Deloitte LLP
Brookfield Place
181 Bay Street, Suite 1400
Toronto, Ontario M5J 2V1
Canada

Tel.: 416-643-8753
Fax: 416-601-6703
www.deloitte.ca

December 2, 2013

Tax Legislation Division
Department of Finance Canada
140 O'Connor Street
Ottawa, Ontario K1A 0G5

Subject: Deloitte's comments on eliminating graduated rate taxation of trusts and certain estates

Dear Sir or Madam,

The purpose of this submission is to provide you with our comments on the measures proposed to eliminate graduated rate taxation of trusts and certain estates.

Trusts have always been somewhat of a challenge for the Department of Finance in terms of finding the most appropriate, fair and neutral way to subject their income to the Canadian tax system. The issue was addressed in the 1966 report of the Royal Commission on Taxation, which recognized the importance of finding a fair way to tax the income realized by a trust without imposing a heavier than necessary burden on their beneficiaries.

We wish to make certain comments concerning the latest issue raised by the Department of Finance, that of testamentary trusts.

GENERAL COMMENTS

Eliminating graduated rate taxation

The Department of Finance proposes measures to amend the tax rules to apply flat top rate taxation to grandfathered *inter vivos* trusts and testamentary trusts, as well as to estates after a 36-month period following an individual's death.

Although it may seem unfair at first to grant testamentary trusts the benefit of graduated tax rates applicable to individuals, we believe that subjecting them to a flat rate appears unfair in several circumstances (family, business or legal situations) as this would increase the tax burden on stakeholders (the trust and its beneficiaries).

Before proposing our solutions to address the concerns of the Department of Finance, we believe it is essential to recall the primary reasons for using trusts in the context of will and estate planning.

Benefits gained from a trust

The main benefit gained from using a trust in will and estate planning is to allow persons to extend control and management of their bequeathed estate after death while protecting the estate against third parties.

Unlike a direct bequest, a bequest in trust allows an individual (the testator) to appoint a person (the trustee) to control and manage their bequeathed estate and carry out their wishes, while looking after the interests of the beneficiaries. A bequest in trust can be used to:

- bequeath a single estate to more than one person to meet the needs determined by the testator or his/her appointed trustees, for the benefit of the trust's beneficiaries; by leaving instructions in a will or allowing trustees to exercise discretion, the testator provides a trust with latitude to adapt to the beneficiaries' economic and personal circumstances, as these cannot be foreseen by the testator when drawing up a will;
- appoint suitable persons—not necessarily the beneficiaries—to exercise control and management of the bequeathed property;
- ensure control and management of the bequeathed estate for the purpose of generating growth in assets while looking after the interests of the beneficiaries;
- allow the beneficiaries to benefit from the fruits and income of the bequeathed estate and a share or all of its property while ensuring that, upon the death of the beneficiaries, the remainder of the estate be distributed to persons chosen by the testator, not by the beneficiaries;
- protect the estate against third parties, e.g., following the insolvency of the testator's heirs;
- allow the estate to grow to its optimal value over a given period;
- ensure equal representation for certain estate assets (e.g., equal voting rights for public company shares); and
- plan for a specific, long-term allocation of funds based on events or beneficiaries unknown at the inception of the trust (e.g., a dedicated fund such as that of the Nobel Foundation).

A trust can be created for one or several persons taking into account various factors, including age of beneficiaries, testator's chosen family unit (e.g., the testator's direct child and his/her own children, or the direct child alone), the testator's basic values or personal family situation (e.g., blended family, children from two or more unions, dependent grandchildren, physically or mentally disabled person, vulnerable person or person with a gambling, alcohol or drug dependence, etc.).

Depending on the testator's wishes, trustees generally have a certain latitude to look after the well-being and interests of the testator's heirs on his/her behalf and according to life's unpredictable events.

Trustees may also be mandated to increase or safeguard the bequeathed estate, an equally commendable objective. We believe that Canada needs the capability of its wealthiest families to invest in and support our country's businesses and economy.

In sum, trusts extend the ability of deceased persons to protect and safeguard their bequeathed estates and beneficiaries.

COMMON WILL AND ESTATE PLANNING SITUATIONS

To better illustrate these objectives, we propose to examine some commonly occurring will and estate planning examples.

1. Use of a trust for minor children

Testimentary trusts are often used by testators who are considering leaving all or part of their estate to their minor children. In such instances, it is often not advisable to create a trust for each child since, as would be the case during their lifetime, testators usually want their property to benefit each minor child according to his/her respective needs, which may differ and require varying levels of financial support. Moreover, when a testator's estate is relatively small, generally only a single trust will be created to ensure the bequeathed estate is sufficient to address major issues or needs specific to each child. A single family trust is less frequent in the case of wealthier testators.

The following is a typical example:

a) a divorced father has a $1 million estate;
b) he has three children, aged 2, 5 and 7;
c) at his death, he wants his estate to benefit his children so as to ensure that they have access to suitable education and that their different needs are met;
d) his ex-wife, the children's mother, cannot be trusted and is unable to manage the estate.

Given the children's age, the father cannot possibly foresee what type of education or activities each child would choose to pursue, and whether an illness or accident might generate greater costs or needs for one child than for another.

Furthermore, his estate is not large enough to be divided into three equal parts, ensuring that the specific needs of each child are met.

It is too early, given the children's ages, to determine if one or the other might develop a gambling, drug or other dependence at the time the capital is distributed.

Finally, the father is concerned about the potential consequences of a capital distribution to his children once they reach 18 years of age, particularly on their motivation to pursue their studies.

Consequently, the father wishes to bequeath all of his property to a discretionary family trust so that the trustees can administer it and make sure that it meets his children's future needs. He also wishes that the remainder of the trust be distributed equally to his children when the youngest will have reached 25 years of age, except if the trustees have good reasons to postpone the distribution, such as a beneficiary's insolvency or gambling or alcohol dependence.

2. Use of a personal trust per child

With wealthier families, estates can be divided at death by the number of children without compromising the well-being of each individual child. With wealthier families, we note that:

- the creation of a personal trust per child is more frequent;
- the trusts have longer time horizons.

The following are the main reasons for creating a personal trust per child and extending their time horizons:

- fairness among children: each trust will be depleted or grow according to the specific needs of the child beneficiary;
- facilitated management and decision-making regarding the trust's property according to the concerns of the beneficiary: even though trustees act independently of the beneficiary, their main duty is to look after the interests of the beneficiary and their decisions would take into account the beneficiary's wishes as long as they do not go against the directives received from the testator and the interest of the beneficiary;
- extended control over the bequeathed estate: generally speaking, it is not advisable to let an 18-year-old (or 25-year-old for that matter) self-manage an estate worth several million dollars;
- sustainability of the bequeathed estate for future generations: such sustainability could be ensured by limiting, for example, access to the beneficiary's capital; and
- ultimate transfer of the estate to a dedicated fund or charity once the estate has ensured the well-being of the testator's family.

In such situations, the testator will often bequeath the remainder of his/her estate in equal shares to as many trusts as there are children. The trustees, as per the testator's directives, will ensure management of each trust's assets in the interest of the child beneficiary according to the objectives and values specified by the testator. The trust's capital will then be remitted to the child at an age determined by the testator or retained for future generations of beneficiaries following the child's death.

Under the proposals of the Department of Finance, the income from these two types of trusts that would not have been distributed or made payable during the year would be subject to flat top-rate taxation. Moreover, in the first example, it is more than likely that the income generated by the capital would have been taxed at a lesser rate if the estate had been bequeathed in equal parts directly to the children. This comment could also apply to the second type of trust considered above if the age of the beneficiaries and their income from sources other than the trust were taken into account.

3. Use of a spousal trust

Most testators with spouses want their will to benefit their spouses by bequeathing them a large share, if not all, of their estate on death. However, depending on a spouse's age, health, vulnerable condition or limited ability to manage the bequeathed property, a testator may want to ensure that his/her estate is managed by persons more qualified than his/her spouse. Furthermore, the testator's family situation (e.g., a second union) will often be such that the testator will want to ensure that the remainder of the bequeathed estate be transferred, on the spouse's death, to persons designated by the testator, not by the spouse.

A spousal trust is the only tool that allows testators to meet those objectives. Subjecting this type of trust to flat top-rate taxation will have less of an impact on the income generated by the trust as it must be paid or made payable in full to the spouse each year. However, flat top-rate taxation could have more significant consequences on taxable income such as taxable capital gains and stock dividends, which qualify as capital for civil purposes. In fact, capital gains realized by the trust are not necessarily required to be paid to the spouse. They would therefore be automatically subject to flat top-rate taxation unless they were paid to the spouse before the end of the year. The same would apply to a deemed disposition on the spouse's death.

ANALYZING THE PROPOSED MEASURES

Under the proposed measures, the income realized by a testamentary trust, or estate beyond the first 36 months of its administration, would be subject to the top rate applicable to non-testamentary trusts.

Although we understand the concerns of the Department of Finance regarding the proliferation of testamentary trusts used solely for tax purposes in certain situations, we believe that the proposed measures could prove to be unfair by increasing the tax burden in cases where beneficiaries are not taxed at the highest marginal rate. We also believe that there are other more suitable solutions.

In its present form, subsection 104(18) of the *Income Tax Act* (the Act) does not allow a trust for minors, created under conditions presented in our first example, to subject minor beneficiaries to the income generated by this type of trust and to benefit from their graduated rates primarily for two reasons:

- allocating income to a beneficiary is left to the discretion of the trustee both in terms of timing and amount;
- allocating the capital to a beneficiary may be postponed by the trustees.

Subsection 104(18) of the Act does not take into account the fact that the objective of the testator is not only for the trustee to retain control and management of the estate until the beneficiary reaches 21 years of age, but also to retain the ability to use more income for one child than for another depending on the specific needs of each, as would have been the case during the testator's lifetime. Subsection 104(18) of the Act removes any discretion and requires testators to give vested rights to their children.

Under the proposed measures, the income that would not have been paid or made payable to one of the children in our example would be subject to flat top-rate taxation. However, we do not believe that the current situation creates inappropriate results. The trust in this case is only the extension of the deceased person and its sole objective is to better control the management of his estate for the benefit of his children, as well as to choose the person who will ensure its management. Under the proposal of the Department of Finance, the testator would have to choose between:

- ensuring the management and control of the bequeathed estate for the benefit of all his children with the unused income be subject to the top marginal rate, thereby increasing the tax burden, or making the income payable to minor children whose guardian could require the payment without necessity; or
- bequeathing in full property the estate to his children and assigning management to a guardian, in which case:
    - in the above example, the guardian (who is automatically the parent) would not have the suitable qualifications to manage the estate;
    - on reaching the majority age, the children could access the bequeathed assets. Clearly, an 18-year-old might not be sufficiently mature to make proper use of an amount of approximately $350,000;
    - it would not be possible to ensure through common management of the estate that the well-being of all children has been satisfied by giving priority to their individual needs.

In our view, this type of trust should not be subject to a flat top marginal tax rate. There is no proliferation of testamentary trusts and no abuse of the tax system in such cases. The trust is simply an extension of a deceased parent over a given period. In our opinion, it would be unfortunate to have to adopt measures that increase the tax burden and limit alternatives.

Personal trust for heir(s)

Even though we believe that using trusts for larger estates is practical and necessary, we also understand the concern of the Department of Finance regarding the increasing number of taxpayers in such situations who are benefiting from graduated tax rates.

However, we believe that the Department of Finance's decision to subject testamentary trusts to flat top-rate taxation could be partly offset by allowing the income and capital gains to be allocated to the beneficiaries of a trust by using a measure similar to the preferred beneficiary election.

In fact, increasing the combined tax burden of the beneficiaries and the trust leads us to conclude that it would be unfair to subject the trust's income to flat top-rate taxation and thus require testators or trustees to choose between paying more tax or ceding control over the income to beneficiaries who they do not deem to be qualified administrators, either because they are minors or because they do not have the requisite management skills.

Spousal trusts

In the case of spousal trusts, we believe that the primary difficulty is not due to the trusts' graduated rates, since spouses must be entitled to all of the trust's income during their lifetime. In fact, this income is automatically included in computing the spouse's—not the trust's—income. In our view, the main issue has much more to do with applying subsection 104(13.1) of the Act to a share of the income when the main reason for the election provided in that subsection is not to use the trust's available losses against previous years. In that sense, using flat top-rate taxation for this type of trust and its income seems appropriate.

However, concerning the trust's capital, we believe that the proposed solution noted above should be considered, i.e., allowing income of a capital nature to be allocated to beneficiaries under the trust by using an election similar to that of the preferred beneficiary election. It should be noted that with this type of trust, the spouse is often only entitled to the capital through the capital encroachment powers granted to the trustees. The beneficiary of the capital of the trust is often one or several different persons.

Deemed disposition

Currently, testamentary trusts are generally subject to a deemed disposition of their property on two occasions:

- on the death of the spouse;
- every 21 years, as a result of the deemed disposition rule.

By subjecting the trust to the top marginal tax rate, its tax burden will be greater than in the case of a direct bequest. Tax rules only provide for the deemed disposition of an individual's property at the time of death whereas the trust will be deemed to have disposed its property every 21 years.

We believe that it is unfair to subject income attributable to a deemed disposition to flat top-rate taxation, especially in the case of a spousal trust or an estate whose administration extends beyond 36 months. In such cases, only spouses who die during the 36 months following the death of the testator, where the bequeathed estate was not transferred to another spousal trust during that time, or spouses who inherited property directly, could benefit from graduated tax rates.

Here again, in our view, an allocation similar to the one described above in favour of the deceased spouse in this situation could help avoid significant inequity between the situation where the spouse has received the bequeathed property directly and that where the spouse inherited indirectly through a trust.

OUR PROPOSAL – A MEASURE SIMILAR TO THE PREFERRED BENEFICIARY ELECTION

Insofar as the primary concern of the Department of Finance is the increasing number of taxpayers benefiting from graduated tax rates, we believe that implementing a measure similar to the preferred beneficiary election combined with the application of flat top-rate taxation would address the Department's concern, while providing testators with the opportunity to protect their bequeathed property and their heirs in accordance with their values and personal family situations.

Trustees could choose to allocate the trust's income to its income beneficiaries, and their income would thus be subject to taxation according to their own tax rates as if they had actually received the income. That would eliminate potential tax inequity through the proliferation of testamentary trusts. The trusts could be subject to flat top-rate taxation without unduly penalizing beneficiaries with far lower marginal tax rates simply because they do not have the qualifications required to manage the bequeathed estate (because of age, maturity, skill, etc.).

Income from the trust would thus be subject to taxation at the beneficiary level in three ways:

- by paying or making payable the income before the end of the year, as provided in subsection 104(24) of the Act;
- by granting vested rights to the beneficiaries, as provided in subsection 104(18) of the Act; or
- by allowing trustees to allocate the trust's income among its income beneficiaries without granting them irrevocable vested rights.

In order to avoid abuse, we believe that the last option should not leave any discretion to trustees as to the sharing of income among income beneficiaries. The income should be allocated in equal shares among the income beneficiaries under fully discretionary trusts, or based on the percentage interest of income beneficiaries if the discretion only applies when income is paid or distributed to the beneficiary.

We believe that the same solution could be considered for the trust's capital (capital gains, stock dividends, etc.). However, owing to the power of encroachment granted at times to trustees in favour of persons other than the actual capital beneficiaries, we suggest that allocations be limited to capital beneficiaries and that those who simply benefit from a power of encroachment in their favour be subject to taxation only on the capital paid to them in accordance with subsection 104(24) of the Act.

Needless to say, the ultimate recipient of the income still might not be the person subject to the applicable tax. However, by removing any discretion as to the allocation of income among beneficiaries, we believe that this will in some cases benefit taxpayers, and in others, the government. In the context of testamentary trusts, ultimately, a trust's income and capital will generally be shared among—and actually distributed to—the members of the testator's family. As well, such distributions will generally be shared equally. Testators only wish to be able to delay distributions until circumstances or conditions are more suitable.

Furthermore, insofar that the Department of Finance is concerned about certain testators adding beneficiaries to these trusts to whom they never intended to leave part of their estate in order to benefit from their specific tax rates, we believe that doing so might expose the testators and heirs to certain risks. Indeed, the law pertaining to trusts generally requires trustees to act in the interest of beneficiaries, even in the context of a discretionary trust. Certain beneficiaries could therefore attempt to challenge trustees' decisions in such circumstances if they believe they have been prejudiced. It could be reckless for a testator to use such a scheme and expose the trust or its trustees to claims—whether warranted or not—by beneficiaries whom the testator did not wish to favour. Moreover, to counter such attempts, it would always be possible to add an anti-avoidance rule relating to the notion of beneficial interests in the trust to discourage those who would consider taking such action.

RELATED TAX RULES AND CHANGES TO THE GRADUATED RATES

Part XII.2 tax and graduated rates

We submit to the Department of Finance that the measures related to the taxation rates of testamentary trusts as well as part XII.2 tax should be grandfathered for existing estates and trusts and apply solely for deaths occuring after 2015 in order to allow the taxpayers who could be affected by these proposals to properly modify their wills.

In our opinion, it would be unfair for trusts and estates that cannot be modified, i.e., those of deceased testators, to be subject to these new rules.

We would be pleased to meet with you to discuss these issues. Feel free to contact the undersigned if you have any questions or if you want to schedule a meeting.

Yours truly,

Deloitte LLP

Albert Baker, FCA
National Tax Policy Leader

Diane Bastien
Partner
Tax
Private Company Services