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Ottawa Acknowledges Unintended Threat: Rescinds New Tax Rule on Spousal Trusts

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The federal government has rescinded a new tax rule that contained unintended, potentially unfair implications for stepchildren.

The revocation serves as a reminder that estate law has been in flux and that anybody whose will contains a spousal trust should review it to ensure that all of the potential consequences of the current law are understood and are being considered.

In a special bulletin in June, 2015, Blaneys on Business discussed the changes that Ottawa had made in the taxes on spousal trusts set up in wills. These trusts often were established to protect the capital of an estate for children from a first marriage and to provide support for the second spouse.

The changes created what now seem to have been unintended consequences, particularly for the second spouse and his or her heirs. The September, 2015 issue of Blaneys on Business reported that the government had acknowledged the problem but that nothing had been done up to that point to resolve it.

Well, surprisingly, after last October's federal election, the finance department *did* introduce changes (in January) to address the problem. They were confirmed in the new government's budget presented to Parliament on March 22, 2016.

Effective January 1, 2016, (by virtue of legislation that will be made retroactive to that date), the death of the beneficiary of a joint spousal trust, a testamentary spousal trust, or an alter ego trust (whether the surviving spouse in the spousal trust cases or the original settlor in the case of the alter ego trust) will continue to trigger a deemed disposition of the assets in the trust.

This means that all of the assets in the trust will continue to be treated as though they have been sold and capital gains and losses, from their original cost when the first spouse got them to their value on the day that the second spouse died, will be determined and tax will be calculated on the taxable gains.

Before the problematic new rules took effect, in the case of a spousal trust created in a will, those taxes were paid by the trust. (There was no real change in the treatment of capital gains in an alter ego or joint spousal trust.)

The problematic new rules, however, made the taxes the obligation of the estate of the second spouse. That meant a reduced inheritance for the second spouse's own children and a tax-free windfall for the children of the first marriage.

Now that the problematic new rules have been rescinded, the tax on those capital gains will be paid in the trust and only the net value after the tax is paid will go to the remaining beneficiaries named in the will.

This is good news, particularly for blended families, because the beneficiaries of the second spouse who has just died will not have their inheritance depleted by tax on assets to which they are not entitled and have no access.

In addition, the beneficiaries of the original will in which the trust was created (usually the children of the first marriage) will not get a windfall but instead will get the value of the trust after the taxes are paid, which was probably the intention all along.

There are still some technical things to keep in mind where spousal trusts are concerned. For all spousal trusts, whether created before 2016 or after, the death of the surviving spouse triggers a year end and the resulting capital gains triggered by the deemed disposition must be reported in a T-3 return due 90 days following the death of the spouse. This is earlier than used to be the case for reporting and paying the taxes.

Also, if there are charitable beneficiaries who are to receive benefits following the death of the spouse, it is now possible to make sure that there are charitable tax credits available to reduce the tax payable in the trust. However, the payment to the charity must be made within 90 days of the death of the spouse and the charitable tax receipt obtained before the tax return is filed. If the 90 day window is missed, the ability to use the tax receipt to claim a tax credit may be lost.

The charitable tax credit is the only benefit potentially available, because the taxable capital gains will be taxed at the highest marginal rate on the entire gain, now that trusts are all taxed at the high rates (based on other trust tax changes that came into effect January 1, 2016 that we discussed in previous issues of *Blaneys on Business*).

While we don't have a perfect system (what tax system is?), the changes that did come in at the beginning of the year at least reflect an awareness that the finance department made a mistake with potentially serious consequences for families and has made a serious attempt to fix the problem.

As we indicated earlier, if you have done a will in the past with a spousal trust, you should review it to make sure that it meets your family's needs and that all of the nuances of the tax changes are considered.

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