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Surprise legislation impacts estate planning

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The 2014 federal budget introduced measures that will have a significant impact on the taxation of testamentary trusts, effective for the 2016 and subsequent taxation years. These changes were noted in our recent release, Changes are on the way that impact post-mortem planning.

In late August 2014, the Department of Finance released draft legislation to implement these proposals, but this legislation included some surprise measures not previously announced in the 2014 federal budget. These new proposals may have a significant impact on some common estate planning strategies, particularly those involving spousal and other life interest trusts.[1] This legislation was recently incorporated into Bill C-43, the second 2014 federal budget bill, currently making its way through Parliament with enactment expected later this fall.

Impact on designations to tax income within a trust

The current rules permit a trust to make a designation[2] to deem income paid or payable to a trust's beneficiary to be taxed within the trust. This designation has commonly been used by testamentary spousal trusts to gain access to a separate set of graduated rates.[3]

The new legislation will effectively limit the ability to make this designation to circumstances where a trust or estate uses tax losses from other taxation years to reduce the taxable income of the trust to nil.[4]

As well as the obvious tax planning implications for testamentary trusts, this change will also have an impact on planning arrangements that use inter-vivos trusts to shift income from higher tax to lower tax jurisdictions (for example, Alberta trusts).

Impact on post-mortem estate planning

Another new proposal could have a significant impact on many current estate planning arrangements involving life interest trusts. The current rules provide that, when a beneficiary of a life interest trust passes away, the trust is deemed to dispose of its assets at their fair market value, and any resulting capital gains and other income earned in the year of death is taxed within the

[1] Spousal, alter-ego, joint partner and other similar trusts (commonly referred to as "life interest trusts").
[2] Pursuant to either subsection 104(13.1) or 104(13.2).
[3] As opposed to having the income that is "paid or payable" being added to the beneficiary spouse's other income.
[4] Proposed subsection 104(13.3)

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trust. The new legislation will deem the trust to have a taxation year-end on the date of the spouse's death and will require the above-noted gains and income to be taxed in the deceased's final income tax return.[5]

This proposed change may adversely impact post-mortem planning strategies where the trust holds private company shares (or other assets with a significant unrealized gain). After the death of the beneficiary spouse, the company is often wound up and its shares are redeemed or cancelled, resulting in a dividend as well as a capital loss on the disposition of the shares[6]. The capital loss can then be applied to offset or reduce the capital gains realized in the trust upon the death of the spouse. Under the proposed rules, this type of planning will no longer work. Instead, double taxation will result, with the capital gain being reported by the deceased beneficiary and the capital loss being realized by the trust, with no mechanism for applying the loss to offset the gain.

For such trusts, there is no corresponding legislation which allows the trust to carry back tax losses and apply them to the deceased's final income tax return.[7]

Also, as the legislation is currently drafted, it is unclear if the trust's taxable income for the year of death can be amended to factor in the carry back of a capital loss so as to permit a late filed designation under subsection 104(13.2).

These proposed rules could also have an adverse impact where the capital beneficiaries of the deceased's estate are different from the trust's beneficiaries. Let's say Mr. Jones sets up a spousal trust and names his children from his first marriage as the capital beneficiaries, while the capital beneficiaries of Mrs. Jones's estate are her children from a previous marriage. In this situation, Mr. Jones's children will receive the assets of the spousal trust, while Mrs. Jones's children will have to fund the income tax payable on the accrued capital gains realized by the estate on those assets. Both the trust and the estate will be jointly and severally liable to pay the estate's income tax liability,[8] but if the estate has sufficient assets to pay the liability, the trust will not be required to make the payment. This may significantly lower the amount of after-tax distributions from the estate to its capital beneficiaries, and leave increased amounts in the spousal trust and for its beneficiaries.

Many existing life interest trusts have been established with the intention of having the trust make charitable donations to help offset the capital gain realized on the deemed disposition of the trust property. In the absence of any relieving provisions, these new rules will frustrate many estate plans.

These new rules will cause the capital gain to be reported on the beneficiary's terminal tax filing, yet the donations will remain in the trust, essentially limiting access to the tax benefit that would normally be achieved from making charitable donations.

It's proposed that the changes noted in this release will apply equally, as of the 2016 taxation year, to both new and existing trusts as there are no grandfathering provisions. Therefore, current estate plans should be reviewed and possibly revised (to the extent that they can be) to take these proposed new rules into account.

Contact your Grant Thornton tax adviser for further details about these proposed measures and how they might impact you and your family.

[5] Proposed subsection 104(13.4)

[6] The shares are deemed to be reacquired at their fair market value on the death of the beneficiary, resulting in an increase in their tax cost base.

[7] A subsection 164(6) election is not available to such trusts.

[8] Pursuant to new subsection 160(1.4).

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