AY Au-Yeung & Company LLP
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February 2015

New changes to the testamentary trusts rules

The federal government's draft legislation released in late August 2014 introduced new rules that will significantly impact the taxation of estates and testamentary trusts. The three major changes to apply starting for the 2016 taxation year are:

- The elimination of the graduated tax rates for estates and testamentary trusts
- Trust income, including capital gains triggered on deemed disposition on certain trusts (such as an alter ego trust or a spousal trust) are to be taxed in the deceased terminal return instead of in the trust
- More flexibility in the tax treatment of charitable donations on death

Elimination of graduated tax rates

Effective January 1, 2016, all testamentary trusts and estates will be subject to tax at the top federal personal tax rate of 29% and top provincial tax rates (at 16.8% for BC for 2016, for a combined rate of 45.8%), other than certain "graduated rate estates" and "qualified disability trusts".

A graduated rate estate, a trust established on the date of death, may continue to be taxed at graduated tax rates for up to 36 months. The estate must be designated as a graduated rate estate and cannot be a testamentary trust created under a will.

A qualified disability trust is a testamentary trust created under a will, resident in Canada and has at least one beneficiary with a disability tax credit certificate. The qualified disability trust must make a joint election with that beneficiary to be a qualified disability trust, and that beneficiary cannot make the same election with any other trust.

Testamentary trusts and non-graduated rate estates will also lose other benefits that they previously enjoyed, including:

- Exemption from quarterly instalment requirement
- Choice of tax year (now requires a December 31st year-end)
- The $ 40,000 exemption from Alternative Minimum Tax
- The exemption from Part XII.2 tax (for certain trust income where there are non-resident beneficiaries)

Deemed disposition of the trust's assets taxed in deceased's terminal return

Under the current rules, taxable capital gains that arise from the deemed disposition of the trust's assets of alter ego trusts, spousal trusts and joint partner trusts are taxed in the trust and cannot be allocated to a beneficiary.

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After January 1, 2016, these capital gains will be taxed in the deceased beneficiary's terminal return and not the trust. This may potentially be an advantage as the capital gains are taxed at the graduated tax rates of the deceased instead of the trust's top marginal tax rate. However, this change may result in unfairness between the trust and the estate as the tax liability now falls on the deceased's estate beneficiaries instead of the capital beneficiaries of the trust. This result may not have been the intention of the testator or their spouse at the time the trust was created (as the capital beneficiaries of the trust are often different than the beneficiaries of the estate).

Flexibility on testamentary charitable giving

The new rules allow for greater flexibility in choosing where to claim the donations provided in a will and those designated under a registered retirement savings plan, registered retirement income fund, tax-free savings account or life insurance policy. These donations will no longer be deemed to be made by the deceased immediately before his or her death but instead be made by the deceased's estate at the time that the gift is actually transferred to the charity.

If the donation is made by a graduated rate estate, the trustee may choose to claim the donations provided in a will and gift by direct designation as follows:

- On the deceased's terminal return or in the immediately preceding year;
- On the graduated rate estate's trust return in the year of the donation; or
- Carry it back to any of the graduated rate estate's prior taxation years or carry it forward for up to five years

Please review your will and estate planning and consider if any adjustments should be made to minimize the impact of possible negative tax consequences and take advantage of potential favorable tax treatments.

If you have any questions and would like further information, please contact us and we would be happy to assist.

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