Income taxes on estates and other testamentary trusts are likely to rise, creating situations that many clients may not have expected. But tax planning opportunities remain

BY RUDY MEZZETTA

SEVERAL NEW TAX MEASURES, ranging from higher taxes on dividends for small businesses to tighter rules for some insurance-based structures, are clearly aimed at tightening the tax system on several fronts. The federal government is focused on collecting more revenue by reducing what it views as tax breaks in certain areas. (See story on page 1).

So, perhaps it's not surprising that the government is proposing to squeeze more money out of estates. But some tax experts say the proposals, which will deprive estates and trusts that are created by wills of graduated rates beginning in 2016, will unnecessarily penalize ordinary Canadians.

Last June, the Department of Finance Canada released a paper calling for comments on its estates-related proposals. The new rules will bring taxes on so-called "testamentary" trusts, including simple estates, in line with *inter vivos* trusts. This change would mean that after three years of the administration of an estate, every dollar of income generated by estate assets would be taxed at the top marginal rate. The top rate will apply to trusts created by wills from the time of death.

Although the proposal is designed to stop affluent families from leaving assets in an estate for extended periods purely to obtain the advantage of graduated rates, Canadians trying to use testamentary trusts to assist vulnerable beneficiaries, such as a disabled child, would be left with few good options to mitigate the loss of the graduated rates.

"Where there's a beneficiary where you absolutely need to have the assets in trust, you'll just have to live with the fact that the taxation is no longer as beneficial as it once was," says Catherine Watson, a lawyer with **McInnes Cooper LLP** in Halifax. "We think, if the general public had more awareness of the implications of the proposed rules, they would be more upset about it."

The deadline for commenting on the proposals is Dec. 2.

However, even with the loss of the graduated rates, the various non-tax benefits of testamentary trusts — including control of how assets flow to heirs, creditor protection and protection of disabled or vulnerable beneficiaries — will continue to be useful for many clients.

"The estate planning benefits of testamentary trusts far exceed the tax benefits in many situations," says Jamie Golombek, managing director of tax and estate planning with **Canadian Imperial Bank of Commerce**'s private wealth-management division in Toronto.

Finance Canada, in announcing the proposed changes (first introduced in the 2013 budget), is concerned about what the feds are calling the potential growth in the use of "tax-motivated strategies" involving testamentary trusts that are considered to be a threat to the tax base. Finance Canada also argues that the differing tax treatment of *inter vivos* and testamentary trusts raise questions of fairness and neutrality.

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The problem, some tax experts say, is that the new rules may cast too wide a net. For example, parents who want to bequeath assets to minor children have no alternative but to use testamentary trusts, because minors legally aren't allowed to receive funds directly before the age of majority. Under the proposed rules, the income earned in a testamentary trust that wasn't allocated to the child would be taxed at the top rate, leaving the child with less than he or she would have had under the old rules.

Other advantages also will be lost. For instance, disabled beneficiaries would lose the opportunity to split income between two sets of graduated rates (their own and that of the trust) and, therefore, would receive less money than they would under the current tax rules. In addition, flowing income out of the trust to the disabled beneficiary might result in a clawback of social-assistance payments that the disabled person might otherwise be entitled to.

The Canada Revenue Agency has responded to these criticisms by noting that a rule dealing with so-called "designated beneficiaries" makes it possible to tax income from testamentary trusts in the hands of certain vulnerable beneficiaries, such as minor children and disabled adult children — even if the income is not paid out of the trust. However, Watson notes, this rule does not remedy the loss of the two graduated rates for these beneficiaries.

There still is some potential for tax planning under the proposed changes, since the ability to split income is preserved. For example, some or all of the income in a trust may be allocated to the beneficiary, even if it's not actually paid out, and taxed on the beneficiary's tax return at his or her graduated rates. The income not paid out remains in the trust, forming part of its capital.

Multi-generational beneficiaries also may benefit from income-splitting. For example, a trust can be set up with both an adult child and a grandchild as beneficiaries. This provides the trustees with the discretion to direct the trust income — typically, toward the grandchild to the exclusion of the adult child. If the trust's amounts are spent on services, such as private-school tuition, that benefit the grandchild, those funds then would be considered "amounts payable" to the grandchild and would be taxed, presumably at lower tax rates, in the grandchild's hands.

The advantage of such a structure is that the attribution rules wouldn't come into play, as they would in the case of an *inter vivos* trust set up by a parent for the child, says Jack Courtney, assistant vice president of advanced financial planning with **Investors Group Inc.** in Winnipeg.

Tax practitioners say that if the proposed rules go through, "alter ego" trusts, which are *inter vivos* trusts that can be set up by Canadians over 65, may become more popular. Alter ego trusts offer a number of benefits, including privacy and avoidance of probate. In the past, many Canadians have chosen not to use these trusts because it's not possible to fund a testamentary trust from an *inter vivos* trust.

"If the proposed changes to testamentary trusts become law," Watson says, "then we might see a resurgence of people taking a closer look at alter ego trusts. Why not avoid probate and have privacy if you cannot access tax-preferred rates through your estate anyway?" **IE**