THE GOVERNMENT'S
ILL-CONSIDERED TAX RULES

Every once in a while, the federal government proposes tax changes that are unfair and are overreaching in terms of their effect. A recent change to tax law, effective January 1, 2016, has the potential to cause a number of problems, particularly for "blended families".

To put this new law in context, let's take an example. Assume that Mr. Smith is no longer married to his first wife either because of her death or as a result of a divorce. He has children from that first marriage. Later, Mr. Smith remarries. We now have a situation which involves a step-mother and step-children. Often in these circumstances, Mr. Smith will make a Will which provides for the following:

1. A significant amount of his assets will be left in trust for his new wife. During the remainder of her life, she will be entitled to the income from the trust.

2. Upon the death of the new wife, the remaining assets of the trust will be left to Mr. Smith's children from his first marriage.

Historically, this type of Will planning met several objectives. The trust is typically designed to satisfy the tests relevant to a "spouse trust" under the *Income Tax Act* (Canada). The advantage of this is that any of the capital property (e.g. shares of private and public corporations) left to the trust are transferred on a "tax rollover" basis on Mr. Smith's death. As such, no income taxes result when Mr. Smith dies. From a non-tax perspective, Mr. Smith has the comfort of knowing that he has provided financially for his new wife for the balance of her life, while at the same time ensuring that his wealth will ultimately pass on to his children from his first marriage. This planning has worked well for several decades.

The problem that we now face with this type of planning is a change to some of the tax rules. In the past, when the new wife ultimately died, the spouse trust would be deemed to have disposed of all of its property at fair market value. To the extent that there was a resulting capital gain, that capital gain would be taxed in the hands of the spouse trust. For example, if the capital gain on the trust's property was $1 million, the tax burden would have been around $200,000.00. Keep in mind that this is a "fictional" gain in the sense that there is no actual sale of property for cash. The capital gain is calculated solely for the purposes of recognizing income that will be taxed. Once the tax was paid, the remaining property of the spouse trust would then be passed on to Mr. Smith's children from his first marriage. Intuitively, this makes sense at least to the extent that the person who has the gain (i.e. the spouse trust) ends up being the person who has to pay the tax.

Under the new tax rules effective in 2016, a different tax regime will apply. The spouse trust will still calculate a capital gain in respect of its property when the new wife dies. The problem is that the capital gain is attributed to the new wife and is taxed in her estate. It is her estate that has the liability and must pay the tax. This is so notwithstanding that the spouse trust has no obligation to reimburse the new wife's estate for the tax liability. We end up with a mismatch: the taxpayer that incurred the capital gain (the spouse trust) is different from the taxpayer who is responsible to pay the tax (the new wife's estate). In the example noted above, this is a $200,000.00 tax problem for the new wife's estate.

Unless this is properly planned for in Mr. Smith's Will, economic hardship could be suffered by the new wife's estate and by her heirs. While at first glance one might simply say that Mr. Smith's Will needs to be designed to make sure that the trustees of the spouse trust make a tax payment on behalf of the new wife's estate to cover off this tax liability, this solution will not always be available. Consider the following two situations:

1. What if Mr. Smith has already died and the spouse trust has been funded? It is no longer possible to amend the terms of Mr. Smith's Will. As such, the trustees will not be in a position where they can make a payment to the new wife's estate to pay the tax liability. To do so would be a breach of trust.

2. Consider another circumstance being one where Mr. Smith is alive and has already made a Will based on the "old" law (i.e. where the tax liability was imposed on the spouse trust rather than on the new wife's estate). If Mr. Smith is no longer competent and therefore cannot modify his Will, then we are left with a significant problem for the new wife's estate.

Apparently the federal government introduced this new law for two reasons. The first is that they wanted to account for the income in the new wife's tax return to make sure that it would be taken into account in calculating any clawback of any Old Age Security. The second reason is the federal government was concerned about interprovincial income splitting in circumstances where the new wife may live in a "high tax rate" province (such as Ontario) and the spouse trust may be resident in a "low tax rate" province (such as Alberta). The federal government would prefer to see the capital gains taxed in the province or territory where the new wife resided at the time of her death.

Surely the federal government could have solved their concerns with a finely-honed scalpel rather than a blunt axe. The approach taken by the government will almost certainly cause significant conflict within blended families in circumstances where spouse trusts are used in their estate planning, and such trusts are not modified to take into account this new tax law. A number of tax practitioners have pointed out the flaws in the new law to the government. Unfortunately these warnings have gone unheeded. This new law was first proposed in the summer of 2014 and the legislation was passed shortly before Christmas that year. There had been no previous warning, whether in a federal budget or otherwise, that the government had even been thinking of putting in place this new tax rule.

At the very least, those persons reading this article should be concerned at the aggressive nature of this new tax rule. In some cases, this new rule may affect you directly. If so, you should bring your concerns to your Member of Parliament and ask that the law be changed. In addition, we recommend seeking legal advice to ensure that your estate planning, if you are affected, is updated to deal with this issue.