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## CANADIAN TAX Highlights

### Graduated Rate Estate: Current Debt

In 2016, new federal rules will apply for graduated rate estates (GREs) without grandfathering for existing trusts or estates (Bill C-43, SC 2014, c. 39, enacted December 16, 2014). In Quebec, these new rules may result in the increased use of an established private-law vehicle—the marriage contract—to create a current debt that may maintain GRE status for certain estates.

A GRE has, *inter alia*, graduated tax rates for its first 36 months on income earned and retained in the estate; more flexible credits for donations made in the will or by the estate (for deaths after 2015); and a nil capital gains inclusion for marketable securities donated at death (for deaths after 2015). An estate may lose GRE status on the transfer or loan of assets to it (subsection 108(1)); for example, on the death of a life interest spouse (spouse B) under a spousal trust, the estate of the first spouse to die (spouse A) pays the taxes owed by spouse B's estate.

Under the old rules, those taxes were owed by spouse A's estate; the new rules make them the liability of spouse B's estate. Thus, on the day that a life interest beneficiary dies (or on the second death, for a joint partner trust), the trust has a deemed year-end at the end of that day and all income of the trust for the shortened year (including any capital gains realized on the deemed disposition arising on the death) is deemed payable in the year to the deceased life interest beneficiary. Spouse A's and spouse B's estates are solidarily (jointly and severally) liable for the resulting taxes, but spouse B's estate appears to be primarily liable and is likely to be the first assessed for the taxes (subsections 104(13.4), 160(1.4), and 160(2)). Spouse A may be tempted to insert a clause in his or her will indicating that his or her estate will assume subsection 104(13.4) taxes to the exclusion of spouse B's estate, but such a clause would apparently result in spouse B's estate losing GRE status because assets were transferred to the estate (subsection 108(1)).

If spouse A wants to have his or her estate assume the taxes without spouse B's estate losing its GRE status, that outcome apparently can be achieved if a current debt arises during the spouses' lifetimes (and not as a consequence of spouse B's estate coming into existence). The current debt will be owed by spouse A to spouse B and will oblige spouse A to pay the subsection 104(13.4) taxes. A current debt may be preferable to an encroachment on trust capital or to the trust's providing for additional distributions in favour of spouse B (exceptions are set out in subsection 108(1)) because the executor's or trustee's fiduciary duty or duty of loyalty may be questioned if he or she exercises discretion to encroach or make the additional distribution.

In Quebec, spouse A and spouse B may create a current debt to a spousal trust. The spouses probably cannot enter into a simple agreement that is not a marriage contract: there is a general prohibition against contracting in relation to a currently non-existent estate (article 631 of the Civil Code of Quebec [CCQ]). However, there is an exception whereby a Quebec marriage contract can set up *inter vivos* gifts (a gift is a contract under Quebec private law) to be performed at the end of a term—for example, upon the death of one or both of the spouses (CCQ articles 1807 and 1840). That *inter vivos* gift may, for example, be an undertaking by spouse A to spouse B to pay—to the exclusion of spouse B—taxes arising upon the termination of spouse B's life interest in any spousal trust established by spouse A.

The *inter vivos* gift in the marriage contract must be carefully drafted. Several Quebec cases deal with whether a marriage contract gift is *inter vivos* (a current debt) or *mortis causa* (a gift in contemplation of death) and generally find that the test is one of the parties' intention as determined by all facts and circumstances, including the text of the gift provisions. (See, for example, *Hennebury*, [1981] CA 136 (QCCA).)

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