# Welcome changes to new life-interest trust rules

January 2016

In January 2016, the Department of Finance released draft legislation proposing amendments to the new life-interest trust[1] rules, which came into effect for 2016 and subsequent tax years. As noted in our November 2014 release, *Surprise legislation impacts estate planning*, the new rules could adversely affect common estate planning strategies and, consequently, have been a cause for concern.

## The new rules

When a beneficiary of a life-interest trust passes away, the trust is deemed to dispose of its assets at their fair market value. Under the new rules, any capital gains and income recognized as a result of this deemed disposition, as well as any other income earned in the year of the death of a life-interest trust's primary beneficiary, are required to be taxed in the hands of the beneficiary in the deceased's final income tax return, instead of in the trust (as was the case under the previous rules).

## Concerns with the new rules

The new rules[2] could adversely affect common estate planning strategies for life-interest trusts. For example, post-mortem planning strategies could be negatively impacted where the trust holds private company shares (or other assets with a significant unrealized gain). After the death of the beneficiary spouse, the company is often wound up and its shares are redeemed or cancelled, resulting in a dividend as well as a capital loss on the disposition of the shares.[3] Under the old rules, that capital loss can be applied to offset or reduce the capital gains realized in the trust upon the death of the spouse. Under the new rules, however, this type of planning would no longer work. Instead, double taxation could result, with the capital gain being reported on the deceased beneficiary's final income tax return, and the capital loss being realized by the trust, with no mechanism for applying the loss to offset the gain.[4] Our November 2014 release also provides other examples where planning strategies would be frustrated.

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[1] Spousal, alter-ego, joint partner and other similar trusts.
[2] Included in new subsection 104(13.4) of the Income Tax Act
[3] The shares are deemed to be reacquired at their fair market value on the death of the beneficiary, resulting in an increase in their tax cost base.
[4] As currently drafted, the rules do not allow the trust to carry back tax losses and apply them to the deceased's final income tax return. The CRA had been asked whether the new rules preclude a strategy whereby a subsequent capital loss of the trust could be carried back to offset the capital gain. The CRA

Many existing life-interest trusts have also been established with the intention of having the trust make charitable donations to help offset the capital gain realized on the deemed disposition of the trust property. In the absence of any relieving provisions, the new rules would cause the capital gain to be reported on the beneficiary's terminal tax filing, yet the donations would remain in the trust, essentially limiting access to the tax benefit that would normally be achieved from making charitable donations.

## The proposed changes to the new rules

On November 16, 2015, the Department of Finance acknowledged the concerns expressed by the tax community and other stakeholders regarding the new rules. It then proceeded to outline an option which arose in its discussions with the Joint Committee on Tax of the Canadian Bar Association and CPA Canada, as well as other stakeholders, for remedying these concerns. The draft legislation effectively adopts this option.

The draft proposals provide that the rules will be amended so that income deemed to be recognized upon the death of the primary beneficiary will be recognized and taxed in the trust (as per the old rules) unless a post-1971 testamentary spousal or common law partner trust (that arose on and as a consequence of a death before 2017) jointly elects with the primary beneficiary's graduated rate estate[5] (GRE) to have this income taxed in the primary beneficiary's final tax return.

The draft legislation also effectively addresses concerns that were expressed about post-mortem donations being trapped in a life-interest trust where such income is taxed in the primary beneficiary's return. In addition to allowing for the income to be taxed in the trust (unless the above-noted joint election is filed), the draft legislation will permit donations made by a life-interest trust after the primary beneficiary's death to be claimed in the trust's deemed tax year-end (that arises on the beneficiary's death), provided that the donation is made no later than 90 days after the end of the calendar year in which the primary beneficiary dies.

## Other proposed changes

The draft legislation also allows greater flexibility for recognizing charitable donations made by an individual's estate after it ceases to qualify as a GRE. New rules first announced in the 2014 federal budget, effective for the 2016 and subsequent tax years, facilitate the tax treatment of donations made by a GRE. A GRE can allocate available donations among any of the following: the tax year of the estate in which the donation is made; an earlier tax year of the estate; or the last two tax years of the deceased individual. The draft legislation proposes to extend these rules to apply to donations made by the GRE after it ceases to have that status (because of the expiry of the GRE's 36-month period) for up to 60 months after the individual's death.

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agreed that there were practical issues with the new rules and that it was not clear whether or not a late-filed 104(13.2) election would be possible to offset the gain in the trust before any balance was allocated to the deceased.

[5] Where certain conditions are met, an estate arising upon the death of an individual is still subject to graduated tax rates after the 2015 tax year (as opposed to being taxed at the highest marginal tax rate) but only for up to the first 36 months after the individual's death. Once the estate ceases to be a graduated rate estate, it is taxed at the highest marginal tax rate.

All the proposed amendments noted in this release apply to the 2016 and subsequent tax years. Please contact one of our firm's tax practitioners for further details about any of the proposed amendments discussed in this release.