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Canada

Graduated Rate Taxation of Trusts and Estates and Related Rules

For the 2016 and subsequent taxation years, the top federal marginal tax rate will apply to grandfathered *inter vivos* trusts and to certain testamentary trusts and estates. Graduated tax rates, as well as the special treatment under a number of related tax rules that are currently available to testamentary trusts, and if applicable to grandfathered *inter vivos* trusts, will only apply to graduated rate estates. Qualified disability trusts will also compute federal tax using the graduated tax rates.

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▼ 1. What are the current tax rates applied to testamentary trusts and grandfathered inter vivos trusts?

Testamentary trusts and grandfathered *inter vivos* trusts compute federal tax using the graduated tax rates available to individuals. Other *inter vivos* trusts pay tax at the top federal marginal tax rate ("flat top-rate") applicable to individuals.

▼ 2. What is a testamentary trust?

A testamentary trust, in a taxation year, means a trust or estate that arose on and as a consequence of the death of an individual, subject to certain exclusions.

▼ 3. What is a grandfathered inter vivos trust?

A grandfathered *inter vivos* trust is an *inter vivos* trust (a trust other than a testamentary trust), created before June 18, 1971, subject to certain restrictions.

▼ 4. How are the tax rates changing for 2016 and subsequent years?

For the 2016 and subsequent taxation years, the flat top-rate will apply to grandfathered *inter vivos* trusts, trusts created by will and certain estates. There are two exceptions to this treatment. Graduated tax rates will still apply to a "graduated rate estate" and a "qualified disability trust".

▼ 5. What is a graduated rate estate?

Beginning on December 31, 2015, a graduated rate estate of an individual at any time is the estate that arose on and as a consequence of the individual's death, if that time is no more than 36 months after the death of the individual and the estate is at that time a testamentary trust.

As there can be only one graduated rate estate in respect of a deceased individual, for an estate to be an individual's graduated rate estate, the following conditions must also be satisfied:

- the estate must designate itself, in its T3 return of income for its first taxation year (or if the estate arose before 2016, for its first taxation year after 2015), as the individual's graduated rate estate;
- no other estate can have designated itself as the graduated rate estate of the individual; and
- the estate must include the individual's Social Insurance Number in its return of income for each taxation year of the estate that ends after 2015 during the 36 month period after the death of the individual.

▼ 6. What is a qualified disability trust?

For the 2016 and subsequent taxation years a qualified disability trust for a taxation year is a testamentary trust that arose on the death of a particular individual, that jointly elects, with one or more beneficiaries under the trust, in its T3 return of income for the year to be a qualified disability trust for the year. In addition, the following conditions have to be satisfied:

- the election must include each electing beneficiary's Social Insurance Number;
- each electing beneficiary must be named as a beneficiary by the particular individual in the instrument under which the trust is created;
- each electing beneficiary must, for the beneficiary's taxation year in which the trust's year ends, be eligible for the disability tax credit;
- no beneficiary who elects with the trust to be a qualified disability trust for the year can elect with any other trust for the other trust to be a qualified disability trust for the other trust's taxation year that ends in the beneficiary's taxation year;
- the trust must be factually resident in Canada (i.e., resident determined without regard to section 94 of the *Income Tax Act*); and
- the trust is not subject to the new recovery tax for the year.

▼ 7. When is a trust that was previously considered a qualified disability trust subject to the new recovery tax?

A trust that was a qualified disability trust in a previous taxation year is subject to the new recovery tax in a year if:

- the trust ceases during the year to have among its beneficiaries any individuals who in one

or more earlier taxation years of the trust were electing beneficiaries of the trust. This will include the year in which the electing beneficiary of the trust (or if the trust had more than one electing beneficiary, the last of them) dies;

- the year is the taxation year deemed to have ended because the trust ceased to be resident in Canada; or
- the trust distributes capital to a beneficiary other than an individual who is an electing beneficiary for a particular year or was an electing beneficiary of the trust in an earlier taxation year. The making by the trust of an amount payable out of the trust's income for a year (i.e., the flowing out of its current income), or the subsequent satisfaction of a beneficiary's right to enforce such an amount, does not trigger the application of the recovery tax. A payment to a beneficiary in the beneficiary's capacity as a creditor of the trust also does not trigger the application of the recovery tax.

▼ 8. What is the new recovery tax?

Generally, the recovery tax is calculated based on the difference between the total of all amounts each of which is the tax the trust would have paid under Part I of the Income Tax Act for an earlier taxation year if the trust had not been a qualified disability trust for the earlier taxation year (hypothetical calculation) and the actual tax paid by the trust.

▼ 9. What are the changes to the taxation year-end and fiscal period rules?

For the 2016 and subsequent taxation years, a graduated rate estate may have a non-calendar taxation year (the period for which the accounts of the estate are made up for purposes of assessment) and fiscal periods. Remaining testamentary trusts will be required to use a calendar year taxation year, and any fiscal period will end in the calendar year in which the period began. For earlier taxation years, any testamentary trust may have a non-calendar taxation year.

Testamentary trusts that do not already have a calendar year taxation year will have a deemed taxation year-end on December 31, 2015 unless the trust is an estate that exists at the end of 2015 and that is a graduated rate estate for its 2016 taxation year.

Graduated rate estates will have a deemed taxation year-end on the day on which the estate ceases to be a graduated rate estate. Subsequent taxation year-ends will be on a calendar-year basis.

Example 1:

On January 31, 2014, Mr. Leblanc died and his estate is a testamentary trust for income tax purposes. His legal representative chooses as the estate's first fiscal period the period that ends January 31, 2015.

Taxation year-end and fiscal period rules implications:

The estate will be able to have the same fiscal period until December 31, 2015. On this date, the graduated rate estate definition comes into effect and the legal representative must decide whether to designate the estate as Mr. Leblanc's graduated rate estate, in the estate's tax return for its first taxation year that ends after 2015. Assuming the estate is so designated, because Mr. Leblanc died on January 31, 2014, the estate may qualify as a graduated rate estate until January 31, 2017 and maintain its original fiscal period until that date, provided that it remains a graduated rate estate. Beginning February 1, 2017, the estate will cease to be a graduated rate estate. A new taxation year will begin on February 1, 2017 and end on December 31, 2017. Subsequent tax year-ends will be on a calendar-year basis.

A Trust Income Tax and Information return will be filed for the period February 1, 2016 to January 31, 2017, and a second one for the period February 1, 2017 to December 31, 2017.

Example 2:

On April 3, 2012, Mr. Smith died and an estate arose, which is a testamentary trust for income tax purposes. His legal representative chose as the estate's first fiscal period the period that ended on April 3, 2013.

Taxation year-end and fiscal period rules implications:

The estate will have the same fiscal period until December 31, 2015. However, since Mr. Smith died on April 3, 2012, and the 36 month period after death ends before December 31, 2015 (i.e., April 3, 2015), the trust will not qualify as a graduated rate estate. The trust will have a deemed taxation year-end on December 31, 2015 (for the period April 4 to December 31, 2015). Subsequent tax year-ends will be on a calendar-year basis.

A Trust Income Tax and Information return will be filed for the period April 4, 2014 to April 3, 2015, and a second one for the period April 4, 2015 to December 31, 2015.

▼ 10. How does the change to the graduated tax rates affect existing grandfathered inter vivos trusts?

Grandfathered *inter vivos* trusts will compute federal tax using graduated tax rates up to and including taxation years ending on December 31, 2015. For taxation years that end after December 31, 2015, the flat top-rate will apply.

▼ 11. How does the change to the graduated tax rates affect existing testamentary trusts?

Existing testamentary trusts will compute federal tax using graduated tax rates until December 31, 2015. After this date, they will have to qualify as a graduated rate estate or a qualified disability trust for the graduated rates to still apply.

Example 1:

On January 31, 2014, Mr. Leblanc died and an estate arose, which is a testamentary trust for income tax purposes.

Tax rate implications:

Graduated tax rates are applicable to the testamentary trust created on the death of Mr. Leblanc until December 31, 2015. On this date the graduated rate estate definition comes into effect. As Mr. Leblanc died on January 31, 2014, the testamentary trust may qualify as a graduated rate estate until January 31, 2017. The taxation year of the graduated rate estate will end on January 31, 2017. The flat top-rate will apply to this testamentary trust after January 31, 2017.

Example 2:

On April 3, 2012, Mr. Smith died and an estate arose, which is a testamentary trust for income tax purposes.

Tax rate implications:

Graduated tax rates are applicable to the testamentary trust created on the death of Mr. Smith until December 31, 2015. Since Mr. Smith died April 3, 2012, and the 36 month period after death ends before December 31, 2015, the trust will not qualify as a graduated rate estate. The taxation year of the estate will be deemed to end on December 31, 2015. The flat top-rate will apply to this testamentary trust for income tax purposes after December 31, 2015. Subsequent tax year-ends will be on a calendar-year basis.

▼ 12. What additional special tax rules are currently available to testamentary trusts and to grandfathered inter vivos trusts (for 2015 and earlier years)?

A number of special tax rules are currently available to testamentary trusts, including:

- an exemption from the tax instalment rules, therefore permitting them to pay any tax owing on their balance-due date;
- a preferential treatment under Part XII.2 of the Act (a tax exemption and, in certain cases, an exemption from treatment as a designated beneficiary);
- the classification as a personal trust without regard to the circumstances in which beneficial interest in the trust was acquired;
- the ability to make investment tax credits (ITCs) available to their beneficiaries for use by the beneficiaries in computing their own income tax liabilities;
- a number of tax administration rules which extend the period:
  - during which the Canada Revenue Agency (CRA), may refund an overpayment of tax,
  - during which, at the trust's request, the CRA may reassess or make determinations in respect of certain income tax liabilities;
  - for objecting to a tax assessment; and
  - for filing an agreement to transfer forgiven amounts under the debt forgiveness rules.

In addition, the basic $40,000 exemption in computing alternative minimum tax (AMT) is

currently available to both testamentary trusts and grandfathered *inter vivos* trusts.

▼ 13. What are the changes to these special tax rules?

Except for graduated rate estates, for the 2016 and subsequent taxation years, the treatment under the special tax rules presently available to testamentary trusts and, where applicable, to grandfathered *inter vivos* trusts, is eliminated.

▼ 14. How does the change to these special tax rules affect existing testamentary trusts, and where applicable grandfathered inter vivos trusts?

Testamentary trusts, and if applicable grandfathered *inter vivos* trusts, will still benefit from the treatment under the special tax rules until December 31, 2015. After this date, only graduated rate estates qualify for the special treatment.

For example:

On January 31, 2014, Mr. Leblanc died and an estate arose, which is a testamentary trust for income tax purposes.

The estate, as a testamentary trust, will continue to benefit from the treatment under the special tax rules until December 31, 2015. Thereafter, if the estate qualifies as a graduated rate estate, it will still benefit from the treatment under the special tax rules until January 31, 2017.

▼ 15. What are the changes to the basic exemption in computing Alternative Minimum Tax?

Currently, testamentary trusts and grandfathered *inter vivos* trusts may claim a basic $40,000 exemption in computing Alternative Minimum Tax.

For the 2016 and subsequent taxation years, the only trusts that may qualify for this basic exemption are graduated rate estates.

▼ 16. What are the changes to the ability to make Investment Tax Credits available to beneficiaries?

Currently, a testamentary trust or a communal organization that is treated as an *inter vivos* trust is permitted to allocate its Investment Tax Credits (ITCs) to its beneficiaries.

For the 2016 and subsequent taxation years, only graduated rate estates and a communal organization that is treated as a trust will have the ability to make ITCs available to their beneficiaries for use by the beneficiaries in computing their own income tax liability. Remaining testamentary trusts will be required to recognize the ITCs in the trust or in the estate.

▼ 17. What is the change to the tax instalment rules?

The income tax rules on instalments for individuals require, when they apply, that instalment payments be made on a quarterly basis. Currently, testamentary trusts are exempt from the tax instalment rules and therefore are required to pay any tax owing only within 90 days after the end of the taxation year. For the 2016 and subsequent taxation years, the only testamentary trusts that will qualify for this legislated exemption from the tax instalment rules will be graduated rate estates.

However, consistent with current administrative practices, the CRA will continue to not assess penalties or interest where a trust fails to make sufficient instalment payments.

▼ 18. What are the changes to the exemption for Part XII.2 tax?

Part XII.2 of the Act imposes a trust-level distribution tax on trusts that make payable certain Canadian source income to non-residents and, in certain circumstances involving dealings in beneficial interests in the trust, to certain Canadian tax-exempts. These beneficiaries are referred to in Part XII.2 as "designated beneficiaries". Currently, testamentary trusts are exempt from Part XII.2 tax and, in certain cases, from treatment as designated beneficiaries.

For the 2016 and subsequent taxation years, this preferential treatment for testamentary trusts will only be available to those that are graduated rate estates.

▼ 19. What are the changes to the classification as a personal trust?

Personal trusts enjoy certain tax benefits, including the ability to distribute property to beneficiaries on a tax-deferred basis. A trust generally qualifies as a personal trust only if beneficial interests in the trust have not been acquired for consideration payable to the trust or to a contributor of property to the trust. Currently, testamentary trusts automatically qualify as personal trusts without regard to the circumstances in which beneficial interest in the trust has been acquired.

For the 2016 and subsequent taxation years, only graduated rate estates will automatically qualify as a personal trust without regard to the circumstances in which beneficial interest in the trust has been acquired.

▼ 20. What are the changes to the tax administration rules?

For the 2016 and subsequent taxation years, a number of tax administration rules will only be available to graduated rate estates but not the remaining testamentary trusts. These include administration rules which for example extend the period:

- during which the CRA may refund an overpayment of tax;
- during which, at the trust’s request, the CRA may reassess or make determinations in respect of certain income tax liabilities;

- for objecting to a tax assessment; and
- for filing an agreement to transfer forgiven amounts under the debt forgiveness rules.

▼ 21. Where can I get more information about this change?

The CRA is committed to providing taxpayers with up-to-date information. The CRA encourages taxpayers to check its webpages often. All new forms, policies, and guidelines will be posted as they become available.

In the meantime, please consult Bill C-43 or the Income Tax Act for details.

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