, were included in the first CCQ in 1866; trusts were added 20 years later.

In many situations, the use of a trust, usufruct, or substitution is neutral from an income tax point of view. The 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.

## Trusts

Since 1994, the CCQ has required trusts to have at least one independent trustee (that is, a trustee who is neither a settlor nor a beneficiary of the trust), which is an uncommon requirement in North America. This has led to interpretative difficulties involving whether

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the independence of a trustee is to be determined objectively or subjectively; interpretative difficulties have also surrounded the penalty for breach of this requirement. The objective test requires that at least one trustee is neither a present nor a future beneficiary (see, for example, *C.T. v. D.J.*, 2009 QCCA 2460), and the subjective test seems to require that at least one trustee is not related to the beneficiaries (see, for example, *Graham v. Boyer-Richard*, 2004 CanLII 20712 (QSC)). The general view is that the lack of an independent trustee does not nullify

the trust itself; rather, it nullifies the actions undertaken by the trust until a suitable appointment is made.

To avoid the difficulties surrounding Quebec trusts, can usufruct or substitution be used instead?

## Usufruct

Like a trust, a usufruct can be established by onerous contract (with cause, which is similar to consideration), gratuitous contract (inter vivos gift), or will. In essence, a usufruct provides the usufructuary with a right of use and enjoyment of property owned by another (the bare owner) for a certain time, including a right to the fruits and revenues produced. Subject to the usufructuary’s rights, the bare owner has the power to sell the property. Since no trustee is required, the interpretive question of independence is irrelevant.

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Usufruct, which is often called “a right of use,” can be employed to allow the enjoyment and use of a family home, for example. In such a case, the user is required to maintain

the property and is responsible for other usual charges, such as insurance. A usufruct is often employed when residential real estate is to be placed in the hands of a user for a period of time.

If protection from creditors is a concern, a usufruct may be problematic because, subject to the rights of the bare owner, creditors are able to seize the rights of the usufructuary. Similarly, however, the Supreme Court of Canada has observed that the rights of a beneficiary under a trust are not always entirely shielded from creditors. (For example, in *Bank of Nova Scotia v. Thibault*, 2004 SCC 29, the court stated that “[t]he trust argument [regarding creditor protection] is, to a certain extent, a mirage. The [property held in 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.”)

### Substitution

In substitution, ownership lies with a first rank of beneficiary (the institute) and then with one or two ranks of substitutes. As in the case of a usufruct, no trustee is required. Unlike a trust or usufruct, substitution can be established only by inter vivos gift or will.

Under the CCQ, the institute must “act with prudence and diligence, having regard to the rights of the substitute.” The institute has a right to income (unless otherwise stipulated) and must preserve the capital, not encroaching on it or disposing of the property for less than fair market value, unless given a specific right to do so. Substitution with encroachment is called “residual substitution”

and was recognized recently by the Quebec Court of Appeal (*Boudreault c. Boudreault*, 2015 QCCA 1781). The institute may change the substance of the capital, unless otherwise provided.

As in the case of usufruct, creditor protection under a substitution may be a concern because, while an institute’s right is in effect, the institute is seen as

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the owner of the property. Another disadvantage is that there is no power to appoint institutes, although it is possible to have several institutes or substitutes in a particular rank. This means that there is no discretion to choose who will benefit at the institute rank; however, there is a power to appoint at the substitute rank from a list of potential substitutes. Substitution can therefore be ineffective in estate freezes, but should remain effective for spousal substitutions (in which the spouse is entitled to all income and, while alive, has the sole right to income or capital) for which a power to appoint in the first rank is not relevant. Therefore, substitution is useful when investment assets (including securities and real estate) are to pass among ranks of users, but there is no need for a power of appointment in the first rank.

Because under the ITA a substitution is a deemed trust, several basic trust tax concepts apply:

- The institute is deemed to be both a trustee and a beneficiary under the

tax trust (CRA TI 9709555, “Legs en substitution de residuo après 1990,” May 13, 1997).

- Revenues paid or payable to an institute are taxed in the hands of the institute.
- A substitution must file a trust tax return within 90 days of the year-end.
- Unless an exemption is provided for (as in the case of 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 or distribution certificates before transmitting property to substitutes (ITA subsection 159(2) and Quebec *Tax Administration Act* section 14).
- The tax deferral of the spousal trust applies also to a spousal substitution (CRA TI 2012-0432201E5, “Payment of Tax by an institute,” March 11, 2013).
- Real estate in the substitution is subject to the same Quebec provincial land transfer tax rules as real estate held in a trust (section 20 of the Quebec *Act Respecting Duties on Transfers of Immovables*).

### Conclusion

In summary, practitioners should note that in Quebec the civil law vehicles of usufruct and substitution are available for use in appropriate circumstances instead of a trust – especially if the Quebec independent trustee rule is meant to be avoided. This situation provides a good example of how different legal systems can work together with a large degree of coherence. ■