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COMMENT

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A GLIMPSE AT THE TAX PROPOSALS FOR TESTAMENTARY TRUSTS

In the 2013 Federal budget, the government announced a review of the income tax provisions with respect to testamentary trusts. On June 3, 2013, the Department of Finance released a consultation paper that outlines proposed changes to the taxation of testamentary trusts. This consultative process gives Canadians the opportunity to review the proposals and provide the Department of Finance with feedback and input by December 2, 2013.

The Department of Finance considers that changes are necessary to "level the playing field" by eliminating what it views as an inequity in the current trust regime. By initiating the consultative process with a series of proposed changes, the Department of Finance is indicating the direction it wants to follow.

One of the most significant changes is the proposal to apply flat top-rate taxation to all existing and new testamentary trust arrangements starting in the 2016 taxation year. A significant tax advantage for testamentary trusts and grandfathered inter vivos trusts (pre-1971 inter vivos trusts) under the current rules is that trust income is subject to tax at the same graduated rates applicable to individuals. As such, individuals can currently structure their wills to leave their family the opportunity for income splitting among several testamentary trusts and surviving family members.

Since testamentary trusts are treated as separate taxpayers, a testamentary trust can retain some of its income and pay tax based on graduated tax rates. With planning, the beneficiary can split income with the testamentary trust and realize a positive tax savings every year. However, if adopted, the proposed new flat top-rate tax means the end of the graduated tax rates for testamentary trusts, with the exception of a short window of time for new estates.

The proposal would allow estates to continue to be taxed based on the graduated rates, but only for a reasonable period of time. The proposal allows a maximum of 36 months as the period during which an estate could utilize graduated tax rates, following which the estate becomes subject to the flat top-rate on all income. The rationale behind "36 months" is to provide the estate's executor with sufficient time to administer and wrap up the estate, with assets being passed on to the beneficiaries.

The proposal confirms that the intention is for the transfer of assets from the deceased to a testamentary spousal trust for the benefit of the deceased's spouse to continue on a rollover (tax deferred) basis. The rollover allows a deceased spouse to pass property to a qualifying spousal trust for the benefit of the surviving spouse on a tax-deferred basis.

The proposal contains a number of other related tax measures:

- Testamentary trusts will be subject to the same income tax instalment rules as individuals. Currently, testament trusts do not need to make instalments with respect to their income tax liability.
- The $40,000 exemption in calculating alternative minimum tax will no longer be available to testamentary trusts. This means testamentary trusts could be subject to alternative minimum tax more often.
- Testamentary trusts will have to use the calendar year for their taxation year. Currently, testamentary trusts can choose a year-end at any time in the first 12 months following the death of the testator. The proposal did not comment on the application of the ability of an estate to carry back a capital loss to the testator's terminal tax return.

The intent of the proposals, in the view of the Department of Finance, is to level the playing field by eliminating tax preferential treatment afforded to testamentary trusts under the current regime. If passed into law, the proposals will significantly change several estate planning strategies from a tax perspective. It is, however, important to note that while tax planning opportunities will change, testamentary trusts will continue as planning vehicles that can facilitate testators' wishes for their beneficiaries.

Change is inevitable. The Department of Finance is inviting comments with respect to the proposals. It is important for individuals and groups to take the opportunity to comment.

I/R 8001.00, 7401.00

PART-TIME FARMERS: THE VALUE OF A LOSS

In a recent tax case (*The Queen v. Craig*) that was appealed all the way to the Supreme Court of Canada (SCC), a lawyer successfully argued that his significant farm losses should be deductible against his other income. The SCC's decision reversed the longstanding precedent that for farm losses to be fully deductible against other sources of income, farming had to be the taxpayer's chief source of income.

In response to the outcome of the Craig case, the Department of Finance announced a change to the income tax provision that sets out the tax treatment of part-time farmers and their ability to deduct farm losses against their other sources of income.

The wording of the new provision will be as follows:

> *"If a taxpayer's chief source of income for a taxation year is neither farming nor a combination of farming and some other source of income that is a subordinate source of income for the taxpayer, . . . the taxpayer's loss, if any, for the year from all farming businesses carried on by the taxpayer shall be deemed to be the total of . . ."*

This new provision adds the underlined phrase "that is a subordinate source of income." This proposal means that, for losses to be fully deductible, farming will now have to be the largest source of income for the taxpayer, and any other source of income must be smaller or subordinate. This new phraseology creates a clearly defined rule that eliminates any need for interpretation by the courts, which had been the case under the prior wording of this provision.

For part-time farmers, there is a "deeming" element within this provision that incorporates a formula to restrict the taxpayer's farm loss and allow only a portion to be deductible against the taxpayer's other sources of income. Where the "deeming" rule applies, it will establish the tax result and the true economics of a situation are disregarded.

While tightening the rules as described above, the budget at the same time proposes to raise the maximum limit to which farm losses can be deducted against other sources of income, and to change the deeming formula that restricts a part-time farmer's ability to deduct farm losses against other income. If a part-time farmer suffers a loss from the farm operations, his or her loss will be deemed to be the lesser of:

- the actual loss; and
- $2,500 plus the lesser of (a) one-half of the loss in excess of $2,500, and (b) $15,000.

This proposed change means that the maximum loss that a part-time farmer can deduct against other income will be $17,500, twice the current limit of $8,750.

Three examples utilizing this new formula follow:

		Example 1 ($)	Example 2 ($)	Example 3 ($)
Actual farm loss	A	7,500	32,500	62,500
1/2 of (A – $2,500)	B	2,500	15,000	30,000
Lesser of B and $15,000	C	2,500	15,000	15,000
C plus $2,500	D	5,000	17,500	17,500
Deemed Farm Loss		5,000	17,500	17,500
Balance available for carry-back or carry-forward		2,500	15,000	45,000

Any amounts that are non-deductible because of the application of the formula become restricted farm losses and can be carried back three years or carried forward ten years, and deducted against farm income realized in any of those years.

There is a certain ebb and flow in the ever-changing landscape of income tax planning. If the courts interpret the income tax legislation in different ways from the intent of the Department of Finance, legislative change can often be anticipated.

I/R 7501.02

CAREFUL CRAFTING OF THE WORDS HELPS ACHIEVE INTENDED OUTCOME

Wills are the documents used to capture testators' last wishes for the disposition of their estates. When the words in a will create ambiguity, it can disrupt the testator's intentions and create angst amongst those involved with the estate, particularly the executors, trustees and beneficiaries. Ultimately, the intervention of the courts may be required. Great care is needed to ensure as much clarity as reasonably possible is reflected in a will. In addition to the choice of words, it is also important to use the correct context.

The following common legal terminology is often found in wills, and can add clarity or ambiguity, depending on the usage.

Issue - The term "issue" refers to the testator's children, grandchildren, great-grandchildren and so forth. If a testator's intention is for the distribution to occur only to the immediately succeeding generation (i.e., the testator's children), the use of the term "issue" can be problematic and may result in the court's intervention. As such, using the term "issue" in the correct context can minimize the need for judicial interpretation.

Per Stirpes - The term "per stirpes" means by roots or by representation, and defines the distribution of an estate whereby a beneficiary receives his or her share as a member of a group rather than as an individual; the group shares in the proportional amount of the deceased ancestor's share of an estate which the ancestor would have received directly if he or she were still living.

The term "per stirpes" should only be used in conjunction with the word "issue" such as, "among my issue in equal shares per stirpes." In simple terms, the intention of using "per stirpes" is to ensure a beneficiary's share of the estate is distributed to that beneficiary's children if that beneficiary predeceases the testator.

Use of the term "per stirpes" in any other context is likely to leave the executor in a quandary that could necessitate judicial involvement to settle the interpretation.

Per Capita - A distribution "per capita" means that all beneficiaries of the described class would inherit an equal share. Using the term "per capita" means that any beneficiaries that pre-decease the testator would not be allocated a share.

Examples of the use of "per capita" include the phrases "equally to my issue per capita" or "equally to my children per capita." In the first example, the testator's estate would be divided equally amongst all of the issue of the testator who are alive at the time of his or her death (children, grandchildren, great-grandchildren, and so forth). In the second example, the testator's estate would be divided equally among the testator's children who are alive at the time of the testator's death.

It is important to recognize that the use of the term "per capita" means that if a beneficiary predeceases the testator, the deceased beneficiary's share is not re-directed onto his or her children or other issue. Instead, the deceased beneficiary is removed from the class and the testator's estate is divided amongst the remaining living members of the class of beneficiaries.

In addition, a "per capita" distribution to a named class could become very broad. For example, the term "per capita to my issue" would include all down-stream issue, which has the potential to be a very large group.

Family Groups - Words describing a family group or relationship can also be problematic particularly in today's era of modern families with a wide variety of blended relationships. The term "children" typically does not include stepchildren or a minor child of whom the testator may have legal custody in a parenting role. However, the term "children" can be more clearly defined in the will to include either of these two groups or to more clearly state that these groups are excluded.

Another example is the word "spouse." Today, the term "spouse" is interchangeable when referring to a married spouse or a common-law partner. Yet, use of the term "spouse" can become problematic in a will because it is not uncommon for an individual to be separated from a spouse and to be in a common-law relationship with another individual — so effectively, the individual could have two spouses. Adding clarity, perhaps through the use specific names, can eliminate potential conflicts.

Careful drafting and a thorough review of terminology will help minimize potential ambiguities and the need for judicial intervention.

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