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Special Advisory

New Trust Taxation Rules: Important Considerations

This Special Advisory provides an overview of the new rules regarding the taxation of testamentary and life interest trusts effective January 1, 2016, and how they may affect existing trusts, trust planning and tax planning for estates.

GENERAL TRUST PRINCIPLES

Definition and Creation of a Trust and Other General Trust Principles

Please refer to our Advisory "Using a Trust in Your Estate Plan" to learn more about general trust principles, such as what a trust is, how it is created, dual ownership under a trust, and key provisions in a trust agreement.

Inter Vivos and Testamentary Trusts

A trust may be established during a settlor's lifetime (an "inter vivos" trust) or it may be established under a will and, as a result, it will only take effect on death (a "testamentary" trust).

Alter Ego and Joint Partner Trusts

An alter ego trust is created by a person for his or her lifetime. A joint partner trust is created by a person for the combined lifetimes of the person and his or her spouse. Alter ego trusts and joint partner trusts are entitled to special treatment under the *Income Tax Act* (Canada) (the "ITA"). Persons age 65 or older may establish an alter ego or joint partner trust and transfer assets to it on a tax-deferred basis. Normally, a transfer of property to a trust, with certain exceptions, results in a disposition, which may result in tax on any resulting capital gains. For more information on the requirements of such trusts and how they are taxed, please see our Advisory "Alter Ego and Joint Partner Trusts".

OVERVIEW OF THE CURRENT TAX RULES FOR TRUSTS

Until January 1, 2016, inter vivos trusts are taxed at the top marginal tax rate while testamentary trusts are taxed at graduated tax rates. As well, until January 1, 2016, testamentary trusts enjoy a variety of additional benefits, such as exemptions from the requirement to have a calendar year tax year-end and from the alternative minimum tax, as well as offering the ability to tax income distributed to a beneficiary in the trust at graduated rates.

Spouse trusts (inter vivos or testamentary), alter ego and joint partner trusts (collectively referred to in this Special Advisory as "life interest trusts") are taxed on the deemed disposition of the assets in the trust on the death of the income beneficiary (or the death of the surviving income beneficiary in the case of a joint partner trust). The tax is payable by the trust, not by the income beneficiary. This allows for a deferral of tax on any unrealized capital gains in the trust until the death of the income beneficiary or last surviving income beneficiary, and taxes all accumulated capital gains in the trust at that time.

SUMMARY OF THE NEW TAX RULES FOR TRUSTS

The new rules provide for a number of fundamental changes to how trusts are taxed in Canada which affect estates, testamentary trusts, life interest trusts, and trusts for beneficiaries with disabilities. These changes may have a profound impact on existing inter vivos and testamentary trusts, trust planning, and tax planning for estates depending on each individual situation.

Rates of Tax on Testamentary Trusts

a) Testamentary Trusts and Marginal Tax Rates

Testamentary trusts will now be taxed at the top marginal tax rate rather than at graduated tax rates. As a result, under the new rules the rate of tax for testamentary trusts, including estates, are the same as for inter vivos trusts, except in two specific situations.

b) Exemption 1 – Graduated Rate Estates

The first exemption is for a "graduated rate estate" ("GRE").

An estate can qualify as a GRE for up to 36 months following a person's death and must:

1. Qualify as a testamentary trust under the ITA (i.e. a trust that does not come into being until the person's death and does not receive any

contributions from another person, subject to certain restrictions regarding debt payments and loans);

2. Designate itself as a GRE in its first tax return filed after December 31, 2015;

3. Be the sole estate designated as a GRE for a deceased person; and,

4. Provide the deceased's Social Insurance Number on all tax returns filed while a GRE (i.e. not a new trust tax identification number).

It appears that only the "general" estate will qualify as a GRE. Ongoing testamentary trusts and insurance trusts provided for in a will or pursuant to a beneficiary designation do not appear to qualify as GREs under the rules, although if an executor has the discretion under the will to do so, it appears that it may be possible to continue the estate administration for the full 36-month period in order to obtain the benefit of the graduated tax rates, even if the estate is immediately distributable.

An estate will cease to be a GRE on the earliest of the following dates: 36 months after the person's date of death; the date the estate no longer meets the requirements set out above; and, the date the general estate administration is complete and ongoing trusts, if any, are set up. On this date, the estate will be deemed to have a tax year end and will thereafter be taxed at the top marginal tax rate, not at graduated tax rates.

Under the new rules, there is no discretion given to the Minister of Finance to extend the time for an estate to be a GRE after the initial 36-month period, even if, for example, there is ongoing estate litigation or unforeseen problems arise which prevent the estate from being fully administered within that time frame.

c) Issues Arising from the New GRE Rules

Many issues involving trust planning and tax planning for trusts and estates arise from the new GRE rules, although some initial concerns have now been alleviated. For example, in response to a question put to it at a recent professional conference, Canada Revenue Agency has confirmed that where a person has executed multiple wills, used in Ontario by way of a "primary will" and a "secondary will" to minimize exposure to Ontario Estate Administration Tax (often referred to as "probate fees"), they will consider there to be only one estate.

Certain tax planning after death can now only be accomplished successfully as long as the estate qualifies as a GRE. For example, if a person owns shares in a private corporation, his or her executor can only engage in certain post-mortem tax planning to avoid double-taxation on the value of those shares if his or her estate is a GRE at the time the planning is completed.

As well, if there are charitable donations in a will, new rules regarding donation tax credits on the payment of these donations provide that these credits can only be applied against income arising in any prior year of the estate or the two years prior to the person's death as long as the estate qualifies as a GRE.

However, draft proposals released on January 15, 2016 by the Federal Department of Finance for consultation would extend the rules regarding donation tax credits for charitable donations made by a person's estate, allowing credits to be applied to the taxation year of the estate in which the donation is made or for the period two years prior to the person's death if the donation is made within 60 months after the person's death, whether or not the estate still qualifies as a GRE at the time the donation is made. The draft proposals are discussed further below under "Are Any Changes to the New Rules Expected?"

Executors will have to be very careful not to disqualify an estate from being a GRE where certain tax planning depends on this status. Qualified advisors should review estate planning to ensure the executors have the necessary powers and flexibility to allow them to complete tax planning after death and maintain an estate's GRE status for as long as it may be necessary and possible to do so.

d) Exemption 2 – Qualified Disability Trusts

The second exemption is for a "qualified disability trust" ("QDT"), a new concept in the ITA. Trusts that qualify as QDTs will be taxed at graduated tax rates.

QDTs are for the benefit of certain disabled beneficiaries, and if properly drafted can allow such disabled beneficiaries to benefit from trust distributions while still being eligible for government disability benefits (e.g. Ontario Disability Support Payments or ODSP).

To qualify as a QDT, a trust must:

1. Have at least one beneficiary who qualifies for the federal disability tax credit (the "qualifying beneficiary") who is specifically named in the trust;
2. File a joint annual election with one or more qualifying beneficiaries (the "electing beneficiary or beneficiaries");
3. Be resident in Canada for the elected year(s); and,
4. Be a testamentary trust (see above under GREs for further information on this requirement).

A qualifying beneficiary can jointly elect with only one trust for the QDT qualification, although a QDT can have multiple qualifying beneficiaries and only one qualifying beneficiary is required to be an electing beneficiary for each QDT.

Problems may arise in making the joint election to be treated as a QDT if the qualifying beneficiary is not legally capable of making an election and has no legal representative who can make the election on his or her behalf. If this is the case, it will be necessary to obtain an appointment of a guardian of property for the qualifying beneficiary from a court in order to be able to make the joint election. Such appointments, however, come with an extensive range of legal responsibilities, often require onerous compliance, and are subject to court supervision.

Also, there is a tax recovery mechanism in the new rules which will be triggered in any year in which the trust stops qualifying as a QDT or a capital distribution is made from the trust to a non-electing beneficiary.

Life Interest Trusts: Taxation on the Death of the Income Beneficiary – Who Pays the Tax?

Under general taxation rules, the death of the income beneficiary of a life interest trust triggers a deemed disposition. Tax will arise on the income beneficiary's death (or in the case of a joint partner trust, on the surviving income beneficiary's death) on all of the income earned by the trust from the beginning of that tax year to the income beneficiary's date of death, as well as on all of the previously unrealized capital gains on all of the trust's capital property, including, in the case of a testamentary spouse trust, on any deferred capital gains.

A major problem created by the new rules which has caused substantial controversy is that the estate of the income beneficiary will now be primarily liable for the tax arising on his or her death. This means that while the trust property will usually be distributed to beneficiaries other than the deceased income beneficiary's estate, the tax arising on the unrealized gains of this trust property will be payable by the income beneficiary's estate, unless these new rules are changed as discussed at the end of this section.

The life interest trust will be jointly and severally liable with the deceased income beneficiary's estate for the tax in question. As a result, recourse can also be had to the trust for payment of the tax.

The following is an example of how these new rules can apply to create an inequitable result:

> *Ken and Lisa have been married for 15 years. Both have children from previous marriages. Lisa has a substantial net worth from her interests in her family's business. Ken is financially comfortable, has a pension and substantial*

investments resulting from an inheritance from his parents which he has successfully grown based on sound investment decision-making. Both Lisa and Ken wish to leave their wealth in trust for each other for the survivor's lifetime, with their respective assets eventually passing to their own children upon the survivor's death.

Lisa dies first, and under her will her estate is held in a spouse trust for Ken's lifetime, under which he has only the right to the income. On Ken's death, the remaining capital of the spouse trust is paid to Lisa's children. Under his will, Ken's estate passes to his children.

Under the new life interest trust tax rules, Ken's estate will bear the burden of the deemed disposition of the capital assets in the spouse trust under Lisa's will. Unfortunately for Ken's children, there are significant unrealized capital gains existing in the trust at the time of Ken's death of over $3M. Since his estate must pay the capital gains tax arising on these gains as well as on the gains on his own assets, Ken's estate is substantially diminished, leaving only a modest sum for his children.

Under the new tax rules, Ken's children ultimately bear the burden of the tax on the spouse trust under Lisa's will, even though they do not receive any of the capital of the spouse trust. Lisa's children receive the capital of the spouse trust tax-paid. This would result in a windfall to Lisa's children and an unfair result to Ken's children, which Ken and Lisa never could have foreseen and did not want.

If Ken had died first, the same result in reverse would have occurred. Lisa's children will bear the tax burden on the spouse trust under Ken's Will, and Ken's children would receive the capital of the spouse trust tax-paid, although the tax burden on the spouse trust under Ken's Will should be less as Ken's assets are less than Lisa's.

In order to alleviate this situation, legal advice will be required to explore available options for dealing with this unintended result.

However, the draft proposals released by the Department of Finance on January 15, 2016 for consultation would modify the rules discussed above by returning the liability for the tax arising on the deemed disposition of the assets in the trust on the income beneficiary's death to the trust, rather than taxing the estate of the income beneficiary. We await further developments in this regard, as discussed below under "Are Any Changes to the New Rules Expected?".

Charitable Donations by a Trust or Estate

This Special Advisory does not examine the impact of the new charitable donation rules applicable to trusts and estates. However, you should be aware that certain fundamental changes to these rules may affect an estate or trust if, for example, charitable donations have been provided under your will which allow for the sheltering of tax triggered on the death of the income beneficiary of a life interest trust. For more information on charitable donations as part of your estate plan, please see our Advisory "Charitable Giving".

Other Tax Rules Which Will Affect Testamentary Trusts

Estates and testamentary trusts which are not GREs or QDTs will be subject to a number of other rules after January 1, 2016 from which they are exempt until December 31, 2015, including that they will now:

1. Have a calendar tax year-end;

2. Pay tax installments, if applicable;

3. Pay alternative minimum tax, if applicable;

4. Be unable to allocate investment tax credits to beneficiaries; and,

5. Be unable to elect to tax income paid to a beneficiary in the trust unless the trust has losses to offset the tax.

Effect of New Rules on Existing Testamentary Trusts and Estates

Existing estates and testamentary trusts which have been in existence for more than 36 months will have a deemed year-end on December 31, 2015. Thereafter, they will be subject to the top marginal tax rate on all income earned by and taxed in the trust.

Existing life interest trusts will be subject to the same rules as life interest trusts created after January 1, 2016. After January 1, 2016, the estate of the income beneficiary of any such trusts will be liable for the tax arising on the deemed disposition of the capital assets of the trust on the income beneficiary's death, or in the case of a joint partner trust on the surviving income beneficiary's death.

There are no grandfathering provisions for existing estates or trusts, which are subject to all of the new rules on January 1, 2016.

PLANNING FOR THE NEW RULES

There are planning options available that should be considered in certain situations. If your will provides for a life interest trust, additional language can be included to provide that the tax arising from a life interest trust on the death of the income beneficiary should be paid from the trust.

Existing life interest trusts which are currently being administered should be reviewed and considered to determine what available courses of action may be appropriate to alleviate any adverse impact of the new rules, or to plan for the ultimate tax burden to avoid an unfair result.

Existing testamentary trusts which are currently being administered should be reviewed to see if trustees should take advantage of the graduated tax rates before the end of 2015.

Some of these solutions may be easier than others. Professional advice is necessary to explore available options in each situation.

BENEFITS OF USING A TRUST

Despite the changes to the taxation of trusts noted above, including that testamentary trusts will now be taxed at top marginal rates which results in the loss of the ability to income split between the trust and a high tax rate beneficiary taxpayer, and possible future challenges associated with them, a trust is one of the most powerful tools available to assist in wealth preservation and management. By using a trust, it is possible to provide for family members now, and also protect their financial interests in future, while maintaining control over the management and distribution of the trust property.

A trust can still be used to achieve one or more of the following estate planning objectives:

1. Wealth protection and management;
2. Protection for beneficiaries with special needs;
3. As a will substitute to provide privacy and minimize estate disputes;
4. In an estate freeze;
5. Provision for the education and other expenses of children and grandchildren;

6. Tax minimization through income-splitting and minimization of exposure to Ontario Estate Administration Tax and probate fees in other jurisdictions.

Further, while the new rules do not provide an exemption for spousal trusts, they also do not affect the ability to transfer assets to an alter ego or joint partner trust or a testamentary spousal trust on a tax-free, rollover basis, thereby deferring capital gains tax which is a primary estate planning objective.

ARE ANY CHANGES TO THE NEW RULES EXPECTED?

The draft amendments in the legislative tax proposals released by the Department of Finance on January 15, 2016, which if implemented would alleviate the effect of certain of the new rules (discussed in a summary way above under "Issues Arising from the New GRE Rules" and "Life Interest Trusts: Taxation on the Death of the Income Beneficiary – Who Pays the Tax?"), are still only proposals. However, their release is a positive sign that changes may be effected soon.

CONCLUSION

The taxation of testamentary and life interest trusts is changing in a number of fundamental ways. If you are a trustee or beneficiary of an existing life interest trust or if you have trusts in your will, you should consider whether you need to seek professional advice with regard to the impact of these new rules in your individual situation.

If, for example, you are a trustee of an existing life interest trust or estate now subject to the top marginal tax rate starting in 2016 you should consider what further steps should be taken to minimize tax. If you are the income beneficiary of a life interest trust or if you have included trust planning in your will or have established an alter ego or joint partner trust you should consider obtaining advice on how the new rules will affect you, the trust and/or your planning.

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