November 23, 2015

# Finance Fix to Life Interest Trust Issues May Come Soon

As part of the 2014 federal budget, the Canadian government enacted significant changes to the taxation of estates and trusts that come into force on January 1, 2016 (see our e-communication *Coming Soon: Amendments to the Taxation of Testamentary Trusts*). The amendments included changes to the taxation of spousal trusts, common-law partner trusts, *alter ego* trusts, joint spousal trusts and joint common-law partner trusts (collectively "life interest trusts"). Life interest trusts are generally subject to a deemed disposition of their property on the death of the spouse, settlor, common-law partner or the last to die of the two (as the case may be) (the "life interest beneficiary"). The life interest trust was subject to tax on any accrued gains realized on this deemed disposition, which reduced the distributions to the remaining beneficiaries of that trust. The amendments would have caused the tax payable in respect of a deemed disposition occurring on or after January 1, 2016 to be borne by the estate of the life interest beneficiary, which could significantly affect estate planning. The amendments also limited the ability of the life interest trust to utilize charitable donation tax credits for donations made by the life interest trust. On November 16, 2015, the Department of Finance sent a letter to the CBA/CPA Joint Committee on Taxation, STEP and CALU, outlining possible revisions to the January 1, 2016 amendments, which would reverse the potential mismatch in the parties who will effectively bear the life interest trust's tax liability and the potential inability to utilize donation tax credits resulting from the proposed changes.

**Current Law**

On death, an individual is generally deemed to have disposed of his or her capital property and certain other properties for their fair market value unless the properties vest indefeasibly in the deceased's spouse or spousal trust within 36 months of the date of death. Subject to an election to the contrary, properties acquired by the spouse or spousal trust are deemed to have been disposed of by the deceased and acquired by the spouse or spousal trust at the deceased's cost. The spouse or the spousal trust will then have a deemed disposition of all capital property on the spouse's death and will realize any unrealized gains on such property at that time. If property is held in a spousal trust, the spousal trust is responsible for any tax on capital gains realized on the trust property on the deemed disposition on the spouse's death.

Spousal trusts are often used in estate planning when the testator has remarried and has children from a prior marriage. In such a plan, the second spouse would be entitled to all of the spousal trust's income during his or her lifetime, and the deceased's children would receive the remaining capital of the spousal trust following the spouse's death (net of any taxes paid in the year of the spouse's death). The spouse's estate will generally devolve to his or her own children.

**January 1, 2016 Amendments**

The January 1, 2016 amendments will affect how spousal trusts (and other life interest trusts) are taxed. Under the proposed amendments, the spousal trust will be deemed to have made an amount of income payable to the spouse on the date of his or her death equal to the amount of any income realized by the trust in its taxation year ending on the date of the spouse's death (including accrued taxable capital gains realized on the spouse's death). The deemed amount would be included in the spouse's terminal return, not in the income of the spousal trust, as is currently the case. The spousal trust and the spouse's estate would be jointly and severally liable for the tax payable in respect of this deemed amount, and therefore the tax may be borne by the spouse's estate rather than the trust. In the case of a spousal trust relating to a second marriage, the amendments could result in a material and unforeseen cost to the beneficiaries of the spouse's estate and a windfall to the capital beneficiaries of the spousal trust. In addition, the trustees of the spousal trust may not have the power to pay the spouse's tax or may be compelled to seek contribution from the spouse's estate if it does pay the tax. The proposed amendments would have complicated standard planning to reduce the tax payable in connection with the deemed disposition by a spousal trust arising on the spouse's death, including charitable donations made by the spousal trust after death to obtain a charitable donation tax credit.

**Department of Finance Letter**

On November 16, 2015 the Department of Finance released a letter summarizing its understanding of the issues related to the potential mismatch between the parties who would bear the tax liability related to the deemed disposition and the parties who would receive the trust capital, and the potential "stranding" of donation tax credits. The letter provided that life interest trusts will continue to bear the deemed disposition tax, except in limited situations in which an election is made to have the proposed amendments apply and if certain other conditions are met. In addition, Finance indicated that it would be amenable to allowing donations by the life interest trust made in the calendar year of death of the life interest beneficiary to be taxed as if they were made prior to death, so that the life interest trust would be in a position to reduce its taxable income by the amount of the charitable donations made. Although Finance has not committed to any specific course of action, practitioners are hopeful that Finance will release draft legislation implementing the November 16, 2015 letter in the near future.

*If you have any questions regarding the foregoing, please contact Rhonda Rudick (514.841.6525) in our Montréal office or Timothy Youdan (416.367.6904), Christopher Anderson (416.367.7448) or Ray Rubin (416.367.7456) in our Toronto office.*