McLaren Trefanenko Inc.
350 - 522 Seventh Street
New Westminster, BC V3M 5T5

Phone 604 524 8688
Fax 604 526 0455
www.mti-cpa.com

Changes in Estates and Trusts Taxation

Effective January 1, 2016, there are significant changes to the taxation of Estates and Trusts.

This handout provides an overview of some of these changes.

1. Graduated Rate Estate (GRE)

A Testamentary Trust is a Trust that arises upon the death of an individual and historically these Trusts have received favourable tax treatment. This favourable tax treatment is now limited to a new type of Trust called a Graduated Rate Estate (GRE). A Trust that is a person's Estate is eligible to qualify as a GRE. An Estate is created on a person's death. It exists until the administration of the Estate is complete and ready for distribution to the beneficiaries, or, to a Trust created by the Will.

To qualify as a GRE, the Estate must be:

- less than 36 months old (from the date of death), and
- designated as a GRE in its first income tax return after 2015, and
- the only Estate created upon an individual's death designated as a GRE.

2. The Estate or Trust will be required to have a December 31st tax year-end.

An Estate or Trust which is not a GRE and had a tax year-end other than December 31st, is deemed to have a December 31, 2015 tax year-end. In this case, there are ***two*** T3 tax returns required for 2015. The first T3 is for the previously designated year-end and the second T3 is for December 31, 2015.

For example, if the Estate normally had an October 31st year-end, then a T3 return is required for the tax year ending October 31, 2015 (to report income earned from November 1, 2014 to October 31, 2015) and for the year ending December 31, 2015 T3 return (to report income earned from November 1, 2015 to December 31, 2015).

In 2016 and future year years, the Estate or Trust will file tax returns on a calendar year basis using December 31st as the tax year-end until the Estate or Trust is wound-up and distributed.

3. Elimination of access to graduated tax rates

All Estates are now subject to flat top-rate taxation, unless it is a designated GRE (see Item 1 above).

Estates established by an individual who died before December 31, 2012, do not qualify as a GRE as of January 1, 2016. This means all income earned in the Estate after 2015 will be taxed at the top marginal personal income tax rate of 47.7% in BC (33% Federal + 14.7% BC Provincial).

4. **Quarterly instalments**

All Testamentary Trusts were previously exempt from making quarterly tax installments. The new rules require all Trusts (except GRE's), to make quarterly tax instalments where annual tax payable is greater than $3,000. Instalment payments are due March 15th, June 15th, September 15th, and December 15th.

5. **Trust income paid or payable to a beneficiary**

Income earned in a Trust which is paid or payable to a beneficiary can no longer be taxed in the Trust and must be allocated to the beneficiary. Previously, an election could be made to tax this income in the Trust and not in the hands of the beneficiary. This election allowed a Trust to minimize overall taxes payable by choosing to tax the income in the Trust instead of to the beneficiary.

Under the new rules, a Trust generally cannot choose to tax the income in the Trust and the Trust must allocate all income paid or payable to the beneficiary. The Trust will issue a T3 slip to the beneficiary, and the beneficiary will use the T3 slip to report the Trust income on their personal tax return. This may result in an increase to overall taxes paid between the Trust and the beneficiary and it could impact any income-tested benefits the beneficiary receives.

A Trust is still able to make an election to leave income in the Trust in order to use up any losses carried forward from prior years. Once the losses are eliminated, any remaining income must then be allocated to the beneficiary so that no taxable income is left in the Trust.

6. **Charitable Gift by Will**

Under the new rules, there is more flexibility for claiming the donation tax credit arising from a Gift by Will and direct designations (e.g. RRSP's, life insurance, etc.). For dates of death after 2015, the use of the donation tax credit is determined based on the date the donation is actually made to the charity. However, to be eligible to claim a donation tax credit on the deceased's T1 for the year of death or the year prior to death, the donation or transfer to the charity must be completed within 36 months from the date of death (while the Estate is still a GRE).

<u>If the Estate is a GRE at the time the gift is made:</u>

i. the donation credit can be claimed on the deceased's T1 for the year of death or the year prior to death *(same as old rules), or*

ii. the credit can be claimed by the Estate in the year the donation is made or any previous year of the Estate *(new), and*

iii. securities gifted by the Estate are exempt from capital gains tax on the deemed disposition at death *(same as old rules).*

If the Estate is ***NOT*** a GRE at the time the gift is made:

i. the credit cannot be claimed on the T1 for the year of death or the year prior to death, *and*

ii. the donation credit is claimed by the Estate in the year the gift is made and any unused portion can be carried-forward for 5 years, *and*

iii. securities gifted by the Estate are subject to capital gains tax on the deemed disposition at death.

The new rules apply to Estates with a date of death after 2015. For Estates with a date of death before 2016, the old rules will still apply for claiming a charitable Gift by Will.

Update: Legislative proposals released for consultation by the Department of Finance on January 15, 2016 will extend the deadline a donation or transfer must be completed to qualify for a credit on the deceased's T1 for the year of death or the year prior to death. The deadline of 36 months from the date of death will be extended to 60 months. The new 60 month period will also apply to the capital gains exemption in the year of death for gifted securities.

7. Life-Interest Trusts

There is a shift in the tax burden of Life-Interest Trusts to which property has been transferred on a tax-deferred basis. Examples include Spousal and Common-Law Partner Trusts, Alter-Ego Trusts, and Joint Spousal and Common-Law Partner Trusts.

On the death of the life-interest beneficiary (or on the second death for a Spousal or Joint Partner Trust), the Trust will have a deemed year-end and a deemed disposition of all assets. The income and capital gains for that year will be taxed on the deceased life-interest beneficiary's T1 for the year of death and not in the Trust.

This may create a mismatch between who is liable for the tax burden that arose from the deemed disposition of the Trust assets and who is entitled to receive those assets. The life beneficiary's Estate is liable for the taxes owing, but the beneficiaries of the Estate may be different from the Trust.

The Trust and the life-interest beneficiary's Estate are jointly and severally, or solidarily, liable for taxes owing as a result of the deemed disposition of trust assets.

Update: According to legislative proposals released by the Department of Finance on January 15, 2016, the capital gains resulting from the deemed disposition on the death of the life-interest beneficiary is taxable in the Trust and not to the deceased life-interest beneficiary (same as the old rules). For deaths of a life-interest beneficiary of a spousal testamentary trust in 2016, a joint election can be made to have the capital gains taxable to the deceased life-interest beneficiary instead of the Trust.

8. Qualified Disability Trusts (QDT)

A Qualified Disability Trust (QDT) is another new type of Testamentary Trust that arises on and as a consequence of an individual's death. A QDT is an exception to the general rule as it is eligible for graduated rate taxation even if it does not qualify as a GRE (see Item 1 above). To be eligible for the more favourable graduated tax rates for the year, the Trust must:

- be a Testamentary Trust resident in Canada, and
- have one or more "electing beneficiaries", and
- jointly elect with an electing beneficiary to be a QDT.

An "electing beneficiary" must hold a disability tax credit certificate and cannot make the same election with any other Trust.

QDT's may be subject to a Recovery Tax if:

- none of the beneficiaries at the end of the year is an electing beneficiary (including the year the electing beneficiary dies), or,
- the Trust ceases to be resident in Canada, or,
- a capital distribution is made to a non-electing beneficiary.

Note: The Preferred Beneficiary Election (PBE) survived the legislation changes so that income not considered paid or payable can still be allocated to a beneficiary who holds a Disability Tax Credit Certificate. The PBE will likely continue to be used to minimize overall taxes between the trust and the beneficiary and it is available to QDT's or any testamentary trust.

The above is not an inclusive list of all of the changes that are coming into effect on January 1, 2016. If you have any questions or concerns about these, or any other Estate and Trust taxation changes, please contact Heather MacLean, CPA, CGA by email at heather@mti-cpa.com or phone 604-524-8688.