NEW ERA IN ESTATE PLANNING

Taxation of Trusts and Estates Post-2015

Presentation to STEP CANADA (Montreal)

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Introduction

- New rules adopted in December 2014 and effective January 1, 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, accountants 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?

New Regime

First Change

- Subject to two exceptions, as of January 1, 2016 testamentary trusts and estates will no longer have the benefit of graduated tax rates and will instead be subject to the highest marginal tax rate.
- Exceptions:
  - Graduated Rate Estate (“GRE”)
  - Qualified Disability Trust (“QDT”)

New Regime (Cont'd)

<u>Second Change</u> – GRE status required for:

- Choice of year-end (calendar year-end mandatory if do not qualify);
- Exemption from tax instalments;
- Exemption from AMT;
- Ability to allocate ITCs to beneficiaries;
- Extended period for filing notice of objection;
- Availability of 164(6) loss carry back to avoid double tax on death;
- Relief from stop-loss rules in 112(3.2) on death;
- Flexibility in claiming tax credits for charitable donations on death;
- Nil capital gains inclusion for donation of shares on death; and
- Exemption from Part XII.2 tax for non-resident beneficiaries.

1st Exception for Entitlement to Graduated Rates – 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.

Qualified Disability Trust

- 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.

Qualified Disability Trust

Issues:

- No grandfathering;
- No relief for late election;
- Only one QDT per individual – if separate trusts established by each parent/grandparent, only one may qualify;
- Need T2201 – Disability certificate;
- Potential loss of graduated rates plus liability for recovery tax if income taxed at G.R. in QDT is subsequently distributed to non-electing beneficiary;
- Impact on "Henson Trusts".

2nd Exception – Graduated Rate Estate ("GRE")

- GRE status important to access graduated rates and other advantages.
- Conditions to qualify as GRE:
  - Estate that arose on and as a consequence of 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 return for its first taxation year ending after 2015;
  - Deceased individual's SIN is provided; and
  - No other estate is designated as GRE of deceased.

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 more income splitting with multiple testamentary trusts;
  - If estate extends beyond 36 months, ceases to qualify.
- Estate must be "testamentary trust" under 108 ITA
  - Excludes trust where property contributed *otherwise than by an individual on or after the individual's death and as a consequence thereof*, and trust that incurs debt to beneficiary or NAL person (subject to certain exceptions);
  - Avoid offside loans and contributions to Estate.

GRE Designation

- Must be made in first estate tax return after 2015
  - Applies to deaths before and after 2015 – important when filing first return post-2015;
  - What if forgotten?
  - Is late designation possible?
- Only one GRE designation
  - Initially unclear whether multiple wills could give rise to multiple estates. At June 2015 STEP conference CRA clarified: one estate;
  - Collaboration required where different liquidators/executors appointed under different wills.

Year-End

- Estates (other than GREs) and testamentary trusts must adopt calendar year-end;
- No grandfathering;
- Existing estates (i.e. deaths prior to 2016) 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;
- Planning tip - consider triggering income or gains in 2015 to benefit from last year of graduated rates.

Year-End

- Post 2015 non-calendar year end possible for GRE only.
- Consider year end other than anniversary of death to extend graduated rates over 4 fiscal periods (limited to 36 months).
- Example : Date of death Nov. 30, 2016:

Taxation year as GRE	Taxation year end on anniversary of death	Taxation year – December 31
1st year	Dec. 1, 2016 to Nov. 30, 2017	Dec. 1, 2016 to Dec. 31, 2016
2nd year	Dec. 1, 2017 to Nov. 30, 2018	Jan. 1, 2017 to Dec. 31, 2017
3rd year	Dec. 1, 2018 to Nov. 30, 2019	Jan. 1, 2018 to Dec. 31, 2018
4th year	——	Jan. 1, 2019 to Nov. 30, 2019

Designation To Pay Tax

<u>Third Change</u> – New 104(13.3)

- Applicable to all trusts and estates, including GREs;
- Currently, trust may make designation to have income or capital gains payable to a beneficiary taxed in trust;
- Beginning in 2016, designation will be invalid, except to the extent that trust has losses;
- Designation to use donation tax credits or ITCs in trust will be invalid;
- Affects inter-provincial planning, but also planning to avoid double tax;

Designation To Pay Tax (cont'd)

- Designation must be made in trust return;
- Designation not possible if no losses available;
- Will late or amended designation be allowed if trust subsequently has loss to carry-back?
  - CRA response at 2015 STEP National Conference: Yes, except in cases of retroactive tax planning.

Death of Beneficiary of Life Interest Trust

<u>Fourth Change</u> – New 104(13.4)

- Applicable to all spousal, common-law partner, alter ego and joint spousal common-law partner trusts ("life interest trusts") (where death of beneficiary triggers deemed disposition);
- No grandfathering – as of 2016 applies to all such trusts (*inter-vivos* and testamentary), 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

- Result - Capital gain on deemed disposition will be taxed in deceased life interest beneficiary'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;
- Under new 160(1.4) trust will be solidarily liable for tax, but……;
- Practical problems for trustees and liquidators;
- May affect planning to eliminate gain.

Example – Spousal Trust

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

Example – Spousal Trust (cont'd)

- Tax Consequences:
  - Wilma's terminal return will include $4M of capital gains, resulting in taxes of approximately $1M. (If pre-2016, Wilma would have capital gain of $2M, trust would have capital gain of $2M and each would pay $500,000 of tax.)
  - CRA/RQ may assess all tax against Wilma's estate, leaving her children with only $1M after tax, while Fred'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 on assets in spousal trust. Would trustees of spousal trust then have fiduciary duty to claim $500,000 from Wilma's estate since primary tax liability is that of Wilma?

Possible Solutions to Mismatch

- Clause providing for spousal trust to fund tax liability, but must avoid "tainting" estate of surviving spouse;
- Payment of tax by spousal trust directly to tax authorities?
- Distribution to ultimate beneficiaries of spouse's estate?
- Spouse's estate as beneficiary of Spousal Trust?
- Clause preventing Spousal Trust from claiming recovery of tax from spouse's estate?
- Create current debt obligation? Gift in marriage contract?
- Create "tainted" spousal trust?
- Clause reflecting testator's intention regarding payment of taxes.
- Problem – if individual has already died or no longer has capacity.
- Capital encroachment during lifetime of beneficiary?

Practical Problems

- Timing of tax payment by Spousal Trust:
  - Voluntary payment;
  - Payment pursuant to 160(1.4) assessment;
- Interest charge on tax payable by estate;
- How will trustee know if spouse's estate has paid the tax?
- Trustee liability for non-payment of tax by estate?

Charitable Gifts 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 qualify as GRE to benefit.
- Current Regime
  - Will gift is deemed to have been made by testator immediately before death.
  - Where the testator suggests that a donation be made but does not oblige the liquidators to do so or does not specify amount, gift is considered to have been made by the estate/trust when the donation is made.

Chartable Gifts at Death (cont'd)

- Change – 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 gifted property. However, if the estate is a GRE then the donation may be claimed by:
  - the deceased in the year of death or preceding year;
  - the estate in the taxation year in which the donation was made (property transferred); or
  - the estate in an earlier taxation year or subsequent 5 taxation years.
- This provides flexibility for donation planning provided gift is made while estate qualifies as a GRE, but creates adverse result if gift is made by life interest trust.

Post Mortem Planning

- Transactions may be implemented under current rules to avoid double taxation on death (e.g. loss carry-back, pipeline, bump).
- 164(6) loss carry-back planning for estates will generally not be affected by new rules since must be carried out in first year, but must ensure all GRE conditions are satisfied.
- Loss carry-back planning for trusts with life interest beneficiaries may be affected.

Loss Carry-back Planning for Spousal Trust

- Example:

  - Barney died leaving shares of Holdco to Spousal Trust for wife Betty.
  - If Betty dies prior to 2016, her death triggers deemed disposition and capital gain in Spousal Trust. Within the next 3 years, as owner of the Holdco shares, Spousal Trust may cause their redemption resulting in dividend to Spousal Trust and capital loss which may be carried back to eliminate gain.

  (Discussion of when this might be advantageous (e.g. CDA, RDTOH) is beyond the scope of this presentation.)

Loss Carry-back – Example (Cont'd)

- If Betty dies after 2015, the capital gain arising on the deemed disposition is taxable in Betty's terminal return. Spousal Trust is not able to elect to pay tax in the Trust except to the extent it has losses.
- Subsequent redemption of Holdco shares gives rise to capital loss for Trust, not Betty.
- However, if Spousal Trust carries loss back to year of death, it may then be able to late file designation under 104(13.2) to have gain on deemed disposition taxed in Trust, and then offset by loss.

Loss Carry-back – Example (Cont’d)

- Conflict between interests of capital beneficiaries of Spousal Trust and beneficiaries of spouse’s estate.
- Loss carry-back planning would eliminate tax for spouse’s estate but would create taxable dividend for Spousal Trust.
- Consider whether to have an agreement to require estate to pay tax refund to Spousal Trust. Should this be addressed in will?

Pipeline Transaction

- Pipeline of interest to Spousal Trust (and its beneficiaries) holding shares with high ACB.
- Pipeline does not provide any tax relief to spouse’s estate (which has liability on deemed disposition).

Checklist for Advisors

- Review wills and estate plans;
- Consider new will (or amendment) where client has capacity;
- Address 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);
- Ensure charitable donations are made while estate qualifies as GRE;
- Ensure 164(6) plan is implemented while estate qualifies as GRE;
- Maximize flexibility;
- Make GRE designation for 2016;
- Verify whether estate has deemed year end December 31, 2015.