Proposed changes to the taxation of Canadian testamentary trusts

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In the 2013 Federal Budget, the Department of Finance announced that the Canadian government would review how testamentary trusts are taxed and would release a consultation paper at a later date. On June 3, 2013 the consultation paper was released by the Department of Finance and can be viewed here. The Department of Finance is seeking input from interested parties no later than December 2, 2013. For practitioners who practice in this area, the short consultation paper will no doubt be mandatory reading since the proposed changes raised in the paper, if implemented, would be a landmark change for testamentary trusts.

The consultation paper's main message is that the Department of Finance is proposing to eliminate graduated tax rates for testamentary trusts except for estates of deceased persons for a limited period of time, as discussed further below.

A "testamentary trust" is defined in subsection 108(1) of the *Income Tax Act* (the "Act") as a trust or estate that arose on and as a consequence of the death of an individual with certain exceptions that are beyond the scope of this blog. Pursuant to subsection 104(2) of the Act, a trust is deemed to be an individual in respect of the trust property and is therefore taxed as an individual (with certain adjustments that are again beyond the scope of this blog). As such, testamentary trusts "benefit" from graduated tax rates like individuals. This is unlike "*inter vivos* trusts" (which are trusts other than testamentary trusts) whose taxable income is not subject to graduated rates and instead are subject to taxation at the highest marginal rates applicable to individuals (see subsection 122(1) of the Act).

Graduated tax rates for testamentary trusts has encouraged some planning over the years:

1. Delaying the Wind-up of the Administration of an Estate

The estate of a deceased person is generally considered a testamentary trust for Canadian income tax purposes. Accordingly, the legal representatives may be encouraged to delay the quick administration and wind-up of the estate so as to obtain access to graduated tax rates for a longer period of time. The consultation paper released by the Department of Finance is proposing that an estate would be subject to the highest marginal tax rate for individuals after 36 months from the date of death (then considered a "flat top-rate estate"). These measures would apply to existing and new arrangements for the 2016 and later taxation years.

2. Testamentary Trusts Receiving Loans From Related Parties

In order to get access to graduated tax rates, a testamentary trust would often distribute assets to capital beneficiaries of the trust on a tax deferred basis and then the beneficiary would then loan such amounts back to the trust. The trust then receives such assets back so as to realize income within the trust and have such income benefit from graduated tax rates. There is currently a technical amendment to the definition of "testamentary trust" before Parliament (which has its origin over 11 years ago) that, if

passed, would cause a testamentary trust that engages in such a plan to lose its status as a testamentary trust and be treated as an *inter vivos* trust. The consultation paper obviously does not discuss this matter since the technical amendment will curb this type of planning.

3. Use of Multiple Testamentary Trusts

Given the tax benefit of using testamentary trusts in estate planning, it might be preferable to use multiple trusts to get access to multiple graduated tax rates on trust income. However, there is an existing anti-avoidance rule that will consider multiple, similar testamentary trusts to be consolidated if substantially all of the property of the various trusts has been received from one person and there is a similar beneficiary, or group class of beneficiaries. The consultation paper does not propose to amend this anti-avoidance rule in subsection 104(2) of the Act.

Some of the other proposed changes that are discussed in the consultation paper are:

1. The proposed measures on graduated rates would not change the preferred beneficiary election rules or the rules that apply to trusts for minor children.
2. The proposed measures on graduated rates would not change the rollover rules that apply on the death of a spouse or common-law partner.
3. The proposed measures would require trusts created by will and flat-top rate estates to use a calendar year taxation year and require that their fiscal periods end in the calendar year in which the periods began.

There are a number of other technical consequential amendments that would be necessary if the proposals are ever passed into law and are beyond the scope of this blog. In short, the consultation paper discusses proposed changes that will have a monumental impact for practitioners who are involved in tax and estate planning. There will no doubt be submissions made by many interested parties including the Society of Trust and Estate Practitioners.

Here are our initial comments:

1. There is no doubt that planning is being done to use testamentary trusts to access graduated tax rates and thus achieve income splitting. However, it is not clear this is a large “problem”. It would be good see statistics associated with the consultation paper so a better perspective could be obtained on the overall effect of the change to the tax base.
2. Practitioners and interested parties will want to study the history of the tax policy involving graduated tax rates for testamentary trusts. How long has this policy been in place? Why was the policy of graduated tax rates implemented for testamentary trusts in the first place? Was it to compensate for the elimination of the estate tax in 1972? Canada did have an estate tax prior to 1972.
3. Is the proposed period of 3 years long enough to allow for estate administration of a deceased person before such estate becomes a “flat top-rate estate”? In today’s complex world, there are many factors that can cause an estate to be administered for a long period and in our experience, many of these factors are not tax motivated.
4. In our experience, trusts created by will are often implemented for non-tax reasons. For example, a parent may wish to create a trust in his or her will to provide for a “problem child”. Upon the death of the parent, the assets would be transferred to the trust and be administered under the terms set out in the will that presumably enable the wishes of the deceased parent to be carried out so that the child does not have free access to the funds. Compare this situation where the problem child would receive his or her inheritance outright in a tax free basis and any

investment income received by the child would be subject to individual graduated tax rates. Is this result fair? In our example, the parent may be discouraged to use a trust for the problem child given the comparable tax result. As such, estate planning may be driven by tax results rather than gift considerations.

It will be interesting to see how practitioners respond to the Department of Finance's consultation paper. Stay tuned!