MONTHLY NEWSLETTER

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Estate Planning: Changes to Testamentary Trusts

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Our goal is to provide updates on topical tax issues. Information contained in the newsletters is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients. We would be pleased to discuss any questions that you, the reader, might have in greater detail.

BACKGROUND

Canadian individual taxpayers are taxed at graduated rates on their annual income. Simply, this means that as an individual earns more income, the income is taxed at a higher rate. The top marginal tax rate in Ontario is currently 49.53%, which takes effect on income over $220,000. When a Canadian individual taxpayer dies, a testamentary trust is created for tax purposes. Income earned by the estate prior to the distribution of the assets of the estate is taxed within the trust. There are a number of legal and tax reasons for using testamentary trusts. Access to graduated tax rates has historically been a primary motivation. Testamentary trusts have access to the same graduated rates and other benefits as individual taxpayers for the life of the trust.

The 2014 federal budget legislated changes to testamentary trusts which come into effect on January 1, 2016. The following changes should be considered for existing testamentary trusts and future estate planning as the consequences could be significant.

CHANGES TO TESTAMENTARY TRUSTS

Elimination of Graduated Tax Rates

Effective for 2016 and later taxation years, all testamentary trusts will be subject to tax at the top marginal tax in the respective province of residency, other than certain exceptions, as discussed below. This means that all income earned by the estate will be taxed at the highest marginal tax rate in the jurisdiction within which they reside. The change could result in as much as $15,000 in additional taxes, depending on the province and the income earned by the estate.

Reporting Year End

Currently, testamentary trusts can choose a taxation year-end within the one year of the anniversary of death. As of January 1, 2016, testamentary trusts and non-graduated rate estates must select a December 31 year-end and.

Testamentary trusts and non-graduated rate estates that have existed for longer than 36 months, and that have off-calendar year-ends, will have a deemed year-end as of December 31, 2015.

Testamentary Charitable Giving

Current income tax provisions require that charitable donations made pursuant to an individual taxpayer's will must be claimed on the personal terminal tax return of the individual or the personal tax return of the year preceding the year of death. For example, if an individual taxpayer passes away in 2014, and a donation is made by the estate pursuant to the will in 2016, an adjustment would be required to amend the 2014 tax return to claim the donation tax credit. The new rules require the donation to be claimed in the estate in the year that the donation is made.

Other Changes

Tax installments are mandatory prepayments of tax. Unlike individual taxpayers, testamentary trusts are currently exempt from paying installments to the Canada Revenue Agency. The new rules revoke this exemption, effective January 1, 2016. Going forward, testamentary trusts will be required to make installment payments.

Additional changes to testamentary trusts that are beyond the scope of this newsletter include the elimination of the $40,000 exemption from Alternative Minimum Tax and the ability to allocate investment tax credits to beneficiaries of the estate.

GRADUATED RATE ESTATES (GREs)

To allow for the administration of an estate following the death of a taxpayer, estates that meet the criteria of a GRE can continue to have income taxed at graduated tax rates for up to 36 months. Only one GRE can exist in respect to an estate of a deceased individual taxpayer. To qualify, the estate must arise from the death of an individual taxpayer, be a testamentary trust, and have existed no more than 36 months from the date of death. GREs may have non-calendar year ends for the first 36 months from the date of death. The estate must designate itself as the deceased individual's graduated rate estate in the first tax year after 2015.

The estate will be deemed to have a year-end after 36 months when it ceases to be a GRE and is then required to select a December 31 fiscal year-end. When the estate ceases to be a GRE, there may be two taxation years, consequently, two tax filings. One filing for the regular year-end and one for the deemed December 31 year-end.

GRE are exempt from the new rules requiring charitable donations to be claimed in the estate in the year that they are paid to the charity. In the case of a GRE, the donation can be claimed in the year of death, the year before the year of death, or any of the three years that the estate is a GRE. Thus, timing of donations to registered charities as bequest in a will become crucial to allow for the flexibility to claim the tax credit in the most beneficial period.

GRE status is important for a number of reasons including entitlement to graduated tax rates. With the exception of specific rollover provisions, there is a deemed disposition for tax purposes of a taxpayer's assets on death. In the case of private company shares, this can pose a particularly complicated issue, resulting in double taxation. A detailed discussion of the double taxation issue is beyond the scope of this newsletter. However, the important takeaway is that in order to undertake post-mortem loss-carryback planning to eliminate the double tax liability, an estate must be a designated GRE. As discussed above, only one GRE can be designated for each individual taxpayer. Where an individual has more than one will, the GRE designation becomes an even more important consideration.

ESTATE PLANNING AND CONSIDERATIONS

Depending on the value of the estate, testamentary trusts may still present an opportunity to accomplish tax savings, if a GRE designation is unavailable or expired. A discretionary testamentary estate allows for income splitting with low income beneficiaries and the flexibility to make distributions to certain beneficiaries depending on criteria. For example, income may made from the estate to grandchildren enrolled in post second education instead of distributions to other high income earning beneficiaries.

There are a number of family law considerations with regards to estate planning that should be considered, depending on the wishes of the deceased. Although testamentary trusts may be less attractive form a tax perspective, there are many non-tax reasons that may warrant their use. For example, in the cases where beneficiaries are minors, it may be prudent to have funds held in trust until they attain a specified age.

If assets of an estate are intended to pass to a disabled beneficiary, the estate may qualify as a qualified disability trust, if a number of criteria are met. The starting point is that the beneficiary is eligible and has applied for the disability tax credit. This type of trust is eligible for tax preferred rates and other benefits and should considered in this scenario.

CONCLUSION

Whether you have a will currently drafted, or are beginning the process of estate planning, we recommend that you consult your professional advisors to ensure that your will achieves your intended bequests, and accomplishes your wishes in the most tax efficient manner. Given the significant changes that will take effect January 1, 2016, having an updated will is more important than ever.

The changes to testamentary estates are broad in nature and should be reviewed on an individual basis. If you have any questions or concerns about how these changes may affect you or your estate or the manner in which your will is drafted, please contact our office for more information.