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## Taxing changes

### Legal Report: Trusts & Estates

Written by Marg. Bruineman

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Looming changes to the Income Tax Act introduce a “whole new world” to the future of estate planning in Canada, calling into question the value of the use of trusts as a tool to achieve tax savings on investments. There are also concerns that one of the changes is misdirected and could have unintended consequences.



Illustration: Jeannie Phan

“They will change how in the future you will plan client situations,” declares Richard Niedermayer, a Halifax, N.S., estates lawyer with Stewart McKelvy. While trusts may well continue to be used for estate planning, they are no longer so effective as a tax-savings tool for the wealthy when the changes come into effect Jan. 1. “The question becomes what could you do or should do differently than before,” says Niedermayer.

Jordan Atin points out that trusts generally serve three purposes: the control of money; the protection of the beneficiary; and tax savings. They serve as a classic form of will planning for those with investment savings. While *inter vivos* trusts created during an individual’s lifetime have always been taxed at the highest rate, testamentary or will trusts have benefited from a tax advantage. Testamentary trusts are treated as a separate tax person and any earnings from investment have been taxed on marginal rates. So some of those earnings would be taxed at lower rates while, as in an individual’s income, higher earnings are subject to the maximum tax rate.

Beginning in January, the marginal rates will no longer be available. “The opportunities are much more limited to take advantage of lower marginal rates for testamentary trusts,” says Atin, an estate lawyer who is counsel to Hull and Hull LLP and an adjunct professor at Osgoode Hall Law School.

There are exceptions to the new highest-rate rule. A new GRE (graduated rate estate) can be established. It allows up to three years for the assets of the will to be distributed to the beneficiaries after the individual’s death. During this time, the old graduated rates can be applied. So, although there remains some tax benefit, it pales in comparison to what is now an allowance for a lifetime of access to the lower rates through will trusts. Also, there’s no flexibility on that time allowance, so even if there is a prolonged dispute, the higher tax rate automatically kicks in after 36 months.

Another continuing benefit within the trusts themselves is the sprinkling or splitting of income among a group of beneficiaries, meaning the trust’s income can be paid out to low-income beneficiaries subject to lower tax rates.

Also, a qualified disability trust can be established for the lifetime of a disabled person (an individual who has qualified for the disability tax certificate) through a trustee. The old marginal rate still applies here as well, and for residents of Ontario, that won’t affect the individual’s eligibility for disability insurance. Daniel Strickland, an estates lawyer with Siskinds LLP in London, Ont., says that is an important distinction for a portion of the clientele with whom he works. There are tax savings to be had for those who meet the difficult test for the disability tax certificate, but he estimates that only 15 to 20 per cent who may well qualify actually take advantage of it, likely because they don’t know about it or don’t have a lawyer advocating on their behalf.

The new rules don’t allow for older, pre-existing trusts to be grandfathered. All trusts, new or old, will be subject to the highest tax rate beginning Jan. 1. That can create extra work for lawyers who will have to revisit old and existing files. There also remains a possibility for some people who had a trust established years ago and failed to revisit it to leave a confusing and potentially costly legacy after death with income from capital taxed way beyond what they had originally anticipated.

David Rotfleisch estimates the additional tax cost could be \$10,000 to \$20,000 per year for each trust. “In terms of future planning, it’s a whole new world. We can no longer do what we did,” says Rotfleisch, a tax and business lawyer and chartered professional accountant, pointing at the spousal trust in particular. “They will wake up Jan. 1 with quite a New Year’s headache.” The rules reduce the flexibility and options after death, although he points out there’s no particular harm in keeping those testamentary trusts in place.

The five-year tax holiday available through immigration trusts was eliminated in 2014, prior to the current changes. Previously, those immigrating to Canada could use the trust as a tax haven for up to 60 months. Now, lawyers must come up with another strategy to achieve savings. With the addition of the latest changes, McMillan LLP tax lawyer Ryan Walker has been advising clients to carefully examine their situations and begin doing corrective planning where necessary. “Trusts are difficult for the tax system to deal with . . . these changes are a further example of the government trying to address these unique legal concepts which are trusts.”

While much of what has changed makes sense in the government’s determination to remove the preferential treatment allowed through testamentary trusts, there is one change affecting life interest trusts including spousal, alter-ego, and joint-partner trusts, leaving many to suggest there is room for a correction of some. There’s a rollover of assets going into those trusts, so there is no triggering for capital gains tax when the trust is created. That tax is paid in the trust at death of the life beneficiary.

Now, under the new rules, on the death of the life beneficiary, the taxes are instead allocated to the life beneficiary’s estate, creating a mismatch of taxes being incurred by one taxpayer and the assets being held by a different taxpayer. This is now considered a significant problem in a blended family situation where the beneficiaries of the trust may not be the same as the beneficiaries of the estate.

“That is a major change that people are concerned about,” says Atin. “One of the classic reasons why you use a spousal trust is exactly this situation, when you have a second marriage.”

But, he adds, when that second spouse dies and triggers payment by those who are not benefiting from the trust, its effectiveness is compromised. And just how the Canada Revenue Agency will deal with that is also a question. “Who knows how to draft around that?”

Strickland is alerting clients with spousal trusts to make them aware of the possible impact and make any necessary changes to avoid troubling situations later. “We’re not certain how the CRA will interpret these rules. . . . We’re at least encouraging [clients] to review the estate planning techniques that go beyond the will” such as life insurance contracts and registered accounts.

The federal Department of Finance says it continues to accept comments online about the changes related to spousal trusts online “as part of developing the measure.”

Nick Smith, of Legacy Tax and Trust Lawyers, points out this is an important distinction in British Columbia, where alter-ego and joint-partner trusts are more commonly used because they help to avoid probate fees as well as challenges under the province’s wills variation legislation. In B.C., all spouses and children have the right to challenge wills. “In other provinces those issues are not as

prevalent,” says Smith.

For those who no longer find value in the trust in the absence of the marginal tax rate, there is the option of collapsing the trust, although, unless the trust terms allow for its collapse, that may involve an application before the courts, which incurs further costs for the clients. Niedermayer expects there may well be more activity in court-ordered variations.

“There’s still some tax advantage, but you won’t see it on such a broad scale,” concludes Atin. Following the changes, the advantages now weigh more in favour of the control and protection elements of will trusts. “We just won’t use them purely for this tax advantage anymore.”

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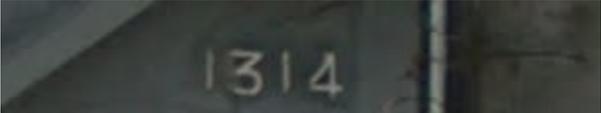
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