NEW ERA IN ESTATE PLANNING

Changes to the Taxation of Estates, Testamentary Trusts and Life Interest Trusts

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June 11, 2015

Introduction

- New rules effective 2016 will affect all those involved in estate planning, whether as financial advisors, tax advisors, or will preparers, as well as those acting as liquidators, trustees and advisors to trusts and estates.

Estate Plan or Will Affected by New Rules

- Does will create trust for benefit of spouse or common-law partner?
- Does will create one or more trusts for children?
- Does will create trust for disabled beneficiary?
- Does will provide gift to charity, either on death or out of spousal trust following death of spouse?
- Does will provide for immediate settlement of estate and funding of testamentary trusts?
- Does individual have multiple wills?
- Does estate plan call for redemption of private corporation shares funded by life insurance?
- Is individual a settlor or beneficiary of an *inter vivos* spousal, common-law partner, alter ego, or joint spousal common-law partner trust?

Current Regime

- Testamentary trusts benefit from graduated tax rates, choice of year-end, other advantages;
- Planning involving testamentary spousal trust, multiple testamentary trusts for children, and charitable remainder trusts;
- Post-mortem planning (including loss carrybacks and insurance funded redemptions to avoid double taxation);
- Planning involving *inter-vivos* spousal trusts, common-law partner trusts, alter ego trusts, joint spousal common-law partner trusts ("life interest trusts").

Changes Announced

- Budget 2013 proposed flat top rate taxation and elimination of other advantages for testamentary trusts;
- Draft legislation tabled August 2014 introduced measures going beyond flat tax that have profound consequences on post-mortem planning relating to private corporation shares, charitable donations and use of spousal and other life interest trusts;
- Amendments adopted December 2014;
- Effective January 2016;
- No grandfathering.

New Regime

Subject to two exceptions, testamentary trusts will no longer have the benefit of:

- Graduated tax rates (they will be subject to the highest marginal tax rate);
- Choice of year-end (calendar year-end mandatory);
- Exemption from tax instalments;
- Exemption from AMT;
- Ability to allocate ITCs to beneficiaries;
- Extended period for filing notice of objection;
- Ability to allocate first year's capital losses to last year of deceased to avoid double tax (164(6) ITA);
- Relief from application of stop-loss rules to avoid double tax in respect of private corporation shares (112(3.2) ITA); and
- Flexibility in claiming tax credits for charitable donations on death.

Exceptions Where Graduated Rates Remain Available:

- Graduated Rate Estate ("GRE")
- Qualified Disability Trust ("QDT")

Qualified Disability Trust ("QDT")

- Testamentary trust that arose on and as a consequence of death;
- Trust resident in Canada throughout the year;
- Jointly elects in tax return each year with electing beneficiary and includes SIN;
- Electing beneficiary qualifies for disability tax credit under 118.3 ITA;
- Electing beneficiary does not make QDT election in respect of any other trust.

QDT Status

- QDT subject to graduated rates for each year it elects and satisfies conditions;
- Recovery tax triggered if any of conditions cease to be satisfied, or if trust makes capital distribution to non-electing beneficiary.

Planning for Disabled Beneficiaries – QDTs

Issues:

- No grandfathering;
- No relief for late election;
- Only one QDT per individual;
- Potential loss of graduated rates;
- Recovery tax.

Planning for Disabled Beneficiaries – QDTs

- Must review existing testamentary trusts for disabled beneficiaries;
- Is year-end changed to Dec 31?
- What if separate trusts established by each parent, grandparent? – only one qualifies;
- Need T2201- disability certificate;
- Future planning- obtain T2201- even if do not need for income tax purposes today;
- "Henson Trust"- generally do not allocate to beneficiary- pay tax in trust so as not to issue a T3 slip, thus loss of graduated rates even more costly;
- At death of disabled beneficiary capital to non-disabled beneficiaries; creates tax liability for undistributed income (previously taxed at graduated rates); ensure after-tax income is distributed.

Graduated Rate Estate ("GRE")

- Estate (not trust) that arose on and as a consequence of individual's death;
- No more than 36 months have passed since death;
- Estate is a testamentary trust under ITA;
- Estate designates itself as a GRE in its first tax return after 2015;
- Deceased individual's SIN is provided; and
- No other estate is designated as GRE of individual.

GRE Status

- GREs entitled to graduated rates, off-calendar taxation years, flexible donation credit rules, and other benefits;
- For new and existing estates important to check:
  - Have more than 36 months passed since individual's death?
  - Any tax returns filed after 2015? If yes, was designation made?
  - Did the individual leave multiple wills?
  - Has any other estate been designated?
- Preservation of GRE status to be considered when drafting wills.

GRE Designation

- Must be made in first estate tax return after 2015
  - Applies to deaths before and after 2015;
  - What if forgotten?
  - Is late designation possible?
- Only one GRE designation
  - Do multiple wills with different liquidators create multiple estates?

GRE Qualification

- Only available to “estate” and only for 36 months
  - If assets transferred to testamentary trust within 36 months of death, trust will not benefit from graduated rates;
  - No income splitting with multiple testamentary trusts;
  - If estate extends beyond 36 months, ceases to qualify;
- Estate must be “testamentary trust” under 108 ITA
  - Avoid transfers and loans to Estate.

Calendar Year-End

- No grandfathering;
- Existing estates that do not qualify as GREs will have deemed year-end December 31, 2015;
- May have two year-ends in 2015;
- Consequences if fail to file (penalties, loss of statute-bar protection);
- Consider triggering income or gains in 2015 to benefit from last year of graduated rates.

Designation To Pay Tax

- Currently, trust may make designation to pay tax inside trust on income payable to beneficiary;
- Surprise change starting in 2016;
- Designation will be invalid, except to extent that trust has losses;
- Designation to use donation tax credits or ITCs in trust will be invalid;
- Applicable to all trusts, *inter-vivos* and testamentary, including GREs;
- Affects planning;
- Will late or amended designation be allowed if trust subsequently has loss carryback?

New Rules Affecting All Trusts With Life Interest Beneficiaries

- Applicable to spousal, common-law partner, alter ego and joint spousal common-law partner trusts, whether *inter-vivos* or testamentary;
- No grandfathering – applies to all such trusts starting in 2016, regardless of when created;
- Trust will have deemed year-end at the end of the day of death of the life interest beneficiary;
- All income of trust for shortened year, including capital gain on deemed disposition arising on death, is deemed payable in the year to the deceased life interest beneficiary.

Liability For Tax On Deemed Disposition Arising On Death Of Life Interest Beneficiary

- Capital gain on deemed disposition will be taxed in deceased life interest beneficiary's (i.e. spouse's) terminal return, not in the trust;
- Potential mismatch between persons receiving trust assets and persons responsible for tax;
- Unfair burden or windfall in certain cases;
- Trust will be solidarily liable for tax;
- Practical problems for trustees and liquidators;
- May affect planning to eliminate gain.

Example – Spousal Trust

- Facts:
  - Ralph and Mary are married; each has children from previous marriage.
  - Ralph died in 2010. Under Ralph's will, his assets were left to a spousal trust under which Mary is entitled to all the income during her lifetime, but no capital; on Mary's death the property of the spousal trust goes to Ralph's children.
  - Mary dies in 2016. At that time spousal trust holds assets with value and unrealized capital gain of $2M and Mary personally owned assets having value and unrealized capital gain of $2M. Under Mary's will her estate goes to her children, while balance of spousal trust goes to Ralph's children under his will.

Example – Spousal Trust (cont'd)

- Tax Consequences:
  - Mary's terminal return will include $4M of capital gains, resulting in taxes of approximately $1M. (If pre-2016, Mary would have capital gain of $2M, and trust would have capital gain of $2M and each would have $500,000 of tax.)
  - CRA/RQ may assess all tax against Mary's estate, leaving her children with only $1M after tax, while Ralph's children get the full $2M from Spousal Trust. Is this the intended result?
  - Since the Trust is solidarily liable, CRA/RQ may (but not obliged to) assess spousal trust for $500,000 of tax triggered upon gain of assets in spousal trust. Would trustees of spousal trust then have fiduciary duty to claim $500,000 from Mary's estate since tax liability is that of Mary?

Other Situations

- Same children from common marriage, but surviving spouse remarries and has more children. Assets in spousal trust go only to children of first marriage, but children of both marriage, as heirs of surviving spouse, are liable for tax;
- Spouses have same children, but, following death of first spouse, surviving spouse excludes one or more of the children from his/her estate (e.g. because of substance abuse or other problem). Excluded child receives assets from spousal trust. If tax is borne by estate of surviving spouse, excluded child effectively receives benefit at the expense of others.

Possible Solutions to Mis-Match

- Clause in will providing for spousal trust to fund tax liability, but must avoid “tainting” estate of surviving spouse by transferring assets to it;
- Payment of tax by spousal trust directly to tax authorities or distribution to ultimate beneficiaries of spouse’s estate;
- Clause in will demonstrating testator’s intention that tax liability be borne by spousal trust and that trust cannot recover same from spouse’s estate;
- Gift in marriage contract;
- Problem – if testator has already died or no longer has capacity.

Charitable Remainder Trust That Is Also Spousal Trust

- Misallocation of tax liability;
- Additional tax on spouse’s death.

Charitable Remainder Trust - Spousal Trust

- Example
  - Mr. X establishes a spousal trust in his will. Income beneficiary for life- Mrs. X, no capital encroachment allowed. Capital beneficiary at death of Mrs. X - JCF. Assets in trust - appreciated securities.
  - Results today - Gift by Mr. X at death based on value of securities and mortality of Mrs. X. Disposition of securities- elect under 118.1(6) to eliminate gain. At Mrs. X's death, further appreciation of securities taxed in trust and allocated to JCF -no tax paid.
  - Under new rules – At death of Mrs. X, appreciation of securities taxed in her final tax return even if JCF owns the assets.

Charitable Remainder Trust - Spousal Trust Example (cont'd)

- Possible Remedies:
  - Taint the spousal trust- add JCF as a discretionary income beneficiary;
  - Gift securities in will not in a trust- take back an income flow for life for Mrs. X. Can receive capital gains exemption on appreciated marketable securities and receive tax receipt from JCF based on split-receipting rules;
  - Use assets which don't appreciate- invest in fixed income.

New Flexible Donation Rules at Death

- New rules effective 2016, for deaths after 2015, will allow greater flexibility as to who can claim donation tax credits and the corresponding timing, as a result of will gifts, but must be GRE to benefit.
- Current Regime – A will gift is deemed to have been made by the testator immediately before death. Will gifts, not "hard", for example where the testator suggests that a donation be made but does not oblige the liquidators to do so would be considered to have been made by the liquidators in the estate/trust when the donation is made.

New Flexible Donation Rules at Death (cont'd)

- Changes – After 2015, will donations (also designations of RRSPs, RRIFs, TFSAs, and life insurance policies) will be deemed to be made by the estate/trust at the time of transfer of property. However, if the estate is a GRE then the donation may be claimed in:
  - the estate in the taxation year in which the donation was made (property transferred); or
  - an earlier taxation year of the estate; or
  - the last two taxation years of the deceased (i.e. "final" return or year before).
- This will help with donation planning, particularly where a subsection 164(6) transaction is contemplated.

Checklist for Advisors

- Review wills and estate plans;
- Consider new will (or amendment) where client has capacity;
- Address ultimate tax burden on death of beneficiary of spousal trust;
- Review purpose of testamentary trusts;
- Review planning for disabled beneficiaries;
- Maintain estate's existence (36 months);
- Review charitable donations;
- Maximize flexibility.