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TaxNewsFlash
CANADA

New Estate Tax Changes — Act Before December 31, 2015

October 29, 2015
No. 2015-31

You only have a few more weeks to revisit your will and estate plans before important new tax changes come into effect on January 1, 2016. Executors, trustees and individuals should pay careful attention to these changes as you may need to take action as soon as possible to preserve estate planning objectives. These changes may require additional tax compliance measures and the forecasting of cash flows for new tax instalment payments starting in 2016.

Under the changes to the estates and trusts rules, many existing testamentary trusts will be taxed at the top marginal tax rate rather than at lower graduated tax rates. All estates and testamentary trusts created upon an individual's death that occurred on or before December 31, 2012 will be taxed at the top marginal tax rate effective January 1, 2016. This means that these estates and trusts may face a federal tax increase of more than $10,000 per year, plus applicable provincial taxes. In addition, accrued capital gains of life interest trusts (i.e., spousal, alter ego and joint partner trusts) will be taxed in the deceased beneficiary's terminal return instead of in the trust itself. As an executor or trustee of these estates and trusts, you only have a few weeks left to take action that will preserve the benefit of graduated tax rates that may be available for a second short taxation year ending on December 31, 2015.

However, the new tax rules will also have some potential benefits, as they allow for flexible charitable donation planning, such that a charitable donation can be allocated between the deceased and his or her estate in certain circumstances.

Many individuals, including executors and trustees, should ensure their affairs are in order in light of these new rules. To help prepare for these changes, consider the following questions:

Individuals

- Have you reviewed your will or life interest trust since the new trust rule changes were introduced?

Executors and trustees

- If your estate or trust doesn't currently have a December 31 taxation year-end, have you prepared for the tax filing requirements of two 2015 taxation year-ends?
- If your estate or trust will have two 2015 taxation year-ends have you considered how you may be able to take advantage of the full graduated tax rates that are available in each of the 2015 tax years?

- Have you considered how cash flow may be affected by quarterly tax instalments and increased tax rates starting in 2016?
- Are you aware that you must make a designation for "Graduated Rate Estate" status and an election for a "Qualified Disability Trust" for these taxpayers to qualify for graduated rate taxation?
- Are you aware that accrued capital gains of a life interest trust will be taxed on the deceased beneficiary's final tax return and not in the trust?
- As an executor, are you aware of the type of transactions that can taint the tax status of a Graduated Rate Estate?
- Have you determined how you will allocate a charitable donation between the deceased's terminal return and his/her Graduated Rate Estate?
- Are you aware that a Graduated Rate Estate must make a charitable donation within 36 months of an individual's death if you want to claim it in the deceased's final tax return or in the deceased's immediately prior year tax return?

Background

The government first announced its intention to apply the top marginal tax rate that generally applies to *inter vivos* trusts, to trusts created by will (i.e., testamentary trusts) rather than graduated tax rates in the 2013 federal budget. In 2014, the government announced detailed changes to eliminate the benefits of graduated rates of taxation for testamentary trusts (including estates) to combat perceived abuses, including the use of multiple testamentary trusts and tax-motivated delays in completing estate administration.

The government also announced proposed changes to the use of donation tax credits for gifts made on or after death in the 2014 federal budget. These changes, which will allow the deceased or the estate to claim donations, address situations where donation tax credits for gifts made by will were unused because the rules restricted the donation claim to the deceased's return for the year of death or the prior year.

The new rules are effective January 1, 2016. For more details on these rules, see the following KPMG publications and resources:

- *TaxNewsFlash-Canada* 2014-49 "New Tax Regime May Upset Your Estate Planning"
- *TaxNewsFlash-Canada* 2013-23, "Family Trusts Face Higher Tax Rates"
- *TaxNewsFlash-Canada* 2014-08, "2014 Federal Budget Highlights"
- KPMG's webcast "New Tax Regime — Review Your Estate Plan".

Two tax filings for 2015 year-ends

There will be two taxation year-ends in 2015 for all estates where the deceased individual passed away on or before December 31, 2012 and all testamentary trusts (both spousal and non-spousal) with non-calendar year ends.

For example, assume that Mr. X dies on October 31, 2012 and October 31 was selected as Mr. X's estate's year-end. In this case, Mr. X's estate will have its usual year-end at October 31, 2015 and the estate's income will be taxed at graduated rates. The estate will also have a

December 31, 2015 year-end since, effective January 1, 2016, only Graduated Rate Estates can have a non-calendar year-end. The estate's income for the December 31, 2015 short (i.e., two month) year-end will also be taxed at graduated rates. However, as long as the estate continues to exist, the estate's income will be taxed at the top marginal tax rate starting in 2016 and every December 31st year-end thereafter.

As a result, Mr. X's estate will have the following filing deadlines in 2016 for its two 2015 taxation years:

- January 29, 2016 (for its October 31, 2015 tax year)
- March 30, 2016 (for its short two-month December 31, 2015 tax year).

KPMG observation
In this hypothetical situation, an estate with a regular October 31, 2015 year-end and a deemed December 31, 2015 year-end is entitled to a full set of graduated tax rates for each year-end. As a result, tax planning may be required to ensure that the short period taxation year (i.e., November 1, 2015 to December 31, 2015) has sufficient income to be able to benefit from a full set of graduated tax rates. Of course, taxpayers must weigh the benefit of having income taxed at marginal tax rates versus the top marginal tax rate against the cost of pre-paying tax, as well as consider non-tax implications from redeeming shares or selling investments.

If you are an executor or trustee of an affected estate or testamentary trust, you should get your affairs in order as soon as possible to properly plan for the two 2015 taxation year-ends.

Cash flow planning

As of January 1, 2016, testamentary trusts and non-Graduated Rate Estates will have to start remitting quarterly tax instalments (i.e., on March 15, June 15, September 15 and December 15) and will no longer be eligible for a $40,000 exemption from Alternative Minimum Tax. As a result of losing these benefits, trustees and executors may have to undertake cash flow planning to ensure potential increased taxes are paid on time to avoid interest and penalties on late or deficient tax instalments and final tax payments.

Graduated tax rate status — Making a designation and filing an election

All estates and trusts will be subject to the top marginal rate of tax effective January 1, 2016 except for Graduated Rate Estates and Qualified Disability Trusts. An estate must meet certain requirements to qualify as a Graduated Rate Estate, including the filing of a designation by the executor for the first taxation year of the Graduated Rate Estate after 2015. Executors should be aware that certain transactions, including certain loans to the estate and contributions to the estate by someone other than the deceased individual can taint the status of a Graduated Rate Estate.

A trustee of a Qualified Disability Trust (QDT) must make an annual joint election with one or more beneficiaries to be considered a QDT eligible for graduated tax rates.

Limited ability to tax income in a trust

Starting January 1, 2016, an executor or trustee can only make a designation to tax income (including capital gains) in a trust to use trust losses. As a result, an executor or trustee can no longer elect to create taxable income and pay tax in the trust.

Previously, executors and trustees could make a designation to tax income in the trust that was otherwise paid or payable to a beneficiary of the trust. The advantage of making this type of election was that it allowed income that was paid/payable to beneficiaries to be taxed at graduated tax rates; or in the case of a life interest trust resident in a province with a relatively lower provincial tax rate the income could be taxed in that lower rate province instead of at the beneficiary's provincial marginal tax rate.

Death of a life interest beneficiary

Effective January 1, 2016, a deemed year-end will be triggered by the death of a life interest beneficiary (i.e., a spouse beneficiary in a spousal trust, a settlor in an alter ego trust, or the survivor of the settlor and their spouse in a joint partner trust). A tax return will be due 90 days after the calendar year end that includes the deemed year-end. For example, if a life interest beneficiary of a trust (Ms. Y) dies on December 31, 2016, the trustee of the life interest trust must file a tax return by March 31, 2017. As well, Ms. Y's executor will have to file Ms. Y's final personal tax return no later than June 30, 2017.

This deemed year-end means that a trustee will have one less year to undertake post-mortem transactions to avoid double tax where the life interest trust owns shares of a private company.

Another important change to the taxation of life interest trusts is that all of the trust's income (including deemed capital gains) will be taxed in the deceased beneficiary's terminal or final tax return. Previously, the deemed capital gains triggered on the death of a life interest beneficiary were taxed in the trust in the trust's tax year that included the deceased's date of death. As a result of this change, even though the capital gains are taxed in the deceased beneficiary's estate, the trust assets are distributed to the capital beneficiaries of the life interest trust. If the beneficiaries of the deceased's estate are different from the capital beneficiaries of the life interest trust, then tax may be borne by persons who are not entitled to the assets. A trustee or executor will therefore need to consider how and by whom the tax liability will be funded, taking into account the terms of the life interest trust deed. For instance, before the trust gives the estate of the deceased beneficiary funds to pay his or her taxes, a trustee and executor will need to consider whether the transfer of funds could be considered a loan that could void the deceased's estate's Graduated Rate Estate status. In addition, undertaking post-mortem loss carryback planning may transfer a tax liability from the beneficiaries of the deceased's estate to the capital beneficiaries of the life interest trust.

Testamentary charitable donations

Under the new rules effective January 1, 2016, the value of a charitable gift made by will is determined at the time the gift is made, instead of immediately before the date of the

deceased's death, as was required under the old rules. As a result, an executor will need to determine the fair market value of the donated property twice — once for purposes of the deemed disposition rules (which require a fair market value as at immediately before death), and again at a later time when the property is actually donated or gifted for purposes of calculating the charitable donation tax credit. Also, if the value of the property decreases after the date of death, an executor will have to ensure the estate makes the gift within the estate's first taxation year to carryback the loss to the deceased's terminal tax return.

Effective January 1, 2016, if a Graduated Rate Estate makes a charitable donation, the donation may be claimed in the deceased's final tax return or in the deceased's immediately prior year tax return. Alternatively, a donation can also be claimed in a Graduated Rate Estate's return in the year the gift is made, the prior year or within a five-year carryforward period.

If a gift is not made by a Graduated Rate Estate then, effective January 1, 2016, it can only be claimed in the year the gift is made or in a five-year carryforward period.

Under the new rules, careful planning is required to ensure the taxpayer receives the maximum benefit of claiming a donation tax credit.

We can help

There are various other issues to consider regarding these new rules that are effective January 1, 2016. Your KPMG adviser can help you assess the effect of these changes on your estate and donation plans to point out ways to take advantage of any benefits arising from the changes or help mitigate their impact. For details, contact your KPMG adviser.