STEP Canada

December 2, 2013

The Honourable James M. Flaherty, P.C., M.P.
Minister of Finance
c/o Trust Graduated Rates - trusts-fiducies@fin.gc.ca
Tax Legislation Division
Tax Policy Branch
Department of Finance
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Dear Minister,

Enclosed is our submission on the Proposals to Improve the Integrity of the Federal Tax System by Limiting Access to Graduated Rates for Trusts and Certain Estates that were released by the Department of Finance on June 3, 2013.

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

Rachel Blumenfeld (Miller Thomson LLP)
Pamela Cross (Borden Ladner Gervais LLP)
Kathleen Cunningham (Trust & Estate Technical Committee)
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We would be pleased to discuss our comments with you at your convenience.

Yours very truly,

Ian Worland, Chair of STEP Canada
Legacy Tax + Trust Lawyers

Pamela Cross, Chair of Tax Technical Committee
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Response to "Consultation on Eliminating Graduated Rate Taxation of Trusts and Certain Estates"

Submission of the Society of Trust and Estate Practitioners (Canada)

December 2, 2013

INTRODUCTION

"Consultation on Eliminating Graduated Rate Taxation of Trusts and Certain Estates" (the consultation paper) proposes to eliminate graduated rate taxation for testamentary trusts. It also proposes to impose December 31 fiscal year-ends on testamentary trusts and remove or modify certain other perceived advantages or anomalies in the current tax treatment of testamentary trusts.

We, the Society of Trust and Estate Practitioners (Canada) (STEP Canada), have organized our response to the consultation paper as follows:

- Part I of our submission describes the proposals contained in the consultation paper and offers a critique of the consultation paper as a whole.
- Part II reviews the policy basis of the current income tax treatment of personal trusts and recommends that the Department of Finance reorient its focus from income accumulations in testamentary trusts to a principled review of the taxation of income accumulations in personal trusts generally.
- Part III makes specific submissions concerning the main proposals in the consultation paper, taking into account the reorientation of focus that we suggest.
- Part IV presents, in summary form, other areas of trust and estate planning that are at least as urgently in need of review or reform as the issues raised in the consultation paper.

PART I: SUMMARY AND CRITIQUE OF THE CONSULTATION PAPER

Summary

The consultation paper proposals can be summarized as follows:

1) The flat high marginal tax rate will apply to all grandfathered *inter vivos* trusts, testamentary trusts, and estates. Estates, however, will benefit from graduated rates for a 36-month period. This new regime will take effect for the 2016 and later taxation years.

2) The current special rules for disabled people and minor children will continue to apply to trusts that become subject to the new flat high marginal rate, such as trusts for which the preferred beneficiary election is currently available. There is no proposal, however, to extend the preferred beneficiary election to a wider variety of beneficiaries.

3) The changes proposed in the consultation paper will not affect the rollover available on the creation of spousal and common-law partner trusts.

4) The instalment rules will be extended to testamentary trusts. Testamentary trusts currently are required to pay tax owing within 90 days following their year-ends.

5) The current $40,000 basic exemption from alternative minimum tax will no longer apply to testamentary trusts.

6) Testamentary trusts will be required to use a calendar year-end.

7) Testamentary trusts will be subject to part XII.2 tax under the *Income Tax Act*.[1] Currently, part XII.2 tax does not apply to testamentary trusts.

8) Testamentary trusts will be required to meet the same conditions as *inter vivos* trusts to qualify as personal trusts. Currently, testamentary trusts automatically qualify as personal trusts, even if the beneficial interest is purchased for consideration.

9) Testamentary trusts will be required to recognize investment tax credits in the trust, as opposed to making them available to their beneficiaries, as is currently the case with *inter vivos* trusts.

10) A number of tax administration rules will no longer apply to testamentary trusts, including the time for filing objections, obtaining refunds for overpayment of tax, and requesting reassessments and determinations.

Critique

The consultation paper contains no historical or empirical analysis, no tax policy analysis, and no fiscal impact analysis. It does not address the relationship between the proposals and technical or policy deficiencies in the taxation of personal trusts generally. It does not provide any evidence of systematic abuses. Rather, the thrust of its argument is that the current tax treatment of income accumulations in testamentary trusts is conceptually anomalous and open to abuse. Its proposed solution is to align the taxation of testamentary trusts with the taxation of *inter vivos* trusts.

We respectfully believe that this approach is incorrect. We are unaware of any evidence, anecdotal or otherwise, of systematic abuses. A reform of entity taxation of this magnitude requires a more rigorous review of tax policy and fiscal impact implications. The focus of any reform of trust taxation should be the current tax treatment of trust accumulations in all personal trusts, not just testamentary trusts.

[1] RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this submission are to the Act.

PART II: HISTORICAL AND CONCEPTUAL CONTEXT OF THE PROPOSED REFORMS

Integrated Tax Treatment of Income Earned in an Entity

The basic design of the taxation of entities in Canada stems from the recommendations of the Royal Commission on Taxation (the Carter commission) and the white paper and legislative proposals that followed it. In the view of the Carter commission, individuals, not entities, should bear the ultimate burden of taxation. The taxation of entities is justified mainly as an anti-deferral mechanism. Complementing this view is the principle that anti-deferral mechanisms should not result in double taxation. Rather, the taxation of entities and their economic owners should be integrated, as far as practically possible.

A trust-deduction and beneficiary-inclusion system seeks to achieve the integrated tax treatment of income earned in an *inter vivos* trust. Character preservation rules ensure the appropriate treatment of the trust's income in the hands of the beneficiaries. However, with the exception of the preferred beneficiary election (subsection 104(14)) and the age-40 trusts (subsection 104(18)), the Canadian system of *inter vivos* trust taxation makes no effort to ensure that the correct marginal rate of taxation is applied to accumulated trust income. There is abundant anecdotal evidence that this feature of Canadian trust taxation results in distortions in trust planning (to avoid a bad tax result) when an accumulation of income might be desirable for legitimate trust-planning reasons.

The graduated rate mechanism used for testamentary trusts also makes no effort to ensure that the correct marginal rate of taxation is applied to income accumulated in the trust. If the correct rate is higher, the probable result in most situations will be overintegration. This feature of Canadian trust taxation creates distortions in trust planning (to achieve a good tax result), as the consultation paper points out.

Origin of the Distinction Between *Inter Vivos* and Testamentary Trusts

Why do Canada's trust taxation rules distinguish between *inter vivos* and testamentary trusts? We are unable to find a clear answer to this question in the Carter commission's report, subsequent government papers, or the tax literature. However, the following possibilities, although speculative, seem plausible:

- The flat high marginal rate that applies to *inter vivos* trusts may be based on the assumption that integration can be achieved at will by the settlor (or the trustees) of the trust simply by ensuring that the trust income is paid or payable to the beneficiaries annually.

- Before its amendment in 1995, the preferred beneficiary election provided broadly based relief against underintegration.

- The selection of the line between *inter vivos* trusts created while the settlor is alive and testamentary trusts created in a will may have been a rough policy compromise based on the obvious need to accommodate accumulation by estates (because of the executor's year and so on) and the assumption that the potential for abuse was not fiscally significant.

- An estate may in some sense have been viewed merely as the alter ego of the deceased and therefore eligible for a separate set of graduated tax rates.

The overall system was kept reasonably simple, and rough justice on the integration issue was achieved. However, the narrowing of the preferred beneficiary election in 1995 and the current proposal to eliminate graduated rates for testamentary trusts create a taxation regime that is decidedly biased against legitimate trust planning requiring the accumulation of trust income for the benefit of the beneficiaries.

We strongly believe in the benefits of trusts and trust planning. Throughout the common-law world (and increasingly in civil-law jurisdictions), the use of trusts to separate legal control from beneficial ownership is often necessary and desirable.

The Proper Scope of Reform

If the Department of Finance wants to revisit the design of trust taxation, it should do so on the basis of sound policy that takes into account the reality of modern trust planning.

In trust planning, the distinction between testamentary and *inter vivos* trusts is largely irrelevant. What matters generally are the settlor's or testator's donative intentions and the familial, business, and financial circumstances. The origin of the trust in a declaration, settlement, deed, or will does not (other than for tax reasons) affect the trust's purpose or design and therefore should not play a determinative role in its tax treatment. In this regard**,** we believe that the consultation paper is correct. However, the consultation paper fails in the identification of the pertinent issue. The elimination of tax preferences for testamentary trusts should not be the focus of reform; instead, the main tax policy question should be the appropriate and fair tax treatment of trust accumulations, regardless of the origin of the trust.

There are many circumstances in which the accumulation of income in a trust is legitimately required or desired for non-tax reasons. In these circumstances, reform should focus on establishing appropriate mechanisms to promote the integrated tax treatment of the income. Reformers should also recognize that perfect integration may not always be achievable; they should therefore accept (as the designers of the current system seem to have accepted in the case of testamentary trusts) that overintegration is a better policy choice than double taxation or overtaxation when the primary purpose of trust planning is the protection of the beneficiaries. Finally, reform should take into account provincial laws and regulatory rules (such as social

assistance programs and Henson trusts) that have a major impact on planning for those most needing the protection of a trust.

Trust-Planning Reasons To Accumulate Income

Trusts with accumulation features are often used to provide benefits for

1) individuals who are disadvantaged because of an intellectual, psychological, emotional, or physical condition;

2) individuals who are in need of protection or guidance because of their vulnerabilities (minors, teenagers, young adults, seniors, and spendthrifts) or individuals who require protection from potential creditors (including children's spouses on marriage breakdown); and

3) spouses (of a first or second marriage) when assets will ultimately pass to a settlor's children after the death of a surviving spouse.

The accumulation of income occurs as a matter of course in the context of an estate. In addition to executor's year accumulations are accumulations of income as a result of technical challenges in the administration of estates, especially estates with complex assets, and accumulations of income as a result of external factors, such as estate and tax litigation.

Some accumulations are required to maximize the ability of certain disadvantaged people to avail themselves of social assistance programs (such as Henson trusts, discussed below). In these cases, improved access to government programs is critical in providing reasonable financial support for intended beneficiaries.

Some trust accumulations, however, are at least partially motivated by income tax considerations. In particular, testamentary trusts can be used to avoid or minimize the old age security clawback and to multiply graduated rates.

The three main categories listed above do not describe all of the situations in which trust planning might require or contemplate the accumulation of income. Tax-efficient trust planning should not be limited to specified situations. Instead, reform should ensure that the rules will apply on a tax-neutral basis whenever a settlor wishes to establish a trust.

Mechanisms of Integration

At least six mechanisms can be used to achieve tax integration for personal trusts:

1) a deduction/inclusion mechanism (as in the case of *inter vivos* trusts currently);

2) an additional taxpayer with additional graduated rates mechanism (as in the case of testamentary trusts currently);

3) a co-ordinated election mechanism (as in the case of the preferred beneficiary election);

4) an initial vesting of the interest in the income mechanism (as in the case of the age-40 trusts);

5) a vesting of the interest in the income (pursuant to the exercise of discretion from time to time) mechanism; and

6) a refundable tax/gross-up/tax credit mechanism (as in the case of investment income earned by Canadian-controlled private corporations) or a remittance/refund on distribution mechanism (as in the case of retirement compensation arrangements).

Each technique has its strengths and weaknesses. The first and second have the deficiencies already described. The first works well only if accumulations are not an issue. The second works well when it is sensible to regard the trust as the taxpayer's alter ego. The third does not work well if there are capacity concerns (legal, intellectual, emotional, or physical) in relation to the electing taxpayer. The fourth cannot be used if the beneficial entitlements under the trust are designed to remain discretionary. The fifth works for discretionary trusts, but there may be technical challenges in ensuring that the income is eventually paid to a selected beneficiary if there are other beneficiaries of the trust. The sixth may work well in all situations but would require a significant change in the law that would have to be carefully considered.

PART III: SUBMISSIONS CONCERNING SPECIFIC PROPOSALS

Introduction

This part addresses the specific proposals contained in the consultation paper. The underlying theme of most of our submissions is that legitimate trust planning – especially planning that legitimately contemplates or requires the accumulation of income – should not be unduly constrained or discouraged by trust taxation rules.

Graduated Rate Proposals

Trust Planning for Disadvantaged Beneficiaries

Disadvantaged Beneficiaries Generally

There are a wide variety of circumstances in which a settlor requires trust arrangements because an intended beneficiary suffers from an intellectual, psychological, emotional, or physical

disadvantage that inhibits practical decision making. Many of these circumstances are described in the current definition of "preferred beneficiary." This submission is not the place to address the deficiencies in the definition of "preferred beneficiary," although we are prepared to make submissions to the Department of Finance on this topic.

Currently, testamentary trusts created for the benefit of disadvantaged beneficiaries do not have to use the preferred beneficiary election to avoid underintegration in respect of accumulated income. Trust income can be accumulated in the testamentary trust and receive graduated rate treatment. However, in an *inter vivos* trust created for the benefit of a preferred beneficiary, the trustees must either distribute the income or use the preferred beneficiary election to avoid underintegration. From a trust-planning perspective, it is generally undesirable to distribute significant amounts of income to a disadvantaged person who may be incapable of managing the funds. The preferred beneficiary election may be impractical or artificial because of the person's limited capacity and the risk (real or perceived) that the election could jeopardize access to otherwise applicable social assistance programs.

We believe that the separate graduated rate trust in these situations should be preserved for testamentary trusts and should be extended to *inter vivos* trusts. Disadvantaged people generally require the resources that their families can provide but lack the ability to manage funds and do not understand the significance of an election. From a tax policy perspective, the election is an extra measure of integration precision that, in our opinion, is often unworkable but should be retained to provide assistance in tax integration where possible. We also recommend allowing many donors to contribute to a single trust.

It should be possible to design a simple set of rules to protect this type of planning from abuse. For example, there might be a rule that prohibits disadvantaged beneficiaries from having more than a single trust or that ensures that multiple trusts share the benefits of the graduated rates. Payments to other beneficiaries could be restricted (or subjected to additional tax) to address rate-shopping concerns. We would be pleased to provide further submissions on this topic.

Henson Trust Planning

Henson trust planning offers a compelling argument against using the deduction/inclusion or preferred beneficiary election techniques of integration in planning for the disabled.

Each province provides assistance to disabled individuals who meet certain criteria. This assistance includes not only a financial stipend in the range of $700 to $1,100 per month, depending on the jurisdiction and various other factors, but also supplementary health benefits for a variety of medical and dental services, therapeutic treatments, and the purchase of devices such as glasses and hearing aids. To be eligible for these benefits (including the non-financial benefits, such as access to treatments and programs), an individual must meet an asset and income test. The value and type of assets that an individual can own and the amount of funds he or she can receive from other sources is limited. In Ontario, for example, an individual can own up to $5,000 in assets and can receive up to $6,000 per 12-month period from other sources

(such as gifts from family members or, as discussed below, income from a trust). In British Columbia, these limits are currently $3,000 and just under $5,500, respectively.

All of the provinces exempt certain types of assets, including registered disability savings plans, principal residences, and automobiles. In many of the provinces, Alberta and Quebec are exceptions, when a disabled person is the beneficiary of a discretionary testamentary or a discretionary *inter vivos* trust, often referred to as a "Henson trust," the assets held in the trust for the person are not included when determining the value of his or her assets for the purposes of the asset limit. However, if the distributions from the Henson trust, whether income or capital, exceed the allowable amount of income, the disabled person's benefits, including non-financial benefits, may be clawed back. In addition, many provinces exempt inheritances or proceeds of life insurance of less than $100,000 that are held in or subsequently transferred to a trust for the purposes of the asset limits.

Using a deduction/inclusion technique of integration would defeat the purpose of Henson trust planning because the disadvantaged beneficiary's income may exceed the allowable provincial limits. If the preferred beneficiary election technique of integration is used, the beneficiary's T1 tax return will include all or some of the undistributed trust income. This may result in the loss of eligibility for provincial social assistance programs (including non-financial programs), or the individual may be required to appeal a decision to reduce or cut off benefits. Anecdotally, we know that disadvantaged individuals or their guardians may be reluctant to make the election because of the risk of jeopardizing their eligibility.

For these reasons, we believe that the status quo in respect of testamentary trusts for this type of trust planning should be maintained, and it should be extended to *inter vivos* trust planning of the same type.

Trust Planning for Individuals in Need of Protection and Guidance

There are many trust-planning situations in which it is desirable to create beneficial interests that are discretionary. In these situations, the trustees serve as surrogate parents, guardians, or best friends, and they act as fiduciaries of the beneficiaries in the widest possible sense. In fact, it is rare in the *inter vivos* trust setting for a settlor to create beneficial interests that are not discretionary, and it is not uncommon to see discretionary trusts used in testamentary trusts as well. In general, the settlor's intention is to restrict the beneficiary's access to trust property because, in the settlor's view, the beneficiary is vulnerable as a result of age, immaturity, or intellectual capacity or is susceptible to the third-party claims or influence of spouses and creditors, which could diminish the trust property intended for the beneficiary and/or his or her children. In the current income tax environment, trust income accumulated in the trust results in the loss of integration, except in the case of age-40 trusts.

Age-40 trusts do not come close to addressing the planning required to accumulate trust funds in almost all situations. Families are justifiably concerned about prematurely transferring interests in and control over their wealth to younger family members**.** Generally, it is not desirable for children to become entitled to any fixed share of the wealth until they are well past the age of 18. Flat high-rate taxation makes this planning undesirable. The age-40 trust appears to recognize

this reality but is a token gesture and clearly inadequate.

We believe that the Department of Finance needs to re-evaluate this result. A vesting strategy or a preferred beneficiary strategy should be considered to allow for trust accumulations in all of these situations, provided that there is protection against rate shopping and the other abuses that led to the amendments to the preferred beneficiary election in 1995. Alternatively, it may be preferable to adopt a modified integration technique similar to the one used for the investment income of Canadian-controlled private corporations. This technique might be applied to accumulated income, and the overall regime of trust taxation might still contemplate a deduction/inclusion technique for income that is distributed in the year.

Trust Planning for Spouses

Spousal trusts serve a variety of functions in estate planning. In the testamentary context, a spousal trust often stands in the place of the deceased. It allows a deceased spouse to provide financially for a surviving spouse by involving friends and trusted advisers as trustees. Income can be retained in the trust and taxed at a graduated rate pursuant to subsection 104(13.1). In the context of blended families, spousal trusts are frequently used to provide income to a surviving spouse while preserving the capital for the deceased's children after the surviving spouse's death. While spousal trusts are required to pay all of their income (including dividends, interest, and rent) to the surviving spouse, capital gains can remain in the trust and be taxed there, unless the terms of the trust dictate otherwise, which they rarely do. If the spousal trust is created in a will, capital gains are taxed at graduated rates; if the trust is not created in a will, taxable capital gains are taxed at the high flat rate.

The consultation paper proposes to subject income retained in the trust pursuant to subsection 104(13.1) and taxable capital gains to flat high-rate taxation. These proposals may encourage trustees to pay income to the spouse instead of accumulating it for the spouses's later use and to accelerate the depletion of the the trust's capital to the detriment of its capital beneficiaries. Further, any deemed gains triggered by the surviving spouse's death would be subject to tax at the high flat rate.

We believe that this result is unfair and inappropriate. A fairer trust taxation regime would tax the taxable capital gains at the marginal rate of the capital beneficiaries or, if technical or practical reasons prevent this mode of taxation, at the marginal rate of the spouse. Accumulated income in the spousal trust should also be taxed at the marginal rate of the spouse.

For these reasons, we believe that the status quo in respect of testamentary trusts for this type of trust planning should be maintained, and it should be extended to *inter vivos* trust planning of the same type.

Estates

The consultation paper includes provisions that will permit an estate to use graduated rates for 36 months, following which the estate will be subject to flat high-rate taxation. Except in the

simplest of estates, 36 months is often not long enough to resolve all of the complications that may arise during an estate's administration. If, for example, an estate is involved in difficult litigation or complex cross-border concerns, more time may be required. We also note that amendments to the Ontario *Estates Administration Act*[2] will give the Ontario government up to four years to reassess probate taxation. Executors may find themselves in a conflict between minimizing income taxation after 36 months and maintaining the estate until the end of the fourth year to protect themselves against personal liability.

For these reasons, the 36-month proposal for estates should not be implemented or should be implemented in a different manner. It is preferable to maintain the status quo, perhaps with a targeted anti-avoidance measure to eliminate undue delay in the the administration of estates for the purpose of taking advantage of the graduated rates for an extended period of time. In the alternative, executors should be able to apply for an extension of the 36 months if the administration of an estate is not yet complete for legitimate reasons.

Transitional Rules

If the graduated rate proposal is implemented, it will have a severely detrimental effect on existing testamentary trusts, estates, and grandfathered *inter vivos* trusts, potentially causing financial hardship for many vulnerable Canadian families, especially in light of today's low investment returns. We believe the Department of Finance should consider allowing the following transitional relief:

1) For testamentary trusts, estates, and grandfathered *inter vivos* trusts that are already established, there should be grandfathering provisions or special transitional rules. These rules or provisions are particularly important in the case of existing testamentary spousal trusts. Without them, the trustees and beneficiaries of these trusts will be forced to expend time and money in applying to the courts for variation.

2) For testamentary trusts arising pursuant to estate planning that is currently in place, particularly trusts that cannot be altered as a result of the incapacity of the settlor or testator, there should be grandfathering provisions or special transitional rules. Without them, many Canadians will be forced to re-evaluate their existing estate plans and may be faced with the difficult choice of giving up the protections afforded by trust planning in order to avoid excessive taxation. The situation is particularly problematic if the planning cannot be altered as a result of mental incapacity.

Technical Changes

If the graduated rate proposal is implemented in its current form, we recommend that the

[2] RSO 1990, c. E.22, as amended.

Department of Finance consider the following technical modifications:

1) Subsection 249(6), which imposes a year-end on a trust that loses testamentary trust status as a result of tainting, should not be required if there is no substantial distinction between a testamentary trust and an *inter vivos* trust. It should be "repealed".

2) The definition of "preferred beneficiary" should be expanded. We are prepared to make further submissions on this point if the Department of Finance is prepared to consider them.

December 31 Year-End

The proposal to impose December 31 year-ends on testamentary trusts raises a number of mainly technical comments:

1) The consultation paper does not clarify the mischief that the December 31 year-end proposal is intended to address. If the only problem is the artificial creation of deferrals through the use of staggered years-ends in tiers of trusts, we believe that the Department of Finance might look to the recent changes in the taxation of partnerships for a less intrusive solution.

2) If the December 31 year-end is applied at the outset of an estate, the trust tax return will be due several months before the terminal year return when a taxpayer dies close to the end of a calendar year. This consequence of the proposal may result in substantial hardship in many situations and necessitate the rushed preparation of returns. The proposal might be amended to allow for an extension of time in which to file the first trust tax return in these situations (the filing could be made coincidental with the filing of the terminal year return).

3) The consultation paper does not explain how the December 31 year-end will affect the application of subsection 164(6). As suggested in part IV of this submission, the one-year period available for loss carrybacks under subsection 164(6) is already too short in many situations. It should not be further shortened as a result of the application of the December 31 year-end to all testamentary trusts.

4) Bulk tax preparers (such as the corporate trustee industry and the tax return preparation industry) will experience considerable increases in administrative costs and burdens if all testamentary and *inter vivos* trust year-ends occur at the same time and have the same filing deadline. Presumably, the Canada Revenue Agency will experience corresponding increases in administrative costs and burdens. The consultation paper does not address the anticipated financial benefits of this proposal or the increased compliance burden.

5) If all personal trusts are required to have December 31 year-ends, the T3 filing period should be extended beyond 90 days. T3 slips could remain subject to the currently applicable time limits.

6) All testamentary trusts will have one short year because of a legislated December 31 year-end. This could result in unfairness.

Tax Instalments

Requiring discretionary trusts to remit tax instalments will create a significant administrative burden for tax preparers in calculating, remitting, and reconciling these instalments. Furthermore, annual distributions to beneficiaries may fluctuate substantially from year to year because the cash available for distribution to beneficiaries will be affected by tax instalments paid in the current year or refunded from the previous year.

PART IV: OTHER RULES

We believe that the reform of trust taxation should proceed on a principled and not a piecemeal basis. We accept that the anomalous overintegration that occurs in the case of testamentary trusts and the potential for abuse that arises as a result of the proliferation of these trusts is open to criticism. However, we think that the simple abolition of testamentary trusts is not the correct approach.

As part of a larger review of the rules governing trust and estate planning in the Act, the Department of Finance should also consider reforming the following rules:

1) The one-year period allowed for the loss carryback in subsection 164(6) is insufficient, especially in light of the uncertainty of pipeline planning in some circumstances. Further, to avoid the inappropriate trapping of losses in a trust, the Department of Finance should consider allowing an estate to transfer losses to estate beneficiaries, in addition to allowing the deceased to use the loss carryback.

2) Technical concerns have been identified in the tax literature about the application of subsection 164(6) and the circularity created by the stop-loss rules. The Department of Finance should consider addressing the technical issues in this area.

3) Subsections 75(2) and 107(4.1) significantly affect trust planning. The Act contains a number of attribution rules that are specifically applicable to trusts. Subsection 75(2) is unclear in its scope and application and, in our view, is no longer necessary. In light of the implications of its application (the loss of the ability to roll out trust property to beneficiaries on a tax-deferred basis), it is time that it be reviewed. The Department of Finance should determine whether subsection 75(2) is necessary or desirable in its current form and whether the penalty imposed under subsection 107(4.1) is appropriate from a tax policy perspective.

4) The stop-loss and bump rules applicable on the death of the spouse in a spousal trust, the second partner in a joint partner trust, and the alter ego in an alter ego trust (subsection 40(3.6) instead of 40(3.61) and paragraph 88(1)(d.3)) do not operate as they should, making the use of these trusts less attractive than the disposition of assets under a will. We cannot identify a policy reason for the distinction between these trusts and an estate. The Department of Finance should consider addressing this longstanding issue.

5) A number of provinces are considering the adoption of the *Uniform Trustee Act*, which includes a recommendation that total return investing be permitted. Under the current rules, spousal trusts are not able to use total return investing. The Department of Finance should consider amending the Act to permit total return investing by spousal trusts. A mechanism to permit tax integration between trusts and beneficiaries would be crucial in making this work from a tax perspective.

6) The rules governing the passing of farm and fishing businesses on a rollover basis to subsequent generations requires that the applicable farm and fishing property vest indefeasibly in the child within 36 months of the death of the taxpayer. The income tax rules that should be in place to allow income accumulation on an integrated basis between a trust and its beneficiaries should be drafted to permit a more extensive vesting period under the rollover rules for these businesses (for example, subsection 118.1(5)).

7) There should be a rule to specifically provide that a change of trustee does not trigger an acquisition of control of a corporation owned or controlled by the trust. The current interpretation of the acquisition-of-control rules serves no purpose and creates considerable uncertainty.

8) The tax credit for gifts made in a will should be available to an estate as well as a testator at the option of the executors.

9) The Department of Finance should address the issues relating to donations made in an alter ego or joint partner trust, particularly when the principal dies late in the year. These issues arise because donation credits cannot be carried back to a previous year. A modification of this rule is desirable in the case of these trusts.

CONCLUSION

STEP Canada recommends a more comprehensive review of the taxation of accumulations of income in trusts, with the goal of ensuring appropriate integration and facilitating legitimate trust planning. We do not agree with the proposals as presented in the consultation paper as they will be detrimental to legitimate trust planning. We also recommend that the Department of Finance review the trust and estate taxation issues identified in Part IV of this submission on an as urgent basis as the proposed reform of the taxation of trust accumulations. Finally, if the proposals do proceed, we recommend that more thought should be given to expanding the categories of the preferred beneficiary election.