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New Tax Rules for Spousal Trusts Could Have Severe Consequences: Reviews of Wills Strongly Advised

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New tax rules for all trusts, including spousal trusts which have often been set up to protect the inheritance of the children from a prior relationship and, at the same time, provide for a second spouse, or to allow for a degree of income splitting, take effect next January 1.

As a result, many of the reasons for spousal trusts in the past are no longer effective. In fact there will be consequences that were totally unexpected.

Anyone with a will that creates a spousal trust, therefore, is strongly advised to review it, and the reasons for it, to make sure that it does not create new, unanticipated and unintended implications.

Here is a scenario to help explain what has happened:

Tom and Carol were each divorced with children from their respective prior marriages. They got married to each other 20 years ago. After their marriage Tom had a will drawn up and in it created a spousal trust in which his assets were left in the trust with the income from those assets left to Carol for the rest of her life and the capital going to his children on Carol's death. Carol did a similar will leaving her assets, which were less than Tom's, in trust for Tom during his lifetime and the capital to her children.

Then Tom died and Carol became the beneficiary of the spousal trust created in Tom's will. The income that the spousal trust earned was paid to Carol, but part of it was taxed in the trust at marginal rates and part was taxed in Carol's hands at her marginal rates so that none of the income was taxed at the maximum marginal rates.

Starting January 1, however, any income taxed in the spousal trust will be taxed at the maximum marginal rate. Income taxed in Carol's hands will be taxed at her marginal rates, so there will be no effective way to reduce the overall tax rate on the income from the trust.

And that is only one impact of the new rules.

When Carol ultimately dies, the assets in the spousal trust will be distributed to Tom's children, whose inheritance the trust was set up to protect. That distribution of capital will be tax free.

However, on Carol's death, all of the assets are deemed to be sold at their then market value and any capital gains from the point where they were acquired by Tom or since are taxable.

If the trust has $ 1 million in assets, for the sake of discussion, and $300,000 of those assets constitute a capital gain, half that gain, or $150,000, will be subject to tax. Historically, the tax was the obligation of the spousal trust which housed the capital assets, or the beneficiaries who received the capital assets, and had nothing to do with Carol personally or Carol's estate.

No longer.

Under the new rules, Carol's own estate assumes the obligation, with the spousal trust's taxable capital gain amount added to her other income in the year of her death. That means that Carol's children, who are to inherit her estate pay the price because the amount of money available to them from Carol's estate is diminished by whatever taxes are owed through the spousal trust.

For years, spousal trusts in wills have been used to defer capital gains, reduce Estate Administration Tax (by ensuring that assets held in trust in one estate and not passing outright to the survivor are only subject to one round of Estate Administration Tax on the death of the first spouse), and provide for some degree of income splitting.

In many cases where spousal trusts have been the planning vehicle of choice, one spouse has substantial assets and wants to preserve their capital value for his or her children from a first relationship, while making proper provision for a second spouse.

The shifting of the spousal trust's tax liability to Carol's estate in the example above could create a significant windfall for the capital beneficiaries of the trust (Tom's children), who will get the trust assets free and clear of tax.

At the same time, there could be a major hardship for Carol's beneficiaries, namely her children, who were to have inherited whatever assets belonged to Carol but whose inheritance will now be reduced or possibly eliminated because of tax owed on capital gains generated in the spousal trust.

The overall result of the change in tax liability may have been an error or oversight on the part of the tax department, which also introduced other similar changes relating to alter ego and joint partner trusts, where the result makes sense.

However, there has been another federal budget introduced since these changes were passed into law late last year and nothing has been done to fix this result. So, for the moment, it appears to be up to Canadian taxpayers, as far as possible, to arrange their affairs to take account of this new situation.

There are ways that can be considered as a means of making the overall result fairer, but they will require changes to existing wills that establish spousal trusts.

For trusts that are already being administered, it may not be possible to vary them in a way that will avoid this consequence when the spouse/beneficiary dies. ■