Understanding the New Federal Trust Rules

A trust can play an important role in financial planning – both for tax-minimization purposes and for non-tax reasons. Starting on January 1, 2016, new rules governing trusts came into force in Canada. If your financial plan makes use of trusts, you need to be aware of the changes as they could have a significant impact on your tax and estate planning. Depending on your situation, you may be advised to restructure your will to avoid any negative tax implications.

The most significant change in the regulations involves elimination of the graduated rates that previously applied to testamentary trusts and grandfathered living trusts (also known as inter vivos trusts) created before June 18, 1971. Under the new rules, all trusts, except graduated rate estates (GREs) and qualified disability trusts, will be taxed at the highest marginal tax rate, which is currently 29%. In provinces that amend their tax codes to align with the federal tax rates, the effective combined tax rate will climb to nearly 50%.

Exceptions

As mentioned, GREs and qualified disability trusts will continue to enjoy the benefits of graduated rates. A GRE is a new classification of estate that benefits from graduated rates for the first 36 months following the death of the individual. In keeping with this limited period of eligibility, a GRE must be established not more than 36 months after death. Your executor or estate trustee will have to meet a number of filing requirements to ensure your estate is treated as a GRE. For example, an estate created before January 1, 2016 must designate itself as a GRE in its 2016 tax return to continue benefiting from graduated rates until the end of the 36-month period. Only one GRE can exist per person and a GRE is only the estate itself – that is, it doesn't include any other testamentary trusts, such as a spousal trust, that may have been created under a will.

Qualified disability trusts (an existing trust type that has a beneficiary that qualifies for the disability tax credit) are still eligible for graduated rates of taxation. This type of trust is required to designate itself as a qualified disability trust by the end of 2016 to benefit from graduated rates.

Trust Primer

Testamentary Trust

A trust established the day a person dies. All testamentary trusts are personal trusts. The terms of the trust are established by the will or by court order in relation to the deceased individual's estate under provincial or territorial law. The assets associated with a testamentary trust form part of your estate. Thus, they are subject to applicable estate fees and taxes.

Living Trust

When you create a living trust, also known as inter vivos trust, ownership of the assets transfers immediately to the beneficiaries, and you're free to contribute more assets to the trust whenever you like. The trust assets do not form part of your estate because the transfer of ownership occurs during your lifetime. Thus, the assets are not subject to probate

Graduated Rate Estate (GRE)

An estate that is defined as a testamentary trust for tax purposes for the first 36 months after the date of death.

Qualified Disability Trust

A testamentary trust that has a beneficiary that qualifies for the Disability Tax Credit.

New Tax Rules Concerning Charitable Gifts

As of January 1, 2016, the federal government also introduced new rules affecting charitable gifts. Previously, Canada Revenue Agency (CRA) considered a charitable gift by will or by beneficiary designation to have been made by the person, not the estate. Your executor would claim the donation credits on your final tax return and, if necessary, your return from the year prior. The new rules designate the gift as coming from the estate. The estate must claim the donation tax credit in the year the gift was given to charity. However, if the estate making the gift is designated as a GRE, your executor or estate trustee has the flexibility to claim the donation credits in either the year of death, the year prior or in any of the three years the estate is a GRE.

This only applies to GREs. All other estates are limited to claiming the donation tax credit in the estate or in any of the estate’s following five taxation years.

Do you plan to have your executor or estate trustee donate publicly traded investments to charity? If so, the GRE designation is crucial. One of the key benefits of donating securities is that they are exempt from capital-gains tax. On the other hand, if your estate makes an in-kind donation of publicly traded securities or mutual funds to charity, you or the estate will be subject to capital-gains tax.

Shares of Private Corporations Could Be Affected

If you own shares in a private corporation, you may wish to designate your estate as a GRE. This will allow you to use capital loss carry back to minimize the double tax that arises on the death of a shareholder when the shares are redeemed by the estate. Any financial plan that involves redeeming private company shares by the estate should ensure that the estate holding the shares is eligible for the GRE designation.

Trusts have long served as a highly effective tool for tax and estate planning. While they still have a role to play, the new regulations concerning the taxation of testamentary trusts is a significant development. It's important to determine as soon as possible how these changes will affect any trusts that you or your family have set up, or that you may have provided for in your will. In particular, with the elimination of graduated rates for testamentary trusts for all but the 36-month exemption period, determining whether you are eligible for the Disability Tax Credit is now more crucial than ever.

Getting Advice

Reviewing your Tax Plans? We encourage you to talk to us. Speak to your Financial Advisor or contact investor services at 1 800 608 7707.