STEP Canada
ADVISING FAMILIES ACROSS GENERATIONS

September 8th, 2023

Trevor McGowan
Associate Assistant Deputy Minister
Finance Canada
90 Elgin Street
K1A 0G5

Via email: Trevor.McGowan@fin.gc.ca

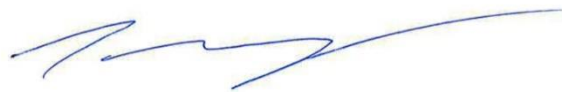
Re: Submission relating to the application of the Alternative Minimum Tax (AMT) rules

Dear Mr. McGowan:

The Society of Trust and Estate Practitioners (Canada) (STEP) is pleased to provide this submission in response to legislative proposals pertaining to the alternative minimum tax (AMT) released on August 4, 2023, and the accompanying explanatory notes (collectively, "Proposals").

We would be pleased to discuss our submission with you at your convenience. Please address any questions to Michael Dodick, Chief Operating Officer, STEP Canada at mdodick@step.ca

Yours truly,



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Introductory Comments

The Proposals were announced in the 2023 Budget with the stated goal of ensuring that the wealthiest Canadians pay their fair share of tax. STEP recognizes the federal government's interest in achieving greater tax fairness for Canadians. The Proposals are intended to "result in a tax cut for tens of thousands of middle-class Canadians" and "more precisely target the very wealthy."

STEP appreciates the opportunity to share our comments on the Proposals with the Department of Finance. The Proposals represent a significant change to the AMT rules, most notably in the broadening of the AMT tax base and the increase in the AMT rate. For individuals and qualified disability trusts (QDTs), the impact of the base and rate changes is alleviated to a great extent by the increase in and indexation of the basic AMT exemption, and by the maintenance of the seven-year carryforward, which permits AMT to be deducted in future years.

Most of our comments focus on the impact that the Proposals will have on specific situations involving the use of trusts. STEP is concerned that the Proposals will inappropriately capture trusts that are designed to provide protection and economic security for vulnerable individuals. Many of these situations involve families of modest means. We also identify situations in which the Proposals will trigger unrecoverable AMT, resulting in a permanent tax in excess of the regular tax that would otherwise be paid if the income were earned directly by an individual with access to the basic AMT exemption and carryforward. We do not believe these outcomes are in line with the stated policy objectives of the Proposals.

Trusts for Vulnerable Persons

Trusts are commonly used to hold funds to support vulnerable persons. Such trusts are established for the benefit of individuals who would be at risk if the funds were held or controlled directly by them. This risk could arise from a lack of legal capacity on the basis of age or disability, or from personal challenges particular to the individual, such as a substance dependency.

Many vulnerable beneficiaries are entitled to provincial or territorial means-based, needs-based, or income-tested social assistance payments, community and government supports and programs, and prescription drug coverage. As a result, discretionary trusts are often used to prevent income and capital distributions from exceeding the thresholds for program eligibility. The use of these trusts is essential to ensure that vulnerable beneficiaries are not disqualified from these programs.

Some trusts may be able to elect to be QDTs and thereby access the AMT exemption under the Proposals. However, other trusts established for vulnerable beneficiaries are prevented from electing to be QDTs, for reasons including but not limited to the following:

- the vulnerable beneficiary is entitled to the disability tax credit (DTC) but the trust is not a testamentary trust;
- another trust set up for the vulnerable beneficiary is already using the only QDT designation available;
- the vulnerable beneficiary is incapable of making a QDT election;
- the vulnerable beneficiary became entitled to the DTC after the testator's death, but a QDT was not contemplated at the time the will was drafted, so the vulnerable beneficiary was not specifically named in the will; or
- the beneficiary is vulnerable but is not eligible for the DTC.

Given that many trusts for vulnerable persons cannot be QDTs, STEP submits that these vulnerable beneficiaries will be unfairly subjected to a higher tax burden and deprived of the benefit of the AMT exemption merely because their circumstances require that their investments be held in a trust.

Recommendation 1

STEP recommends that the Proposals be amended to allow the AMT exemption to be claimed by any trust that has at least one preferred beneficiary (PB) as defined in subsection 108(1) of the *Income Tax Act* where the PB jointly elects with the trust to include income of the trust in calculating the PB's income for any year in which the trust is liable for AMT. STEP recommends that this election be available regardless of whether any income was actually allocated under subsection 104(14).

Recommendation 2

Since there are a significant number of Henson trusts where there are no PBs, STEP further recommends that the Proposals be amended to allow the AMT exemption to be claimed by any trust that has a beneficiary who, as a result of a physical or mental infirmity, is a recipient of means-based, needs-based, or income-tested provincial or territorial social assistance benefits.

Blended-Family Spousal or Common-Law Partner Trusts

Both inter vivos spousal trusts and testamentary spousal trusts, established in accordance with the rules of paragraphs 73(1.01)(c) and 70(6)(b) respectively, require the spouse or common-law partner beneficiary to be entitled to receive all of the income of the trust that arises before the spouse's or common-law partner's death. For the purpose of this requirement, subsection 108(3) provides that a trust's income is its income computed without reference to the Act. In other words, the entitlement of the spouse or common-law partner beneficiary to the trust's income is determined under trust law, not tax law.

In situations where a settlor or testator has children from a previous relationship, and capital preservation is to be maximized for these children, it is not uncommon for the trust deed or testamentary trust terms to be drafted in such a manner so as to retain a capital gain's default legal nature as part of trust capital, while restricting the ability of the spouse or common-law partner beneficiary to encroach on capital (as opposed to specifying that a capital gain should be considered income of the trust for trust administration purposes). Such trusts will retain taxable capital gains rather than distribute them to the spouse or common-law partner beneficiary.

> Example
>
> Juan has a daughter, Elle, from his first marriage; later in life he marries Chris. Juan's will provides that the residue of his estate will fund a testamentary spousal trust for Chris and that Elle will be the residual beneficiary on Chris's passing. Chris has no power to encroach on capital, and under the terms of the trust any capital gain is treated as capital of the trust.
>
> On Juan's death, the residue of his estate is $500,000, all of which is transferred into the testamentary spousal trust. In year 1, the trust earns $6,000 in interest income and realizes a $4,000 capital gain. The trust distributes the $6,000 interest income to Chris and retains the $4,000 capital gain, as required by the terms of the trust. The trust is subject to ordinary federal income tax of $660 [$4,000 capital gain x 50% capital gain inclusion rate x 33% federal income tax rate]. The trust is also subject to an additional tax of $160, which is the amount by which the minimum amount determined under the proposed AMT rules exceeds the trust's

ordinary income tax [$4,000 x 100% inclusion rate x 20.5% AMT rate = $820, which is $160 higher than the $660 of ordinary federal income tax].

The additional tax of $160 becomes a carryover that can be recovered to the extent of any excess of ordinary income tax over the minimum amount over the seven following years. However, recovering this amount will be impossible unless Chris dies during the seven-year carry forward period. This is because both the trust terms and the Act require the spouse (Chris) to be entitled to all of the trust's non-capital-gain income during the spouse's lifetime. This $160 (or 4% of the $4,000 capital gain) will therefore likely become a permanent tax. Most provinces and territories will also add a provincial/territorial AMT based on the federal AMT.

Although no income is distributed to the residual beneficiary of the blended-family spousal trust during the lifetime of the surviving spouse, it is the residual beneficiary who is ultimately entitled to the capital. If the blended-family spousal trust must pay unrecoverable AMT during the surviving spouse's lifetime because a taxable capital gain is retained in the trust, the payment of such tax reduces the trust capital that is ultimately payable to the residual beneficiary.

We do not believe that it is equitable to make AMT a permanent tax for spousal or common-law partner trusts in such blended-family situations. These trusts are often used by families with modest means, especially in the testamentary context. It is a common approach, and sometimes the only one possible, for taking care of dependants in complex or acrimonious family situations.

Recommendation 3

STEP recommends that residual beneficiaries be entitled to elect to allocate all or a portion of their exemption(s) for the year to the trust. The maximum exemption available arising from a particular beneficiary's election could be limited to an amount prorated to that beneficiary's proportionate share of the residue of the estate. In these circumstances, the taxable capital gain is effectively retained for such beneficiaries. We submit that this would be an equitable result. Were it not for the legislative requirement that no person other than the surviving spouse receive or otherwise obtain the use of any of the income or capital of the trust during the surviving spouse's lifetime, such taxable capital gain would have been made available to the residual beneficiaries, and those beneficiaries would have been able to utilize their personal exemption in respect of the AMT consequences.

Graduated Rate Estates That Must Run Beyond 36 Months

The Proposals deny access to the AMT exemption to all trusts except graduated rate estates (GREs). Estates that are required to continue beyond the period in which they can be GREs (36 months) will be forced to bear the full burden of AMT. Further, owing to the duties and obligations surrounding estate administration, the AMT paid may never be recoverable. There are often non-tax reasons why an estate requires more than 36 months to administer. These factors, which are beyond the control of the executors, include but are not limited to the following:

- litigation among beneficiaries that lasts several years, or estate challenges by a spouse,

child, or other dependant for whom a will has not made adequate provision;[1]

- estate assets that are difficult to gather or dispose of (such as the sale of real estate, especially where there are environmental issues, or the sale or winding up of a private company); and
- assets and beneficiaries that are difficult to locate, especially if they are in foreign jurisdictions.

STEP submits that the availability of the AMT exemption afforded to an estate should not be determined by the GRE administration period, which is necessarily arbitrary. While a bright line may have needed to be drawn to circumscribe other tax benefits available to estates, there is no cogent tax policy reason to deny the AMT exemption to an estate that would otherwise be a GRE but for the fact that it needed to continue longer than 36 months. The policy reasons for this submission are consistent with the estate charitable donation rules, which permit the application of the rules for an additional two years after an estate ceases to be a GRE if the only reason the estate ceased to be a GRE was time.

We note that if the Proposals are enacted in their present form, there is no scope to expand the time span of a GRE. The Canada Revenue Agency (CRA) has stated, "The GRE definition does not provide the Minister [of National Revenue] with the ability to extend the 36-month GRE period, nor can the authority for an extension be found elsewhere in the Act."[2] Similarly, the Tax Court of Canada cannot extend the time on the grounds of unfairness or for any other reason.[3]

Recommendation 4

To ameliorate the unfair treatment of estates that, through no fault of the executors, cannot be administered within 36 months, STEP recommends that the Proposals be amended to allow the AMT exemption to apply to any estate that meets the definition of GRE under subsection 248(1) if that definition were read without reference to element (a) of the definition ("the modified GRE period"). A specific anti-avoidance rule could be adopted to prevent the modified GRE period from applying to estates where it is established that the main purpose for extending the administration of an estate beyond 36 months is to obtain a tax benefit.

Insufficient Special Foreign Tax Credit

To prevent double taxation, AMT is reduced by an individual's "special foreign tax credit" determined under section 127.54 for the year. The proposed amendments do not include any changes to section 127.54, which we believe creates an improper tax leakage for an individual, including a trust, earning foreign income. The adverse impact of the insufficient credit is more pronounced with trusts, given their lack of access to the basic AMT exemption.

Example

A spousal trust's only income for the year is a foreign capital gain of $1,000, in respect of which the trust is subject to $300 of foreign income tax. The trust does not distribute the $1,000 of capital gain, so the taxable portion of this gain ($500) is taxed in the trust. At the

[1] The possibility of litigation and estate challenges is heightened in British Columbia under the *Wills, Estates and Succession Act*, which provides that independent adult children are eligible to challenge a will, and in Nova Scotia under the *Testators' Family Maintenance Act*.

[2] 2021 STEP Canada/CRA Round Table, June 15, 2021, question 14; CRA document no. 2021-0883041C6.

[3] *Wenikajtys (Estate) v. The Queen*, 2021 TCC 93. [The original case was in French but an official English translation is available.]

federal tax rate of 33%, the trust's ordinary income tax before any foreign tax credit will be $165. Because a foreign tax credit claim is limited to foreign tax for the year otherwise payable, the trust's foreign tax credit claim under subsection 126(1) will be $165, which will reduce the trust's ordinary income tax to $0.

The trust's minimum amount of tax under the proposed AMT regime will be computed as $1,000 (100% of the capital gain) multiplied by the proposed AMT rate of 20.5%, or $205. Pursuant to section 127.5, the trust's AMT will be this minimum amount minus the trust's special foreign tax credit.

The current definition of special foreign tax credit, which is unchanged under the Proposals, is the greater of

(a) the foreign tax credit under section 126 [$165], and

(b) the lesser of

(i) 2/3 of the non-business-income tax paid [$200], and

(ii) the "appropriate percentage" (15%) multiplied by the "foreign income" ($500) [$75].

The formulaic calculation of special foreign tax credit yields $165. This results in AMT payable of $40 [$205 – $165].

This result does not appear to be equitable because, on this $1,000 of foreign capital gain, the trust has already paid foreign tax of $300. This is an effective tax rate of 30%. The trust is subject to an additional 4% of federal AMT (plus any provincial/territorial AMT) in this situation.

Recommendation 5

STEP recommends that the special foreign tax credit be determined to be the lesser of

(i) 100% (rather than 2/3) of the foreign income tax paid, and

(ii) 20.5% of the foreign income.

STEP also recommends that the determination of foreign income be subject to adjustments similar to those contained in section 127.52, such as the 100% capital gains inclusion rate.

If these recommendations were applied to the example above, the foreign tax credit would be $205, equal to the minimum amount, resulting in no AMT. This would be an equitable result since foreign tax paid already exceeded the proposed AMT rate of 20.5%.

Permanent Double Taxation Resulting from Applying 50% to Section 119 Credit

A trust that departs Canada holding shares that constitute taxable Canadian property is entitled to claim a credit under section 119 if the trust later receives dividends on these shares and Part XIII withholding tax applies to the dividends. The section 119 credit then reduces the tax previously payable on the capital gain arising on the deemed disposition on departure. This mechanism is necessary because the dividends subject to Part XIII may be derived from the same value that has been taxed as a capital gain on departure, so section 119 alleviates the double taxation arising from this overlap.

Because section 119 is factored into the AMT calculation as part of the basic minimum tax credits under section 127.531, the proposed amendment to halve the amount of basic credits will also halve the section 119 credit.

This result does not appear to be fair. A section 119 credit is not a tax preference item; it is simply a mechanism to prevent double taxation on the same dollar of value. Further, AMT arising from halving the section 119 credit will be impossible to recover because the trust will have already departed Canada and most likely will not have income in subsequent years to which the AMT carryforward can be applied.

We note that the same issue arises for a natural person who departs Canada holding shares that are taxable Canadian property. However, a trust's lack of access to the basic AMT exemption means that this issue has a more widespread impact on trusts.

Recommendation 6

STEP recommends that the section 119 credit be exempted from the 50% limitation on the basic minimum tax credit.

Loss Carryovers

Pursuant to paragraph 111(1)(b), a trust that realizes net capital losses in a particular taxation year can use those losses to reduce capital gains in any of the three preceding taxation years or in any future taxation years. This provision recognizes that capital gains and capital losses can be "lumpy" and permits the smoothing out of capital gains and capital losses over multiple years.

The Proposals will amend paragraph 127.52(1)(i) so that, for AMT purposes, the net capital loss that can be claimed under paragraph 111(1)(b) is limited to 50% of the loss. This will be the case even if the trust has suffered a true economic loss and would have been able to offset capital gains with 100% of the capital loss if only the capital loss was realized in the same taxation year as the capital gain. It is not clear why the timing of the realization of the capital loss should impact the application of AMT. This is especially true for net capital losses realized in taxation years prior to 2023, when the trustee would not have known that carrying forward the net capital loss could subject the trust to AMT.

Example

A testamentary trust holds marketable securities on which it realized a net capital loss of $5,000 in its 2022 taxation year and is not able to realize a net capital gain in its 2023 taxation year (and did not have net capital gains in the three preceding taxation years). In 2024, it realizes a net capital gain of $5,000. The trust earns no other income in 2024.

For regular income tax purposes, the trust will have taxable income of nil because the amount of the net capital gain is fully offset by the net capital loss carried forward from the 2022 taxation year. However, for AMT purposes, the adjusted taxable income will be $2,500 [$5,000 capital gain minus 50% of the $5,000 capital loss carried forward], resulting in AMT of $512.50 [20.5% x $2,500] (plus any provincial/territorial AMT).

When a trust for a vulnerable person or a spousal or common-law partner trust is faced with this situation, there may be little or no opportunity to claim the AMT against regular federal income tax in a future taxation year. This result does not appear to be fair, and it may force trustees to make financial and investment decisions that are not in the best interests of the beneficiaries. For example, a trustee that realizes a capital loss in a taxation year may be

compelled to sell other assets to realize a capital gain in order to avoid the impact of AMT, even if such a sale is not in the beneficiaries' best interests.

Recommendation 7

STEP recommends that the Department of Finance reconsider restricting the deduction of capital loss carryovers to 50% given that a capital loss carryover represents a true economic loss realized in the trust.

Donations

Pursuant to proposed revisions to section 127.51, in calculating AMT payable (if any), only one half of an individual's basic minimum tax credit (determined under section 127.531) may be deducted. An individual's basic minimum tax credit includes a charitable donation tax credit under section 118.1.

This amendment could result in tax implications that would dissuade an individual (including a trust) from making donations.

Example

An individual owns a painting that was acquired many years ago for a nominal amount, but that has grown in value to a current fair market value of $100,000. Because of the cultural significance of the painting, the individual wishes to donate the painting to a museum.

For regular income tax purposes, on donating the painting, the individual will realize a taxable capital gain of $50,000 on which there will be federal tax payable of $16,500 (assuming that the individual is taxable at the highest marginal tax rate). The individual will also be able to claim a donation tax credit of $16,500 (assuming that the individual has sufficient income subject to the highest marginal tax rate in paragraph 117(2)(e)), leaving the individual with an additional donation tax credit of $16,500 to claim against other income tax payable or to carry forward to use in a future taxation year, so that federal income tax payable will be nil. However, for AMT purposes, the individual's adjusted taxable income will be $100,000, and the resulting AMT will be $12,250 [(20.5% x $100,000) – ($16,500 x 50%)] (plus any provincial/territorial AMT).

As a result, by donating the painting in this example, the individual will have tax payable without receiving any proceeds from the painting with which to pay it.

Recommendation 8

STEP recommends that the Department of Finance reconsider restricting the application of the donation tax credit to 50% for the purposes of calculating AMT. Whether or not the amount of a donation is motivated by the tax benefits of donating, the charities that receive the donations (and Canadians overall) are benefited.

Drafting Error

Aside from the foregoing substantive recommendations, we note a typographical error in proposed clause 127.52(1)(k)(ii)(A), where the reference should be to paragraphs in section 127.52, not section 127.51.

Recommendation 9

STEP recommends that the reference in proposed clause 127.52(1)(k)(ii)(A) to "paragraphs 127.51(1)(b), (c), (c.2), (c.3) and (e.1)" be revised to refer to "paragraphs 127.52(1)(b), (c), (c.2), (c.3) and (e.1)."