

TESTAMENTARY SPOUSAL TRUSTS

INTRODUCTION

Under the *Income Tax Act* (the "Act"), a taxpayer is deemed to have disposed of all of his/her property immediately before death for proceeds equal to the then fair market value. As a result, there may be substantial income, losses, capital gains and capital losses to be included in computing the taxpayer's income for the year of death. One method available to defer payment of these taxes is to transfer the property to a qualifying spousal trust.

When transferring property to a qualifying spousal trust, the Act deems the disposition to occur at the "tax cost" of the property to the deceased. Although there is not an absolute net saving of income tax, the spousal trust inherits the "old" tax attributes of the property and will only be taxed on the inherent gain in the property either on a disposition of the property or on a deemed disposition on the death of the spouse. The tax benefit is realized by a deferral of tax thereby maximizing the taxpayer's estate.

The definition of spouse in the Act includes a person of the opposite sex (subject to the recent Supreme Court of Canada ruling) who cohabits at that time with the taxpayer in a conjugal relationship and has so cohabited with the taxpayer throughout a 12-month period ending before that time or is a parent of a child of whom the taxpayer is a parent.

BENEFITS OF TESTAMENTARY SPOUSAL TRUSTS

1. The tax-free rollover to the trust on death is the same as if the assets were left directly to the spouse. Therefore, the taxpayer can provide the same level of financial support for the surviving spouse as if the property had been left directly to the spouse while maintaining control over the ultimate disposition of any remaining capital. This often has significant appeal to many taxpayers, especially those in second marriages.
2. Income of the trust is taxed at the graduated marginal personal tax rates. This income, once declared, can be paid to the spouse or added to the capital of the trust and withdrawn by the beneficiary spouse on a tax-free basis.
3. Spousal trusts give the testator the ability to specify ultimate beneficiaries upon the surviving spouse's death.

REQUIREMENTS FOR A VALID TESTAMENTARY SPOUSAL TRUST

1. Testator must be resident in Canada immediately before his/her death;
2. Property must be property to which the deemed disposition rules would otherwise apply;
3. Property must be transferred or distributed on or after the testator's death and as a consequence thereof (i.e., pursuant to the will);
4. Property must be transferred to a trust:

- (a) created by the testator's Will;
- (b) that is resident in Canada immediately after the property vests indefeasibly in the trust;
- (c) under the terms of which:
 - (i) the spouse is entitled to receive all of the income of the trust that arises before the spouse's death; and
 - (ii) before the spouse's death, no person except the spouse may receive or otherwise obtain the use of any of the income or capital of the trust;

and

5. It must be shown that the property has vested indefeasibly in the trust within the 36 month period following the testator's death.

If all of the above requirements are satisfied for the testamentary spousal trust, the Act automatically provides a rollover by requiring the trust to assume the deceased's tax position in relation to the property affected by those provisions. As a result, no income, loss, capital gain or capital loss will be realized by the testator in his/her final taxation year.

REASONS FOR AVOIDING THE APPLICATION OF THE SPOUSAL ROLLOVER UPON THE DEATH OF THE TAXPAYER

In certain circumstances, it may be advantageous to avoid the rollover in respect of some or all of the testator's assets. Examples of such situations include:

1. the potential for use of the capital gains exemption both by the testator and other taxpayers;
2. the extent to which the testator had income in the current or previous taxation years which could be offset by the realization of losses (capital or income) which have accrued at his/her death in respect of certain assets;
3. the extent to which the testator had losses in the current or previous taxation years which could be offset by the realization of gains (capital or income) which have accrued at his/her death in respect of certain assets;
4. where the testator's marginal rate of tax at death is low and an anticipated early realization of gains by the spouse or trust might result in greater overall tax; or
5. if there is property in respect of which no significant gains have accrued as at the testator's death, it may be desirable to avoid a deemed disposition upon the surviving spouse's death if it is reasonably expected that the surviving spouse will live less than 21 years from the date of the testator's death. If the election is made to avoid the rollover, and the assets are transferred into a non-spousal trust, there will be a deemed disposition of the assets at the testator's death, albeit for minimal or no tax consequences, and a further deemed disposition by the trust 21 years after the testator's death (assuming the assets are not depleted or transferred to the other beneficiaries directly), not at the surviving spouse's death.

The spousal rollover upon death of the taxpayer can be avoided in two ways:

1. Election by the trustee/executor under the Act to have property subject to deemed disposition provisions.
2. Create two trusts in the will; one spousal and one non-spousal with the trustee having the discretion to decide which assets to transfer to which trust. In general terms, assets without any

-inherent gains as at the date of death should be transferred to the non-spousal trust and the deemed disposition provisions will then be applied.

BASIC RULES FOR TAXATION OF TRUSTS AND BENEFICIARIES

Income of a testamentary spousal trust is either taxed in the trust itself or in the hands of its beneficiaries in accordance with the rules set out in the Act. The income which is taxed in the trust is taxed at graduated marginal personal tax rates. Income earned by a trust is generally taxable in the trust except in two circumstances:

1. where an amount is “payable” in the year to a beneficiary. An amount is considered to be “payable” to a beneficiary when the beneficiary is entitled to enforce payment thereof during the year; and
2. where an amount is paid by the trust out of the income of the trust for the upkeep, maintenance or taxes in respect of property that is required under the terms of the trust to be maintained for the use of the spouse.

SIMPLE EXAMPLE OF THE BENEFITS OF A SPOUSAL TRUST

A surviving spouse with pension and investment income totaling \$32,000 per year inherits additional capital of \$200,000 on the death of the other spouse. If this \$200,000 is invested and earns 5%, it will generate \$10,000 per year of interest income which, when added to existing income, will be taxed at approximately 38%. The tax paid would be \$3,800 per year, plus clawbacks of government benefits.

If the \$200,000 had been left to a spousal trust, the \$10,000 would be taxed in the trust at the lowest marginal tax rate of approximately 24%. Once the trust declares this income and pays the taxes, the remainder can be added to the capital of the trust and withdrawn tax-free by the surviving spouse whenever needed. The capital withdrawals would also have no effect on the net income of the surviving spouse in the calculation of government benefits.

There would be additional annual costs to file a tax return for the trust (estimated at \$400), but the net saving to the wife would be approximately \$3,400 per year.

For more information, please contact:

**Arthur M. Szabo
Szabo DeVries
#400, 1111 - 11 Avenue SW
Calgary, Alberta T2R 0G5
Phone: (403) 229-1111
Fax: (403) 245-0569
Internet: www.szaboco.com**