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Tax Policy Branch
Department of Finance
90 Elgin Street
Ottawa ON
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Dear Sir/Madam:

Re: <u>Comments on Draft Legislation</u>

This letter includes comments on the draft legislative proposals (the "**Proposals**") released on January 15, 2016 in respect of the income taxation of certain trusts and estates.

My comments are restricted to the Proposals that concern testamentary spousal trusts, joint spousal trusts and alter-ego trusts (each, a "**Life Interest Trust**").

Election in Proposed Subsection 104(13.4)

I support the proposed addition of paragraph (b.1) to subsection 104(13.4) of the Income Tax Act (the "**ITA**"). This allows the taxable capital gain that arises on the deemed disposition of assets held inside a Life Interest Trust to be taxed inside the Life Interest Trust.

I have the following comments on the election proposed in subparagraph 104(13.4) (b.1)(iii).

1. The election has to be made on an all or nothing basis. Either all the income of the Life Interest Trust is taxed as income of the estate or none of that income is taxed as income of the estate.

    (a) I suggest that parties to the election be allowed to select the amount of trust income that will be taxed as income of the estate. This would increase the flexibility of the joint election and allow the Life Interest Trust to take advantage of any graduated rate room that has not been fully used up in the terminal return of the deceased.

    (b) It would be even better if the Life Interest Trust remained primarily liable for tax on the elected amount, so that the election resulted in the graduated rate room that is not used in the terminal return of the deceased being transferred to the return of the Life Interest Trust. This may require additional the insertion of additional administrative measures, however, and would require substantial redrafting (including changes to paragraph (b) of subsection 104(13.4). I suggest this as a longer-term project.

(c) If the election were restructured as set out above, the election mechanism could be extended so that it could be used in respect of taxpayers who die after 2016.

2. If the joint election is made, the estate will be primarily liable to pay tax on the taxable capital gain generated by assets held inside the Life Interest Trust. As a result, the election will be made only if there is some arrangement between the estate and the Life Interest Trust for the payment of that tax. If the joint election is made and the estate takes on the tax liability, one would expect that the Life Interest Trust would provide the estate with the funds to pay the tax on the elected income. However, if the Life Interest Trust pays the tax bill, it could be seen as a contribution by the Life Interest Trust to the estate and could result in the estate ceasing to qualify as a testamentary trust and a graduated rate estate.

(a) Loss of graduated rate estate status has numerous consequences for the estate. Among other things, the estate would lose access to the more flexible charitable donation tax credit allocation rules.

(b) In order to allow an estate to safely make the election with a trust, I suggest that a provision be inserted providing that any payment

(i) made by the Life Interest Trust to the estate to pay taxes owing in respect of the terminal return of the deceased; or

(ii) made by the Life Interest Trust directly to the CRA to pay taxes owing in respect of the terminal return of the deceased;

will be deemed not to be a contribution to the estate if the payment can reasonably be considered to relate to the payment of an amount owed as a result of the joint election. This deeming rule would apply for purposes of the testamentary trust definition.

(c) If the election is modified as set out in comment 1(b) above, so that the tax liability remains with the Life Interest Trust and the Life Interest Trust is able to use the graduated rate room that has not been used by the estate, the deeming provision suggested in comment 2(b) above would no longer be necessary.

Charitable and Other Donations Made by a Life Interest Trust

As of the start of 2016, a Life Interest Trust has a deemed taxation year end at the end of the day on which the relevant individual (the "**Deemed Disposition Individual**") dies. The

Deemed Disposition Individual is the individual who created the alter-ego trust or the surviving spouse in the case of a joint spousal trust or a testamentary spousal trust.

The draft legislation provides the trustee of a Life Interest Trust with at least 90 days to make a charitable or other donation in order to claim the donation tax credit against the tax generated by the deemed disposition. I support this change in approach, as it allows the donation tax credit to be used against the deemed disposition tax.

The 90-day period of time is measured from the end of the calendar year in which the death occurs. If the Deemed Disposition Individual dies on January 1 of a calendar year, the trustee has the rest of that calendar year plus 90 days in the following calendar year (455 days in total). If the Deemed Disposition Individual dies on December 31, however, the trustee has only 90 days.

In my view, the 90-day period is too short. Any number of reasons might prevent the trustee from making the donation within that 90-day period.

1. While a Life Interest Trust does not require probate, a dispute could still arise in respect of the assets located inside the trust.

    (a) In my experience, an *inter vivos* Life Interest Trust is often established out of a concern that a "black sheep" child might challenge the way in which the deceased deals with assets.

        (i) In British Columbia, each child has a statutory right to challenge a will under wills variation legislation on the basis that the child did not receive a "fair" distribution of the estate.

        (ii) While an *inter vivos* trust is not subject to wills variation legislation, a child could attempt to characterize the trust as a testamentary instrument that depends on death for its vigor and effect. For example, the Deemed Disposition Individual might have established an alter-ego trust and might have been the sole trustee of the alter-ego trust until the Deemed Disposition Individual's death. In that case, a disappointed child of the Deemed Disposition Individual might argue that the alter-ego trust was really a disguised form of will because the individual (as sole trustee) had full control over the assets until the date of death. This would make it impossible for the successor trustee to make charitable donations within 90 days of the end of the calendar year in which the Deemed Disposition Individual died.

    (b) If the Deemed Disposition Individual was one of several trustees, there could be a dispute as to the identity of his or her successor.

    (c) As noted below, a Life Interest Trust can claim a donation tax credit only if the donation is made pursuant to a discretionary power to make donations. A beneficiary could challenge the trustee's exercise of that discretionary power as having been made for an improper purpose (known as a "fraud on the power" in trust jargon).

2. The assets of the Life Interest Trust might not be liquid and easily converted to cash. For example, the trust might hold real estate. In order to fund the charitable donation, the trustee might have to sell the real estate. Depending on the condition of the real estate market and the general economic climate, it may well take more than 90 days before the real estate sale can be completed. Generally, it takes 30 days to close a transaction after the agreement of purchase and sale is signed. This effectively gives the trustee only 60 days to actually find a buyer.

3. The assets of the Life Interest Trust might be hard to value and the donation power might depend on the overall value of the assets at the date of death of the relevant individual. For example, the trustee might have a power to donate up to 30% of the value of the trust as of the date of death, with the balance of the assets after any such donation to be distributed among specific beneficiaries. The creator of the trust might have left a letter of wishes that the trustee would like to honour. In order to determine the value of 30% of the estate, however, the trustee might need to value or sell some assets (such as real estate or shares of a private corporation).

I presume that the 90-day extension was chosen primarily because that is the deadline for the trustee to file the tax return for the taxation year that ends on the date of the relevant death. As indicated above, however, delays can arise in the administration of an *inter vivos* trust. Accordingly, I suggest that the trustee be given more time so that the trustee can arrange the affairs of the trust following the death of the relevant individual.

Given that a Life Interest Trust is an alternative to a will, the death of the relevant individual is akin to the death of an individual who chooses to leave assets under a will. As a result, the rules applicable to the deemed disposition death in a Life Interest Trust situation should largely parallel the rules that apply in the case of a deceased who leaves assets by will. I suggest that the trustee be given to the end of the fifth taxation year that ends after the calendar year in which death occurs. This would provide the trustee with at least five clear years (even if death occurred on December 31).

If the donation were made after the filing of the trust income tax return for the year ending on death, the trustee would have to file an amended T3 return but that is not dissimilar from an executor of a graduated rate estate who makes a charitable donation in year 3 of the graduated rate estate.

Another Thought on Gifts Made by Life Interest Trusts

I have previously discussed with Grant Nash the problem that arises whenever an individual establishes a Life Interest Trust and wishes to provide for the making of charitable and other donations on the death of the Deemed Disposition Individual.

If the trust document *requires* that the trustee transfer property to the charity on the death of the Deemed Disposition Individual, the transfer of the property does not qualify as a gift. As a matter of law, the transfer is made pursuant to a legal requirement set out in the trust document. Any such gift would have been made at the time of establishment of the trust. That gift would consist of the beneficial interest granted to the charity. In many cases, it is impossible to quantify the value of that gift because the trust document allows for the trustee to encroach on trust capital for the benefit of the alter-ego individual or the spouses or the surviving spouse (as the case may be). At the time that such a trust is established, therefore, it is impossible to know whether the charity will in fact receive any amount.

It is possible for an individual to claim a charitable donation tax credit on the establishment of a charitable remainder trust. In this case, it must be fairly certain that the charity will receive the donation. There must be no power to encroach on capital and the investments must be investments that have security of capital. If that is the case, the individual who creates the trust and transfers assets to the trust can usually claim a discounted amount as a donation. The discount will depend on the life expectancy of the individual.

As a long term project, I suggest that the Department of Finance look at allowing a charitable donation tax credit for property that a trustee must transfer to a charity provided that no donation tax credit was previously claimed by any person in respect of the beneficial interest held by the charity in the trust.

This would require that the Canada Revenue Agency be able to track trusts to ensure that the trust had not been treated as a charitable remainder trust in respect of any previous taxpayer. Given that a trust can now obtain a Tax Identification Number ("**TIN**") prior to filing its initial income tax return, it would be possible to do that tracking by requiring that any person claiming a donation tax credit in respect of a charitable remainder trust provide the TIN of the trust when claiming the donation. The Canada Revenue Agency would then have to note on the file of that specific trust that a donation tax credit had been claimed on the establishment of the trust and that no charitable donation tax credit could be claimed in respect of any amount that is required to be paid to a charity pursuant to the trust document.

Of course, a charitable donation tax credit would still be available to the trustee if the trustee exercised a discretionary power to make a donation.

Currently, anyone who wishes to make a charitable donation through a Life Interest Trust supplies the trustee with a letter of wishes and relies on the trustee's sense of honour in respect of those wishes. Some potential donors who are considering Life Interest Trusts are dismayed by their inability to require that the donation be made. The above change would provide some peace of mind to those donors.

Thank you for considering my comments and for responding to the various points raised by tax professionals concerning the problems that stemmed from the original draft legislation.

If you have any questions, please contact me at (250) 360-2110.

Yours very truly,

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