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The Joint Committee on Taxation of
The Canadian Bar Association
and
Chartered Professional Accountants of Canada

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September 26, 2014

Ms. Alexandra MacLean
Director, Tax Legislation Division, Tax Policy Branch
Department of Finance
L'Esplanade Laurier, East Tower
140 O'Connor Street, 17th Floor
Ottawa, ON K1A 0G5

Dear Ms. Maclean:

Re: 2014 Federal Budget Amendments to Trust and Estate Rules

On August 29, 2014, your Department released a package of draft legislative proposals that would implement tax measures arising from the 2014 Federal Budget. You invited interested parties to provide comments on the draft legislative proposals and, in response to such invitation, our comments follow with respect to certain of the proposed trust and estate taxation amendments.

Several members of the Joint Committee participated in discussions concerning our submission and contributed to its preparation, in particular:

- Kim G C Moody (Moodys Gartner Tax Law LLP)
- Anthony Strawson (Felesky Flynn LLP

We trust that you will find our comments helpful and would be pleased to discuss them with you at your convenience.

Yours very truly,

Janice Russell	Mitchell Sherman
Chair, Taxation Committee	Chair, Taxation Section
Chartered Professional Accountants of Canada	Canadian Bar Association

Cc: Gabe Hayos, Vice President, Taxation, CPA Canada

2014 Federal Budget Amendments to Trust and Estate Rules
Submission by the Joint Committee on Taxation
September 26, 2014

On August 29, 2014, your Department released a package of draft legislative proposals that would implement tax measures arising from the 2014 Federal Budget. You invited interested parties to provide comments on the draft legislative proposals and, in response to such invitation, our comments follow with respect to certain of the proposed trust and estate taxation amendments.

Amendments to Section 94 Regarding "Immigration Trusts" – Lack of Transitional Provisions

As previously communicated to the Department of Finance by way of letter dated April 28, 2014, we believe that the elimination of the immigration trust rules should be subject to transitional provisions in order to provide fairness to taxpayers who relied upon the existing incentive provisions of the *Income Tax Act* (Canada). We believe that the elimination of the immigration trust rules without adequate grandfathering will be an adverse precedent should Canada in the future seek to pursue other incentive provisions targeting non-residents.

Proposed Subsection 104(13.3)

New proposed subsection 104(13.3) provides that a designation under subsection 104(13.1) or (13.2) by a trust for a taxation year is invalid if the trust's taxable income (determined without reference to subsection 104(13.3)) is greater than nil.

Subsections 104(13.1) and (13.2) provide a trust with the ability to designate an amount in respect of a beneficiary. In general terms, the amount designated is limited to the beneficiary's income under the trust under subsection 104(13) or 105(2), minus amounts deducted by the trust under subsection 104(6). The effect of the designations (which require the trust to forego a deduction) generally is to avoid an income inclusion in the beneficiary's hands under subsection 104(13) or 105(2) and have the income taxed instead to the trust. But for the designations and foregoing the deduction, the income generally would be taxed in the hands of the beneficiary and not the trust.

Issue #1 – Reference to Taxable Income

Proposed subsection 104(13.3) invalidates designations if the trust's taxable income is greater than nil. The explanatory notes indicate that this amendment is intended to ensure that designations are made only to the extent of the trust's tax balances (e.g., loss carry-forwards).

It is not clear whether taxable income is intended to be computed without regard to specified future tax consequences (i.e., loss carry-backs). We assume that the implications of a designation being invalid, and then ceasing to be invalid due to loss carry-backs, would be complex administratively, such that the Canada Revenue Agency ("CRA") may be reluctant to agree that taxable income should be computed with regard to loss-carry-backs.

On the other hand, generally where taxable income is measured without regard to specified future tax consequences, the Act specifically so provides, which suggests that loss carry-backs should also be taken into account.

In either case, we believe that it would be beneficial to clarify what is intended. The ability (or lack thereof) to carry back losses also has implications as discussed below.

Recommendation – Issue #1

If taxable income for purposes of proposed subsection 104(13.3) is intended to be measured based upon loss carry-backs (or other subsequent adjustments to taxable income), we suggest that the example in the explanatory notes be clarified to also refer to loss carry-backs. Alternatively, if taxable income is not intended to include loss carry-backs, proposed subsection 104(13.3) should be amended to provide that taxable income is to be determined without regard to specified future tax consequences.

Issue #2 – Uncertainty of Effect of Subsection 104(13.3) on Trust Deductions

In order to potentially make a designation under subsection 104(13.1) or (13.2), the trust must forego a deduction under subsection 104(6). Indeed, it is only the prospect of designating an amount that causes the trust to forego the deduction; but for the designation the trust would deduct the amount under subsection 104(6) to avoid the same amount being taxed in the hands of both the beneficiary and the trust.

The effect of invalidating the designations is to cause the beneficiary to include in income the same amounts that the trust effectively includes in income by virtue of the foregone deduction. It is not clear that a trust may amend "*the amount that the trust claims*" under paragraph 104(6)(b) (as proposed to be amended), if it is subsequently determined that a designation is invalid. We submit that it would be inequitable for the same amount to be included in the income of the beneficiary and the trust.

Recommendation – Issue #2:

Subsection 104(6) or the explanatory notes to that provision should be clarified to provide that *the amount that a trust claims* under paragraph 104(6)(b) may be amended by a trust if it is subsequently determined that the trust could have deducted more under that provision than was claimed in the original return for the year without impairing designations made by the trust.

Issue #3 – Ability to Amend or Make New Designations

There are many instances where taxable income is uncertain, or where a genuine error is made in computing taxable income. For example, an information slip may be received by a trust after it has filed its return for the year, or the character of property as inventory or capital may be uncertain, as just two common examples. As a consequence, after a trust has filed its return and made designations, it may determine that its taxable income is greater than nil, rendering the designations invalid under proposed subsection 104(13.3). We believe it would be equitable for designations to be changed after the fact, particularly in cases of genuine error or uncertainty with respect to the trust's taxable income. In addition, if taxable income is intended to be computed taking into account loss carry-backs as discussed above, it presumably may be necessary to amend designations to take into account the subsequently revised taxable income.

In *Lussier v. R.*, 2000 D.T.C. 1677 (T.C.C.), certain income was payable to a beneficiary of an estate, and the estate apparently deducted that amount in computing its income under subsection 104(6). The beneficiary needed to include the amount in her income under subsection 104(13). On further review, it was determined to be advantageous for the estate to amend its return to designate the amount under subsection 104(13.1), so that income could be "split" between the beneficiary and the estate. (Presumably the amendment to the estate's return also removed the deduction under subsection 104(6).) The Court held that the designation was valid even though it was not made in the original return, and there was no requirement for the designation to be made within a certain period of time.

Although the reasoning in *Lussier* arguably would extend to permit designations to be amended, or new designations to be made where an original designation is rendered "invalid", this is not entirely clear.

Recommendation – Issue #3:

If it is intended that new designations may be made if an original designation is considered invalid to avoid the inequity described above, we believe that it would be helpful to indicate that the original designation is not merely invalid but void, by changing the word "invalid" to "void".

If it is intended that original designations may be amended, we believe it would be helpful to refer to the *Lussier* decision in the explanatory notes and indicate that the amendments are not intended to preclude new designations or amended designations.

Proposed Subsection 104(13.4)

New proposed subsection 104(13.4) applies where certain trusts, such as spousal / common law partner trusts, joint partner trusts, and alter ego trusts (collectively, "Special Trusts") are deemed to dispose of their property as a consequence of the death of an individual (e.g., spouse) (referred to as the "Deceased").

The new rule deems the Special Trust to have a year-end at the end of the day of death, and also deems all of the Special Trust's income (for purposes of the Act, with certain modifications) for that short year to be payable to the Deceased.

As a result, the Special Trust's income for purposes of the Act for that short year, with certain modifications, must be included in computing the Deceased's income in his or her terminal return. In addition, in light of new subsection 104(13.3), the Special Trust will not be able to designate any of that income to not be payable to the Deceased if the Special Trust's taxable income would be greater than nil.

Issue #1 – Subsections 104(13.4) and 104(13.1) Integration

The explanatory notes to subsection 104(13.4) provide that no amount may be designated under, *inter alia*, subsection 104(13.1) in respect of the Special Trust's income for the deemed short year, in respect of any beneficiary other than the Deceased. We assume that it was intended that a Special Trust could rely upon subsection 104(13.1) to have income taxed in the trust, provided that its taxable income does not exceed nil in accordance with proposed subsection 104(13.3).

However, the designation under subsection 104(13.1) is a function of the beneficiary's share of the income of the Special Trust "*computed without reference to this Act*". Since the Special Trust's income for purposes of the Act is deemed to be payable to the Deceased for the short year, but the Deceased will not typically be entitled to any income of the Special Trust computed without reference to the Act for that short year (because they are deemed to be entitled to income for purposes of the Act and because the Deceased will be dead), it does not appear possible to use subsection 104(13.1) to leave income in the hands of the Special Trust even if its taxable income would not be greater than nil.

Recommendation – Issue #1:

We recommend that subsection 104(13.1) be amended to contemplate amounts that are deemed to be payable to the Deceased under new subsection 104(13.4).

Issue #2 – Inability to Take Subsequent Events Into Account

When an individual dies, losses incurred within the first year of the estate generally may be carried back to the terminal year return of the deceased pursuant to subsection 164(6). Subsection 164(6) recognizes that subsequent events after death may arise (e.g., decline in the stock market or conventional private corporation planning to avoid double-taxation) and that it would be equitable to allow such subsequent events to be taken into account. Had the individual not died the general rules with respect to loss carry-backs typically would allow for this equitable result to follow. However, since the individual and the estate are separate taxpayers, a specific statutory rule (subsection 164(6)) is needed to "bridge the gap" between those separate taxpayers.

New subsection 104(13.4) generally will have the effect of including an amount in the income of the Deceased with respect to property owned by the Special Trust at the time of the Deceased's death. However, there is no provision similar to subsection 164(6) to "bridge the gap" between the Deceased and the Special Trust. Consequently, subsequent events will not be able to be taken into account to alleviate taxation arising on death where the property is owned by a Special Trust. This is a substantive change from the existing state of the law and adversely impacts existing and yet to be created Special Trusts.

Recommendation – Issue #2:

We recommend that a parallel provision to subsection 164(6) be introduced to allow losses of a Special Trust following the death of the Deceased to be carried back to the Deceased's terminal return.

Issue #3 – Inequity to Estate of Deceased

Since subsection 104(13.4) deems an amount to be payable by a Special Trust to the Deceased, and generally will result in an income inclusion in the Deceased's terminal year return, the resulting tax liability will, in the first instance, be borne by the Deceased's estate.

However, the Deceased's estate may not (and we believe often will not) have any entitlement to the property of the Special Trust notwithstanding being deemed for purposes of the Act to be entitled to an amount. Consequently, the tax liability that will, in the first instance, be borne by the estate will effectively result in an enrichment of the Special Trust (and therefore its beneficiaries) to the detriment of the estate (and therefore the beneficiaries and possibly creditors of the estate). If these persons are one and the same, this may be of little practical consequence. However, in many instances the beneficiaries of the Deceased's estate will not be the same as the beneficiaries of the Special Trust.

Proposed subsection 160(1.4) imposes joint and several liability on both the estate and the Special Trust, thus ensuring that the taxes will be paid, even if the estate lacks capacity to pay the tax arising from the amount that is deemed to be payable to the Deceased. However, this provision does not require the tax to be assessed against the Special Trust in the first instance, such that there appears to be no mechanism for the estate to be kept whole for taxes relating to property that it does not own and may have no entitlement to. In addition, it is doubtful that the Special Trust could simply distribute property to the estate without breaching the terms of the Special Trust or the fiduciary duties of the trustees of the Special Trust to act in the best interests of the beneficiaries of the Special Trust.

Recommendations – Issue #3:

We recommend that provisions be made such that the liability for the tax payable by the Deceased as a consequence of an amount having been deemed to be payable by the Deceased is to be assessed in the first instance against the Special Trust, or at least request that the CRA announce that they will administer the Act on this basis.

In addition, we recommend the introduction of a provision which provides that an estate is entitled to recover from the Special Trust any amount that is required to be paid on account of the Deceased's taxes as a consequence of an amount having been deemed to be payable to the Deceased. We also recommend that you either include provincial taxes in the concept of "taxes" for this purpose, or encourage your provincial counterparts to introduce similar measures to ensure that an estate can be kept whole for both federal and provincial income taxes arising from the deemed amount.

Proposed Paragraph 249(1)(c)

Our December 2, 2013 submission to your Department laid out our concerns with respect to the proposed change to require testamentary trusts to have a taxation year that coincides with the calendar year. Proposed paragraph 249(1)(c) does not reflect our concerns and will require testamentary trusts that are not graduated rate estates ("GRE") to have a taxation year that ends on December 31.

We respectfully request that you reconsider such a requirement or, at a minimum, provide transitional relief for existing testamentary trusts.

Definition of "Testamentary Trust"

Paragraph (d) of the definition of "testamentary trust" in existing subsection 108(1) contains an anti-avoidance rule (some refer to this rule as the "anti-stuffing" rule) which can cause a testamentary trust to lose its status and thus be considered an inter vivos trust. Given new proposed subsection 249(4.1), the repeal of existing subsection 249(6) and the fact that only GREs and a "qualified disability trust" (as proposed to be defined in subsection 122(3)) are eligible for graduated tax rates, we query the continued need for the anti-stuffing rule in paragraph (d) of the definition of testamentary trust. We would welcome discussions with your Department on this point and suggest that you consider deleting this provision to simplify the Act.

Qualified Disability Trust ("QD Trust")

Our December 2, 2013 submission laid out a recommendation that the preferred beneficiary election under subsection 104(14) be amended to enable a trust created for the benefit of one specifically identified beneficiary and require that income and capital of the trust be allocated only to that specifically identified beneficiary. In addition, we recommended that the definition of preferred beneficiary under subsection 108(1) be amended in such a fashion to enable a testamentary trust to include any individual beneficiary specifically identified by the settlor.

The August 29, 2014 proposals did not accept our above noted recommendation but instead contain provisions that enable a new QD Trust to access graduated tax rates if certain conditions are met. We note that paragraph (b) of the proposed definition of QD Trust in subsection 122(3) will limit the beneficiary of such a trust to an individual in respect of whom paragraphs 118.3(1)(a) to (b) apply for the individual's taxation year.

We believe that such restrictions are too narrow and, at a minimum, should be consistent with the current definition of preferred beneficiary in subsection 108(1) and, specifically, should include subparagraph (a)(ii) of that definition.

Proposed Change to Subsections 164(6) and 112(3.2)

As you know, subsection 164(6) of the Act is a unique provision that enables a capital or terminal loss of an estate from the disposition of property, realized in the first taxation year of the estate, to enable the legal representative(s) of the deceased individual to treat such losses as those of the deceased taxpayer for the taxpayer's last taxation year.

The draft legislation will limit the ability to utilize the provisions of subsection 164(6) to only GREs. We do not understand the policy reasons for such a proposal. We submit that subsection 164(6) should continue to apply to the estate of a deceased individual, and not just the GRE of the deceased individual. We request that such a proposal be abandoned.

Subsection 112(3.2) is a provision that reduces any capital loss of a trust (other than a mutual fund trust) arising from the disposition of a share in a corporation that is capital property, where capital dividends have previously been received by the trust in respect of that share.

Subparagraph 112(3.2)(a)(iii), a relieving provision, reduces the amount of the loss reduction otherwise determined, where the trust is an individual's estate, the share was acquired as a consequence of the individual's death, and the disposition occurs during the trust's first taxation year.

The August 29, 2014 proposals intend to limit the relief provided in subparagraph 112(3.2)(a)(iii) to an individual's GRE. Again, there does not appear to be any policy objective served by limiting subsection 112(3.2) to the GRE of the deceased taxpayer. We submit that subsection 112(3.2) should continue to apply to the estate of a deceased individual, and not just the GRE of the individual. We request that such a proposal be abandoned.