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COMMENT

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Taxation of Estates: Changes Are Coming

In the 2013 federal budget the federal government announced its intention to amend the tax provisions with respect to testamentary trusts (i.e., trusts created as a result of death). These were followed by specific proposals in the 2014 budget. On December 17, 2014, Bill C-43 received Royal Assent and brought into force many new income tax provisions.

One of the most widely discussed changes is that graduated tax rates will generally no longer be available to testamentary trusts. Beginning in 2016, income earned and retained by a testamentary trust will be subject to tax at the top flat tax rate, with the exception of a graduated rate estate and a qualified disability trust (QDT).

The graduated rate estate (GRE) is a completely new type of trust that comes into effect for income tax purposes beginning January 1, 2016. In general terms, a GRE is an estate that arises as a consequence of a death and can exist for up to 36 months following death provided the trust remains a testamentary trust. A GRE will be subject to the "old" graduated tax rate treatment. In simple terms, an estate will be treated as a GRE for up to 36 months immediately following the testator's death and during that time it will be eligible to utilize graduated tax rates. If the estate exists beyond the 36 month point following the deceased's death, the estate will no longer be a GRE and becomes subject to the top flat tax rate regime.

The estate representative can select any year end for the GRE; however, if the trust continues to exist beyond the 36 month point, the trust year end will convert to a December 31 year end from that year forward.

An estate typically remains open for the time needed by the estate representative to complete the work required to administer the estate, including activities such as identifying the assets, locating beneficiaries, and completing the estate distributions. The federal government suggests 36 months is a reasonable period for an estate to be treated favourably through GRE status because the majority of estates are typically wound up within this window of time.

EXAMPLE

Let's look at an example that highlights the year end for a new estate under the new regime.

Ted passes away on September 30, 2016 with a fairly complex estate which will likely remain open for an extended period of time. Ted's estate taxation year begins at the moment of death and will be treated as a GRE for up to 36 months from his date of death.

First tax return	April 30, 2017 (Selected by Ted's estate representative)
Second tax return	April 30, 2018 (12 months)
Third tax return	April 30, 2019 (12 months)
Fourth tax return	September 30, 2019 (36 months following Ted's death) – GRE period ends.
Fifth tax return	December 31, 2019 – Top flat tax rate
Sixth tax return	December 31, 2020 (12 months)

Any testamentary trust arising because of a death, other than a GRE or QDT, will now be immediately taxed at the top flat tax rate. For example, if Ted decides to establish a testamentary trust for each of his three children and their respective children, the three testamentary trusts will be taxed at the top flat tax rate if Ted dies after December 31, 2015. Using trusts to achieve specific testamentary wishes such as passing assets on to successive generations remains a valid estate planning tool, but the income tax consequences have changed somewhat dramatically.

A second significant change to the taxation of trusts was not addressed in the government's 2013 announcement or the 2014 budget but appeared in the final legislation. A spousal trust, alter ego trust and joint partner trust are all subject to a deemed disposition of their capital assets upon the death of the income beneficiary (second death in the case of a joint partner trust). This deemed disposition triggers the realization of any accrued capital gain in the

assets held by the trust and is currently reported as income to the trust. For deaths after 2015, these capital gains will be taxed in the deceased beneficiary's terminal tax return and not the trust.

While the change seems simple because all it does is shift the income tax liability from the trust to the deceased, the implications may be significant, particularly in situations that cannot be changed.

EXAMPLE

Consider Mark and Mary, a married couple. This was a second marriage for each and both have children from a first marriage. At the time of Mark's death several years ago, Mark left the preferred shares of a family business to a spousal trust, with Mary as the beneficiary of the income earned in the trust. Mark's children were named the "capital" beneficiaries who would ultimately receive the shares at the time of Mary's passing. The business purchased a last-to-die life insurance policy on the lives of Mark and Mary. The intention was to use insurance proceeds to redeem a portion of the preferred shares held by the spousal trust in order for it to meet its cash flow needs relative to the income tax liability arising in the trust upon Mary's death. Mark and Mary's plan was designed with the current income tax rules in mind; insurance was going to provide the liquidity to fund the income tax liability.

Beyond the shift of the income tax liability, planning will also be significantly impacted because post mortem plans that depended on netting capital losses against capital gains will all need to be revised.

Under the new regime, the tax liability resulting from the deemed disposition of the trust's assets will now arise in Mary's estate. This means that Mark's children, as capital beneficiaries of the trust, will inherit the remaining preferred shares from the spousal trust, plus the cash that the trust will receive from the redemption of shares from the business. Mary's estate will bear the income tax liability arising from the trust's deemed disposition of the shares, and only the residue of her estate will be available for distribution to her own beneficiaries. This is not what Mark and Mary would have intended based upon their planning objectives and the tax rules in effect when they undertook their estate planning.

Mark and Mary's situation involves a testamentary spousal trust; however, a similar situation arises with an *inter vivos* spousal trust as well as alter ego and joint partner trusts. In each of these scenarios, the tax liability is shifted from the trust to the deceased. Unless the deceased's estate has the same beneficiaries as the trust, an unanticipated inequity will arise. To the extent the deceased spouse's estate does not have sufficient funds to pay the resulting tax liability, the trust is jointly and severally liable.

Beyond the shift of the income tax liability, planning will also be significantly impacted because post mortem plans that depended on netting capital losses against capital gains will all need to be revised. The capital gain triggered by the deemed disposition will be reported by the deceased, but the capital loss created by a redemption will be realized in the trust.

Planners and clients will want to review the impact of these changes. Some clients will need to revise plans, and others may need to develop additional plans to deal with those situations that cannot be changed.

I/R 2500.00; 7401.00

Interest Expense: A Valuable Deduction

The federal *Income Tax Act (*Act*)* provision that allows for the tax deduction of interest expenses appears deceptively simple. However, there are a significant number of details and interpretations that require close attention. One such detail is that the courts have held that interest is generally considered to be on account of capital and is not tax deductible except under the specific provision within the Act.

Paragraph 20(1)(c) of the Act allows the deduction for certain interest expenses. The provision, which can be summarized as follows, allows a deduction for:

An amount paid in the year or payable in respect of the year, pursuant to a legal obligation to pay interest on:

- borrowed money used for the purpose of earning income from a business or property; or
- an amount payable for property acquired for the purpose of gaining or producing income from the property or for the purpose of gaining or producing income from a business.

To be tax deductible, the interest must be paid or payable. A borrower would normally service the investment debt on a monthly basis. Alternatively, the loan agreement may allow the borrower to defer the interest payment, in which case the lending institution would increase the amount owing. If the interest is added to the loan outstanding in this manner, the interest becomes payable which meets the criteria of the provision.

Where a prescribed rate loan is advanced between non-arm's-length parties, it must be a bona fide loan arrangement and interest must be paid within 30 days following the end of the year.

Simple interest (i.e. interest on the principal amount) can be tax deductible even if it is not paid but becomes payable. However, compound interest is only deductible when it is paid. Compound interest is interest charged on unpaid interest that is added to the loan.

For interest to be deductible, the purpose of the borrowing must be to earn income from a property or business. As such, investments that produce only capital gains, where there is no expectation of interest or dividends, would generally not result in deductible interest. Care needs to be exercised to determine whether there is a prohibition on dividend payments. Some prospectuses actually state that there is a clear intention to not pay dividends.

In a recent decision, the Federal Court of Appeal (FCA) affirmed a lower court's decision where interest expense claimed on money borrowed to buy shares of a family business was denied. The business in this case had never paid dividends on any shares, did not have a stated dividend policy, and distributed its profits by paying bonuses to the shareholders in proportion to their holdings. Effectively, there was no reasonable prospect of dividend income associated with the shares purchased.

In a technical interpretation, the Canada Revenue Agency (CRA) responded to the court decision indicating their intention to continue following their published administrative position. In general terms, the CRA's administrative practice is to allow an interest deduction on the purchase of common shares even though no dividends have ever been paid, provided there is a reasonable expectation that dividends could be paid at some point in the future. A stated "no dividend" policy would negate the reasonable expectation premise.

I/R 7401.00

Death of the RRSP Plan Holder

About one-third of Canadians contribute to a registered retirement savings plan (RRSP) as a means to save for their retirement. While contributions into the RRSP are tax deductible, the death of the plan holder creates an immediate income inclusion equal to the fair market value of all of the assets held within the plan at the time of death. This income must be reported on the deceased's terminal tax return. As discussed below, tax planning opportunities are available where RRSP assets pass to a surviving spouse or certain financially dependent children.

Refund of Premiums

When preparing the deceased's terminal return, the executor may claim a deduction for a "refund of premiums", which generally is equal to the RRSP funds passed to the deceased's surviving spouse (common-law partner) or a financially-dependent child or grandchild.

A child or grandchild is defined to be financially dependent on the deceased at the time of death if that child ordinarily resided with and was dependent on the deceased.

Refund of premiums treatment requires that the spouse or child receive the RRSP proceeds as a named beneficiary of the plan. However, where the proceeds pass to the deceased's estate, and the spouse or child would receive the funds from the estate under the terms of the will, the executor and the spouse or child can jointly elect to have refund of premiums treatment apply.

The Canada Revenue Agency (CRA) has indicated in a technical interpretation that an individual may have two spouses for the purposes of the definition of "refund of premiums" – a married spouse from whom the deceased was separated but not divorced, and a common-law partner.

A child or grandchild is defined to be financially dependent on the deceased at the time of death if that child ordinarily resided with and was dependent on the deceased. The child's net income for the previous year is generally required to be less than the basic personal amount ($11,138 in 2014). For children with a physical or mental impairment, net income must be less than the combined basic personal amount and the disability

amount ($11,138 and $7,766 = $18,904 in 2014). Note that these dollar limits are rebuttable – in other words the taxpayer can argue that a child with income higher than the stated limits was in fact still financially dependent on the deceased person in the particular facts and circumstances. Also note that the child cannot also be financially dependent on someone other than the deceased or refund of premiums treatment will not be available.

Any portion of the RRSP proceeds paid on death that qualifies as a "refund of premiums" is deductible by the executor as an offset of the deceased's RRSP income inclusion. The recipient beneficiary is taxable on the receipt of those RRSP proceeds to the extent of the deduction claimed on the terminal return. In some circumstances, options are available to qualifying beneficiaries that allow them to shelter the income.

- The beneficiary spouse or common-law partner can transfer amounts received into an RRSP, registered retirement income fund (RRIF), or a registered annuity under which he or she is the annuitant. If the beneficiary is over age 71, the transfer must be to a RRIF or registered annuity. Effectively, the registered funds are rolled over by the survivor and income tax is deferred.
- In the case of a qualifying child or grandchild who is financially dependent by reason of mental or physical infirmity, the proceeds can be transferred into a registered plan under which the child is the annuitant. In addition, he or she has the option to transfer the funds into a registered disability savings plan (RDSP).
- In the case of a qualifying financially dependent child or grandchild under the age of 18, the funds can be transferred to a registered term certain annuity payable to age 18.

Change in Value

To the extent the value of the assets held within the RRSP increases or decreases between the date of death and the time the executor liquidates the account, an adjustment is available. Should the account decline in value, a deduction from the fair market value at date of death can be claimed on the deceased's final return. This is reasonable as it results in an inclusion of the true realizable amount. In general terms, the RRSP issuer completes and signs the CRA form (RC249) at the time the RRSP is distributed. The executor sends the completed RC249 to the CRA with a letter requesting an adjustment to the deceased's terminal return.

To be eligible for the deduction, the account is to be distributed by the end of the year following death. The executor may apply to the Minister requesting the deduction be permitted beyond the standard period. The Minister has the right to waive this time limitation. It would seem reasonable that exceptional circumstances would be given consideration. The decline in value deduction is not available where the RRSP plan holder's spouse or common-law partner is named as the sole beneficiary of the plan.

Similarly, should the account increase in value, a T-slip (T4RSP) is issued for the difference and must be reported on the beneficiary's or estate's return (depending on who is entitled to receive the growth amount).

The income tax liability associated with an RRSP upon the plan holder's death is quite significant. Understanding the options can lead to a more optimal outcome.

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