New Estate Rules Start Jan. 1: Large Implications for Taxes on Trusts, Contents of Secondary Wills

Date: September 09, 2015
Lawyers You Should Know: Margaret Rintoul

Original Newsletter(s) this article was published in: Blaneys on Business: September 2015

In the December, 2013 issue of Blaneys on Business, our colleague, Paul Schnier discussed the advantages and issues involved in using more than one will and, in particular, noted the anticipated change in tax rates for trusts starting in 2016.

Sure enough, the federal government did pass the legislation, in spite of many representations from the legal, accounting and financial planning communities about the benefits of testamentary trusts (those established in wills) , which will eliminate most of the advantages that have been enjoyed by those trusts since 1972.

Under the new rules that come into effect on January 1, 2016, estates will be allowed 36 months as “graduated rate estates”, where income that is taxed in the estate will be taxed at the marginal rates appropriate to the income of the estates, much as happens now in testamentary trusts.

For estates that are to be distributed as soon as possible, and therefore would be fully distributed within three years of the death of the testator (the person who has made the will), any income that is, for some reason, taxable in the estate will be taxed at marginal rates.

For on-going trusts created by wills, after the first 36 months, any income that is not taxed in the hands of a beneficiary will be taxed at the top tax rate, which is approximately 46 per cent in Ontario.

Therefore the income-splitting potential that motivated the establishment of many testamentary trusts, where some of the income would be taxed in the trust and some in the hands of the beneficiary, will not exist after the end of this year.

In past years, many spousal trusts, in which the sole beneficiary, and often the sole executor, was the spouse, were established because of the potential for income splitting between the spouse and the trust. Anyone who has structured estate plans with trusts like that will want to rethink whether the additional administration issues accompanying an on-going trust, including an additional tax return for each year that the trust operates, and the need to maintain a separate set of estate investments, is worthwhile when there are no tax benefits to be obtained.

There is one exception to the tax rate change for income taxed in a trust, and that is for a trust that is established for a disabled beneficiary. It has been common planning practice for many years to set up a fully discretionary trust for the benefit of a disabled person who is otherwise entitled to government benefits that are severely income tested. (These trusts are often referred to as Henson trusts, so named for the original case where the court approved the use of such vehicles.) This discretionary trust structure prevents any capital or income of the trust from being treated as belonging as of right to the disabled person, and therefore enables the disabled beneficiary to remain entitled to whatever provincial disability benefits are available and still have extras provided through the trust.

Under the new rules that come into place on January 1st, undistributed income in such trusts will still be taxed at marginal rates, but the beneficiary will have to qualify under the income tax rules for a disability tax credit and the trustee will have to file an annual election to keep the trust qualified to pay tax at the marginal rates.

As well, and an important point in terms of family estate planning, only one discretionary trust per disabled person will qualify for marginal tax rates. Therefore, if both the parents and grandparents of a disabled child set up Henson trusts in their wills, for example, only one of those trusts will qualify for marginal tax rates on the accumulating income.

Insofar as multiple wills are concerned, as Paul Schnier noted in his earlier article, there has been a significant advantage from the perspective of Estate Administration Tax (formerly probate fees) in having one will intended for probate (and therefore subject to the Estate Administration Tax) and another that deals with assets that can be transferred without the need for a Certificate of Appointment of Estate Trustee with a Will (probate) and therefore without the need to pay Estate Administration Tax on the value of those assets. That advantage remains and, in fact, may be greater now than was anticipated in 2013.

From January 1, 2015, there has been an obligation on estate trustees to file a very detailed Information Return with the Ontario Minister of Finance setting out the nature and history of the assets in the estate. The filing must be made by the estate trustee within 90 days of the issue of a Certificate of Appointment of Estate Trustee, and the Ministry of Finance has the authority to audit and reassess tax, and is in fact carrying out audits and issuing reassessments already.

To the extent that assets can be transferred through a Secondary or Non-Probate or Private Will without the need for a certificate of appointment, not only does it save paying Estate

Administration Tax on the value, but there is no need to report the asset and its value in the Information Return that must be filed.

Secondary or Non-Probate wills have generally been used to deal with shares in private companies controlled by the testator (the person who has made the will) or by close family members, because the shares can be transferred by the company directors. In addition to private company shares, there are a number of other assets that can be included in such a will. These include art and jewellery, motor vehicles and boats which can be transferred or sold without having to have a Certificate of Appointment of Estate Trustee to secure the transfer.

To reduce Estate Administration Taxes, people have also used joint accounts, simply adding the name of another family member or members to a bank account, investment account or real estate title, with the notion that the asset would go to the surviving owner but with the further expectation (sometimes set out in a form of side agreement) that the survivor would deal with the assets according to terms set out in a will (in effect trying to create a form of trust where the surviving owner will hold the assets in trust for other estate beneficiaries.)

The Supreme Court of Canada in 2007 essentially confirmed that holdings of this sort are trusts for the estate beneficiaries, but the new Information Return required in Ontario also treats such joint accounts as estate assets and therefore subject to Estate Administration Tax.

Anyone intending to have a joint bank or investment account or jointly held real estate held by the surviving holder for the benefit of estate beneficiaries other that the surviving holder needs to deal specifically with such an account in a Secondary or Non-Probate Will in order to keep the asset out of the Estate Administration Tax jurisdiction.

In terms of income tax treatment of multiple wills, as long as the executors or estate trustees of each will are the same, CRA has said that, for tax purposes, there is one trust. Therefore during the first 36 months of the estate administration, if income is not distributed, it can be taxed in the overall estate at marginal rates as a Graduated Rate Estate.

If the terms of either the primary or secondary will call for an on-going trust, however, any income not paid out to a beneficiary and therefore taxable in the trust, whether it comes from an asset in the primary or the secondary estate, will be taxed at the highest marginal rate.