Alarming new changes to testamentary trust rules

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The 2014 federal budget introduced measures that will significantly impact the taxation of trusts created upon the death of an individual. Some of these proposed changes, effective as of the 2016 taxation year, were addressed in our *June 2014 Wealth preservation update*, in the article, "Is testamentary trust planning still 'alive?'". Since that time, draft legislation released in late August revealed some surprise measures that were not included in the original federal budget announcement.

These new proposed measures, also effective as of the 2016 taxation year, may have a significant impact on common estate planning strategies, particularly those involving spousal and other life interest trusts[1]. The proposed rules have raised concerns regarding potential double taxation issues where the trust holds private company shares or other assets 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.

For example, 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 proposed legislation, the deemed capital gain is 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 shares are only 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, resulting in double taxation in respect of the shares.

[1] i.e. alter-ego, joint partner and other similar trusts.

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.

Although the proposed legislation is not yet law, current estate plans should be reviewed and possibly revised to take these proposed new rules into account. For more information about the proposed rules, please contact a Grant Thornton succession and estate planning professional near you.

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