New draft legislation will have a great impact on traditional estate planning for Canadians

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On August 29, 2014, the Department of Finance released 100+ pages of draft legislation. Much of the draft legislation was to enact the 2014 Federal Budget proposals. However, there were a couple of nasty surprises, one of which will have a great impact on traditional estate planning for Canadians. The Department of Finance gave interested parties until September 28, 2014 to provide comments.

For those of you who recall, August 29, 2014 was the Friday before the September long weekend. For tax geeks like me, the release of any draft legislation is like Christmas… goodies and presents galore (minus the sugar)! Unsurprisingly, I spent much of the long weekend and the days and weeks following absorbing the new material. As mentioned, there were a couple of surprises and some technical glitches. Accordingly, The Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada ("Joint Committee") submitted comments to the Department of Finance on the surprises and technical glitches. I was one of the principal authors of the Joint Committee's submission. Regrettably, the Department of Finance chose not to respond to the Joint Committee's comments and no changes were made as a result of the submission. The draft legislation is now contained in a Bill before Parliament.

So what is the main concern about the draft legislation that will affect many Canadians' traditional estate planning? It is the introduction of subsection 104(13.4) into the Income Tax Act (the "Act"). Overly simplified, this will deem spousal trusts, alter ego trusts and joint partner trust's income that is realized upon the death of the spouse, individual or last to die spouse / common law partner respectively to be included in the income of the deceased – by reporting such income on the deceased's terminal return – rather than taxed in the trust.

Let's consider an example to help explain this concern. Assume the case of Mr. and Mrs. Apple who are both Canadian residents and not US citizens or residents. Further, assume that Mr. Apple died a number of years ago. Upon his death, much of his assets were transferred to a testamentary trust for the benefit of Mrs. Apple. The trust was conditioned so as to ensure that there was a "rollover" of the assets into the trust (generally meaning that no income taxes would be triggered as a result of Mr. Apple's death). The conditions for rollover, under subsection 70(6) of the Act, are that:

> (i) the trust must be created by the taxpayer's will (this condition would be met since the spousal trust for Mrs. Apple would be created by terms set out in Mr. Apple's will);
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> (ii) the trust was resident in Canada immediately after the time the property vested indefeasibly in the trust;
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> (iii) Apple must be entitled to receive all of the income of the trust that arises before her death; and
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> (iv) no person except Mrs. Apple may, before her death, receive or otherwise obtain the use of

any of the income or capital of the trust.

The trustee of the spousal trust for Mrs. Apple is a Canadian resident lawyer friend of Mr. Apple and he was appointed pursuant to the terms of Mr. Apple's will. After Mrs. Apple's death, the beneficiaries of the spousal trust are Mr. and Mrs. Apple's three children. Under existing law, the spousal trust would have a deemed disposition of its trust assets at fair market value on the day of the death of Mrs. Apple under subsection 104(4) of the Act. The spousal trust would then include any gain or loss as a result of such a deemed disposition in the taxation year of the trust that included the date of death. The spousal trust assets would then be used to pay for the resulting tax liability.

Now, however, proposed subsection 104(13.4) will require the trust's otherwise income inclusion to the date of death to be included in Mrs. Apple's hands for deaths that occur after 2015. Let's carry on with the example to illustrate a significant consequence of this new rule.

Let's assume that Mrs. Apple remarried after the death of Mr. Apple. She married Mr. Banana 2 years after the death of Mr. Apple and had a wonderful life. Mrs. Apple and Mr. Banana built up additional assets during their marriage. Mr. Banana and Mrs. Apple effected standard "mirror" wills whereby each of them would receive the other's assets upon the first death and then to charity upon the last death. The surviving spouse would be the executor or executrix of the estate of the first to die spouse. Structured this way, there should be "rollovers" to the surviving spouse upon the first death under subsection 70(6) of the Act.

Let's now assume that Mrs. Apple dies before Mr. Banana in 2017. Upon Mrs. Apple's death, the spousal trust would be deemed to have disposed of its assets but the income inclusion would be in the terminal return of Mrs. Apple. Accordingly, Mr. Banana, as executor of Mrs. Apple's estate, would report the spousal trust's income in Mrs. Apple's final income tax return pursuant to new subsection 104(13.4). However, how will Mr. Banana get the funds to pay the resulting tax liability? Well, the simple answer is the spousal trust, of course. However, what if the lawyer friend trustee of the spousal trust refuses to transfer assets to Mrs. Apple's estate to pay the tax? Will Mr. Banana be out of pocket to fund the tax liability out of assets that should have been transferred to him on a rollover basis? Perhaps.

Are there any remedies to the above possibility? Unfortunately, no. The Department of Finance obviously thought about this kind of situation and introduced new subsection 160(1.4) of the Act which will make the trust and the estate jointly and severally liable for the payment of the trust's tax liability. That hardly solves the problem illustrated above but certainly protects the Government's interest. In a worst case scenario, as already mentioned, Mr. Banana would be out of pocket while the newly sprung beneficiaries of the spousal trust, the 3 Apple children, would be enriched.

Moreover, there will be no mechanism available, such as a subsection 164(6), to carry back any losses realized by the trust after the death of the spousal beneficiary to be utilized in the deceased's terminal return.

So why did the Department of Finance introduce this surprise into the August 29, 2014 draft legislation? I honestly do not know. I have had discussions with the Department of Finance regarding this very question and the only thing that I hear is that the Department believes that it is right in tax policy to have the spousal trust's income inclusion that is realized upon the death of the spouse to be included directly in the income of the spouse. Frankly, that is not all that illuminating and very debatable.

Are there other consequences that will arise as a result of the introduction of subsection 104(13.4)?

Certainly. Here's another one. Let's consider the following facts:

1. Mr. and Mrs. Orange are married and both are Canadian residents for income tax purposes.

2. Mrs. Orange is a US citizen and Mr. Orange is not. Since Mrs. Orange is a US citizen, her death will trigger US estate taxes to the extent that the value of her assets exceeds her applicable exclusion amount under I.R.C. § 2010(c)(2) (which is generally US$5.34M for 2014).

3. The combined net worth of the Oranges is US$20M split equally amongst them.

4. Mrs. Orange will die in 2017.

5. Orange's applicable exclusion amount for US estate tax purposes for 2017 is assumed to be US$6M (which in reality, we do not know what this amount will be in 2017).

In the above familiar fact pattern, it would be common to have the will of Mrs. Orange provide for a spousal trust for the benefit of Mr. Orange if she died first. Such a trust would meet all of the conditions of subsection 70(6) so that a "rollover" for Canadian tax purposes would occur on her death.

Additionally, if the planning was completed properly, Mrs. Orange's will would provide that such a spousal trust could qualify as a "qualified domestic trust" ("QDOT") for US estate tax purposes and would rely on the provisions of paragraph 5 of Article XXIX-B of the Canada-US Tax Convention (the "Treaty") to enable a rollover of certain property into that trust for the benefit of Mr. Orange. Normally, the only amount that would be transferred into the trust would be the portion of Mrs. Orange's estate exceeding her applicable exclusion amount (which in our example would be US$10M less US$6.0 = US$4M). Transferring the assets in this way will enable a deferral of the payment of both Canadian income taxes and US estate taxes upon Mrs. Orange's death. If Mr. Orange was to ever receive any of the capital of the spousal trust / QDOT during his lifetime, a portion of the capital would need to be paid to the US government that reflects the US estate tax that would have otherwise been paid upon Mrs. Orange's death.

Upon Mr. Orange's death, the spousal trust will have a deemed disposition of its trust assets pursuant to subsection 104(4) of the Act. However, any income resulting from the trust's deemed disposition will now need to be included in his terminal income tax return pursuant to the provisions of new subsection 104(13.4). In addition, US estate tax must be paid. How will the new rules under subsection 104(13.4) interplay with Article XXIX-B of the Treaty? Good question. Frankly, I'm still working through the implications of this and don't have a good answer to that question although our office's initial review of the rules and the Treaty have concluded that it is not all bad but ultimately VERY careful planning will need to be done. Suffice it to say that it's complicated.

Overall, there are many tax and non-tax implications as a result of the introduction of new subsection 104(13.4). Any estate planning that has been implemented for Canadians that utilizes spousal trusts, alter ego trusts or joint partner trusts needs to be reviewed to consider the implications of the new rules.