CASE COMMENTS AND NOTES

NEW LEGISLATIVE CHANGES IN ESTATE TAX AND GIFT TAX

Amendments to the Estate Tax Act and the Gift Tax Act[1] which came into force this Spring have produced the most fundamental change in this area of our tax law since the introduction of the Estate Tax Act itself. These changes warrant an extensive re-evaluation of existing estate plans and their implications must be understood by all lawyers doing any estate work.

Gift Tax

In the gift tax area substantial changes have been made. Gifts which were heretofore considered exempt have been drastically changed, transactions which are deemed to be taxable gifts have been expanded and the rates of tax have been greatly increased. In addition the gift tax rates have now been integrated with the estate tax rates. Prior to these new amendments in ascertaining when a gift was made we were dealing exclusively with the common-law concept of the legal meaning of a "gift". There are now exceptions to this concept due to the fact that certain things are now deemed to be a gift irrespective of the common-law position. The gift area usually involves a family situation. With this in mind it is important to realize that our courts have held that while intention is a prerequisite to a valid gift being made where we have either a husband-wife or parent-child situation a presumption of a gift is made by the courts in appropriate circumstances. Mr. Justice Jackett, President of the Exchequer Court, in a recent case[2] adopted the reasoning of Mr. Justice Thurlow in his judgment in the well known *Conway Estate* v. *M.N.R.*[3] wherein it was stated:

> The intention to make such a gift may appear either from an expressed declaration from the contributor to that effect or from circumstances but where transfers made by a husband to his wife or by a father to his child whether jointly with himself or otherwise *a gift is presumed* until the contrary is shown.

It should be noted that the word used by Mr. Justice Thurlow is "transfer" which has an extremely wide connotation. It therefore behooves us to be very careful in any family transfer that results will not inadvertently give rise to a gift through these presumptions. We have several instances of this presumption resulting in a gift in the use of joint property, which is very common particularly between husbands and wives. Another common area which gives rise to this presumption is the use of joint bank accounts. In this area it is my strong opinion that fathers should not under any circumstances open joint bank accounts with their children. I have seen this done in many instances, particularly in the situation where the child is leaving home for some purpose such as attending a university. It is convenient but very dangerous.

1 S.C. 1968, c. 33.
2 *Edwin Goeglein* v. *M.N.R.*, (1968) 68 D.T.C. 5271.
3 (1965) 65 D.T.C. 5169 at 5172.

The former exemption from gift tax of gifts not exceeding the greater of $4,000 or 1/2 the previous year's taxable income less the federal tax thereon, as well as the exemption of gifts to an individual when the gifts did not exceed $1,000, have been repealed. The new exemption entitles the taxpayer to deduct the first $2,000 of the value of gifts made in the year to an individual. Gifts made by a person to his spouse will not be considered to be taxable gifts no matter what the amount of the gift. Thus a husband may make a gift of any size to his wife and not include it in his commutation of taxable gifts. There is nothing, in my opinion, preventing a husband giving $2,000 to a child and also another $2,000 to his wife who then gives it to the child. It must, of course, be noted that in circumstances similar to this the Tax Department has on occasion attempted to show that the wife was not acting in her own capacity but merely as an agent of the husband and therefore the gift was not in reality the wife's but the husband's. It must therefore be made perfectly clear that the monies given by the husband to the wife are hers to do with as she wishes and there is no "earmarking" of those funds for a particular purpose. The proof of this, of course, will rest mainly upon your documentation.

This new concept, wherein a husband may give any amount to his wife tax free, has been given wide publicity by the news media but has some built-in pitfalls for the unwary. If property is given to a wife and this property produces income it is true that no gift tax will be exigible. However one must be aware of section 21 of the Income Tax Act which states that in such circumstances the income produced from the property will continue to be taxed in the husband's hands rather than the wife's hands. This is true even though the wife is the legal owner of the property involved. You may find you have some rather unhappy clients who continue to be taxed on income from property which they have gifted away.

I question whether this new exemption will in fact promote gifting between husbands and wives. Prior to the amendments gifts were made to reduce the husband's estate prior to his death. Now there is no necessity to reduce the husband's estate on assets passed to the wife because estate tax can be simply avoided if a husband leaves these same assets to the wife under his will and this enables him to keep control of these until his death. It may well be that wives who previously have built up some financial independence from their husbands by means of a gifting program may now be dependent upon their husbands up to the point of his death.

Because all gifts between husbands and wives are now to be free of tax, the $10,000 once in a lifetime exemption of an interest in property used as a domicile has been dropped. Under the Act as previously constituted it was possible for both the husband and the wife to make a $10,000 gift to a child of an interest in farm property. It is now clear that a transfer can only now be made by either the husband or the wife, but not by both.

The exemption of $2,000 previously mentioned is available provided that the gifts are made outright and are not 'made by settling property in a trust". Thus with certain exceptions to be mentioned later, all gifts

of property or money to settle the trust will be subject to gift tax. One exception to this general statement relates to gifts made to a trust where the spouse is an income beneficiary provided that during the lifetime of the spouse no other person has the right of any kind whatsoever to receive, use or enjoy any or all of the property settled on the trust or has any beneficial interest in any of the income from the trust property. In other words the trust property in order to be exempt must be "frozen" during the lifetime of the spouse. This provision is directed against trusts which are established to provide income or capital to the family of the settlor during the lifetime of his wife. If any child of the settlor has a possible right to either income or capital during the lifetime of the spouse the value of the property used to settle the trust would be subject to gift tax. Thus if a husband is feeling benevolent and provides in the trust that part of the trust income may be paid to his mother or invalid sister or brother while his wife is alive the settlement funds would not be exempt from tax. It is therefore now of paramount importance to set-up inter vivos trusts in such a way that you have an individual trust for each separate purpose you wish to accomplish.

Another exception to the general rule that any gifts to a trust will be taxable is found in the situation where the trust is created having only one beneficiary who was living at the time the gift was made to the trust. Such type of trust will have the normal $2,000 exemption for gifts made to it.[4]

A rather startling example of how much wider the net has been cast with respect to gift taxes was given by Mr. Martin O'Brian in a paper delivered to the Canadian Tax Foundation Convention last November[5] wherein he stated *inter alia:*

> Section 186 of the Criminal Code provides that everyone is under a legal duty as a parent, foster parent, guardian or head of a family to provide the necessities of life for a child under the age of 16 years. The necessaries to be provided are not required to be equivalent to the station in life of the parent but may just be the bare necessities of life. It is therefore arguable that any standard of living granted to a child over and above the bare necessities constitutes a gift. It is apparent that there is no obligation on a parent to provide a university education for a child. If a parent sees fit to do so the Minister could argue that the university education constitutes a gift to the child. Also if a parent sees fit to send a child to a private school as opposed to the public school system then again it could be argued that the parent has made a gift equal to the difference in cost of the two types of education. Gifts to a child on birthdays and upon graduation would be taxable if the value of the gift exceeds the sum of $2,000. When one considers that there is no obligation to support a child over the age of sixteen years then in today's high cost of living it is fairly simple to expend more than $2,000 a year on any child.

The reason these problems did not arise under the old act was by virtue of the exemption of one half the difference between an individual's taxable income for the preceding taxation year and the tax paid thereupon. Taxpayers who are apt to spend large sums on their children were usually in high tax brackets and could take refuge behind this exemption. However as I pointed out previously this exemption has been repealed and hence the new problem. Personally I will be surprised if the Tax Department attempts to levy tax in circumstances envisaged by Mr. O'Brian, however, the illustration points out the viciousness of

[4] Section 112(3).
[5] Canadian Tax Foundation, 1968 Conference Reports, 61.

the new amendments and I would suggest a client be advised to review his normal activities with this new possibility in mind.

Owing to the proposed integration of the gift tax and estate tax rates, gift tax is to become, in effect, a prepayment of estate tax. The rates of gift tax have been greatly increased. Whereas under the old legislation the rates varied from 10% on yearly gifts of up to $5,000, to 28% on yearly gifts of over $1,000,000, the new rates provide for a 12% rates to be applied on lifetime accummulated taxable gifts of up to $15,000 to 75% on life time accummulated taxable gifts of over $200,000.

COMPARISON OF NEW AND OLD GIFT RATES

Cumulative Taxable gifts	Basic tax	Rate of tax upon excess	Old gift tax on lower limit (non-cumulative)
0 - $ 15,000		12%	
$ 15,000 - 30,000	$ 1,800	15%	$ 1,800
30,000 - 45,000	4,050	18%	3,900
45,000 - 60,000	6,750	22%	6,750
60,000 - 80,000	10,050	26%	9,600
80,000 - 100,000	15,250	30%	13,600
100,000 - 125,000	21,250	36%	17,000
125,000 - 150,000	30,250	45%	22,500
150,000 - 200,000	41,500	60%	27,000
200,000 and over	71,500	75%	38,000

One other aspect of the new legislation which is of vital importance to keep in mind is that if the aggregate of gifts exceeds the specified amount relating to a particular tax rate the next tax rate specified applies to the total of the aggregate of the gift and not just to the amount which exceeds the specified level. For example if a person made a gift of $5,000 the gift tax would have been $500 under the old rates and if this same person made a gift of $5,001 the gift tax would have been $500 on the $5,000 portion of the gift with the higher rate applying only to the excess which, in my example is $1. However under the new legislation if this $5,000 gift brings you to the top of, for example, the 15% bracket an additional $1 gift will make the whole $5,001 gift subject to the 18% rate of tax and not merely the $1 excess which was the case under the old legislation.

Under the new legislation the rates of tax are to be imposed upon the taxpayer's cumulative gift tax sum. For example, if in one year the taxpayer were to make gifts having an aggregate taxable value of $50,000 and in the following year he were to make an additional $50,000 worth of gifts his cumulative gift sum at the end of year two would be $100,000. If he were to make an additional $50,000 gift in year three his cumulative gift sum at the end of year three would be $150,000.

In order to illustrate the rather startling difference this makes upon the actual dollars of gift tax payable I suggest this example. Suppose a taxpayer were to make a gift of $30,000 in one year. He would pay a tax of 18% namely $4,050. If in year two he were to make another gift of $30,000 thereby increasing his cumulative gift sum to $60,000 the actual tax payable would be $6,000 on this second gift or an increase of

approximately 33 1/3% in year two on exactly the same amount of gift. The method of computing this $6,000 involves a rather complicated formula which takes cognizance of previous gift tax paid and gives a partial credit. It is not my intention in this article to discuss this formula at any great length, however one should be aware that there are a new set of rules for the computation of the actual tax payable under the new legislation.

One of the areas most fraught with danger is the new concept of the deemed gift introduced in these tax amendments. The definition of gifts has been broadened to include:

(1) the act of permitting a debt owed by a person with whom the taxpayer is not dealing at arm's length (i.e. a son or daughter or company controlled by the taxpayer) to become enforceable by virtue of the operation of any law limiting the time for bringing action upon the debt;

(2) the exercising of a general power of appointment;

(3) gifts made by a corporation at the direction or with the concurrence of a shareholder to some other person as a benefit that the shareholder desired to have conferred on the other person;

(4) transfers to a person other than the taxpayer's spouse pursuant to an agreement made in the consideration of marriage.

The last provision has its main application in the province of Quebec and is therefore not appropriate to this discussion. However the other three provisions have wide application in common situations. Dealing first of all with the act of permitting a debt to become statute barred, in the case of an ordinary debt under our laws this period of time is six years. Certain practical ramifications resulting from this amendment will be mentioned later.

With respect to the general power of appointment as a deemed gift; this poses some problems. It is my understanding that the Minister proposes that the granting of all powers of appointment will be subject to gift tax. However it cannot be a granting of a power under a will which is to be the subject of gift tax because, of course, the property over which the donee has a power will be included in the value of the deceased's estate and be subject to estate tax. Also if a gift were made by the will it would be exempt from gift tax because it would constitute a gift which would not take effect until the death of the donor. Therefore the paragraph must be aimed at the granting of powers of appointment in inter vivos trusts. For example, a settlor might establish a trust and transfer to the trustees a sum of money (which would be subject to gift tax) and also in the trust instrument confer a power of appointment on a third party. If this grant of the power of appointment in the trust document constitutes a gift to the donee of the power within the meaning of the new subparagraph, we would then have a double taxation situation. It would also catch existing trust settlements which are amended to grant a power of appointment. Therefore in every trust situation the trust document should be re-read in order to see if any possible application of this new subsection might occur.

As mentioned previously the general rule is that all gifts to trusts are taxed. Section 112(3) makes an exception to this general statement.

The taxability of all gifts to trusts have serious ramifications when we consider the very common concept of insurance trusts. Normally the trust is set up whereby the annual premiums will be looked after by gifts to the trusts. The most common form of this type of trust has been a trust set up for the children which of course means that there is more than one beneficiary. Therefore any gifts given would be taxed. This continuing type of trust should be closely examined and a decision made as to whether or not the trust should be split into several trusts each qualifying under section 112(3). Each of these trusts might have joint ownership of a common insurance policy and hence you may still accomplish the purpose without attracting gift tax. Another suggestion with respect to this type of trust is a loan made by the father to the trust for the insurance premiums. However in my opinion this must be carefully done due to the fact that there have been occasions where the Department of National Revenue has attacked an alleged loan as not being a loan at all but merely gifts in the guise of a loan. In order to have a *bona fide* loan there should be repayment provisions which, of course, is not normally compatible with this insurance type trust situation.

I have been unable to find any example where it is advisable to pay gift taxes in Alberta where we have the Estate Tax Rebate Act.[6] In every situation which I have considered if gift taxes are paid the client is losing money.

A deemed gift is made where section 16 of the Income Tax Act is applicable. In this type of situation you might have a corporation diverting income at the behest of its controlling shareholder which would attract income tax under section 16. This situation is fraught with double taxation possibilities. As a result of the new amendments a gift is deemed to have been made resulting not only in income tax being assessed but also gift tax. In an extreme example the combined tax on this amount can amount to 125% of the deemed gift. How the tax authorities intend to collect is unknown to me.

The deemed provisions must also be kept in mind when one is examining existing estate plans. As mentioned previously where one allows a debt to become statute barred there is a deemed gift. Take, for example, a simple estate "freeze". In many cases the assets are sold to the "freeze" company for redeemable preference shares plus a promissory note. Normally this promissory note is not repaid within six years— if ever: You will have a very sad client if he finds himself facing a gift tax assessment under the new gift tax provisions. Normally we are dealing with quite sizable sums. Two hundred thousand dollars is not uncommon. Hence your client is facing a possible gift tax assessment at the rate of 75%. This provision is easily avoided by taking an acknowledgment of the debt; however, I can foresee many people being assessed gift tax by simply not knowing the implications of this new amendment.

Revocable *inter vivos* trusts continue to have no place in estate planning. However I believe that we will see trusts being settled more often by non-resident persons or at least by persons having a low cumulative gift sum.

6 S.A. 1967, c. 18.

Insurance policies of unlimited face value may now be owned by a wife on her husband's life with premiums payable out of tax free transfers of moneys given by the husband to the wife and there is no necessity for a wife to own the policy if the proceeds are payable to her upon the husband's death.

Summary Re Gift Taxes

In conclusion it is obvious that these new amendments not only extract a higher tax but widen the tax base as it relates to gifts. It seems to me that the use of an estate "freeze" is all the more imperative under these new gift tax provisions and perhaps we will see them being used at an earlier stage. In the case of an estate freeze with the accretion in value of the estate going to the common shareholders there is no gift tax or income tax exigible on this amount. Hence this is a method whereby portions of an estate may be passed to the children without taxes being applied.

Another estate planning possibility which may become common due to these amendments is that of equalizing the estates between husband and wife. This can be done by way of gifts or by means of a will. In my opinion it is better to pay some tax at the death of the first spouse rather than have the higher rates apply to the whole of the estate upon the death of the second spouse. This is particularly true while we enjoy the benefits under the Estate Tax Rebate Act.

Estate Tax

In the area of estate tax we again have major changes which after examination have fundamental significance to the average estate taxpayer and estate planner. The two main objects of the legislation appear to be the exemption of tax in situations where property is transferred between spouses and, as previously mentioned, the integration of gift tax and estate tax. With respect to the marital exemption; in order to qualify for this the property must pass to the spouse outright or to a trust in which the spouse has an exclusive life interest. There is no dollar amount which applies to this exemption. There are, however, qualifications. It must vest within six months of death or "such longer period as may be reasonable in the circumstances". This means that the usual common disaster clause found in most wills today involving a thirty or sixty day time limit will not disqualify the marital exemption. If the property passes to a trust this trust must be for the sole benefit of the surviving spouse. Any payments to the children of income or capital will disqualify the trust. Thus "sprinkling" clauses or clauses allowing encroachment on capital for the benefit of children must be avoided if one wishes to take advantage of the marital exemption envisaged in the new estate tax amendments.

A clause in which it is stated that the income of a trust ceases to go to the wife upon her remarriage will also have the effect of disqualifying the trust for marital exemption purposes. It should be noted, however, that if there is a superannuation fund or pension fund a clause stating that the benefits cease upon his or her remarriage will not disqualify the fund from the marital exemption for estate tax purposes.

The new amendments state that if a fund is provided wherein amounts are payable to the spouse at intervals not greater than twelve months with payments to be made out of interest and if interest is exhausted then the deficiency is to be made up out of capital, the fund is not disqualified from the marital exemption even though any excess of interest is payable to other parties. Therefore in a large estate you may have a type of trust wherein the widow is to be paid a certain number of dollars and the excess is to be paid to someone else and the Tax Department will compute the present value of the wife's interest which will be the amount exempted for estate tax purposes. The balance, of course, will be taxed in the usual way.

Another important aspect of the Estate Tax Act amendments has to do with children. There is a basic exemption for each adult child of $10,000. This is new. If the child is under the age of twenty-six the amendments read that an additional $1,000 for each year between the date of death and the year in which the child will reach age twenty-six is allowable. The maximum exemption is $35,000. The exemption for children under twenty-one years is reduced by the average income the child has for the three years immediately prior to the death of the parent. The child is allowed to have a total of $15,000, that is $5,000 in each of the three years immediately prior to death. If the child is fully dependent upon the deceased the formula is to add to the $10,000 basic exemption the sum of $1,000 times the number of years between the date of death of the parent and the date the child would reach the age of twenty-one. The maximum exemption under this clause is $80,000.

There is a fundamental difference between exemptions under the new amendments and under the old act. Under the old act the exemptions applied whether or not the party to whom the exemptions applied received anything. If a man left everything to his mistress his estate was still entitled to the marital exemption. If a man left everything to his wife the estate would still receive the exemption for any infant children. Under the new amendments the exemptions are only applicable to benefits received by dependents. If the amount is not in fact left to the person receiving the exemption, the exemption is lost.

The exemption with respect to children still qualifies if the bequest takes the form of a trust for the benefit of the child provided the trust vests in the child for his benefit indefeasably within six months of the testator's death or "such longer time as may be reasonable in the circumstances" or subject to defeasance only in the event of the child's death prior to reaching a certain age not to exceed forty years. Therefore the usual trust clause in a will leaving property in trust for a child to be settled upon him upon attaining a certain age (e.g. 25 years) will still qualify for the child's exemption under the new amendments.

There is a basic exemption against estate tax on the first $20,000 of taxable value of all estates. This replaces the former basic exemption of $40,000. In addition any estate under $50,000 will not be taxed. However if the estate exceeds $50,000 there will only be the basic $20,000 exemption which may be applied against the tax applicable.

As mentioned previously a trust set up solely for the benefit of the wife will qualify as property passing to the wife and hence no estate

taxes will be exigible at the time of the husband's death. However, if property is transferred to a trust which is exempt from estate tax due to the fact that it is for the sole benefit of the spouse, the value of that property will be taxed at the death of the surviving spouse. Accordingly any growth in the trust assets between the death of the two spouses will be taxed. This brings into consideration the possibility of "freezing" the value of the assets in the trust. Care should be taken in drawing any trust agreements and consideration should be given to allowing the trustee to invest in non-appreciating assets or convert appreciating assets to non-appreciating assets such as preferred shares, notes, debentures, etc. It is of interest to those dealing with estates to note that where a trust is set up in such a manner that the corpus was partially exempt from estate tax due to the fact that the spouse had an interest in the income, the amount to be taxed upon the death of the surviving spouse is the lesser of the value at the time of the original spouse's death or the surviving spouse's death. Therefore the growth in this type of a trust appears to escape tax. The difference between the two results is the type of trust which is set up.

A new concept is in evidence under the new amendments with respect to the payment of tax. There is a provision whereby you may have annual installments and an executor may elect to pay the estate tax applicable in six annual installments. The first installment is due six months after death. Interest will be payable at a rate prescribed by the regulations and the interest payable on the balance due is fixed at the time the election is made.

It should be noted that there is a change under the new amendments in the situs rule in connection with the situs of debts. The old rule as to debts was that the debt owing was situated in the ordinary place of residence at the date of death of the debtor. Where the debtor was a corporation and the corporation was a federal incorporation the location was at its head office, in a provincial corporation the location was its place of incorporation. This has been changed. Under the new amendments we are now back to the old common law of central management and control. This has particular significance when one considers the applicability of the Alberta Estate Rebate Act.

I think it obvious that under the new amendments a wider tax net has been cast. I think now is the time for re-examination of estate problems with a view to ascertaining if changes should be made in light of these new amendments. Increased taxes will probably be the result of the extensive review of our income tax system which we are told will be shortly forthcoming. An awareness of the changes in the estate tax and gift tax area is an essential base from which to orient one's thinking and consider future advice which must be given in order to keep up in the rapidly changing fiscal times which are now upon us.

—FRANK D. JONES*

* B.A. (Alta.), LL.B. (Dal.), LL.M. (Tor.) Professor, Faculty of Law, The University of Alberta.