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COMMENT

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TRANSITIONING TO THE NEW TAX RULES FOR TRUSTS

Commencing January 1, 2016, testamentary trusts will no longer be eligible for graduated tax rates when filing their annual income tax returns. Instead, the new tax structure means testamentary trusts (i.e. trusts created on death) will now be taxed at a flat rate equal to the top marginal combined federal and provincial rate for individuals. There are two exceptions to the application of this new rule - qualified disability trusts and graduated rate estates (GREs). The focus of this article is on graduated rate estates.

A GRE is an estate that arises as a consequence of an individual's death. For deaths that occur after December 31, 2015, to ensure that the estate is treated as a GRE for tax purposes, the estate representative will include the deceased's social insurance number and designate the trust as a GRE when filing the income tax return for the estate's first year-end. GRE status continues for up to 36 months from the individual's date of death, after which the estate remains a testamentary trust but becomes subject to tax at the top marginal rate like all other testamentary trusts.

A deceased individual can have only one graduated rate estate and it must be the estate itself that becomes the GRE. This means that testamentary trusts established through an individual's will cannot qualify for graduated tax rate treatment; instead, they will be taxed at the top marginal personal tax rate from inception. Examples of testamentary trusts arising upon death though an individual's will include an insurance trust, spousal trust, family trust and education trust. Estate planning may involve keeping the estate together and only settling these non-GRE trusts as time passes and nears the 36-month anniversary. However, the estate executor needs to be mindful of obligations to the respective beneficiaries and not unnecessarily delay the establishment of other trusts simply for the tax benefit.

There is no grandfathering for estates and testamentary trusts created prior to January 1, 2016, which enjoyed the benefit of graduated tax rates. The status of pre-2016 testamentary trusts will immediately align with the new rules. An estate created by a death prior to January 1, 2016, will be entitled to access the graduated rate structure for the 36-month period immediately following the date of the individual's death. However, the estate executor must designate the estate as a graduated rate estate in its first tax filing after January 1, 2016. At the 36-month anniversary, following the date of death, the estate will no longer qualify for GRE status and will be treated as a testamentary trust under the new tax structure.

Take for example the situation where Kelly died on September 15, 2014, and her estate remains open on January 1, 2016. Given that Kelly's estate has existed less than 36 months since her death, her estate is eligible for GRE status beginning in 2016. Kelly's executor will designate the estate as a GRE in its 2016 year-end filing (first tax filing after January 1, 2016). Her estate remains a GRE until the 36-month anniversary of her death, September 15, 2017, after which it becomes a regular testamentary trust.

In addition to tax rate changes, the new rules affect the choice of a fiscal year-end for the trust. A GRE will continue to have the option to select a non-calendar year-end, which will apply throughout the GRE period. Testamentary trusts that do not qualify for GRE status will be subject to a calendar year-end (December 31) from the onset.

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When a GRE reaches its 36-month anniversary, the point at which its special status ends, it will have a deemed year-end at that date, followed by a subsequent year-end on December 31 in that same year. From there forward, the trust will be subject to a December 31 year-end throughout its remaining existence.

The following chart summarizes key information as to how the new tax rules, beginning January 1, 2016, will apply to existing and new estates and testamentary trusts.

Date of Death	Tax Status
December 31, 2012 and earlier (Estates and testamentary trusts)	• The estate/testamentary trust no longer qualifies for graduated rate treatment beginning January 1, 2016 onwards. • To enable the transition, the estate/testamentary trust will have a deemed year-end on December 31, 2015, where it will report all income earned since its last reporting period. The December 2015 return will be the last period for which graduated tax rates will apply. • On a go-forward basis, the estate/trust's next year-end will be December 31, 2016 and every December 31 thereafter.
January 1, 2013 to December 31, 2015 (Estate that qualifies for GRE status)	• The estate will retain its elected year-end until the 36 month anniversary of the individual's date of death. • The executor must indicate in the first estate return due during 2016 that the estate is a GRE. • The GRE will have a deemed year-end at the 36-month anniversary of the individual's date of death, and a subsequent year-end at December 31 in that same anniversary year. • At the 36 month anniversary of the individual's death, the GRE loses its special tax status and transitions to a regular testamentary trust.
January 1, 2013 to December 31, 2015 (Non-GRE testamentary trusts)	• These non-GRE testamentary trusts lose access to graduated tax rates on January 1, 2016. To enable the transition, the testamentary trust will have a deemed year-end on December 31, 2015, where it will report all income earned since its last reporting period. The December 2015 return will be the last period for which graduated tax rates will apply. • On a go-forward basis, the trust's next year-end will be December 31, 2016 and every December 31 thereafter.
January 1, 2016 and later (Estate that qualifies for GRE status)	• The executor can chose the estate's first year-end (can be non-calendar) and is eligible for graduated tax rates for 36 months. • The executor must indicate in the first tax return that the estate is a GRE. • The estate loses its GRE status and will have a deemed year-end on the 36-month anniversary of the individual's death (the last period under which it is eligible for graduate tax rates). Subsequently, that same year, the estate will have a December 31 year-end, which will be the first transition to a regular flat tax rate structure. The estate's year-end continues as December 31 on a go-forward basis.
January 1, 2016 and later (Non-GRE testamentary trusts)	• All non-GRE testamentary trusts will be subject to a calendar year-end beginning December 31 immediately after the individual's death. The trust is subject to the regular flat tax rate structure.

Consider the example of Stan who passed away on February 2, 2016. Stan has a very complicated estate and it will take a considerable period of time to settle his affairs. Stan's executor, Saun, will have to be aware of the following dates in his management of Stan's estate.

- Saun can choose the date for the first taxation year of the estate. The first taxation year does not have to be twelve months. Assume that Saun chooses November 15, 2016, as the first taxation year of the estate, designates the estate as a GRE and files the estate's first tax return.
- Saun would be required to file the estate's second and third tax returns for the November 15, 2017 and 2018 year-ends, respectively. The second and third tax returns would each be in respect of a twelve-month period.
- Saun would be required to file a tax return for the period ending February 2, 2019, the 36-month anniversary of Stan's death. This tax return represents the final period during which the estate qualified as a GRE.
- The estate's status shifts to a regular testamentary trust immediately following the 36-month anniversary. As such, the estate is now subject to a calendar year-end, requiring Saun to file a tax return in respect of the December 31, 2019 year-end, and every December 31 thereafter.

The introduction of GREs and new rules for the taxation of testamentary trusts is a significant change that will require careful attention to ensure all reporting requirements are met.

PENSION INCOME SPLITTING CREATES SAVINGS OPPORTUNITY

Pension income splitting is a tax savings strategy designed to lower a couple's overall family tax bill, leaving more disposable income. When filing their annual income tax returns, a couple can jointly elect to shift up to one-half of eligible pension income from the spouse in a higher tax bracket to the spouse in a lower tax bracket, which shifts the associated income tax liability. Tax savings are derived from the difference in the couple's tax brackets multiplied by the amount of income shifted. In addition, if the pension income allocated to the lower income spouse results in the ability to claim the Pension Income Tax Credit for which he or she would otherwise not qualify, additional savings result.

To qualify for pension income splitting, a couple is defined as two individuals who are married or in a common-law partnership. A relationship breakdown would disqualify the couple from undertaking this strategy. A breakdown in the relationship is defined as one where the couple is living separate and apart from each other at the end of the year and for a period of 90 days or more beginning in the year. However, couples living apart at the end of a year because of medical, educational, or business reasons would not be disqualified. The couple must be residents of Canada on December 31.

The definition of eligible pension income depends on the age of the spouse in receipt of the income.

For Canadians who are **age 65 or older** by the end of the year**,** eligible pension income includes:

1) Registered pension plan (RPP) payments

2) Registered retirement income fund (RRIF) payments

3) Life income fund (LIF) payments

4) Locked-in retirement income (LRIF) fund payments

5) Lifetime annuities from registered plans, i.e. registered annuities

6) Interest portion of non-registered annuities, prescribed and non-prescribed

For Canadians who are **less than age 65** at the end of the year**,** eligible pension income includes:

1) Registered pension plan payments

2) Plus any of the items from (2) to (6) of the above list if received as a consequence of the death of the spouse.

It is important to note that only periodic payments qualify as eligible pension income. In addition, Canada Pension Plan (CPP) and Old Age Security (OAS) are not included in the list of eligible pension income amounts.

Consider the example of **Ben and Barnie**.

- Common-law partners, Ben and Barnie, are ages 67 and 64 respectively.
- Ben is in receipt of $60,000 of RRIF income, $8,000 of Canada Pension Plan retirement pension, $6,000 of Old Age Security and no investment income.
- Barnie is in receipt of $40,000 of interest income, $6,000 of Canada Pension Plan retirement pension and $6,000 of Old Age Security. While Barnie holds an RRSP, he has not as yet taken any income out of the plan.
- Ben can shift up to $30,000 of his $60,000 of RRIF income to Barnie's tax return. However, he would likely choose to shift $11,000, which would leave each of them with $63,000 of taxable income.
- While shifting $11,000 of RRIF income from Ben to Barnie has made their taxable incomes equal, their final income tax liabilities will probably be different because Ben qualifies for the pension income credit and the age amount credit, both of which are available to taxpayers age 65 or older.

Eligibility for the pension income tax credit utilizes similar rules to those used for pension income splitting.

The availability of the pension income credit is based on the individual's age and the type of pension income. In Ben and Barnie's case, Barnie is not yet age 65 and therefore not entitled to the pension income credit nor the age amount credit.

To initiate this strategy, the spouse whose income is to be split completes and files the election (CRA Form T1032) with his or her annual income tax return. Both spouses must sign the form to acknowledge the split. This is an annual election, which provides the couple with the opportunity to re-evaluate their income situation annually and structure the split to meet their ongoing needs. Because the election is filed by the income tax filing due date, it provides the couple with time to evaluate their respective incomes and optimize the election each year. Completion of the form requires a splitting of taxes withheld at source on the eligible pension income.

It is interesting to note that the strategy results in one spouse paying an increased amount in income taxes without actually receiving any of the pension income. Legal entitlement to the pension income remains with the first spouse even though the liability to pay income taxes shifts to the other spouse. The couple is jointly and severally liable for any amounts of tax, interest and penalties that arise as a result of filing the election.

Splitting pension income is a valuable strategy for couples because it allows them to lower their combined income tax liability, resulting in more after-tax cash flow to meet their retirement needs.

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