CANADA ADOPTS CHANGES TO TRUST & ESTATE TAXATION RULES

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INTRODUCTION

On January 1, 2016, new income tax rules came into effect regarding the Canadian taxation of trusts, particularly testamentary trusts, and estates (the "New Rules"). These rules were first proposed in the 2013 Federal Budget under measures intended to address concerns over abusive tax planning. Draft legislation, proposing a series of amendments to Canada's *Income Tax Act* (the "Act"), was released in early 2014 and revised during the summer of 2014.

Organizations representing the Canadian tax, trust, and estate industries have expressed serious concern with the New Rules. In particular, industry representatives took issue with the amendments to the taxation of spousal and similar trusts and questioned the practicality of the New Rules with regard to the use and application of charitable tax credits by Canadian estates. In spite of these concerns, the New Rules received royal assent at the end of 2014, to take effect at the start of 2016.

Following discussions with industry representatives – which have been ongoing from the time the New Rules received royal assent – Canada's Department of Finance ultimately addressed the most pressing concerns by proposing further amendments to the Act. These proposed amendments were released on January 15, 2016.

This article provides a general overview of the New Rules and the problems they present with regard to the taxation of spousal and similar trusts and the use of charitable donation tax credits by Canadian estates. The article also discusses the manner in which the Department of Finance has proposed to remedy these problems.

BACKGROUND TO THE NEW RULES

As indicated above, Canada's 2013 Federal Budget included a surprise for tax and estate practitioners. Previously, Canadian testamentary trusts and estates were subject to taxation at graduated rates similar to the graduated rates for individuals. This contrasted with the single tax rate for *inter vivos* trusts, which was the highest marginal tax rate applicable to individuals in the province of the trust's residence. In the 2013 Federal Budget, the Canadian government announced that it was considering the elimination of graduated tax rates for testamentary trusts. This announcement was followed by a consultation paper, released on June 3, 2013, that proposed, *inter alia*, the application of the highest marginal tax rate to all trusts created by will and all income earned by estates for tax years ending more than 36 months after the death of the relevant individual.

The Federal government's primary concern was that testamentary trusts were being used in an abusive manner to avoid the payment of tax. In certain cases, the Federal government noted that multiple testamentary trusts were formed in order to benefit from graduated rates multiple times. Estates were taxed in the same manner as testamentary trusts under the law then in effect, and the Federal government expressed the view that the administration of certain estates was being unduly delayed for tax-motivated reasons.

The Federal government also expressed concern with deferral of tax on transfers of property to spousal or similar trusts, which are commonly used as part of Canadian tax and estate planning. Under prior law, the tax imposed on an inherent gain at the time of the transfer was deferred until the death of the beneficiary spouse. In general, all of the net income of a spousal or similar trust was payable to a surviving spouse during his or her lifetime, and discretionary payments of capital could also be made to the surviving spouse during that period. Spousal and similar trusts have become particularly attractive in circumstances involving multiple marriages or blended families.

To a lesser extent, the Federal government was concerned with inter-provincial tax planning involving opportunities that could be derived from manipulating the domicile of trusts. Prior to the New Rules, planning opportunities existed to access lower provincial tax rates based on the tax residence of a trust's trustee.

GRADUATED RATE ESTATES

Based on the Federal government's view that the time required to administer most Canadian estates is 36 months, the New Rules provide that graduated tax rates will apply only to taxation years ending within the first 36 months after the individual's death. During this period, estates are referred to as "graduated rate estates" ("G.R.E.'s") under the New Rules. After the 36-month period, G.R.E. status terminates and a continuing estate will be taxed only at the highest marginal tax rate applicable to individuals in its province of residence. Any testamentary trusts established under the terms of an individual's will are also taxed at the highest applicable marginal tax rate from the time of inception.

SPOUSAL AND SIMILAR TRUSTS

The New Rules introduce changes to Canadian income tax consequences upon the death of a surviving spouse. The new paragraph 104(13.4)(b) of the Act (which forms part of the New Rules) provides that, upon the death of a surviving spouse who is a beneficiary of a spousal trust, the capital gains arising from the deemed disposition are to be taxed in the surviving spouse's estate and not in the trust. Many industry leaders raised concerns regarding the fairness of this provision. It results in considerable inequity when the beneficiaries of a surviving spouse's estate are different from the residuary beneficiaries of the trust. In blended family situations, the capital gains tax liability triggered by the surviving spouse's death was typically borne by the estate. This diminished the overall property available for distribution to the beneficiaries of the estate. At the same time, the capital property of the trust could be distributed to the residuary beneficiaries of the trust and the recipients would take a cost base equal to fair market value of the property received.

A second major concern with the treatment of spousal and similar trusts under the New Rules is the risk of "stranding" charitable donation tax credits ("C.D.T.C.'s,") in a trust that gifts property to a charity after the death of the surviving spouse.

Because the tax liability associated with the surviving spouse's death will be borne by the estate and not by the trust, the trust may not have sufficient income tax payable to obtain a benefit from the donation tax credit. In the one-year period between the adoption and the effective date of the New Rules, practitioners had time to review estate plans in order to identify those involving spousal trusts that would be adversely affected. Typically, estate plans involving blended family situations and residual beneficiaries that differed from the beneficiaries of the surviving spouse's estate were most at risk.

CHARITABLE DONATION TAX CREDITS

Under the New Rules, an estate that is a G.R.E. for the purposes of the Act is generally permitted to allocate C.D.T.C.'s to any of the following taxation years:

- The taxation year of the estate in which the donation was made
- An earlier taxation year of the estate
- The two taxation years of the individual preceding his or her death

In general, publicly listed securities and units of mutual funds are exempt from capital gains tax, which arises on an individual's death, if the property is donated to a charity by the individual's estate following his or her passing. The capital gains tax exemption is only applicable to the taxation year of the individual's death.

Industry representatives raised concerns over the feasibility of completing all charitable gifting within the 36-month G.R.E. period in complex estate situations.

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PROPOSED CHANGES TO THE NEW RULES

In response to a submission made by the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada, the Department of Finance indicated in November 2015 that it was seeking to understand the concerns raised in respect of the New Rules. On January 15, 2016, the Canadian Department of Finance released legislative proposals to amend certain portions of the New Rules.

The amendments proposed by the Department Finance are aimed principally at the apparent inequity caused by new paragraph 104(13.4)(b) of the Act. The proposed amendments introduce a new paragraph 104(13.4)(b.1), which limits the application of paragraph 104(13.4)(b) to circumstances involving a surviving spouse who meets the following criteria:

- Immediately prior to his or her death, the surviving spouse was resident in Canada.
- The surviving spouse was a beneficiary of a post-1971 spousal or common law testamentary trust that was created by the will of a taxpayer who died before 2017.

If these conditions are met, the trustee or administrator of the surviving spouse's estate may jointly elect with the trustee of the spousal or common law partner testamentary trust to have paragraph 104(13.4)(b) of the Act apply, with the result that the capital gains arising as a result of the surviving spouse's death will be taxed in the estate and not in the spousal or common law partner trust.

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For deaths occurring before 2017, there may be compelling tax reasons to make this election. For example, it may be beneficial to make use of the election if there is a capital gain in a spousal trust and, at the time of the surviving spouse's death, he or she had personal capital losses that otherwise could not be used.

As previously noted, the joint election in proposed paragraph 104(13.4)(b.1) of the Act will only be available for spousal trusts created by the will of a taxpayer who died before 2017. Otherwise, the capital gains tax deemed to be recognized in a spousal or similar trust upon the death of a surviving spouse will continue to be taxed in the trust (at the highest marginal tax rate applicable to the trust) and not in the estate of the surviving spouse, as under prior law.

The Department of Finance's proposed amendments to the New Rules also extend the time during which testamentary trusts may allocate C.D.T.C.'s. While the existing legislation allows for the allocation to be made only within a 36-month period following an individual's death, the proposed changes would extend this period to 60 months. According to a Department of Finance release regarding the proposed amendments, it appears that any C.D.T.C.'s arising from donations made after the estate ceased to be a G.R.E. would be allocable among either (i) the taxation year in which the donation was made or (ii) the last two taxation years of the individual.

CONCLUSION

In general, the Department of Finance's proposed amendments to the New Rules would apply from the 2016 tax year. If implemented in the proposed form, the amendments will be welcomed by many individuals, families, and industry members. As drafted, the proposals provide more flexibility with respect to the taxation of capital gains and the period for claiming C.D.T.C.'s. They also restore a perceived sense of fairness to the taxation of spousal and similar trusts.

In the coming months, individuals with estate plans developed in contemplation of the New Rules should revisit planning done prior to the proposed amendments. Others should evaluate how the Department of Finance's proposed amendments will affect their estates and planned charitable giving.