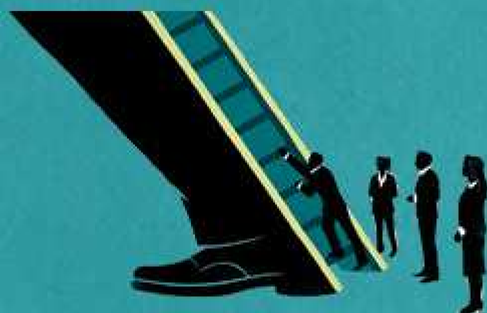

CBA WEBINAR SERIES

THE CANADIAN BAR ASSOCIATION

The Changed Landscape:

The Impact of New Tax Rules on Trusts and on Estate Donations

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Presenters

Introduction

- Summary of New Rules
  - Testamentary Trusts/Graduated Rate Estates
  - Life Interest Trusts
  - Estate Donations

- Case Studies:
  - Interprovincial Trust Planning
  - Life Interest Trust with Private Company Shares
  - Life Interest Trust and Blended Family

Introduction (cont'd)

- Charitable Donations
  - Donation through Life Interest Trust
  - Donation with Holding Company
- Will Review
- Planning Principles – What did we learn?

What's the difference between death and taxes?

Parliament doesn't meet every year to make death worse.

Summary of New Rules – TTs and GREs

- Elimination of graduated rates of taxation for testamentary trusts (TT's) – 122(1) amended and (2) repealed
- Top marginal tax rate will now apply to trusts created by will and certain estates

TTs and GREs (Cont'd)

Two proposed exceptions:

1. Graduated rate estate (**"GRE"**) – three part test
   - Means (i) an estate that arose on and as a consequence of an individual's death, (ii) that is a testamentary trust and (iii) only for 36 months from date of death
   - Must be designated as a GRE by the executors in the estate's first tax return
   - Only one GRE per taxpayer
2. QDT - testamentary trust established for benefit of disabled individual (i.e. eligible for disability tax credit) are exempt – details beyond scope of this presentation

TTs and GREs (Cont'd)

- Implications of this change:
  - spousal trusts
  - other tax planned trusts
- Drafting to ensure benefit from full 36 months
- Will not take effect until 2016 and later taxation years
- No grandfathering for testamentary trusts and estates already established
- Practice point – "unwind" current testamentary trusts or revise planning?

TTs and GREs (Cont'd)

- Testamentary trusts will now have a calendar year end:
  - Existing testamentary trusts without a calendar year end will be deemed to have a year end that ends on December 31, 2015 – may have two year ends in 2015
  - Existing estates that are not GREs (i.e. older than 36 months) -same rule
- May make administration of TT's easier going forward

TTs and GREs (Cont'd)

- TT loses $40,000 exemption from alternative minimum tax requirements (treated same as IV trusts) – GREs keep the exemption
- TT will have liability for Part XII.2 tax
- No longer able to make investment tax credits available to beneficiaries

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TTs and GREs (Cont'd)

- GREs (now existing or created later) are different
- Can still choose an off-calendar year end BUT lose this status 36 months post date of death (Note – possible to have 4 Y/E's within one GRE although 2 will be short years)
- On loss of status have a deemed year end and thereafter December 31 year end going forward – two year ends in the same year?
- Only a GRE eligible for 164(6) loss carry back and 112 (3.2) loss restriction
- Only a GRE can make estate donations under the new rules
- No installment obligation for a GRE
- Graduated tax rates apply

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TTs and GREs (Cont'd)

- Note – new 104 (13.3) provides that income paid or payable to a beneficiary can only be taxed under 104 (13.1) or 104 (13.2) in a TT to the extent of any losses in the trust to make taxable income nil

Life Interest Trusts

- New 104(13.4) will apply to life interest trusts effective January 1, 2016
- Life Interest Trusts (LIT) – trusts which received a rollover on a transfer of property to the trust where a deemed disposition occurs on the death of the surviving life interest beneficiary:
  - Spousal and common-law partner trusts (spouse trusts)
  - Joint spousal and common-law partner trusts (JPTs)
  - Alter ego trusts and self benefit trusts (AETs)

Life Interest Trusts (cont'd)

- New provision applies regardless of when trust settled
- Two components on death of the life interest beneficiary (or survivor in a JPT)
  - Deemed year end and deemed disposition occur at end of day of death (new tax year for the trust starts the next day)
  - All income (including realized gains on the deemed disposition) is deemed payable to the life interest beneficiary and taxable on terminal return

Life Interest Trusts (cont'd)

- Shifts tax burden from the life interest trust to the estate of the life interest beneficiary
- 160(1.4) also added - provides that the life interest beneficiary and the LIT are jointly and severally liable for taxes owing as a result of 104(13.4)
- While Finance anticipates 160(1.4) to be applied so that the LIT is liable in the first instance, it remains to be seen how CRA will administer
- Also, creates significant possible mismatch of assets (in the trust) and tax liability (in the estate of the deceased beneficiary)

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Life Interest Trusts (cont'd)

- Note: If the LIT by its terms pays the life interest beneficiary's tax triggered by the deemed disposition under 104(13.4) does that "taint" that estate from being a GRE?
- Yes, given definition of "testamentary trust" in 108(1) (property would have been "contributed to the trust otherwise than by an individual on or after the individual's death and as a consequence thereof")

Life Interest Trusts (cont'd)

- Important to maintain GRE status for the reasons noted previously
- LIT also different re loss carry back - normal three year carry back rules in 111 apply not 164(6)
- Creates another mismatch as the LIT owns the asset that can create a loss and now the capital gain is elsewhere and not able to be reduced (and the shares in question cannot be allocated to the shares to the estate as GRE status is gone and 164(6) is not available there either!)

Estate Donations

- Applicable for 2016 and subsequent taxation years for a death that occurs after 2015
- Donations made in a will, and those made by designation under a Registered Retirement Savings Plan, Registered Retirement Income Fund, Tax- Free Savings Account or life insurance policy, will no longer be deemed to be made by the individual immediately before the individual's death
  - These donations will be deemed to have been made by the individual's estate at the time the property is transferred to a qualified donee, provided the transfer occurs within 36 months after death

Estate Donations (cont'd)

- In addition, the executor/trustee of the individual's estate will have the flexibility to allocate the available donation credit among:
  - the taxation year of the estate in which the donation is made
  - an earlier taxation year of the estate **or**
  - the terminal and immediately preceding taxation year of the individual
- Note: to obtain the carry back the donation must be made by a GRE
  - if estate not a GRE credit only available against the estate's income in year donation made plus 5 year carry forward
- The current annual credit limits will continue to apply (i.e. 100% or 75% of taxable income)

Estate Donations (cont'd)

- Property being gifted must be "property that was acquired by the estate on and as a consequence of the death" or "property that was substituted for that property"
- Note – these rules do NOT apply to donations made by a LIT
- Because of 104(13.4), donations cannot be made by LIT's and claimed against terminal gains

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"Well, we've licked taxes—that just leaves death."

CASE STUDIES

1 – Interprovincial Planning

- Jane Smith owns an Opco with the share ownership as:
  - Preferred freeze shares – Alter ego trust
  - Common shares – IV Family Trust
- The structure is a result of a carefully planned estate freeze 5 years ago
- The preferred shares are being periodically redeemed
- Trustee of the AET is an Alberta trust company
- The family trust is for the benefit of Jane's children

1 – Interprovincial Planning

- Jane, a resident of Ontario, is trying to accomplish the following:
  - Freeze and reduce her direct interest to lower the tax base
  - Reduce the provincial tax rate on the disposition of death
- Note that dividends (deemed on redemption or otherwise) during Jane's lifetime are taxed to Jane as the AET is a "reversionary" trust
- On death, the pre 2016 rules will allow the capital gain to be taxed to the AET in Alberta (this assumes "mind and management" is in Alberta)
- New 104(13.4) will cause the gain to be taxed on Jane's final return - this is what the changes are designed to catch
- Still possible to use an IV trust to shift taxable income to a different province

2- LIT and Private Company Shares

- Jim sold his operating business years ago and created Investco with significant investments from tax deferred proceeds
- Jim died in 2013 leaving the shares of Investco in a spousal trust with his wife Sally as beneficiary and trustee
- On Sally's death, the plan is to wind up Investco and distribute the assets to 4 of Sally's 5 children - Sally does not get along with the 5th child who is Sally's daughter from another marriage
- 104(13.4) must now be considered

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2- LIT and Private Company Shares

- Double tax could result as:
  - the gain (CG) on Sally's death in the spousal trust will be included in Sally's final return
  - On windup of Investco, there will be a deemed dividend and capital loss (CL)
  - The CL and CG are with different taxpayers such that the CL cannot be used

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2- LIT and Private Company Shares

- Alternatives to consider

  a. Have the spouse trust distribute the shares to Sally and then use 164(6) to avoid double tax to Sally's estate (designated as a GRE)

  - concern is opening up estate for challenge by daughter under dependant's relief legislation

  b. After death, use a "pipeline" strategy to windup company

  - possible 84(2) challenge by CRA given *The Queen v. MacDonald*, 2013 FCA 110, precedent
  - arguably would have to keep the company active after death
  - also careful attention given to 84.1 and "bump" rules if appreciated securities in the company

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2- LIT and Private Company Shares

- Other issues
  - If estate has tax liability, funds may come from spouse trust
  - This will taint GRE status of the estate, but does that matter?

3 – Blended Family

- Paul and Pam are in a second marriage for each
- Each have adult children from a prior relationship
- Both are 75 years old
- Each have their own assets, although the value of Paul's assets is significantly higher than Pam's
- Paul's will establishes a spouse trust for Pam to benefit her with income during her lifetime with limited access to capital, and with a gift over to his children on Pam's death
- Paul's primary concerns are to provide for Pam so she can maintain her lifestyle during her life, but to ensure the capital goes to his kids and not Pam's kids

3 – Blended Family

- Pam's more modest assets will pass under her will to her children with no provision for Paul except her interest in the matrimonial home and some personal affects
- OLD RULES – Paul's trust on Pam's death would have a deemed disposition and pay tax in the trust in the year of death before distributing the residue of the trust property to the residual beneficiaries
- NEW RULES – 104(13.4) applies to create the year end on the date of Pam's death and to push the tax bill to her estate
- This is likely no concern if Paul survives Pam

3 – Blended Family

- If Paul predeceases Pam, Pam's estate has a significant tax bill related to Paul's assets, but Paul's children receive the distribution from the spouse trust
- What can be done?
- If Paul alive and competent, will/plan can be changed
- If Paul deceased or incompetent, options are much more limited

3 – Blended Family

1. Trust pays the amount of the tax to Pam's estate – taints Pam's estate as a GRE – does that matter? (see prior slide)

2. Trust pays residual beneficiaries of Pam's estate directly to compensate for reduced value of estate due to the tax (calculated by formula) – complicated drafting, calculation and administration, but possible

3. Issue to Pam a promissory note equal to the tax liability that will arise on death (again by formula) and an irrevocable direction from Pam to pay the note on her death to the Receiver General to credit toward her terminal taxes – this may not taint Pam's estate as a GRE but does it work given terms of trust?

3 – Blended Family

4. Indefeasibly vest the amount of the tax (again by formula) in Pam and then pay that amount to Pam's estate after death – again may not taint the estate as a GRE but does it work given terms of trust?

5. Enter into a contract with Pam to pay the tax (again by formula), and then pay the debt to the estate – again may not taint the estate as a GRE but how can trustees do that in light of fiduciary duties to remainder beneficiaries?

6. Is a court ordered trust variation under provincial variation of trusts legislation appropriate? Paul's children as residual beneficiaries of the trust may object to the amendment

3 – Blended Family

7. Will 160(1.4) solve this problem?

4 – Charitable Donations - Donation through a LIT

- John and Jane have the following in their estate planning:
  - They leave their non registered assets in a spouse trust for each other - each of their assets include securities with accrued gains
  - John and Jane have RRIF's and TFSA's that they leave to each other
  - On the last death, the assets are left to a charity
  - The spouse trust has been structured to give the trustee discretion to allow the donation at the trust level

4 – Charitable Donations - Donation through a LIT

- Plan well set up under old rules
- 104(13.4) will now cause the income in the spousal trust in the year of death to be in the final return and deem a year end
- Possible solutions include:
  - Do not use a spousal trust as the donations can be made by the surviving spouse's will and will be used against income in the final return
  - Have the spouse's estate as a beneficiary of the spousal trust such that the assets are distributed to the estate and then donated BUT this taints the estate as a GRE and donation credit only available in the estate and not on final return
  - Consider other options discussed in previous case study
  - Need to consider the importance of the spouse trust and GRE status

4 – Charitable Donations

- Cyril and Gail have substantial assets, the majority held in an Investco
- Their ultimate estate objectives are:
  - Put $5m in trust for their disabled son Mike
  - Leave the rest of their estate to their private charitable foundation
  - Protect the bequests from a challenge from their estranged daughter
- The Investco shares are in a joint partner trust to protect against dependant relief challenge and the donation was structured to be available to offset income in the JPT
- They each leave personally held assets to a spouse trust for each other.
- Cyril is no longer competent and cannot change his will

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4 – Charitable Donations – Donation of a Holding Company

- 104(13.4) deems the JPT income to be taxed in the final return of the survivor
- Presumably Investco will be wound up - this creates an inability to use the capital loss and a double tax
- Possible solutions:
  - Wind up JPT and allocate to Cyril
    - not competent
    - his will leaves assets to a spouse trust (cannot change)
  - Wind up JPT and allocate to Gail
    - Set up Son's trust on her death, even if first
    - Consider tax on funds from Investco
    - Bequest to Cyril, if company left intact, cannot be in a spousal trust
    - Can assets left to Cyril then be managed with an enduring Power of Attorney?

4 – Charitable Donations – Donation of a Holding Company

- Wind up Investco now and make donations to reduce tax - not likely to be as tax efficient re: personal funds needed

- The above alternatives ignore a challenge by their daughter - can this be managed outside of a JPT?
- May be a trade-off between asset protection and donation credit
- Modeling may be required to understand that trade-off

5 – Will Review

- Natalie and Bill are long time clients who regularly review their wills and related estate planning documents with you
- Yesterday they came for a regularly scheduled meeting and you reviewed their wills

5 – Will Review

- The wills currently provide seeding trusts for their (both of whom are incorporated professionals), spousal trusts for each other for income splitting purposes and residual trusts for their two children also for income splitting, and a $100,000 charitable bequest payable by the spouse trust on the second death – Natalie's and Bill's wills are mirrors of each other

- Given the legislative changes taking effect on January 1, 2016 – what do you advise them?

5 – Will Review

1 - Elimination of seeding trusts

- Seeding trusts had been popular as a means to sprinkle income through a testamentary trust where it could receive a modest settlement amount ($100) and use those funds to acquire dividend streaming shares from a private corporation

- Trust itself received a tax rate, and income could be sprinkled to beneficiaries (possibly including minors subject to application of Kiddie tax)

- No continuing benefit to such trusts on a rate basis, but still possible to sprinkle income (easier to use an IV trust)

5 – Will Review

2 - Change spouse trust to outright distributions to each other

- No continued income splitting opportunity for the spouse trust – all income retained in the trust would be taxed at the highest marginal tax rate
- Outright distribution also simplifies estate administration for the survivor
- No other reason for the spouse trust to be there in this case, but consider in others whether such applies (i.e. in a second marriage or with significant inherited wealth by one of the spouses)

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5 – Will Review

3 - Convert children's trusts to "estate fund" type

- No continued benefit to testamentary trust purely for each adult child as with spouse trust
- Convert to "estate fund" type trust - discretionary trust where income and capital can be allocated among a class of beneficiaries at the discretion of the trustee or through a power of appointment exercisable by a beneficiary or another person

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5 – Will Review

- Beneficiary of each trust would be each child, his or her children, and possibly his or her spouse (subject to matrimonial claims and consequent matrimonial creditor proofing issues)

- Investment income can be "sprinkled" to beneficiaries in lower tax brackets than the child (i.e. their children, including minor children) - 75(2) attribution is not applicable as trust as settled by deceased testator

5 – Will Review

- Upon child's death, estate fund trusts typically end and assets are divided equally among that child's children or other beneficiaries through a power of appointment or otherwise
- If all income is made paid or payable to one or more of the beneficiaries each year, nothing is taxed in the trust and the income is taxed by each beneficiary (Note – previously the trust itself had it's own graduated rate, but that is no longer available)
- Consider possibility of wind-up by child if no future benefit

5 – Will Review

4 - Grandchildren's Trust

- If one of Bill and Natalie's children predecease them or upon their parent's death, assets are held in trust for each grandchild
- Ensure trust terms allow for income to be "paid or payable" to a beneficiary while a minor (for things such as tuition, sports activities, extra travel expenses etc.) to obtain deduction by trust and consequent inclusion in income of minor

5 – Will Review

- Avoids having income actually paid into the hands of the minor – surviving parent can be reimbursed for those expenses

  (Note: cannot be for the minor beneficiary's "ordinary family household expenses" – see *Degrace Family Trust v. Canada*, [1998] TCJ 1112)

5 – Will Review

5 - Ensure will has ability to extend the holding of assets in the estate for up to 3 years to take advantage GRE taxation

- Consider clause similar to this:
- In their discretion, my executors may continue to hold the assets of my estate in trust in the estate for up to three years after my death before distributing the residue of my estate in accordance with the provisions of this will
- Similar provisions should be added to extend spouse trust if used

5 – Will Review

6 - Consider other estate planning reasons for testamentary trusts

- Are there other reasons to have a testamentary trust for each other, children or grandchildren?
- Reasons could include:
- Matrimonial protection for the beneficiary
- Spendthrift trust to protect capital income from a spendthrift beneficiary
- Henson trust to protect a disabled beneficiary who may be receiving now or in the future provincial social assistance benefit

5 – Will Review

- Blended families to ensure assets ultimately go where they should after others are provided for – but watch out for 104(13.4) if spouse trust is used
- Continuity of ownership for real estate such as cottages or other properties (but watch out for the 21 year deemed disposition rule)
- Protection for incapacitated or vulnerable beneficiaries (i.e. addictions, elderly persons etc.)

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5 – Will Review

- Bypass of US estate tax for a US citizen, US resident or US property owning beneficiary by having capital available only upon the US "ascertainable standard"
- Avoiding double probate by only probating assets once to get them into the trust and then not again to get them out
- General creditor protection for a beneficiary
- Not an exhaustive list

And finally I leave everything
to my lawyer.

Planning Principles – What did we learn?

1. Avoid life interest trusts if you can – can you get to the same place in another way?

2. If you must use a life interest trust (because of dependant relief concerns or spousal protection), avoid including private company shares in the LIT

3. If the client wishes to make donations, try to effect those outside of the LIT from other assets or sources (i.e. life insurance, RRSP/RRIF, etc.)

Planning Principles – What did we learn? (cont'd)

4. If the client has capacity, amend documents later in 2015 as January 1, 2016 approaches and consider alternate scenarios in the will or trust which provide for different dispositive provisions if the client dies prior to January 1, 2016 versus after January 1, 2016

5. Consider utility of existing TTs and possible wind-up

6. The wasting freeze approach to planning using holdcos is still appropriate and should be utilized

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Planning Principles – What did we learn? (cont'd)

7. Be very careful of blended families to avoid a mismatch of assets and tax

8. Watch out for tainting the GRE and losing marginal rates, estate donation rules and 164(6) carry backs

9. Model the results a lot more frequently than may have been done before to ensure that the client's specific scenario is fully analyzed (particularly when private company shares are involved)

Conclusion

- A lot of work to do for advisors in next 3.5 months!
- Changes creates opportunities
- Changes create responsibilities

QUESTIONS

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