Wealth Management

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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

Aaron Fennell, MBA, CFA
Portfolio Manager & Investment Advisor
Tel: 416-313-6397
aaron.fennell@rbc.com

RBC Dominion Securities
181 Bay Street, Suite 2350
Toronto, ON M5J 2T3
www.aaronwfennell.com

The effect of the proposed increase to the capital gains inclusion rate on trusts

Canada's recently unveiled 2024 federal budget (the budget) proposes to increase the capital gains inclusion rate from 50% to 66.67% for capital gains realized by an individual that are above $250,000 and for all capital gains realized by a trust or a corporation. This article focuses on the impacts this change may have on trusts and outlines some planning considerations.

For a more robust discussion of the extensive impacts of these proposed changes on individuals, corporations, estates, trusts and more, please ask your RBC advisor for the comprehensive article titled "2024 Federal Budget – Planning for the proposed increase to the capital gains inclusion rate."

While the budget document provided a general outline of the changes to the capital gains inclusion rate, there are still many unanswered questions given there was no accompanying draft tax legislation. The government stated that additional design details will be released in the coming months. As of the date of writing, Quebec is the only province or territory that has announced its intention to harmonize with the federal increase.

Taxation of capital gains earned in a trust

A trust is a separate taxpayer and may be required to file an annual tax return, known as a T3 return, in certain circumstances. The taxation of capital gains earned by a trust will depend on how the trust is structured, the terms of the trust and the actions taken by the trustees. In general, if a trust is properly structured (so that the super attribution rules, discussed later, do not apply), any capital gains earned by a trust that have not been paid or made payable to a beneficiary of the trust, are taxed in the trust. Currently, only 50% of the gain realized by the trust would be taxable to the trust. Based on the government's proposed change, if a capital gain is realized by a trust on or after June 25, 2024, and is taxed in the trust, it will be subject to an inclusion rate of 66.67%. There's no $250,000 threshold as there is in the case of an individual. The budget did not exclude any specific type of trust, such as a graduated rate estate, life interest trust or qualified disability trust, from the 66.67% inclusion rate.

Generally, income earned and taxed in the trust is subject to tax at the highest marginal tax rate in the trust's province of residence. The proposed higher inclusion rate on capital gains would effectively increase the average federal-provincial marginal tax rate on capital gains at the top marginal tax rate from 25.3% to 33.8%.

Taxation of capital gains earned in a trust where the super attribution rules apply

If a person who transfers property to the trust (e.g. the settlor or the contributor to the trust) retains control over the trust property or the trust property can revert back to them, subsection 75(2) of the Income Tax Act (the super attribution rules) will apply to this trust. Where the super attribution rules apply to the trust, capital gains/losses earned in the trust are attributed back to the settlor or contributor and taxed in their hands at their marginal tax rate. Since the capital gains are not taxed in the trust, but in the settlor's or contributor's hands, it may be possible for the settlor/contributor to use their 50% inclusion rate for the first $250,000 of capital gains. Draft legislation is needed to confirm this tax treatment.

Taxation of capital gains earned in a properly structured trust that are paid or made payable to a beneficiary

As mentioned, when a properly structured trust (e.g. one that's not subject to the super attribution rules) earns a capital gain, the taxable portion of the gain would be included in the trust's income. If the trust pays or makes this capital gain payable to a beneficiary of the trust, it can claim an offsetting deduction, so it's not taxed in the trust. The capital gain would then be taxed in the beneficiary's hands. A beneficiary of the trust who earns a capital gain may be able to benefit from the 50% inclusion rate to the extent their total gains for the year do not exceed $250,000.

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When considering the proposed change to the inclusion rate, trustees will want to consider whether a capital gain realized by the trust can and should be allocated to a beneficiary of the trust to potentially benefit from the lower inclusion rate. The trustee would need to review the terms of the trust document to determine whether the trust allows for such an allocation to a beneficiary. They would also want to consider whether making such an allocation is in line with the objectives and purpose of the trust. Distributing more income than necessary to the beneficiaries may not be what the settlor of the trust intended.

There are still questions, however, that remain unanswered at this time. For example, if the trust realizes a capital gain prior to June 25, 2024, but is only allocated to the beneficiary on or after June 25, 2024, at what inclusion rate will these gains be included in the beneficiary's income? As well, the Canada Revenue Agency (CRA) has previously commented that only the taxable portion of the trust's capital gain realized in a year that has been allocated to a beneficiary needs to be paid or made payable to the beneficiary, and not the non-taxable portion. Would the trust owe the beneficiary 66.67% of the capital gain, even if the beneficiary's inclusion rate is 50%?

The effect on an alter ego trust (AET) and joint partner trust (JPT)

An AET or JPT is a living trust that can be set up when the settlor is age 65 or over. The terms of the trust must provide that the settlor (and their spouse in the case of a JPT) are entitled to the income of the trust and no one but the settlor (or their spouse in the case of a JPT) can receive or use the income or capital of the trust during the settlor's (and their spouse's) lifetime.

It's common that the settlor (and contributor) to an AET or JPT will be a sole trustee and/or a capital beneficiary of the trust. In this situation, the super attribution rules will apply to this trust. If the super attribution rules apply to this

trust, all income/losses and capital gains/losses earned in the trust are attributed back to the settlor/contributor and taxed in their hands. The settlor/contributor may be able to use their 50% inclusion rate on the first $250,000 of capital gains attributed to them annually (assuming they have no other gains); however, draft legislation is still needed for clarification.

If the AET or JPT is not subject to the super attribution rules, the trustee may be able to, pursuant to the terms of the trust, pay or make payable the taxable capital gain to the trust beneficiary (beneficiaries) and get a deduction on the trust tax return so that the taxable capital gain is not taxed in the trust. The beneficiary may then be able to use their 50% inclusion rate for the first $250,000 of capital gains.

On the death of the AET beneficiary or the second spouse in the case of a JPT, there's a deemed disposition of the assets in the trust at fair market value, triggering the unrealized capital gains/losses. The taxable capital gains must be taxed in the trust at the highest marginal tax rate in the trust's province of residence. The capital gains are not attributed back to the settlor/contributor even if the super attribution rules applied to this trust during the beneficiary's lifetime. They also cannot be allocated to the trust beneficiary and taxed on their terminal tax return. Based on the government's proposed changes, if the beneficiary of the AET or surviving spouse of a JPT passes away on or after June 25, 2024, the capital gains realized as a result of their death, and taxed in the trust, would be subject to a 66.67% inclusion rate.

If the AET or JPT makes a charitable gift on the death of the AET beneficiary or second spouse in the case of a JPT, the trust might be able to claim a donation tax credit and use it to reduce the taxes payable on capital gains realized as a result of death. Unlike an estate, a gift of securities in kind will not eliminate the capital gains realized as a result of the trust beneficiary's death.

Trustees of an AET or a JPT should consider managing the capital gains to reduce the gains subject to higher tax on death. Trustees may also wish to consider planning for the donation of securities at death from assets held outside of the AET/JPT.

21-year deemed disposition rule

Most trusts are subject to the 21-year deemed disposition rule. This means the trust is deemed to dispose of its property at fair market value and trigger the unrealized capital gains, 21 years after the date of its creation and every 21 years thereafter. Trusts that are subject to the 21-year deemed disposition rule may be impacted by the capital gains inclusion rate increase. If the trust cannot be or is not wound up prior to its 21st anniversary, the capital

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gains realized as a result of the deemed disposition may be taxed in the trust and subject to the 66.67% inclusion rate (if the deemed disposition occurs on or after June 25, 2024).

If a trust is approaching its 21st anniversary, and they are expected to retain the property in the trust and have the trust pay the tax, then they may wish to consult a qualified tax advisor as to whether it makes sense in this case to realize the capital gains prior to June 25, 2024.

Consider alternative minimum tax (AMT)

When triggering any capital gains in a trust, it's important to consider whether this would result in AMT for the trust. For more information on AMT, ask your RBC advisor for an article on this topic.

Consider the timing for realizing capital losses

When selling securities in your trust, remember that realized capital losses will reduce capital gains realized in the same year. For tax purposes, there appears to be no benefit to proactively realizing capital losses before June 25 in order to realize losses at the 50% inclusion rate. There also appears to be no downside to waiting to realize the loss on or after June 25 at the 66.67% inclusion rate.

Conclusion

Given the budget's proposal to increase the capital gains inclusion rate, and in continuing to proactively plan for the future, it's important to discuss your trust's situation with your qualified tax and legal advisors to understand the significance of the potential impact and determine if it makes sense to take action prior to June 25, 2024.

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