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VIA EMAIL

Trust Graduated Rates
Tax Legislation Division
Tax Policy Branch
Department of Finance
L'Esplanade Laurier
17th Floor, East Tower
140 O'Connor Street
Ottawa, ON K1A 0G5

Dear Sirs:

Re: Consultation on Eliminating Graduated Rate Taxation of Trusts and Certain Estates

I am writing on behalf of the Conference for Advanced Life Underwriting (CALU). CALU was formed in 1991 to meet the needs of financial and professional advisors who specialize in advanced applications of life insurance and related financial services, including such areas as employee benefits, wealth accumulation, retirement planning, estate planning and business succession planning.

In matters of advanced tax policy, CALU also represents the members of Advocis. Advocis is the trade name for The Financial Advisors Association of Canada (TFAAC), which is the largest voluntary professional membership association of financial advisors in Canada, representing more than 11,000 advisors across Canada. Advocis members provide comprehensive financial and retirement planning, employee benefits planning, wealth management, estate and tax planning, risk management products and advice to millions of Canadians.

We are writing to provide you with our comments on the proposed changes contained in the document entitled "Consultation on Eliminating Graduated Rate Taxation of Trusts and Certain Estates" released by the Department of Finance ("Finance") on June 3, 2013 (referred to herein as the "Consultation Document"). We will limit our comments primarily to those changes that affect testamentary trusts and estates.

1. Introduction

As discussed in the Consultation Document, testamentary trusts and estates under administration are eligible to use the graduated tax rates available to individuals. On the other hand, *inter vivos* trusts must

pay tax at the top federal marginal tax rate applicable to individuals, which is currently 29%.[1] There is concern that the ability of testamentary trusts to access marginal tax rates can raise questions of both tax fairness and neutrality in comparison to the treatment of beneficiaries of ordinary *inter vivos* trusts and taxpayers receiving equivalent income directly, as well as the potential loss of government tax revenues.

The Consultation Document notes that tax planning opportunities arising from the availability of graduated rates include the use of multiple testamentary trusts to facilitate income splitting with trust beneficiaries, as well as delays in completing the administration of estates for similar purposes. Such strategies may also assist beneficiaries in avoiding the Old Age Security Recovery Tax.

The Government therefore proposes to amend the Act to apply flat top-rate taxation to testamentary trusts. In addition, flat top-rate taxation is proposed to apply to estates ("flat top-rate estates") after the 36-month period that follows the individual's death.[2] Estates of deceased individuals would therefore be eligible to retain access to graduated rates for up to the first 36 months of the estate's administration. These measures would apply to existing and new arrangements for the 2016 and later taxation years.

The Consultation Document indicates that the preferred beneficiary election rules[3] and the rules for trusts for minor children[4], which allows income to be recognized for tax purposes in the beneficiary's hands (i.e. taxed at the beneficiary's marginal rates) even though the income actually accumulates in the trust, will not be impacted by the proposed changes. As well, the proposed measures on graduated rates would not change the rollover rules that apply on the death of a spouse or common-law partner.[5]

The Consultation Document also proposes that testamentary trusts and estates would be subject to the same treatment as ordinary *inter vivos* trusts in other respects. This will mean that the instalment rules would be extended to trusts created by will and flat top-rate estates; the basic $40,000 exemption under the alternative minimum tax regime would no longer be available; such estates and trusts would be required to use a calendar year taxation year and require that their fiscal periods end in the calendar year in which the periods began; Part XII.2 tax would apply; qualification for personal trust status would be the same as for *inter vivos* trusts; investment tax credits can only be recognized in the trust or estate; and certain administration rules would be modified to apply. Although not expressly stated, it is assumed that all these changes would also take effect in 2016 with application to existing and new trusts and estates.

2. Commentary on Proposed Changes

(a) General Comments

CALU recognizes that Finance has valid concerns relating to tax planning involving testamentary trusts. It has become common practice, at least for larger estates, to provide for a separate testamentary trust for each beneficiary under a will, with the purpose of facilitating income splitting with the estate beneficiaries. The proposed changes will eliminate the benefits of this type of planning, while still permitting the use of testamentary trusts for bona fide non-tax purposes.

However, we have identified situations where it is important and even essential for a testamentary trust or estate to have the power to retain trust income in order to protect the integrity of the estate plan as well as

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[1] Subsection 122(1) of the of the Income Tax Act (the "Act").
[2] It is proposed that the estate would be subject to a deemed taxation year-end upon expiry of that period.
[3] Subsections 104(1) and (14) of the Act. The definition of a "preferred beneficiary" is contained in subsection 108(1) of the Act.
[4] Subsection 104(18) of the Act.
[5] Subsection 70(6) of the Act.

the interests of the beneficiaries. The testamentary trust in effect takes the place of the testator and exercises discretion over the use of the trust capital and income. Examples include trusts established for physically or mentally handicapped beneficiaries; trusts for "financially immature" beneficiaries; spousal trusts which have a secondary goal of preserving assets for children of another marriage; spendthrift trusts and trusts designed to protect assets from the creditors of a beneficiary.

In these situations, if the testamentary trust uses its discretionary powers to retain trust income, the proposed application of the flat top-rate tax to such income could have an unfair and adverse impact where the receipt of such income by the intended beneficiary would otherwise be taxed at a lower marginal tax rate. This is a particularly harsh result where the flat top-rate tax includes provincial high income surtaxes and the beneficiary under such trust would otherwise be taxed at the lowest marginal tax rate.

(b) Expansion of the Preferred Beneficiary Election

The preferred beneficiary election, as originally enacted, was intended to allow for the allocation of income to a wide range of family beneficiaries under an *inter vivos* or testamentary trust, without actually distributing the income to such beneficiaries. Any income subject to a preferred beneficiary election would be taxed in the hands of the preferred beneficiary and excluded from the income of the trust.

However, the scope of the preferred beneficiary election was significantly restricted by changes announced in the 1995 federal budget, effective for 1996 and future taxation years. The reason for these changes are similar to those being proposed in the Consultation Document – to ensure a level tax playing field between property held in a trust and property held directly. Specifically, there were concerns that the preferred beneficiary election would permit a trust to allocate income to "low-rate" beneficiaries, while subsequently distributing such income (in the form of capital) to other family members who are in a higher marginal tax bracket. In effect, the preferred beneficiary election offered an indirect method of income splitting between family members.[6]

CALU recognizes that it would be difficult for Finance to consider expanding the scope of the preferred beneficiary election without effectively dealing with these concerns. We would therefore propose that the expanded preferred beneficiary election only be available to testamentary trusts under which no person except the preferred beneficiary may, before the preferred beneficiary's death, receive or otherwise obtain the use any of the income or capital of the trust.

We would note that while it may still be possible to establish separate testamentary trusts for family beneficiaries of the estate, this will not result in a multiplication of marginal tax rates since the income will either be subject to tax in the trust at the flat top-rate or at the marginal rate of the beneficiary. As well, the recommended change to the preferred beneficiary election would ensure that during the period of time while the preferred beneficiary is alive, distributions of income or capital can only be made to that preferred beneficiary and to no other family member as a capital beneficiary. This significantly restricts the income splitting opportunities that otherwise could arise under the pre-1996 version of the preferred beneficiary election rules.

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[6] It should be noted that this concern related primarily to *inter vivos* trusts, since income earned and retained in a testamentary trusts is eligible for marginal tax rates.

(c) Life Insurance Trusts

Life insurance can play a key role in providing a guaranteed source of capital on death for the benefit of family beneficiaries. In fact, life insurance may be the main or most significant asset available to beneficiaries under an estate. As part of an estate plan it is possible to structure the payment of the insurance proceeds under a beneficiary designation in one of three ways:

(i) Payable to the deceased's estate – in this case the life insurance proceeds will form part of the estate to be distributed in accordance with the terms of the will (or provincial intestacy rules). The benefit of this arrangement, assuming there is a will, is that the testator can direct and control how the proceeds are to be invested and distributed by using a testamentary trust. The downside of this arrangement is that the insurance proceeds are subject to probate fees and taxes, delays in estate administration and are available to creditors of the estate.

(ii) Payable directly to the beneficiary – in this case the proceeds of the policy flow directly to the named beneficiary. The benefits are that the insurance proceeds are not subject to probate fees or taxes, delays in estate administration and are not available to creditors of the estate. On the other hand, the testator cannot control how the proceeds are invested or utilized by the beneficiary.

(iii) Life Insurance Testamentary Trust – in this case the insurance proceeds are payable to a trustee for the benefit of the named beneficiaries. This represents the "best of both worlds" as the insurance proceeds flow outside the estate and the testator, through the terms of the trust, can control how the insurance proceeds are invested and distributed to the beneficiaries.

It is our understanding from Finance officials that a life insurance testamentary trust will be treated the same as a "normal" testamentary trust rather than an estate in administration, and therefore any income that is retained in a life insurance testamentary trust will be subject to tax at the flat top-rate and not eligible for the "three year deferral" otherwise available had the insurance designation been in favor of the estate. We are concerned that this tax treatment could cause testators to utilize one of the first two beneficiary designation options discussed above, to the detriment of their overall estate plan. We believe this would be a very unfortunate result and the tax rules should be "neutral" when it comes to life insurance planning. As discussed above, a possible solution to this issue is an expanded preferred beneficiary election that would permit the option of allocating trust income to the preferred beneficiary while retaining such income in the trust.

Should Finance not move forward with an expanded preferred beneficiary election, we would request that consideration be given to a special rule that would provide life insurance testamentary trusts with a 36-month deferral in the application of the flat top-rate tax. While this would mean that the deceased's estate and any life insurance testamentary trusts created on death would have access to marginal tax rates for up to 36 months after the death of the testator/settlor, we don't believe this will result in significant planning opportunities or tax leakage. However, if there was a concern, a rule could also be introduced requiring that the income of the estate and all life insurance testamentary trust created on the death of the testator/settlor be aggregated in determining the effective marginal tax rate to be applied to such income. This would treat life insurance testamentary trusts similarly to estates in administration and ensure that testators are not influenced by the tax rules in terms of making a beneficiary designation in favor of the estate vs. the use of a life insurance testamentary trust.

(d) Fiscal Period of Testamentary Trusts Established before 2016

As discussed above, one of the proposed rule changes in the Consultation Document is to require that trusts and flat top-rate estates use a calendar year taxation year and require that their fiscal period end in the calendar year in which the period begins. While we understand there is a one-year tax planning

opportunity for new estates and trusts that utilize non-calendar year tax reporting, for existing trusts this change appears to be driven by a desire for "administrative simplicity" rather than any concerns with unintended tax benefits.

However, this change will require existing trusts and flat top-rate estates that are not currently using a calendar year taxation year to change their taxation year effective in 2016. This in turn will result in two taxation years in 2016 and require the trust to complete and file two separate tax returns. In turn, this will likely result in the acceleration of tax reporting to the beneficiaries of such trusts. Relief, if any, from this acceleration of tax and increased tax burden in respect of 2016 would likely be administratively complex and expensive for affected trusts and beneficiaries, particularly where the trust assets are modest.

We are therefore of the view that the benefits to the government of moving to a calendar year tax reporting for existing trusts and estates is far outweighed by the costs, both in time and fees to the trust and the acceleration of income to beneficiaries, of requiring existing trusts to move to calendar year reporting. As a result, we are recommending that this particular administrative change only apply to trusts and estates that come into existence in 2016 and later years.

In Summary

As discussed above, CALU has three main recommendations relating to the Consultation Document:

1. That the preferred beneficiary election be expanded to ensure that income retained in a trust is not subject to a higher rate of tax than would have arisen had the income been distributed to a preferred beneficiary.
2. If recommendation 1 is not accepted, that life insurance testamentary trusts be treated like an estate in administration and be eligible for marginal tax rates for the first 36 months of their existence.
3. That the requirement for trusts and estates to be on a calendar year tax year and fiscal reporting basis only apply to trusts and estates established in 2016 and later years.

We appreciate the opportunity to provide our comments on the Consultation Document and look forward to further dialogue relating to our comments and recommendations.

Yours truly,

Kevin Wark, LLB, CLU, TEP
President, CALU

cc. Don Smith, CALU Chair