Changes To The Tax Treatment Of Trusts And Estates

Budget 2014 proposes a number of changes to the taxation of trusts and estates under the *Income Tax Act* (Canada) (the "**Tax Act**") that will have a significant impact on tax planning. The most significant changes are (i) the elimination of graduated-rate taxation and other tax benefits for testamentary and certain other trusts, (ii) increased flexibility in the tax treatment of charitable donations made on death, and (iii) the elimination of so-called "immigration trusts" provided for under Canada's non-resident trust tax rules.

Elimination Of Tax Benefits Enjoyed By Testamentary And Certain Other Trusts

Under the Tax Act, while *inter vivos* trusts are generally taxed at the highest tax rate applicable to individuals (currently 29%), testamentary trusts (trusts created by will) are taxed at the same graduated rates applicable to individuals (which range from 15% to 29%). In either case, provincial taxes are also generally applicable.

The differential treatment of testamentary trusts was perceived, in some quarters, as permitting taxpayers to obtain improper tax advantages by settling multiple testamentary trusts to access the lower graduated tax rates generally available to individual taxpayers. In last year's Budget, the Government announced that it would consult on possible measures to eliminate the tax benefits that arise from the graduated-rate taxation of testamentary trusts.[1] The Government now proposes to generally eliminate the preferential treatment afforded to testamentary trusts by taxing such trusts at the highest individual rate.

In recognition of the fact that estates require a reasonable period of time for proper administration, the amendments will permit an individual's estate that is a testamentary trust (a "**graduated rate estate**") to continue to access graduated rates for the first 36 months after the individual's death. In addition, the Government has indicated that graduated rates will continue to apply to testamentary trusts with beneficiaries who are eligible to claim the federal disability tax credit ("**DTC**"), although the Government has said that it will provide further details about the parameters of this exception in the coming months.

Budget 2014 further provides for the elimination of a host of other benefits enjoyed by testamentary trusts in order to bring their tax treatment more closely in line with the treatment of *inter vivos* trusts. Among other changes, testamentary trusts (other than graduated rate estates) will:

- no longer have the ability to designate investment tax credits to beneficiaries;
- no longer be eligible for a $40,000 exemption in computing alternative minimum tax;
- be required to have a calendar-year taxation year; and
- no longer automatically qualify as "personal trusts" and will be required meet certain conditions in order to access the tax benefits available to such trusts.

It is unclear, at this time, whether these additional changes will also apply to testamentary trusts with beneficiaries eligible for the DTC.

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[1] See McMillan LLP Bulletin "Budget 2013: Proposed Consultation on Changes to the Income Tax Rate Applicable to Trusts and Estates".

It should be noted that some of the above changes, including the elimination of graduated-rate taxation, are also proposed to apply to "grandfathered" *inter vivos* trusts (certain trusts created by an individual during his or her lifetime before June 18, 1971).

Although the Government may have a legitimate concern about preventing taxpayers from exploiting the rules applicable to testamentary trusts, there are many legitimate reasons, not tied to tax savings, for the establishment of such trusts and many beneficiaries who will be adversely affected by this increase in trust income tax. Moreover, it is unclear that such sweeping changes were required to address the Government's legitimate concerns about the abuse of testamentary trusts. Nevertheless, it is proposed that these new changes will generally come into effect for taxation years ending after 2015.

Increased Flexibility In The Taxation Of Estate Charitable Donations

Budget 2014 proposes changes to the tax treatment of charitable donations made as a consequence of death that are meant to increase flexibility in the application of charitable donation tax credits.

Individuals who make donations to registered charities and other qualified donees ("**charitable donations**") are generally eligible to claim an income tax credit that is calculated on the basis of the fair market value of the donated property, subject to limits and reductions required by the Tax Act. Currently, where an individual (i) provides for a charitable donation in his or her will, or (ii) designates that a charitable donation be made from the proceeds of a RRSP, RRIF, TFSA or life insurance policy as a consequence of his or her death (a "**designation charitable donation**"), the Tax Act treats the charitable donation as having been made by the individual immediately before his or her death. The tax credit may be claimed in the year of death or, in certain circumstances, the preceding year.

Budget 2014 proposes to change the current rule to deem charitable donations by will and designation charitable donations to have been made by the individual's estate at the time the property to be donated is transferred to the charity or qualified donee. At the same time, an estate trustee will be granted the ability to apply the charitable donation to either the taxation year of the estate in which the charitable donation was made, an earlier taxation year of the estate, or the individual's last two taxation years.

To be eligible for this new, flexible treatment, a charitable donation by will or designation charitable donation must be effected by a transfer to a registered charity or other qualified donee within 36 months of the individual's death. Certain limitations, including rules restricting the amount of charitable donations creditable in a given year, will remain in effect with respect to these charitable donations.

These changes are expected to apply to charitable donations made in the context of deaths that occur after 2015. They provide a welcome degree of flexibility in managing the taxes of deceased individuals and their estates.

Elimination Of 60-Month Exemption For Non-Resident Trusts

The Tax Act contains special rules (the "**Non-Resident Trust Rules**") which, in general terms, deem a non-resident trust to be resident in Canada, and subject to Canadian income tax, for the purposes of the Tax Act, where a person resident in Canada has contributed property to the non-resident trust. These rules are designed to prevent Canadian-residents from avoiding Canadian taxation by contributing property to non-resident trusts that are otherwise outside of the Canadian tax base.

However, an exception to the Non-Resident Trust Rules is generally available where contributors to a non-resident trust are individuals, each of whom has been resident in Canada for less than 60 months (the "**Trust Exemption**"). The Trust Exemption has typically been relied upon by new immigrants to Canada to avoid paying Canadian income tax on the trusts' foreign-source income during their first five years after arriving in Canada.

In Budget 2014, the Government states that the use of these so-called "immigration trusts" raises concerns about "tax fairness, tax integrity and tax neutrality". Therefore, Budget 2014 proposes to eliminate the Trust Exemption for taxation years ending on or after February 11, 2014. However, the measure will not go into effect until a trust's first taxation year that ends after 2014 if (i) the Trust Exemption applies to the trust at any time after 2013 and before February 11, 2014, (ii) and no contributions are made to the trust on or after February 11, 2014 and before 2015.

This proposed amendment represents a significant change in tax policy, the effect of which will be felt all the more deeply because the Government is only providing limited transitional relief for existing immigration trusts. It remains to be seen whether this change will have a material impact on the number of high net-worth individuals seeking to immigrate to Canada.

by Ryan Walker

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