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Bill C-43 Impacts To Life Interest Trusts

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Bill C-43 received Royal Assent in December of 2014, ushering in a new era of estate planning with changes to the Income Tax Act (the "Tax Act"). Included in the bill were changes which have had profound implications on planning using trusts to which an individual can transfer property on a tax-deferred basis such as spousal trusts, alter ego trusts, joint spousal or common law partner trusts (referred to herein as "life interest trusts"). Some of the changes introduced are problematic and led to joint submissions being made to the Department of Finance ("Finance") by the Society of Trust and Estate Practitioners (STEP) Canada, the CBA/CPA Canada Joint Committee on Taxation and the Conference for Advanced Life Underwriting (CALU) outlining substantial issues with the new rules. In November of 2015 Finance issued a letter acknowledging the concerns and indicating willingness to work towards a solution.

Finance has recently published legislative proposals (the "proposed amendments") and explanatory notes which address a number of the concerns raised in the joint submissions.

Rules Currently in Force

Deemed Disposition

Effective as of January 1, 2016, life interest trusts now undergo a deemed year-end triggered at the end of the date of the death of the last surviving life interest beneficiary, which will either be the settlor or the spouse, depending on the nature of the life interest trust. All of the trust's income for the tax year, including capital gains arising on the deemed disposition of assets triggered by the death of the life interest beneficiary, are deemed to have been made payable to the life interest beneficiary and will be included in his or her terminal tax return. In essence, the tax burden associated with the trust assets is shifted as a result of the deemed shifting of income to the estate of the deceased beneficiary.

This deemed payable mechanism addresses concerns with having the trust income taxed in the life interest trust at the highest marginal rate; however it may also create significant financial hardship in certain circumstances where trusts are commonly used to retain control over the distribution of income or capital from a trust. This hardship is illustrated by the following example:

A spousal trust is established in John's Will to provide for his second wife, Jane. On Jane's death the capital of the spousal trust is to be left to John's children of his first marriage. Under Jane's Will, her own estate is left to her children from her first marriage. If John dies first, his assets will pass to the spousal trust. On Jane's death, the spousal trust will undergo a deemed disposition of its assets, and under the new rules, all income will be deemed payable to Jane, with the tax reported in Jane's terminal return and borne by Jane's estate. As Jane's beneficiaries (her children) are different than the remainder beneficiaries of the spousal trust (John's children), and her children will not receive any of the assets of the spousal trust, they will effectively bear the tax burden of the spousal trust, without benefiting from any of its assets. This results in a windfall for John's beneficiaries to the detriment of Jane's beneficiaries.

Joint Liability

The rules now in force provide that the life interest trust (i.e. John's spousal trust) will be jointly and severally liable with the life interest beneficiary's (i.e. Jane's) estate for the tax liability.

Finance had released explanatory notes on the liability provisions, stating that "it is intended that that the Minister [of Revenue assess the trust], in respect of an amount owing… as though the trust were liable in the first instance for that amount." However, given that these rules are clear that the life interest beneficiary (i.e. Jane's estate) is primarily liable for the tax, and that the administrative practice of the Canada Revenue Agency ("CRA") is to assess and initiate collection proceedings against the primary taxpayer and only initiate proceedings against other taxpayers as a last resort, it is unclear if the provisions could or would be administered as suggested by Finance.

Further, even if the CRA exercises its discretion to enforce against the trust assets, it will not necessarily forgo its rights against the life interest beneficiary to the extent that the trust assets are (i) illiquid or (ii) insufficient to fund the tax.

Although the potential financial hardship is clearly problematic, these rules may also have other unexpected results. Given the uncertainty of which taxpayer will ultimately bear the tax burden, and the fact that the tax liability will not be determined until after the life interest beneficiary's terminal tax return is filed and assessed, it may be difficult for the trustees and executors to ensure timely payment of the tax, even in circumstances in which all parties are co-operating.

Additionally, to the extent the taxes are collected against the trust rather than the estate of the life interest beneficiary, as is intended by the Finance, the trustees of the trust may be obliged by virtue of their fiduciary duties to litigate to recover taxes from the estate of the life interest beneficiary. Further, a reimbursement by the life interest trust to the beneficiary's estate of the taxes triggered may cause the estate to lose its status as a testamentary trust which may have significant adverse implications on other planning, such as loss of status of the beneficiary's estate as a Graduated Rate Estate ("GRE").

The Proposed Amendments

The legislative amendments proposed by Finance in January 2016 address a number of the above noted concerns. Among other changes, the proposed amendments contain

important modifications to the provisions which shift the income of a life interest trust (and therefore associated tax liability) to a deceased beneficiary in the circumstances described above. Subject to a limited exception, the income of the life interest trust (and therefore the associated tax liability) will not be shifted to the estate of the life interest beneficiary. Income (and tax) shifting will only occur in the context of a spousal or common law partner trust that arose on and as a consequence of a death before 2017, in circumstances where the trust and the legal representative of the GRE of the life interest beneficiary (i.e. the spouse or common law partner) jointly elect to have the income (and tax) shifting occur. Where such an election is not made, or any of the other listed conditions are not met, the trust will be liable for the taxes triggered on the deemed disposition.

Where such an election is not made or available, the income of the trust will not automatically be deemed to be payable to the deceased beneficiary, and any gains arising from the deemed disposition of the trust's assets will generally be taxed in the trust. This provides a simple mechanism for avoiding the problems discussed above relating to financial hardship for the estate of the deceased life interest beneficiary. The option to elect into the application of the deemed-payable mechanism still remains in limited circumstances, and may be desirable in some situations. For example, it may be desirable to make the election in order to shift income to the deceased beneficiary's GRE to access graduated tax rates where the beneficiaries of both the life interest trust and the estate of the deceased beneficiary are identical. In such circumstances, the joint liability provisions discussed above will still apply.

Conclusion

The proposed amendments show that Finance has made large strides in remedying the concerns identified by stakeholders. It should be noted the proposed amendments may not be passed in their current form, and Finance is seeking comments on the legislative proposals no later than February 15, 2016. While the publishing of the legislative proposals is undoubtedly a positive sign, those affected by the new rules in their current form should obtain advice to ensure that they fully understand the impact of the new rules on their estate planning.

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