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Ms. Janice Russell and Mr. Mitchell Sherman
Chairs, Joint Committee on Taxation of the
Canadian Bar Association and
Chartered Professional Accountants of Canada
c/o Chartered Professional Accountants of Canada
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Mr. Kevin Wark
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Ms. Pamela Cross
Chair, Technical Tax Committee
STEP Canada
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Dear Ms. Russell, Mr. Sherman, Mr. Wark and Ms. Cross:

We are writing to you further to the submissions of your organizations regarding certain amendments (released on August 29, 2014) to the income taxation of trusts and estates. These amendments were subsequently enacted as part of the *Economic Action Plan 2014 Act, No. 2*, SC 2014, c. 39, which received royal assent on December 16, 2014. Your submissions include comments on subsection 104(13.4) of the *Income Tax Act* and related provisions, which deal with the income tax treatment of certain trusts that are subject to deemed realization events as a result of the death of a beneficiary.

More recently, over the past several months, these provisions have been the subject of discussions between ourselves and a joint group of representatives from the Joint Committee, CALU and STEP Canada.

The purpose of this letter is to express our appreciation for the engagement on this issue of interested members of the tax community. Seeing value in further discussions, we wish to confirm our understanding of the principal issues raised by your organizations concerning these provisions, and to describe an option for responding to these issues that was raised in our discussions and that we understand is generally supported by the Joint Committee, CALU and STEP as significantly mitigating these issues.

Spousal, *alter ego* and similar trusts

The income tax rules contain special provisions for *alter ego* trusts, joint spousal and common-law partner trusts, spousal and common-law partner trusts, and trusts to which property has been transferred by the beneficiary in circumstances described in subparagraph 73(1.02)(b)(ii) or subsection 107.4(1) (together referred to as “spousal and similar trusts”).¹ These special provisions permit certain property to be settled upon these trusts on a tax-deferred (i.e., “rollover”) basis.

These trusts are also subject to a modified trust-level deemed disposition regime. Trusts are normally subject to a deemed disposition of certain trust property every 21 years, the first such deemed disposition measured from the creation of the trust. Under the trust deemed disposition rules for spousal and similar trusts, the first deemed disposition generally occurs on the death of the trust’s primary (“lifetime”) beneficiary, in effect suspending the 21-year provision rule until after that death.

Subsection 104(13.4) and related provisions

Subsection 104(13.4) of the Act, which applies for the 2016 and later taxation years, was introduced in the context of the special provisions for spousal and similar trusts.

Prior to subsection 104(13.4) taking effect, certain income of spousal and similar trusts that is deemed to be recognized on the lifetime beneficiary’s death (in most cases being principally the gains resulting from the trust deemed disposition described above) is not eligible to be paid out to beneficiaries on a tax-deductible basis – that is, the amounts are excluded from the portion of a trust’s current income payable that is eligible for a deduction under paragraph 104(6)(b) of the Act. Accordingly, common practice is to recognize these amounts in the trust for the relevant taxation year.

¹ As a technical matter, these are trusts for which a day is determined in respect of the trust under any of paragraphs 104(4)(a), (a.1) and (a.4) of the Act.

Subsection 104(13.4) modifies this treatment as follows:

- Paragraph 104(13.4)(a) deems the trust's taxation year in which the lifetime beneficiary's death occurs to end at the end of the day on which that death occurs.
- Paragraph 104(13.4)(b) deems the trust's income for the year (including amounts deemed realized in that year as a result of that death) to have become payable to the lifetime beneficiary in the year.

In effect, under subsection 104(13.4) all of the trust's income for the trust's year is required by subsection 104(13), subject to any valid designations made by the trust under subsections 104(13.1) or (13.2), to be included in computing the beneficiary's income for the beneficiary's taxation year (*i.e.*, the beneficiary's final taxation year) in which the trust's year ends.

Where subsection 104(13.4) applies in respect of a trust and a beneficiary, subsection 160(1.4) makes the trust jointly and severally liable with the beneficiary for the portion of the beneficiary's income tax payable in the beneficiary's final taxation year because of the inclusion in the beneficiary's income for that year of the amounts described in paragraph 104(13.4)(b). The explanatory notes for subsection 160(1.4) confirm the intention that the Canada Revenue Agency apply section 160 in respect of an amount owing under subsection 160(1.4) as though the trust were liable in the first instance for that amount of tax.

Subsection 104(13.4) and the related provisions, as a whole, reflect a number of tax policy objectives associated with the Budget 2014 measures that they accompanied, including better ensuring that trusts do not provide unintended tax benefits and improving fairness and neutrality in the tax rules. In addition, paragraph 104(13.4)(b) ensures that post-1971 spousal or common-law partner trusts that are testamentary trusts, and that compute income taxes payable for the 2015 and earlier taxation years using the graduated tax rates of ordinary individuals, are not subject to mandatory flat top-rate taxation with respect to amounts realized in the trust as a result of the death of the spouse or common-law partner beneficiary.

Discussions with Joint Committee, CALU and STEP

We understand from our discussions with the representatives of your organizations that the overall tax policy objectives of the subsection 104(13.4) and related amendments are recognized by the Joint Committee, CALU and STEP. However, your submissions, and other submissions with respect to these

amendments, identify both technical concerns with the amendments² and, more significantly, concerns that the amendments may apply in some cases with unfair and unintended results. With respect to the latter, we understand two issues to be of particular concern.

The first issue arises because of the possibility that the income tax liability associated with the beneficiary's income inclusion arising from the application of subsection 104(13.4) will ultimately be borne by that beneficiary's estate, even though the trust's property, the income from or gains on which results in that liability, will be enjoyed by the trust's beneficiaries, in some cases to the exclusion of the estate's beneficiaries. Although subsection 160(1.4) is intended to address this concern by having the trust assessed a tax liability as though it were liable for the resulting tax in the first instance, from our discussions we understand that concerns remain on the part of your organizations that the beneficiary's estate may bear all or part of the tax liability or that the estate may be subject to an undue compliance burden in seeking to prevent that result.

The second issue involves the possible "stranding" of donation tax credits and a corresponding negative impact on charitable giving. Specifically, where an affected trust makes a gift of property after the death of the beneficiary, one effect of deeming all of the trust's income for its taxation year in which the beneficiary dies to have become payable to the beneficiary is that the trust itself, assuming it is eligible for and makes a corresponding deduction under paragraph 104(6)(b), will not have income tax otherwise payable against which it can deduct the donation tax credit for the gift made. The donation tax credit will, therefore, be "stranded" in the trust, separate from the income tax liability in the beneficiary's tax return. This concern is exacerbated by paragraph 104(13.4)(a) deeming the trust's taxation year to end at the end of the day on which the death occurs, with the result that gifts made by the trust after the end of that day will be made in a later taxation year of the trust, and the donation tax credit will be available only in that later year or as permitted under the carry-forward rules, and not in the trust's taxation year in which the death occurs.

In the context of discussing these issues, your organizations noted that (ignoring grandfathered *inter vivos* trusts), among the categories of spousal and similar trusts, only testamentary spousal or common-law partner trusts were directly affected by the change in income tax rates for trusts introduced as part of the Budget 2014 measures. The remaining categories of the special trusts, being *inter vivos* trusts, were already subject to flat top-rate taxation and so were not directly

² For example, uncertainty regarding whether subsections 104(13.1) to (13.4) interact in a manner that accommodates the carry-back of losses under section 111 of the Act from a later taxation year of the trust to the trust's year deemed ended by paragraph 104(13.4)(a).

affected by these tax rate changes. Moreover, it was submitted to us that spousal and similar trusts – whether *inter vivos* or testamentary – would have been created (or provision made for their creation) on the understanding that certain amounts of income that are deemed recognized on the lifetime beneficiary’s death would be effectively required to be recognized in the trust because of the restrictions contained in paragraph 104(6)(b) (as it applies before 2016) with respect to the deduction of these amounts. We understand from our discussions that your organizations place particular emphasis on these two points in support of an option that would respond to the issues raised in your submissions by treating the income of the trust that has not in fact become payable to that beneficiary as income to be taxed in the trust for the trust’s taxation year in which the beneficiary dies.

Our discussions also included the consideration of options for responding to the above concerns. We understand from these discussions that the Joint Committee, CALU and STEP Canada would generally support an option that would, put in very general terms, subject affected trusts and their beneficiaries to an income tax treatment for the 2016 and later taxation years that more closely corresponds to that available to trusts for 2015 and earlier taxation years, by taxing in the trust the income deemed to be recognized on the death of the beneficiary. Under this option, the subsection 104(13.4) and related amendments generally would remain as enacted, except that paragraph 104(13.4)(b) would be amended so that it did not apply to a trust in respect of the death of a particular beneficiary unless

- the trust is immediately before the particular beneficiary’s death a testamentary trust that is a post-1971 spousal or common-law partner trust;
- the trust was created by the will of a taxpayer who dies before 2017;
- the particular beneficiary is resident in Canada immediately before the particular beneficiary’s death; and
- the trust and the particular beneficiary’s graduated rate estate jointly elect in prescribed form to have that paragraph apply.

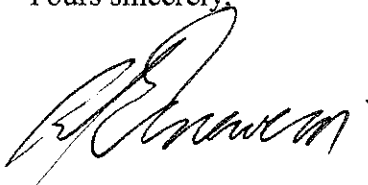
Finally, we recognize that to fully address the “stranding” issue described above in a manner that would allow for consistent tax treatment with that available in respect of gifts made by similar trusts before 2016, the option described above would include provision for a trust to be permitted to allocate the eligible amount of a donation made by the trust after the beneficiary’s death, but during the calendar year in which the death occurs, to its taxation year in which the death occurs (i.e., the taxation year deemed to end by paragraph 104(13.4)(a)). Such a provision would be expected not to impose any additional compliance burden on

the trust given that paragraph 104(13.4)(c) operates to defer the trust's filing-due date for that taxation year to the day that is 90 days after that calendar year.

It remains an important tax policy objective that trusts (including estates) not obtain unintended benefits under the income tax laws administered by the Canada Revenue Agency. In addition to considerations relating to fairness, neutrality and the prevention of tax base erosion, these objectives extend to tax compliance and administration. We will, therefore, include in our consideration of whether the above option should be recommended, whether additional amendments may be necessary to give effect to these policy objectives.

In closing, we hope that this statement of our understanding of your concerns, and of the option that we understand you to support for addressing these concerns, together with a description of some of the related tax policy considerations, is helpful. We are interested in your comments on our understanding of your submissions and of our description of the option identified in our discussions that we understand you to support.

Yours sincerely,

A handwritten signature in black ink, appearing to read "B. Ernewein". The signature is fluid and cursive, written over a faint horizontal line.

Brian Ernewein
General Director – Legislation
Tax Policy Branch