New legislation impacts life-interest trusts beginning in 2016

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In December 2014, new legislation was enacted that will impact the taxation of life-interest trusts upon the death of the beneficiary or settlor. These new rules were first proposed in August 2014 and came as a surprise as they were not announced in the 2014 federal budget. The new rules will be effective as of the 2016 taxation year and will apply to both new and existing life-interest trusts, as there are no grandfathering provisions in the legislation. As a result, the new rules may have a significant impact, and in some cases an adverse impact, on common estate planning strategies done for these types of trusts.

The new rules have raised concerns regarding potential double taxation issues where the trust holds private company shares with a significant unrealized gain. Current tax planning strategies to eliminate double taxation will now be subject to limitations and require additional planning considerations. Specifically, if the trust provisions were drafted on the understanding that subsequent capital losses would be carried back to eliminate the capital gain realized on death, this planning may no longer be applicable. In addition, the new legislation may create a mismatching of the liability for income tax arising upon the death of a surviving spouse and the passage of capital residing within the trust established for the benefit of that spouse.

Applying an example to better explain the risks identified in the preceding paragraph, let's say Mr. Smith establishes a spousal trust in his will and names his children from his first marriage as the capital beneficiaries. The trust holds private company shares. No tax is payable on Mr. Smith's death, but when Mrs. Smith passes away the shares are deemed to be disposed of and the accrued capital gain becomes taxable.

This is consistent with the current legislation. However, as a result of the new legislation, the deemed capital gain will be reported in Mrs. Smith's final tax return instead of in the trust's tax return. Any capital losses realized by the trust on the redemption of the private company shares will only be available to the trust with no mechanism for applying the losses to the gains reported in Mrs. Smith's return. Further, the trust will realize a deemed dividend upon wind-up of the subject company, resulting in double taxation in respect of the shares.

Taxing the deemed disposition of the trust assets in Mrs. Smith's final tax return also creates a potential mismatch between the assets and tax liability. If the capital beneficiaries of Mrs. Smith's estate are, for instance, her children from a previous marriage, Mr. Smith's children will receive the assets from the spousal trust while Mrs. Smith's children will be responsible for paying the taxes on the accrued gains realized by her estate.

Additionally, current planning often has the life-interest trust making charitable donations of trust property shortly after the death of the life beneficiary so that the resulting credits are available to offset the capital gains realized on the deemed disposition of the trust property. The new rules will frustrate this planning, as the capital gains will be reported on the deceased beneficiary's terminal tax return, yet the donation credits will remain in the trust.

We would be pleased to meet with you to discuss the potential impact of the new rules on your estate planning and look at possible planning strategies for mitigating any adverse impact that the new rules may have. For more information and details about the new rules, please contact a Grant Thornton succession and estate planning professional near you.

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