New Spousal-Trust Tax Rule: Ottawa Acknowledges Issues

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Federal Department of Finance and Canada Revenue Agency officials have acknowledged that a new tax rule for spousal trusts taking effect Jan. 1 could have negative consequences for spousal beneficiaries that were not foreseen.

They have indicated to lawyers, accountants, trust officers and insurance professionals specializing in the trust and estate area that the matter is being examined, but no further information has been received.

Regardless of any such examination, however, the new rule, part of a broader revision of trust taxation, will come into force at the beginning of the New Year.

Therefore, anyone whose will creates a spousal trust, or any trustee of a spousal trust, remains strongly advised to review the terms of the trust and the way that it is administered, to make sure that it does not create new, unanticipated and unintended problems.

The upcoming changes were reported in a special *Blaneys on Business* Bulletin in June:

“New tax rules for all trusts, including spousal trusts… often … 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 (historic) reasons for (establishing) spousal trusts are no longer effective. In fact there will be consequences that were totally unexpected….

A typical scenario where spousal trusts have been used was set out in the previous report:

“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 while Carol is alive....

"However, on Carol's death, all of the assets (will be) ... deemed to be sold at their then market value and any capital gains from the point where they were acquired by Tom, or since, (will be)...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 (those)...capital assets, or the beneficiaries who received ... (them), and had nothing to do with Carol personally or with 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.

"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…."

Parliament passed the new trust tax rules in late 2014. The spousal trust issues with those new rules were discussed earlier this summer at the National Conference of the Society of Trust and

Estate Practitioners (STEP) in a roundtable discussion with officials from the federal Department of Justice.

The government, it would appear, was aware of the impact that the new rules would have on income splitting and no changes in that regard are likely to be considered, since numerous representations had been made previously by tax and estate professionals with no result and the end of income splitting with a trust appears to be considered by the Finance Department as equitable tax policy.

The implications of the change in the treatment of capital gains after the death of a beneficiary spouse did not appear to have been intended and therefore there was an indication that this was going to be re-examined.

Even if the government and Parliament ultimately choose to redress the capital gains issue, it seems likely that it would take many months to get the job done.

Trust tax rules are part of the *Income Tax Act* and any amendments are usually dealt with in a federal budget. With Parliament dissolved and a general election scheduled for October 19, a new government likely will not be in place until November and its first budget likely would not be presented before late winter or early spring.

And, even then, who can say what kind of priority this particular matter might have?

As we cautioned earlier, anyone whose will creates a spousal trust, or any trustee of a spousal trust, remains strongly advised, for the moment and for the foreseeable future, to review the trust and its administration to sure that any new, unanticipated and unintended implications are minimized or eliminated.