Manulife

There's hope for issues with taxation at the death of a spouse beneficiary of a spousal trust

On November 16, 2015 the Department of Finance sent a letter to the professional bodies that had made numerous submissions relating to the recent changes to the taxation of certain trusts. This letter acknowledged the concerns raised by STEP, the Joint CBA-CPA Committee on Taxation and CALU, seeking input on one suggested solution.

The problem: There is a deemed disposition at the time of death of a spouse under a spousal trust. (This also applies on the death of the settlor under an alter-ego trust and the surviving partner under a joint partner trust, collectively referred to as "life interest" trusts (for simplicity I only discussed spousal trusts in this article). Amendments made to the Income Tax Act adding subsection 104(13.4) that were enacted and that would be effective January 1, 2016 deem there to be a yearend at the end of the day of death of the spouse and deem the trust's income for the year (including amounts deemed to be realized as a result of death) to have become payable to the spouse in the same year. What this means is that the trust's income is included in the spouse's hands for tax purposes (see the October 2014 issue of As a Matter of Tax *"Impact of August 29, 2014 Draft Legislation on Spousal trusts at death of spouse"*). Even though subsection 160(1.4) makes the trust jointly and severally liable for the tax payable in the beneficiary spouse's hands, the problems resulting from this "switcheroo" are numerous:

- The spouse's estate may end up being responsible for the tax liability while having none of the assets that generated the tax liability (this is particularly egregious in situations where the spouse trust ultimately benefits the children of a prior marriage of the testator who are not the beneficiaries of the deceased spouse).
- Interference with charitable gifts at death by the spousal trust (now only useable by the spouse trust in the year of the gift with a carry-forward because the spouse trust is not a "graduated rate estate" – see the September 2014 issue of As a Matter of Tax *"New rules for Estate Donations"*) with the goal of offsetting the tax liability (now no longer in the trust) resulting from the deemed disposition on the death of the spouse.
- Uncertainty about whether it will be possible to absorb capital losses carried back to the year of death of the spouse within the trust if the income is deemed payable to the spouse and no elections to bring that income back into the spouse trust are permitted.

The suggested solution: To amend subsection 104(13.4) so that it would not apply on the death of a spouse unless the trust is a testamentary trust that is a post-1971 spousal or common-law partner trust, the testator dies before 2017, the spouse is a resident in Canada at death, and the trust and the graduated rate estate of the spouse jointly elect to have that subsection apply (so the switcheroo would only apply if elected into by these types of trusts).

Also, the Department of Finance also suggested that the trust be permitted to allocate the eligible amount of a donation made by the trust after the beneficiary's death but during the calendar year of the death, to its taxation year in which the death occurs.

This would put things back where they were for all life interest trusts before the switcheroo with the exception of those that qualify to elect into the spouse's estate being taxed on the income from the deemed disposition on death in the spouse trust. Given all the problems that this suggested change would resolve, I can't imagine too many testamentary spouse trusts electing into the spouse's estate being taxed, just to get graduated rate taxation.

There are no guarantees but this does look promising. I will keep you informed of the outcome.

November 2015

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