New Tax Rules May Affect Your Estate Plan

New tax legislation which originated from the 2014 Federal Budget will take effect on January 1, 2016. These changes will have significant implications for existing and future testamentary, spousal, alter-ego and joint-partner trusts, as well as affecting testamentary charitable gifts. This article provides a brief summary of the upcoming changes.

Testamentary trusts

A common estate planning strategy involves the use of a "testamentary trust" which is created at death (typically in the deceased's Will) to achieve various non-tax benefits, such as the control and protection of assets, as well as certain tax benefits, such as income splitting. With regards to the latter, testamentary trusts are currently able to take advantage of the graduated marginal tax rates available to an individual, allowing tax savings to be achieved on income that is retained in the testamentary trust. In contrast, a trust created during one's lifetime (an "inter-vivos" trust) pays tax on undistributed income at the top marginal rates for individuals.

Due to the government's concern regarding the growth in the tax-motivated use of testamentary trusts, it was announced in the 2013 Federal Budget that they would undertake a review and consult on possible measures aimed at eliminating the special tax benefits that arise from taxing the income of testamentary trusts at graduated marginal tax rates. Following this consultation period, the 2014 Federal Budget reaffirmed the government's intention to proceed with these measures, which includes subjecting the trust to tax on undistributed income at the top marginal rate – the same tax rate applied to inter-vivos trusts. This change takes effect for 2016 and subsequent taxation years.

Two exceptions to the imposition of the flat top tax rate will apply:

1. During the first 36 months following death, a deceased individual's unadministered estate may be eligible for the graduated tax rates, provided the executor does not distribute the estate assets during this period (if so permitted under the terms of the Will).
2. Graduated marginal tax rates will continue to apply for certain testamentary trusts (defined as "Qualified Disability Trusts") whose beneficiaries are eligible for the federal Disability Tax Credit.

The new legislation will also eliminate some of the other special tax treatments accorded to testamentary trusts. For example, testamentary trusts will be required to make income tax instalments and must have a December 31 taxation year-end, similar to inter-vivos trusts. Existing testamentary trusts (and estates in existence for more than 36 months) with an off-calendar year-end will have a deemed year-end (but <u>not</u> a deemed disposition of capital assets) at December 31, 2015. This will create an opportunity for these trusts to access the graduated marginal tax rates one final time on any undistributed income or capital gains realized in this period.

Although these forthcoming changes will eliminate access to the graduated tax rates on income retained and taxed within all existing and future testamentary trusts (except as noted above), trusts created in your Will (such as a trust for each child and his/her family) may still provide income splitting opportunities, since they can be used to distribute or "sprinkle" income on a discretionary basis if the trust's income is paid or made payable to family member beneficiaries in lower tax brackets. In addition, testamentary trusts offer many other benefits, including control and protection of assets, which continue to make them an important consideration in tax and estate planning.

Spousal, alter-ego and joint-partner trusts

Another unexpected, though important, related legislative change taking effect at the beginning of 2016 will deem capital gains arising in "spousal" trusts (or "alter-ego" trusts and "joint-partner" trusts) on the death of the beneficiary individual after 2015, to be payable (and taxable) to that individual rather than the trust, as is the case under the existing rules. This change to the incidence of tax can dramatically impact an existing estate plan, particularly in situations (such as a second marriage or 'blended family') where the beneficiaries of the deceased individual's estate are not the same as the ultimate beneficiaries of the trust. In addition, charitable donations and other post-mortem strategies involving these types of trusts may be adversely affected.

Because of the significance of these upcoming changes, it is important to consult with your tax and legal advisors to determine any impact to your current Will and estate plan, as well as any existing testamentary, spousal, alter-ego or joint-partner trusts that have been established by you or your family members.

Estate donations

The charitable donation tax credit is generally subject to an annual limit of 75% of net income. However, for donations made in the year of death the credit limitation is increased to 100% of the deceased's net income, and any donations that cannot be claimed in the year of death can be claimed in the deceased's prior year tax return; also up to 100% of net income in that year. There is also a special provision within the current tax legislation that allows specific donations made pursuant to a Will to be deemed to have been made by the individual immediately prior to his or her death, even though the actual transfer may occur during the estate administration. This treatment can be beneficial in allowing a donation tax credit to reduce taxes otherwise payable at death in the individual's terminal tax return (or in the year preceding death). Similar provisions apply where an individual designates a qualified donee as a beneficiary under a Registered Retirement Savings Plan (RRSP), Registered Retirement Income Fund (RRIF), Tax-Free Savings Account (TFSA) or life insurance policy.

Conversely, under the current legislation, donations made by an individual's estate (which are not pursuant to specific terms of the Will or beneficiary designation) do not qualify for this preferential treatment and can only be applied against the estate's income tax otherwise payable; which in some cases may not be sufficient to allow the full benefit of the donation tax credit to be realized. However, new legislation originating from the 2014 Federal Budget will allow more flexibility in the tax treatment of charitable donations with respect to deaths occurring after 2015. Specifically, a donation made by Will (and designated donations) will no longer be deemed to have been made immediately before death. Instead, these donations will be deemed to have been made by the estate at the time the specific property is donated to the qualifying donee. As a result, further planning opportunities will exist starting in 2016 for certain qualifying estates. Where applicable, estate trustees will have additional flexibility to apply the donation tax credit, resulting from donations made during the first 36 months of an unadministered estate, to:

1. The taxation year of the estate in which the donation is made;
2. An earlier taxation year of the estate; or
3. The last two taxation years of the deceased individual.

In light of these upcoming changes that take effect on January 1, 2016, you should consult with your tax and estate professionals to fully review the potential tax implications and benefits of any charitable bequest strategy within your existing estate plan.

Contact your BMO Nesbitt Burns Investment Advisor

Making sure your estate plan is up to date is an important planning consideration. Please contact your BMO Nesbitt Burns Investment Advisor if you have any questions about these upcoming changes or would like to discuss your estate plan.

BMO Wealth Management
BMO Nesbitt Burns