
Canada

Consultation begins on eliminating tax benefits of trusts and certain estates

Introduction

In the March 2013 Federal Budget, the government announced its intention to consult on possible measures to eliminate the tax benefits arising from taxing at graduated rates testamentary trusts and grandfathered *inter vivos* trusts. A testamentary trust is a trust meeting certain criteria arising on the death of an individual. These trusts are often created under the will of a deceased individual, but may also be created by other means, such as a trust funded on death with proceeds of life insurance. Generally the term “testamentary trust” as defined for income tax purposes includes the estate of a deceased individual, but for the purposes of this bulletin the term excludes estates. A grandfathered *inter vivos* trust is an *inter vivos* trust created before June 18, 1971 that satisfies certain restrictions regarding its activities.

The government noted in the budget papers that the differing tax treatment of such trusts as compared to ordinary *inter vivos* trusts and individuals raises questions of tax fairness and neutrality. In addition, the government was concerned with the potential growth in the tax-motivated use of testamentary trusts and its associated impact on the Canadian tax base.

On June 3, 2013, the Department of Finance Canada began the consultation process by releasing a paper discussing its proposed tax changes affecting these trusts and estates. All members of the public are invited to comment on the proposals by December 2, 2013.

Elimination of graduated rate taxation

The main proposed change for grandfathered *inter vivos* trusts and testamentary trusts is the elimination of the graduated rate taxation which applies to individuals. Testamentary trusts and grandfathered *inter vivos* trusts will become subject to tax at the top federal marginal tax rate (currently 29 percent) that applies to ordinary *inter vivos* trusts. A deceased individual's estate would remain subject to graduated rate taxation for the first 36 months after the individual's death; however, after 36 months have passed, the estate would be subject to a deemed taxation year-end and become a “flat top-rate estate” subject to the top marginal tax rate.

The proposal to eliminate graduated rate taxation would not change the rules which suspend or lessen the effects of high flat-rate taxation on income that accumulates in certain trusts for disabled persons or certain non-discretionary trusts for minor children (commonly referred to as “age 40 trusts”). Those rules allow trust income to be retained in the trust but taxed in the beneficiary's hands, at the beneficiary's presumably lower marginal tax rate. Also, the proposal would not change the current rollover rules applicable on the death of a spouse or a common-law partner, which allow an individual's property to be transferred on his/

her death to his/her spouse or common-law partner (or an eligible trust for such a person) on a tax-deferred basis.

Other proposed changes affecting trusts and estates

In addition to eliminating graduated rate taxation, the Department of Finance's consultation paper proposes changes to certain related tax rules that would result in grandfathered *inter vivos* trusts, testamentary trusts and flat top-rate estates being subject to the same treatment as ordinary *inter vivos* trusts. These proposed changes are outlined below.

- **Income tax instalments:** Currently, testamentary trusts and estates are exempt from the quarterly tax instalment rules applicable to ordinary individuals, and are only required to pay any tax owing within 90 days after the end of the taxation year. The government proposes to extend the application of the instalment rules to testamentary trusts and to flat top-rate estates.
- **Alternative minimum tax (AMT):** The government proposes to eliminate the CAD 40,000 basic exemption in computing AMT for grandfathered *inter vivos* trusts, testamentary trusts and flat top-rate estates. The exemption would be preserved for estates during their first 36 months of existence.
- **Taxation year and fiscal period change:** While the taxation year of most trusts is the calendar year, testamentary trusts are currently allowed off-calendar year taxation years and fiscal periods. The government proposes to require testamentary trusts and flat top-rate estates to use a calendar year taxation year and to have each fiscal period end in the calendar year in which the period began.
- **Part XII.2 tax:** Testamentary trusts and estates are currently exempt from Part XII.2 of the *Income Tax Act*, which imposes a trust-level distribution tax on trusts that make payable certain Canadian source income to “designated beneficiaries”, i.e., non-residents and, in certain circumstances involving dealings in beneficial interests in the trust, certain Canadian tax-exempts. Under the proposals, testamentary trusts and flat top-rate estates would no longer be exempt from Part XII.2 or, in certain cases, from treatment as designated beneficiaries under Part XII.2.
- **Personal trust status:** While a trust generally qualifies as a “personal trust” only if beneficial interests in the trust have not been acquired for consideration payable to the trust or to a contributor of property to the trust, testamentary trusts automatically qualify as personal trusts regardless of how beneficial interests in the trust have been acquired. Since personal trust status carries with it certain tax benefits, such as the ability to distribute property to beneficiaries on a tax-deferred basis, the government proposes to require testamentary trusts and flat top-rate trusts to satisfy the same conditions that apply to other trusts in order to qualify as a personal trust.
- **Investment tax credits (ITCs):** While *inter vivos* trusts are required to claim ITCs at the trust level, testamentary trusts can flow through ITCs to their

beneficiaries so that the beneficiaries can claim them in computing their own income tax liability. The government proposes to eliminate that benefit and to require testamentary trusts and flat top-rate estates to claim ITCs in the trust or estate.

- **Tax administration rules:** A number of special tax administration rules apply only to individuals and testamentary trusts, but not to other trusts. These rules extend the period (i) during which the CRA may refund an overpayment of tax, (ii) for objecting to a tax assessment, (iii) for filing an agreement to transfer forgiven amounts under the debt forgiveness rules, and (iv) during which, at the trust's request, the CRA may reassess or make determinations in respect of certain income tax liabilities. Under the proposals, the special rules would continue to apply only to estates for the first 36 months of their existence. These rules would no longer apply to testamentary trusts or to flat top-rate estates.

Leveraging the tax benefits of graduated tax rates has long been a staple of estate planning for high and medium net worth individuals. Given the many other tax and non-tax benefits of trust planning, it is unlikely that these proposals, if enacted, will significantly reduce the use of trusts as part of a well-designed estate plan.

Commenting on the Proposals

The deadline for submitting comments on the government's proposals is December 2, 2013. Comments can be sent to the Department of Finance by email (trusts-fiducies@fin.gc.ca) or by mail addressed to:

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