Why the new 2016 rules for trusts and estates in Canada may surprise you and why the Department of Finance may reconsider

Wills, Estates and Trusts Update

Tax Update

16 DEC 2015
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January 1, 2016 will bring many significant changes to the taxation of trusts and estates in Canada. These changes were passed into law in December 2014, after being announced as part of the 2014 federal budget.

Most people are totally unaware of how their wills, estates and trusts are affected by these changes and they may be in for a surprise. If you have a will in place it should be reviewed to see how it is affected under the recent legislation. The drafting of a new will or the establishment of a trust may require a different perspective given the amended rules. This bulletin outlines certain key areas of changes, and what you can do to prepare.

1. Loss of graduated income tax rates for trusts and estates

Beginning January 2016, testamentary trusts (trusts created pursuant to the death of an individual) and estates are generally going to be taxable at the top marginal rate for individuals on all of their income. The progressive tax rates previously enjoyed by such trusts and estates, accordingly, will be lost. Given the issuance of draft legislation on December 7, 2015, the top marginal rates across the country in 2016 will range from 47.70% to 58.75%. We ran some calculations using 2015 rates assuming $30,000 of eligible dividends (not grossed-up) and $20,000 of interest income. The loss of graduated rates for trusts located in Quebec, Ontario or British Columbia would increase taxes by amounts between $11,400 and $13,600.

Once the benefit of graduated rates are lost, many trusts will have lost their raison d’etre. It may be time to wind up these trusts.

An exception to this general rule applies to estates (but not trusts) during the first 36 months following the death of the relevant individual. Estates eligible for the 36 month exemption are known as graduated rate estates and are entitled to continue to benefit from the graduated rates of tax. To be considered a graduated rate estate, an estate must designate itself as such in its first income tax return to be filed after 2015, and must continue to do so in all the returns filed during the 36 month period. Failure to do so will cause the loss of graduated rate estate status.

2. Deemed year-end

All estates that are more than three years old and all existing testamentary trusts will have a deemed year-end on
December 31, 2015 and will continue to have a December year-end thereafter.

All estates which are not 36 months old at December 31, 2015 will not have a deemed year-end on that date, but will have one on their third anniversary. For example, a graduated rate estate that opened up on June 30, 2015 can have an off-calendar year-end until June 30, 2018 when it will have a deemed year-end. Its next year-end will be December 31, 2018. It will have to file two trust tax returns in respect of the 2018 year.

Effective 2016 and thereafter, all spousal trusts, alter ego trusts and joint spousal trusts will have a deemed year-end at the end of the day in which the life interest beneficiary dies.

3. Tax installments

Previously, all testamentary trusts including estates did not have to pay installments. Now only graduated rate estates will be exempted from making installments.

If you are involved with a testamentary trust or an estate, speak to your accountant in early 2016 to see if installments have to be made in the first quarter of the year.

4. Shifting the tax burden - the new trust rules

Another important change to the law concerns three types of trusts: alter ego trusts, spousal trusts and joint spousal trusts. Ordinarily there is no tax payable upon a transfer of assets to these trusts when they are established. Any capital gains related to the transferred assets can be deferred until the death of the trust’s income beneficiary or, in the case of a joint spousal trust, the death of the surviving spouse. After the death of the applicable person, there would be a deemed disposition of the assets owned by the trust generally giving rise to a capital gain.

Under the current law, the tax arising on the death of the income beneficiary has to be paid by the capital beneficiaries of the trust. That makes sense since the capital beneficiaries end up with the trust assets.

Under the new amendments, when the relevant income beneficiary of an alter ego, spousal or joint spousal trust dies, the entire income of the trust for the relevant year including the deemed capital gains is to be transferred from the trust to the trust beneficiary that died. These new rules are to come into effect January 1, 2016.

Imagine that a spousal trust owns shares of an investment company worth $2 million and that these shares have a tax cost of $1. The capital gain to the trust on the spouse’s death would be $2 million and the income would now be transferred to the spouse and not left in the trust. Let us assume that the spouse now has an additional tax liability of approximately $500,000. That might be enough to wipe out the spouse’s entire estate.

The rules were changed as to who must pay the taxes with no grandfathering provisions allowing existing structures to be taxed as originally contemplated.

a) The Trustees’ Dilemma

Under the new rules, the trust is to be jointly and severally (or solidarily in Québec) liable with the deceased beneficiary for the payment of this transferred tax liability. Are the trustees to represent the interest of the income beneficiary, now deceased, or that of the capital beneficiaries?

b) Second Marriages and Sibling Rivalries

These new rules could create significant difficulties if the capital beneficiaries of the trust do not have the same interest as the heirs of the income beneficiary who has died.

The beneficiaries of an estate could find themselves paying taxes on income that will be allocated to other people. The classic example is a spousal trust where the income beneficiary is the second spouse and the capital beneficiaries are the children from the first marriage of the testator. Another classic example is where one sibling is the income beneficiary and the capital beneficiaries are the...
5. No grandfathering

What is surprising is that these new rules were introduced with no grandfathering provisions. They could affect both existing wills that have not yet come into effect (and therefore may be modified) and also lifetime or testamentary trusts that are already in existence and may not be modified easily, if at all.

6. The recent department of finance letter

After more than a year of hue and cry from the tax community, the Department of Finance finally announced on November 16, 2015 that it is considering reversing course, at least with respect to the shifting of tax liability, and amending the new law to bring it back to what it was. In other words, the trust’s income will not be shifted to the income beneficiary that died and the tax liability will remain with the trust.

While the Department of Finance’s intentions were only announced in a letter and do not even form part of proposed legislation, the tax community is generally assuming that the law will be amended in line with the November 16, 2015 letter. Of course, intentions are not guarantees. The situation should be monitored closely and we are hoping to see draft legislation in short order.

Time to review

Estate plans and existing wills and trusts should be reviewed in light of the amendments coming into effect in 2016, including the higher tax rates which will affect all *inter vivos* (lifetime) trusts and all testamentary trusts and estates which are not graduated rate estates.

This overview provides a sample of some of the challenges trustees and testators will face with these new rules. There are many other changes to the tax law which have not been mentioned in this short summary. If you would like more details on these changes or need more information, please contact the authors. This summary is being provided as information only and is not meant as legal opinion or advice.

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