STEP Canada

September 25, 2014

The Honourable Joe Oliver, P.C., M.P.
Minister of Finance
c/o Tax Policy Branch
Department of Finance
90 Elgin Street
Ottawa, Ontario
K1A 0G5

Submitted via email: EAP-PAE2014.tax-fiscalite@fin.gc.ca

Dear Minister Oliver,

Enclosed is our submission on the Proposals relating to the elimination of graduated rates for certain trusts, modification to certain charitable donation rules and other measures released on August 29, 2014. We appreciate the invitation to provide our comments.

Several members of the STEP Canada Tax Technical Committee participated in discussions concerning our submission and contributed to its preparation, in particular:

Pamela Cross (Borden Ladner Gervais LLP)
Lisa Heddema (Smetheram & Company)
Ian Lebane (TD Wealth)
Ruth March (KPMG)

We would be pleased to discuss our comments with you at your convenience.

Yours very truly,

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SUBMISSION: LEGISLATIVE PROPOSALS RELATING TO INCOME TAX RELEASED AUGUST 29, 2014

The Society of Trust and Estate Practitioners (Canada) ("**STEP Canada**") is pleased to provide you with this written submission in response to certain of the legislative proposals released on August 29, 2014 ("**Proposals**") and the accompanying explanatory notes ("**Explanatory Notes**").

The following definitions are used throughout this submission:

Act	*Income Tax Act* (Canada)
Consultation Paper	Consultation on Eliminating Graduated Rate Taxation of Trusts and Certain Estates released on June 3, 2013
Previous Submission	Our letter dated December 2, 2013 to the Minister of Finance, including the attachment thereto.

Unless otherwise indicated, references to subsections, paragraphs, etc., are to provisions of the Act as proposed to be amended under the Proposals.

1. AMENDMENTS TO ELIMINATE GRADUATED RATE TAXATION FOR TRUSTS AND CERTAIN ESTATES

In our Previous Submission we identified our concerns with the approach taken in the Consultation Paper, the alignment of the taxation of testamentary trusts with *inter vivos* trusts by eliminating graduated rates of taxation for testamentary trusts, and invited the Department of Finance (the "**Department**") to conduct a more thorough review of trust taxation. Although we commend the Minister of Finance and his officials for the work that they have undertaken on these matters and the collaborative process in which it was carried out, we are disappointed that our invitation was not accepted and the Proposals have generally, except for the expansion of the benefit of graduated tax rates to qualified disability trusts ("**QDTs**"), adopted the narrow approach set out in the Consultation Paper. We do acknowledge that the Proposals do provide for greater flexibility in claiming charitable deductions, which is a welcome change. However, we are concerned that the Proposals contain additional changes, not previously announced, which in our view may give rise to some unexpected adverse consequences. The Proposals appear to go well beyond the stated intention of eliminating graduated rate taxation, and instead include new amendments to a number of provisions which, in our view, may have sweeping impact on Canadians. STEP Canada has welcomed the opportunity to participate in the process.

We recommend that the Proposals be revisited in light of the significant issues identified below. We have identified two aspects of the Proposals which cause us significant concern: (i) the restriction of certain rules commonly used in post mortem estate planning to avoid double taxation or to facilitate charitable giving to graduated rate estates ("**GREs**"); and (ii) the transfer of the income (including income resulting from the deemed disposition of trust assets) of *alter ego* trusts, joint spousal and common-law partner trusts, and spousal and common-law partner trusts (each a "**life interest trust**"), in the year of death of the life interest beneficiary (generally

the settlor or the settlor's spouse) from the trust to the terminal return of the deceased life interest beneficiary.

The issues we have identified in connection with these aspects of the Proposals, which we anticipate are only a subset of the issues that will in fact arise if the Proposals are enacted as proposed, are described in several examples set out below. However, our concerns are magnified by the fact that many individuals will have trusts *currently in existence* which will be adversely impacted by these changes in 2016. These *existing* arrangements may not be able to be amended (by virtue of the fact that the settlor is deceased or incapable), and even if amendment is legally possible, a court order may be required. In short, we are concerned that the hasty introduction of these previously unannounced changes will have serious unintentional repercussions.

We urge the Department to carefully consider the examples discussed below (which are illustrative but not exhaustive) before proceeding. STEP Canada would be pleased to work with the Department to identify current common estate planning strategies (which vary greatly as a result of the application of different provincial laws), assess the specific implications of the Proposals on these strategies and develop proposals that will address the Department's objectives without imposing material hardship on Canadians.

2. COMMENTS ON PROPOSED AMENDMENTS RELATING TO GRADUATED RATE ESTATES:

A. Graduated Rate Estates

An estate will qualify as a GRE only if a number of requirements are met. One such requirement is that it must designate itself as the GRE of the deceased in its return of income under Part I for its first taxation year (GRE definition, paragraph (e)). Only one GRE may be so designated for a deceased individual (paragraph (f)). However it is common practice for many individuals to have more than one testamentary trust that could qualify as a GRE (for example, by the use of multiple Wills), each of which may have different trustees and/or different beneficiaries. Although there may be a debate about whether an individual can have more than one estate (as opposed to creating more than one testamentary trust), it appears that the definition of GRE contemplates the existence (at least for tax purposes) of multiple "estates" only one of which can be designated a GRE. Should a testator have created several separate testamentary trusts, we hope that the Canada Revenue Agency will administratively permit the filing of a single estate return (with the GRE designation). However, where there are different executors (each with different legal duties and obligations) and different beneficiaries, it appears there is a significant risk that it will not be possible to ensure that a single return and designation will be possible.

Under the Proposals, the importance of being designated a GRE cannot be understated.

Example #1:

The testator has dual Wills, a Primary Will for publicly traded investments and a Secondary Will for his private corporation shares. The executors appointed under each Will are different, given the testator's wish to ensure the executors of the Secondary Will have experience with the

corporation's affairs. Under the Primary Will, the testator wishes to donate his public investments to charity. Under the Secondary Will, the executors wish to undertake loss carry-back planning utilizing the corporation's capital dividend account (CDA) which arose from proceeds of corporate-owned life insurance on the testator's life.

A taxpayer's taxable capital gain from gifts of publicly traded investments will be zero if certain conditions are met. New subparagraph 38(1)(a.1)(ii) will limit this treatment to gifts made by a GRE.[1] Further, the ability of a taxpayer's estate to carry-back to the terminal tax return of the deceased 50% of the loss created on a redemption or repurchase of the private corporation shares will be restricted to GREs under subsection 112(3.2). In this situation, it will be important for both the "estates" established under the Primary and Secondary Wills to be GREs. Further, there are no rules to address how competing designations would be addressed.

We believe that limiting these provisions to GREs is unwarranted and inappropriate and will have unintentional adverse effects (especially where such planning is in place and cannot be changed).

B. Deemed Dispositions of Life Interest Trusts Taxed in Deceased's Life Interest Beneficiary's Hands

New subsection 104(13.4) contains significant changes to the rules relating to life interest trusts, each of which undergo a deemed disposition triggered by the death of the life interest beneficiary (or the death of the surviving life interest beneficiary). First, the affected trust's year will be deemed to have ended at the end of the date of death of the life interest beneficiary. Second, the trust's income for the year, including capital gains resulting from the deemed disposition of assets resulting on the death of the life interest beneficiary, will be deemed to have been payable to the life interest beneficiary and will be included in the terminal return of the life interest beneficiary.

Although we applaud ensuring that the income associated with the deemed disposition will be taxed at the available marginal tax rates applicable to the life interest beneficiary instead of at the flat top rate in the affected life interest trust, we have concerns that the mechanism by which this is to be achieved will give rise to a myriad of unanticipated problems.

Example #2:

A spousal trust is established in a husband's Will for his wife of a second marriage, with the capital to be left to the husband's children of his first marriage. On the death of the wife, her estate is responsible for the taxes attributable to the deemed disposition triggered on her death. Under the wife's Will, her estate is left to her children from her first marriage. Wife's estate has different beneficiaries than the beneficiaries of the spousal trust established by her husband. Wife's estate has different executors than the trustees of the spousal trust.

The wife's estate is liable for the taxes triggered in the spousal trust. If the wife's estate has assets, those assets may have to be used to pay the taxes associated with the deemed disposition

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[1] Similar preferential treatment for GREs is also proposed for cultural gifts, total ecological gifts and gifts of art by the artist.

of the assets in the spousal trust established by her second husband. Therefore, the wife's beneficiaries bear the cost of the tax arising on assets going to the second husband's children. Although proposed subsection 160(1.4) provides that the spousal trust is jointly and severally responsible for the tax on the deemed disposition, it appears, this is intended to protect against situations where the wife's estate would have insufficient assets to fund the tax, not in circumstances such as those described above where the taxes are borne by persons who do not benefit from the assets. There is no mechanism requiring the life interest trust to bear the tax liability and, in fact, the terms of the life interest trust may not permit any distribution of assets to the wife's estate and permitting such a distribution could constitute a breach of the fiduciary duties of the trustees. Even if permitted, the transfer itself may taint the spouse's estate so it cannot qualify as a GRE.

Example #3:

A taxpayer establishes an alter ego trust to hold her assets during her lifetime. The capital beneficiaries of the alter ego trust are her children. The taxpayer also owns a RRIF, and designates a charity as beneficiary of the RRIF. The taxpayer has few other assets.

Under current tax rules the RRIF would be included in her income on the date of death, but the taxes triggered on the deemed disposition of the RRIF would be offset by the charitable donation tax credit. Also under current rules, the tax on deemed gains in the *alter ego* trust would be paid by the trust, with the residue then distributed to her children.

Under the Proposals, the donation is deemed to be made by the taxpayer's estate. Only a GRE can carry back a donation to the terminal return. Further, the taxpayer's estate is also responsible for the payment of tax arising on the deemed disposition of assets in the *alter ego* trust. The taxpayer's estate has no other assets from which to pay tax associated with the *alter ego* trust. If the *alter ego* trust funds the tax liability in the estate, it appears the *alter ego* trust will have made a contribution to the taxpayer's estate, with the result that the estate would no longer qualify as a testamentary trust under subsection 108(1). If the trust is not a testamentary trust then it cannot be a GRE, and as such, the donation cannot be carried back to the terminal return to offset the taxes triggered by the deemed disposition of the RRIF. The donation tax credit can only be claimed by the estate in the year the donation is made. The estate has no other assets and accordingly will have no income against which to use the donation tax credit.

Example #4:

A taxpayer establishes an alter ego trust to hold her assets during her lifetime. The capital beneficiaries of the alter ego trust are her children. The Taxpayer also owns marketable securities which are to be left to a charity in the taxpayer's Will.

As noted above, under the Proposals the taxpayer's estate is responsible for the tax on the gains arising in the *alter ego* trust. The taxpayer's executors have a duty to pay the deceased's debts (including taxes) before giving the bequest to charity. It is possible there will be no assets left in the estate to give to the charity. If the *alter ego* trust pays the tax liability (in order to allow the estate's assets to be given to charity), the estate appears to lose its status as a GRE (as it would no longer qualify as a testamentary trust because of the contribution by the *alter ego* trust). As

such, (i) the donation tax credit cannot be claimed in the terminal return, and (ii) the capital gains on the transfer of the securities to the charity will not be reduced to zero under paragraph 38(a.1)(ii).

Example #5:

A deceased taxpayer has established a testamentary spousal trust in his Will. The spousal trust is not a GRE. The terms of the testamentary spousal trust instruct the trustees to, after the death of the spouse life interest beneficiary, donate a certain percentage of the capital then remaining to charitable organizations. The trustees have discretionary capital encroachment powers during the life of the spouse beneficiary.

We understand that under current rules, because the amount of the donation is indirectly subject to the discretion of the trustees (by virtue of their capital encroachment powers), the donation tax credit would be able to be claimed by the testamentary spousal trust. Under the Proposals, the deemed gains in the testamentary spousal trust triggered on the death of spouse beneficiary are taxed in the deceased spouse's terminal return. There appears to be no ability to match the donation tax credit of the testamentary spousal trust with the testamentary spousal trust's income taxed in the terminal return of the deceased spouse. In addition, even if the testamentary spousal trust's income were to be taxed in the testamentary spousal trust, the donation would not be made in the same taxation year as a result of the deemed year end on the death of the surviving spouse. The donation tax credit cannot be carried back to the prior year because the testamentary spousal trust is not a GRE.

If the testamentary spousal trust is already in existence today, or if the testator is otherwise incapable, there is no ability to change the trust terms to address these issues.

<u>Recommendations</u>:

The examples set out above demonstrate significant technical deficiencies with the Proposals. Unfortunately, we believe there are many more examples that could be presented. We do not understand the policy behind some of these proposals.

We believe a better approach would be to allow a trust which is subject to the deemed dispositions under paragraphs 104(4)(a), (a.1) or (a.4) to be able to choose to bear the tax arising on the deemed disposition triggered on death, with appropriate adjustments to avoid over-taxation by ensuring that the available marginal tax rates of the deceased life interest beneficiary are fully utilized. The life interest beneficiary should not be taxed on income "deemed" to be payable to him or her unless he or she so agrees (and there are circumstances where this may be appropriate, such as where the life interest beneficiary is also taxable by virtue of citizenship in another jurisdiction such as the United States). However, the automatic transfer of the tax liability to the estate of the deceased life interest beneficiary is inappropriate in many circumstances and may in some circumstances adversely interfere with the ability of the estate of the deceased life interest beneficiary to be designated as a GRE. The default taxation rule should be taxation in the life interest trust with the ability to tax the income in the terminal return of the life interest beneficiary if the life interest beneficiary's personal representative so agrees. A joint election could provide for this result.

If the Department has identified specific instances of abuse, presumably these could be address with targeted rules that will not adversely impact the majority of taxpayers.

We recommend that the increased flexibility surrounding charitable donations be modified and made applicable to all life interest trusts, such that the charitable donation credit can be used against trust income or income of the life interest estate. From a policy perspective, it does not appear reasonable to restrict access to charitable tax credits in these circumstances.

We also believe that a similar approach should be available in circumstances where a life interest trust intends to offset capital gains triggered on death with a loss carry-back created on the redemption of shares. In fact, it is important to enable a loss carry-back in circumstances where events after death (such as a financial crisis as we recently experienced) creates losses in the estate that cannot be used against gains arising at death. The Proposals threaten loss carry-back planning which is, in essence, designed to prevent double taxation. Subsection 164(6) should be expanded to ensure that losses arising in any life interest trust on the redemption of shares can be used to offset the gains triggered on death.

3. OTHER COMPLIANCE ISSUES RELATED TO GRADUATED RATE ESTATES:

A. Increased Compliance Burden:

Example #6:

Assume a spousal trust owns preferred shares of a private corporation. The deemed gains on the death of the spouse are taxed in the deceased spouse's terminal return. The private corporation shares are redeemed in the spousal trust and a capital loss is realized on redemption.

We are concerned that taxing the gains in the deceased beneficiary's estate makes post mortem loss carry back in a trust more complex from a compliance perspective.

Under the Proposals, the loss is carried back to the taxation year of the spouse trust ending on the spouse's death, but there are no gains in the spousal trust's tax return because they were required to be taxed in the spouse's terminal tax return. Accordingly, the T3 return will have to be amended to claim a 104(13.2) designation so that sufficient gains can be realized in the spousal trust and then offset by the loss carry-back. The deceased spouse's terminal return will also have to be amended to remove the gains included on death.

Under current rules, it may be possible to implement the redemption in the same year as the spouse's death, such that the gain on death and the loss on redemption could be reported in the same return. Even if a carry-back is required, current rules require only a single loss carry-back request to be filed (T3A).

Rather than just a loss carry-back request being filed under current rules, under the Proposals two amended returns will have to be filed as well as the T3A.

B. Designations under subsection 104(13.1) or 104(13.2):

Under the Proposals it will not be possible for a trust to make a designation under subsections 104(13.1) or (13.2) if the designation results in taxable income in the trust. However, the Proposals do not appear to allow for a late designation so as to permit the trust to utilize losses on a carry-back basis.

We recommend that the Proposals and Explanatory Notes be clarified to confirm that trusts may make late designations.

C. Shortened Year End:

Further, the deemed year end under subsection 104(13.4) will significantly shorten the period within which post mortem planning can be undertaken, as the first year after death will, in most cases, be a short taxation year.

D. Calendar Year for Testamentary Trusts:

Under amended paragraph 249(1)(b) of the Proposals, a testamentary trust that is not a GRE is required to adopt a calendar year as its taxation year. This amendment applies to 2016 and subsequent years with no relief for testamentary trusts in existence prior to the introduction of the amendments.

We are concerned that requiring existing testamentary trusts to have a calendar year end will result in unnecessary administrative burdens in requiring an additional T3 return and other filings for short taxation years resulting from the conversion to a calendar year. Administrators of such trusts typically put careful thought into the selection of a taxation year end, taking into account not only the date of death but also the timing of available information needed to calculate the particular trusts' income.

We recommend that existing testamentary trusts be grandfathered and not be required to adopt a calendar year end. Instead, such trusts should be permitted to continue with their selected year ends but be subject to the highest marginal tax rate commencing with their first taxation year beginning after December 31, 2015.

4. COMMENTS ON PROPOSED AMENDMENTS RELATING TO QUALIFIED DISABILITY TRUSTS:

A. Scope of Application:

The introduction of QDTs in proposed subsection 122(3) is a welcome exception to the elimination of graduated tax rates.

For a trust to meet the definition of a QDT, the trust, among other things, must be created by will (subparagraph (a)(i)) and must jointly elect with a beneficiary who qualifies for the disability tax credit (subparagraph (b)(i)). In addition, such a beneficiary cannot have so jointly elected with any other trust (subparagraph (b)(ii)).

A QDT can only exist in respect of electing beneficiaries who qualify for disability tax credits under paragraphs 118.3(1)(a) to (b). This concept is narrower than the concept of “preferred beneficiary” in subsection 108(1) in that it does not also extend to individuals who have attained the age of 18 years who are a dependent of another individual because of mental or physical infirmity. We see no policy reason for restricting the definition in this manner.

We recommend that the definition of “QDT” be extended not only to electing beneficiaries who qualify for the disability tax credit, but also to individuals described in subparagraph (a)(ii) of the definition of “preferred beneficiary” in subsection 108(1).

B. Single Trust Permitted:

We also have concerns that allowing only one QDT per disabled beneficiary will result in hardship in a wide variety of situations. Many disabled individuals are beneficiaries of more than one testamentary trust. The Proposals will result in all but one of those trusts losing graduated rate treatment on accumulating income.

Example #7:

A disabled beneficiary has four grandparents. Under each of their Wills, a Henson trust is established for that disabled beneficiary. Each trust generates annual income of only $20,000 and given that the disabled beneficiary is receiving provincial disability benefits, all of the income will be accumulated until the benefits cease when the beneficiary turns 65.

Under the Proposals, just $20,000 annually will be taxed at the graduated rates; the other $60,000 will be taxed at the highest marginal tax rate.

Example #8:

A disabled beneficiary is an only child and his sole surviving parent is terribly concerned about her son's financial well-being after her death. One significant concern is that the tax exigible on her RRIF at death will be such that her remaining assets may not be sufficient to look after her son, especially after his provincial assistance ceases at age 65. She drafts a Will that creates a Henson trust with her unregistered assets and directs that the proceeds of her RRIF be put into a Lifetime Benefit Trust to avoid a full income inclusion of the RRIF proceeds on her death. Given the legal requirements of these two types of trusts, of necessity they cannot be drafted as a single trust. Each trust generates annual income of only $40,000 and it is expected that most of the income in the trust will be accumulated until available provincial disabiilty benefits cease when the beneficiary turns 65.

Under the Proposals, just $40,000 annually will be taxed at the graduated rates; the other $40,000 will be taxed at the highest marginal tax rate.

As the above examples illustrate, multiple trusts for a disabled individual may be established for valid estate planning reasons having nothing to do with an attempt to multiply a set of graduated rates. Given that the vast majority of families with disabled beneficiaries are of modest means and the income arising from a particular single trust created for such a beneficiary may be

relatively small, it is our view that a disabled beneficiary should be permitted to be the beneficiary of more than one QDT.

Consequently, we recommend that subparagraph (b)(ii) of the definition of QDT be deleted. To avoid multiplication of graduated rates over several trusts, we submit that, in many cases, subsection 104(2) would be applicable to treat multiple trusts with the same beneficiary as a single trust. In circumstances where this provision cannot be invoked, then consideration should be given to allow trustees of several trusts with the same disabled beneficiary to designate themselves as a single trust for the purposes of being a QDT. This would place the onus on taxpayers to identify trusts that warrant consolidation for purposes of utilizing a single set of graduated rates.

C. Created by Will:

The requirement that a QDT be "created by will" is overly restrictive. An insurance trust emanating from a stand-alone designation, although currently regarded as a testamentary trust, would be automatically ineligible to be a QDT. This would be the case *even if* that was the only trust arising as a consequence of death and all of the other QDT requirements were present.

We recommend that the words "created by will" contained in subparagraph (a)(i) of the definition of "QDT" be deleted so that it reads "(a) the trust (i) is a trust that is, at the end of the trust year, a testamentary trust." Since "testamentary trust' is defined under paragraph 108(1) more broadly as including trusts that arise on and as a consequence of death, this would address the problem. Alternatively, the words "or by a life insurance policy designation" could be added immediately following the phrase "created by will".

5. OTHER COMPLIANCE ISSUES RELATED TO QUALIFIED DISABILITY TRUSTS:

We have the following additional recommendations with respect to certain technical aspects of the QDT portion of the Proposals:

1. If any capital distribution is made in a year to a non-electing beneficiary of the trust, there are two significant implications:

    a. the trust no longer qualifies as a QDT for that year, which means it no longer qualifies for graduated tax rates for that year; and

    b. the trust is subject to the recovery tax described in paragraph 122(1)(c).

    In our view, the first implication is overly harsh in that the trust will be denied access to graduated tax rates regardless of the amount of capital distributed to a non-electing beneficiary. For example, where a trust with $50,000 of income makes a capital distribution of a nominal amount, such as $500, to a non-electing beneficiary, the trust will be subject to the highest marginal rate in addition to the recovery tax under paragraph 122(1)(c).

Our recommendation is to not disqualify a trust as a QDT as a result of a distribution to a non-electing beneficiary, but to instead rely on the recovery tax mechanism in paragraph 122(1)(c).

2. The election to be a QDT must be included with the T3 return for the particular trust. From a policy perspective, trusts that otherwise qualify as QDTs should not be denied the benefits of such designation simply because the filing deadline is missed.

   We recommend including the election to be a QDT in those prescribed under Regulation 600 for purposes of subsection 220(3.2) for late, amended or revoked elections.

3. Under paragraph 122(1)(c), the recovery tax is payable if the distribution to a non-electing beneficiary 'can reasonably be considered to be made out of' the amount taxable for a preceding year. There is no guidance on how to determine whether a distribution in a particular year is paid out of the amount taxable for a preceding year or whether it is instead paid out of other capital of the trust.

   We recommend that guidance be provided on how to determine whether a distribution is reasonably considered to be made out of an amount taxable for a preceding year.

4. Under subsections 122(2) and 122(3), a trust ceases to be a QDT in the first year in which there is no electing beneficiary. As a result, the trust will no longer be entitled to graduated tax rates. From a policy perspective, our view is that the 36-month period of graduated tax rates granted to GRE should also be extended to QDTs on the death of the last electing beneficiary. In our view it is reasonable to provide sufficient time to the administrators of such trusts to decide whether and how to continue or wind-up such trusts and, as such, we recommend that graduated tax rates should continue to apply to QDTs for 36 months following the death of the last electing beneficiary.