New Tax Regime May Upset Your Estate Planning

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If your estate plan includes creating a trust in your will or you are a trust beneficiary or an estate trustee, you may be affected by the federal government’s new legislation to tax certain trusts at the top marginal tax rate rather than the lower graduated tax rates that some trusts currently pay. You may also be affected by a surprising change that will tax accrued gains in spousal, alter ego and joint partner trusts in the deceased’s beneficiary’s hands and not in the trust itself. The rules also introduce flexibility in the use of your estate’s donation tax credits.

Since these changes are effective January 1, 2016, you have just more than a year’s time to revisit your will and estate planning to make any needed adjustments and minimize the impact of these changes.

Will the new tax regime affect my estate planning?

- Do you have a will?
- Does your will create a testamentary trust for the benefit of your spouse or common-law partner or your children?
- Are you now or will you be a beneficiary of a trust?
- Are you a trustee of a trust?
- Are you an executor of an estate?
- Does your will or estate make provisions for gifts to charity?
- Have you established an inter vivos spousal, alter ego or joint partner trust?

If you answered yes to any of these questions, you should contact your KPMG adviser to help ensure your plans will still accomplish your objectives for minimizing taxes and leaving as much as possible to your beneficiaries.

Finance’s new legislation includes changes to:

- Eliminate the graduated rate taxation of testamentary trusts
- Tax the accrued capital gains of certain trusts (such as a spousal trust) in the deceased beneficiary’s terminal return, instead of in the trust itself
- Allow a charitable donation to be allocated between the deceased and their estate in certain circumstances
These new rules will affect your estate planning including any existing and future trusts. We expect these proposed changes to be passed into law before the end of the year and take effect January 1, 2016.

**Background**

The government originally announced its proposal to apply the top marginal tax rate to trusts created by will in the 2013 federal budget. Generally, eligible testamentary trusts have been taxed more favourably than inter vivos trusts. The 2014 federal budget announced changes to eliminate the benefits of graduated rates of taxation for testamentary trusts (including estates) to combat perceived abuses, including the use of multiple testamentary trusts and tax-motivated delays in completing estate administration.

The proposed changes to the use of donation tax credits for gifts made on or after death were also announced in the 2014 federal budget. The budget introduced these changes, which will allow the deceased or the estate to claim donations, to address situations where donation tax credits for gifts made by will were unused because the rules restricted the donation claim to the deceased’s return for the year of death or the prior year.


The new rules are now contained in Bill C-43, which received first reading in Parliament on October 23, 2014.

**Testamentary trusts to pay tax at the top marginal rate**

Under the new rules, effective January 1, 2016, all testamentary trusts will be subject to tax at the top federal rate of tax of 29%, other than certain “graduated rate estates” and “Qualified Disability Trusts”. The combined top marginal federal/provincial rates currently range from 39% to 50%, depending on the trust’s province of residence. The current tax savings available to a trust from graduated rate taxation, as opposed to being taxed at the top marginal tax rate, is in the range of up to $15,000 or more per year, depending on your province.

A graduated rate estate may continue to enjoy the benefits of graduated tax rates for up to 36 months. To qualify, the estate must arise on, and as a consequence of, an individual’s death, be a testamentary trust, no more than 36 months can have passed from the date of death and there can be no other graduated rate estates for the deceased individual. The estate must also designate itself as the deceased individual’s graduated rate estate in its first taxation year that ends after 2015. The estate will be deemed to have a year-end when it ceases to be a graduated rate estate and is then required to select a December 31 fiscal year-end.
The new rules provide that existing testamentary trusts and estates that have existed for longer than 36 months, and that have off-calendar year-ends, will have a deemed year-end as of December 31, 2015.

As of January 1, 2016, testamentary trusts and non-graduated rate estates must select a December 31 year-end and will lose other benefits, including:

- The exemption from remitting quarterly tax instalments
- The $40,000 exemption from Alternative Minimum Tax
- The exemption from Part XII.2 tax dealing with the designated income of certain trusts (such as Canadian capital gain allocated to non-resident beneficiaries)
- The ability to allocate investment tax credits to their beneficiaries
- The extended time period to file a notice of objection (the notice must be filed within 90 days of the date of the notice of assessment).

The new rules replace the term “estate” with “graduated rate estate” which may adversely affect your estate plan, including the ability to eliminate double tax that can arise in certain situations on death by undertaking capital loss carryback planning within the first taxation year of the estate under subsection 164(6) of the Income Tax Act.

**KPMG observations**

Despite these tax tightening changes, testamentary trusts can still be used to achieve savings, such as income splitting by paying testamentary trust income to discretionary beneficiaries who have no or low income levels. As well, trust income that has vested in a beneficiary under 21-years-old can be taxed in their hands, but the income can be retained in the trust as long as it is distributed to the beneficiary before he or she turns 40.

There may also still be tax savings where a testamentary non-spousal trust resides in a province with a lower rate of taxation than the beneficiaries’ province of residence, provided the trust is resident in that particular province, based on its central management and control.

Since only an estate can be a graduated rate estate, consideration must be given to when the estate ceases to exist. If, during the 36-month time frame after death, the estate’s property is transferred to a trust created under the will, that new trust would not be eligible to be taxed as a graduated rate estate for the remainder of the 36-month period because it would not be considered an estate.

Certain transfers and loans, such as, for example, to pay a deceased beneficiary’s tax, may cause an estate to lose its graduated rate estate status and should not be undertaken without first considering the resulting implications.

Graduated rate estate status is relevant to more than just whether the benefits of the lower marginal tax rates are available. Loss of graduated rate estate status may also affect the ability to undertake post-mortem loss-carryback planning to eliminate the double tax liability inherent in the shares of private corporations held by the estate. This must be
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carefully reviewed before undertaking such planning.

It is not clear whether the CRA will consider there to be multiple estates where, for probate planning purposes, a deceased taxpayer has more than one will and each will has a separate executor (e.g., as required in British Columbia). If so, this could affect your estate planning if you have made provision for donations in a probatable will and own shares of a private company in a second non-probatable will.

These changes will also impose an additional administrative burden on trustees, since there will be two taxation years in the year that a loss of graduated rate estate status occurs. Any existing testamentary trusts or estates that have existed for longer than 36 months will have two fiscal year-ends in 2015.

### Spousal, alter ego and joint partner trusts

The new rules provide that, after January 1, 2016, a deemed year-end will be triggered by the death of a spouse beneficiary in a spousal trust, a settlor in an alter ego trust and the survivor of the settlor and their spouse in a joint partner trust (referred to as a life interest trust). For that year, trust income (including capital gains triggered as a result of their death) will be taxed in the deceased beneficiary’s terminal return and not the trust.

These types of trusts require the payment of trust income to the beneficiary. By filing a designation, it is possible to have income taxed in the trust that was otherwise payable, and thus taxable, to the beneficiary.

Starting in 2016, this designation can only be made if the trust would have no taxable income after making the designation. This means that the designation can only be made in circumstances where the trust has loss carry forwards.

### KPMG observations

The new rules may significantly affect the allocation of wealth between the deceased’s estate compared to the life interest trust’s capital beneficiaries. The capital gains that arise from the deemed disposition of the trust’s assets will now be taxed in the deceased’s terminal return, and the tax cost will fall on the deceased’s estate beneficiaries (not the capital beneficiaries of the trust). However, this result may not have been the intention of the testator or their spouse at the time the trust was created (e.g., in a second marriage, the capital beneficiaries of the testamentary spouse trust are often different than the beneficiaries of that spouse’s estate).

If the deceased’s beneficiary’s estate does not have sufficient assets to pay the tax liability, the CRA will have recourse to the trust, as the trust and the deceased beneficiary are jointly and severally liable under the rules. However, if the trust transfers funds or makes a loan to the estate to allow it to pay the taxes, this could disqualify the estate as a graduated rate estate. This loss of status must be carefully considered before making such a transfer or loan.
The new changes should not affect post-mortem planning to avoid double tax where the life interest trust owns shares of a private company, other than to add additional compliance filings to this planning.

**Qualified Disability Trusts**

Qualified Disability Trusts will continue to be eligible for graduated rate taxation. A Qualified Disability Trust is a testamentary trust that is resident in Canada that has one or more beneficiaries with a disability tax credit certificate (referred to as an "electing beneficiary"). The Qualified Disability Trust must make a joint election with an electing beneficiary to be a Qualified Disability Trust and the electing beneficiary cannot make the same election with any other trust.

To take advantage of the graduated rate of taxation, trust capital must be paid to the disabled beneficiary. If capital is paid to a non-disabled beneficiary, there will be a repayment of the tax savings previously enjoyed.

**KPMG observations**

There is no time limit that applies to Qualified Disability Trusts. The trust qualifies provided it meets the required criteria for a particular year.

It is possible that a testamentary trust that does not qualify as a Qualified Disability Trust in one year can qualify in subsequent years. Consider, for example, a testamentary spousal trust where the spouse beneficiary subsequently becomes disabled and is eligible for the disability tax credit. In such circumstances, it may be possible to have certain types of income (which is income for tax purposes but not income for trust law purposes) become eligible for graduated rate taxation.

**Testamentary charitable giving**

The new rules allow greater flexibility in using the donation tax credit related to donations made by will and gifts by direct designation, as of January 1, 2016. The new rules will allow a donation to be allocated between the deceased and their estate where the donation is made by a graduated rate estate. In such case, the deceased may use the donation credit in the year of death or in the immediately preceding year. Alternatively, the graduated rate estate may use the donation in the year of the donation, carry it back to any of its prior taxation years, or carry it forward for up to five years.

The rules continue to provide for no tax on capital gains for gifts of publicly traded securities as long as the gift is made by a graduated rate estate.

If the estate makes the gift after its first 36 months or if the estate loses its graduated rate estate status during the year the gift is made, the gift may only be claimed by the estate in
the year of the gift or carried forward five years.

The new changes also deem gifts made by will or by an estate to have been made by the estate at the time that the gift is actually transferred to the charity (not as of the date of death).

KPMG observations
Since not every estate will be a graduated rate estate at the time that it makes a donation, it is not certain that a donation made by an estate will be eligible to offset taxes in the deceased’s terminal tax return and the immediately prior year. As a result, it may be necessary to fund the taxes payable in the terminal tax return until such time as the gift is actually made and it is confirmed that the estate qualifies as a graduated rate estate.

There may be situations where a gift by will cannot be made within the 36-month period (e.g., where a bequest is subject to estate litigation). In this case, the flexibility to allocate the donation between the estate and the deceased will not be available because the estate would not be a graduated rate estate at the time of the eventual donation.

As of January 1, 2016, the new rules determine the value of a charitable gift at the time the gift is made, but the income inclusion to the deceased is based on the fair market value of the asset immediately before death. As a result, it will be necessary to carefully consider changes in value and the allocation of the donation credit between the estate and the deceased’s return to minimize overall taxes payable. To the extent that the donated property has declined in value from the date of death, the donation must be made within the first taxation year of the estate in order for any capital loss to be eligible to be carried back to the deceased's terminal tax return.

We can help
Your KPMG adviser can help you assess the effect of the proposed legislation, and point out ways to take advantage of any benefits or help mitigate its impact. For more details on this legislation and its potential impact, contact your KPMG adviser.

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