The graduated rate estate

Since 2016, existing and future testamentary trusts are generally subject to the flat top-rate taxation applicable to individuals. Exceptions to this general rule are available for graduated rate estates (GREs) and qualified disability trusts[i]. In addition, many other key tax benefits are available to GREs but not to non-GRE testamentary trusts. This article gives an overview of the GRE concept, including why the GRE rules were introduced, what a GRE is and what changes it has brought to the planning landscape.

Background

Before the introduction of the GRE concept, accountants and lawyers used planning strategies to take advantage of the graduated tax rates available to testamentary trusts. A popular technique involved structuring a client's Will so that a testamentary trust is set up for each heir instead of gifting assets to them directly – effectively multiplying the sets of graduated tax rates available to the family. Another example: trustees delay distributing the assets of an estate to prolong the family's access to graduated tax rates. The federal government introduced amendments to the *Income Tax Act* in the 2013 federal budget in response to these perceived abusive planning techniques.

What is a GRE?

A GRE is defined in the *Income Tax Act* (Canada) (the "ITA") to be an estate (succession in Quebec) that arose on and as a consequence of the individual's death if the following conditions are met:

1. The estate is a "testamentary trust," meaning all contributions must have been made as a consequence of the individual's death.
2. The estate designates itself as the GRE of the individual in its tax return for its first taxation year that ends after 2015.
3. No more than 36 months have passed since the date of death.
4. No other estate of the individual designates itself as a GRE (this is clarified below).
5. The deceased's social insurance number is provided in the estate's tax return.

Estates in existence as of Jan. 1, 2016, may qualify as GREs if all above conditions are met.

Benefits of GRE status

An estate (succession in Quebec) must be designated a GRE to access the following tax benefits that will no longer be afforded to non-GRE testamentary trusts:

1. Graduated tax rates

As noted, a GRE can access the graduated tax rates applicable to individuals, which may result in significant tax savings. Non-GRE testamentary trusts will be taxable at the top combined federal and provincial tax rates for an individual, which in many provinces is approximately 50%.

2. Post-mortem planning options for business owners

GREs may use subsection 164(6) of the ITA to minimize double-tax exposure arising upon the death of a shareholder. The double-tax exposure generally stems from the capital gain realized in the deceased's terminal return and the taxable dividend the estate receives when the corporation liquidates assets to distribute to the deceased's heirs. Subsection 164(6) allows for a post-mortem planning technique that triggers a loss in the estate, which can be carried back to offset a gain in the deceased's terminal return. This results in the estate, rather than the deceased, having a tax liability.

This type of loss carryback planning using subsection 164(6) will only be available to GREs, not to other testamentary trusts. Stop-loss rules apply to this type of planning in select situations where the dividend received by the estate is a capital dividend. As a result, where the deceased held private company shares and post-mortem loss carryback planning is desirable, it will be necessary to ensure the estate qualifies as a GRE.

3. Flexibility with allocating donation tax credits

Since 2016 a gift by Will or by beneficiary designation under a life insurance policy is deemed to be made by the deceased's estate (not by the deceased taxpayer) at the time that the gift is transferred to a registered charity. The estate must be designated as a GRE to be able to allocate the donation tax credit (DTC) to the deceased's final taxation year and preceding year. As a result, an estate's GRE status will give it the flexibility to allocate the DTC to:

- The last two taxation years of the deceased individual
- The year of the donation or any of the following five years of the estate; or
- Any preceding year of the GRE

As noted, an estate may qualify as a GRE up to 36 months after death. However, there's a relieving provision for gifts made by the estate to a qualified charity after this period. This flexibility for allocating a DTC also applies to a gift made by an estate after the 36-month period, but within 60 months after the date of death, where the estate was a GRE and continues to meet all of the requirements of a GRE except for the 36-month time limit.

4. Alternative minimum tax

Only GREs are entitled to a basic $40,000 exemption from alternative minimum tax. Other testamentary trusts will not have this exemption.

Other benefits

GREs generally have the ability to use non-calendar taxation years; be entitled to refunds beyond the normal reassessment period; be exempt from remitting quarterly tax installments and have an extended period for filing a notice of objection to a tax assessment. Other testamentary trusts don't have these benefits.

Planning concerns and considerations with GREs

1. More than one estate?

When the GRE concept was introduced in 2016, the tax planning community was concerned that someone could have two estates if, for example, multiple wills were used for probate planning and the estate trustees under each will were different people. If there were two estates and only one GRE, then problems could arise where, for example, one estate wanted to make a charitable donation to reduce the deceased's tax liability while the other estate wanted to do a subsection 164(6) loss carryback. Fortunately, this issue was addressed favourably by the CRA when they confirmed, for the purposes of the GRE, that "an individual's estate encompasses all of the worldwide property owned by the individual at death" – meaning a person only has one estate[ii]. As a practical matter going forward, executors under multiple will situations must coordinate the filing of the estate's tax return to obtain (and avoid losing) GRE status.

2. No grandfathering of existing testamentary trusts

   These changes applied to testamentary trusts existing before 2016. Existing testamentary trusts that did not qualify as GREs would have a deemed year end on Dec. 31, 2015.

3. Life insurance trusts

   A life insurance trust is a trust that is settled upon the receipt of life insurance proceeds. It may be created by a will or through a standalone document (in either case, legal advice should be sought in providing for the trust). Life insurance trusts are not estates (succession on Quebec) and therefore may not be designated as a GRE. As a result, a life insurance trusts will be subject to flat top-rate taxation[iii].

4. Ongoing use of testamentary trusts

   Many clients will see the benefit of using testamentary trusts for non-tax purposes, which include protecting minor beneficiaries and/or spendthrift beneficiaries. In these cases, the testamentary trust's income doesn't necessarily need to be subject to top-rate tax if it can be paid to discretionary beneficiaries who are subject to tax at lower marginal rates.

Since 2016, the GRE concept has occupied a central role in estate planning. Qualifying as a GRE not only provides an estate access to graduated tax rates, but also allows an estate to take advantage of other important tax benefits – such as flexibility regarding the use of donation credits and the ability of shareholders to implement postmortem tax planning strategies.

---

[i] A qualified disability trust (QDT) must be a testamentary trust and must jointly elect with a beneficiary who qualifies for the disability tax credit. A QDT continues to benefit from graduated tax rates for the life of the disabled beneficiary.

[ii] Question 2 of Questions and Answers from STEP Canada's 17th National Conference, held June 18-19, 2015, in Toronto, Canada.

[iii] A life insurance trust may be subject to graduated tax rates if it's a qualified disability trust.