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FINANCIAL ADVISORY SUPPORT

The Testamentary Spousal Trust

An Income Splitting Strategy

In an age where people feel that they are taxed more and more every day, it is always refreshing to discover ways of reducing or eliminating your tax bill. The income-splitting strategy of creating a testamentary spousal trust is not a new strategy. This strategy, if properly structured, can offer significant tax savings.

This document is intended to provide a general overview of the topic. Individuals interested in pursuing the use of a testamentary spousal trust should consult their legal and tax advisors to determine if this is appropriate for their circumstances.

What Is A Testamentary Spousal Trust?

A testamentary spousal trust is a trust that is established for the benefit of the surviving spouse through provisions in the Will of the deceased spouse. This structure, if certain criteria are met, will allow a deferral of the capital gains tax consequences upon death, and would avoid the deemed disposition rule that would apply after 21 years of the existence of a non-spousal trust.

What Criteria Must Be Met?

The requirements set out in the ***Income Tax Act*** **(ITA)** to achieve this deferral are the following:

- The transfer of the property occurs as a consequence of the taxpayer's death, to a trust created by provisions in the taxpayer's Will;
- The surviving spouse is entitled to receive all income from the testamentary spousal trust which arises during the surviving spouse's lifetime. In addition, no other person may obtain the use of any of the income or capital of the testamentary spousal trust during the surviving spouse's life. Simply put, only the surviving spouse should have access to the testamentary spousal trust funds until he/she dies. However, restrictions can be imposed on the capital encroachment abilities of the surviving spouse;
- The testamentary spousal trust must be resident in Canada immediately after the time the property is vested **indefeasibly** in the testamentary spousal trust, and the surviving spouse and the deceased (immediately prior to his/her death) must have been a resident of Canada. The residency of the trust is decided based on the residency of the trustees and possibly any other parties controlling the trust;

- The spouse of the testamentary spousal trust has the right to absolute ownership of the property and no future event can deny him/her of this right;
- The property vests **indefeasibly** in the testamentary spousal trust within 36 months of the deceased's death. Generally, property vests indefeasibly in a person when that person acquires absolute and unconditional legal or beneficial ownership in the property.

What Are The Potential Tax Savings?

The transfer of property to most trusts will trigger a disposition of the property at its Fair Market Value (FMV). However, property transferred to a testamentary spousal trust is transferred on a tax-deferred basis if the aforementioned criteria are met. Also, a testamentary trust is treated as a separate taxpayer and its income is taxed at graduated tax rates, which means that the surviving spouse can take advantage of the lower tax brackets twice (personally and through the testamentary spousal trust).

A testamentary trust can also, in calculating its taxable income, claim certain credits (charitable tax credits, foreign tax credits and the dividend tax credit). However, it may not claim some credits allowed for individuals (basic personal amount, age amount, etc.)

For these reasons, using a testamentary spousal trust instead of making an outright rollover of assets to your spouse upon death will allow for income splitting and a reduction of your surviving spouse's overall tax burden.

Example:

Mrs. Jane Smith, who has lived in New Brunswick all her life, has recently died leaving all of her assets directly to her spouse Frank. The assets that were left to Frank generate approximately $40,000 of investment income. Frank is already receiving $60,000 in taxable income in the form of company pensions and investment income. In the past Frank's taxes payable were in the vicinity of $14,300 a year. With the added taxable income his tax bill would jump to approximately $29,000. However, if the assets of Jane were left in a qualifying testamentary spousal trust the savings to Frank would be significant. The savings would be the result of two taxpayers (the testamentary spousal trust and Frank) splitting the income and being taxed at progressive rates. If the spousal trust were in place Frank's total tax bill would be in the range of $22,000, an overall savings of approximately $7,000.

In addition, by splitting the income with the testamentary spousal trust Frank can minimize the impact of the Old Age Security clawback.

Other reasons to consider a spousal trust

(a) <u>Second Marriages</u>: Second marriages add an additional level of complication to the estate planning process, especially if the parties have children from their previous marriages. A testamentary spousal trust is one strategy amongst many that may be useful in a second marriage scenario. The possible benefits of a testamentary spousal trust are illustrated in the following example. You wish to provide for your second spouse, but on her death you want your assets to go to your children from the first marriage. If the assets are given to your second spouse outright then, on her death the assets would form part of her estate and would likely end up in the hands of her children.

What do you do? You can consider using a testamentary spousal trust as a component of your estate planning strategy. With the testamentary spousal trust a portion of your assets would be held in trust for your spouse for her lifetime. All the income from the assets would be paid to the spouse for her support. The trustee that you choose to manage the trust could also be given discretion in regards to the encroachment of the capital of the trust. It is imperative that you carefully consider your choice of trustees and consider your replacement trustees especially in a second marriage scenario where your surviving spouse and children have conflicting interests. A corporate trustee may be considered in this scenario.

On the death of the surviving spouse, there is a deemed disposition of the assets in the trust. The remaining assets of the testamentary spousal trust could be paid out to your children of the first marriage as per the trust deed or the assets may be paid out to successive testamentary trusts for your children. In essence, with the testamentary spousal trust as a component of your estate planning strategy you have the potential to satisfy both of your estate planning needs: support of your second spouse and an inheritance to your children from your first marriage.

A testamentary spousal trust is one option that may be considered in a second marriage. Other possibilities include the use of investment strategies such as the use of a segregated fund or an annuity where the surviving spouse receives income during his/her lifetime and the irrevocable beneficiaries receive the benefits on the death of the spouse.

(b) Spouse lacks financial expertise: Barbara is a successful professional with some health complications who has managed to create a sizeable investment portfolio over the years. Barbara is married to Jack, an artist, who has no interest in managing his financial affairs. Barbara is concerned that if something should happen to her, Jack would have difficulty in managing the wealth on his own.

What can Barbara do? A testamentary spousal trust may help. A testamentary spousal trust with a corporate trustee would ensure that the funds are well managed. Upon Jack's death the capital would be distributed to their son, Jeffrey.

This strategy would ensure that if Jack got remarried after Barbara's death, on his death the assets would go to Jeffrey rather than Jack's second spouse.

However, a testamentary spousal trust will not be appropriate in all circumstances.

(c) Transferring a Family Business: Jennifer, aged 80, is the matriarch of the Matti Clan. The family business is worth several million dollars. She is currently married to Harold, aged 45. Jennifer has two adult children from a previous marriage and the children are feuding with Harold. Jennifer wants the business to eventually go to the children. However, at the present time the business cannot fund the tax liability that would be generated on her death.

Would a testamentary spousal trust be appropriate? The testamentary spousal trust would solve the current tax liability issue and would ensure that the business would EVENTUALLY be transferred to the children. However, the fact that the children are feuding with Harold, and the fact that the company would not vest to the children until Harold's death, could cause problems in the efficient running of the business. For example, the desire of the children to reinvest the earnings back into the business to keep the dynasty alive might clash with Harold's income requirements.

The risk of disruption to the business might be so high that the tax advantage of the testamentary spousal trust may have to be waived in order to ensure a peaceful and practical solution.

Can my RRSP/RRIF be rolled over to my spouse's RRSP/RRIF and be held within the restrictions of a testamentary spousal trust?

It is not possible to transfer your assets from your RRSP/RRIF on a tax-deferred basis into a surviving spouse's RRSP/RRIF while still keeping these RRSP/RRIF assets subject to the restrictions set out in a testamentary spousal trust. Under the Income Tax Act ITA, assets within an RRSP/RRIF can be transferred to a surviving spouse's RRSP/RRIF on a tax-deferred basis. However, once these assets are rolled into the surviving spouse's RRSP/RRIF, the surviving spouse is typically free to do whatever they wish with these assets. A marriage contract is a useful tool that may offer some protection to an estate plan that contemplates the surviving spouse will not recklessly deplete the RRSP/RRIF and will designate certain beneficiaries to ultimately receive the proceeds on the death of the surviving spouse.

However, you may feel strongly that it is more important that the use of the proceeds of your RRSP/RRIF be subject to certain conditions rather than be tax deferred. You may be concerned about a possible remarriage by your surviving spouse, or you may be in a second marriage. In this case, you may prefer not to designate your spouse as the beneficiary on your RRSP/RRIF or enter into a marriage contract. Your Will could be worded appropriately so that these assets would pass through the estate and into a testamentary spousal trust. As a result, probate fees may have to be paid on the RRSP/RRIF assets, and since the RRSP/RRIF assets were transferred into a testamentary spousal trust and not the surviving spouse's RRSP/RRIF, the RRSP/RRIF would be fully taxable at death.

It may be possible to avoid the full taxation of your RRSP/RRIF at time of death without naming your spouse as a beneficiary if your surviving spouse has his/her own non-registered assets and the executor and the surviving spouse elect to use the following strategy.

Combining Testamentary Trust and RRSP/RRIF Strategy

This strategy combines the benefits of a testamentary spousal trust and the ability to transfer on a tax-deferred basis your RRSP funds to the extent that your surviving spouse has the equivalent amount of non-registered assets and is willing to transfer them into an RRSP/RRIF. This strategy allows the assets in your RRSP to be paid to the estate and as a result form part of the testamentary spousal trust. However, provided that your spouse is a beneficiary of your estate (even of only $1) or, under a proposed amendment to section 146(8.1) of the ITA, a beneficiary of a trust set up under the estate, the executor and your surviving spouse could jointly elect for an amount up to your RRSP value at date of death to be included in your spouse's income as a refund of premiums, and your surviving spouse can pay up to that amount from his/her own funds to his/her RRSP/RRIF by way of an election and claim an offsetting deduction under section 60(l) without using RRSP contribution room. This strategy works since it is not necessary to transfer the exact assets out of your registered plan to your surviving spouse's registered plan. Therefore, your spouse could use his/her own non-registered assets to make a contribution and claim a deduction. This strategy has the following benefits:

1) Your registered plan assets form part of your testamentary spousal trust subject to taxation at the marginal tax rates. In addition, through the use of the testamentary spousal trust, you could control these assets and ensure that they don't form part of your spouse's estate, which may be important in case of a second marriage;

2) Your registered plan assets will not be subject to taxation at time of death to the extent that your spouse rolls over the same amount into an RRSP/RRIF, which allows your spouse to get a deduction to offset his/her income inclusion;

3) Your surviving spouse is able to turn his/her non-registered assets into registered plan assets to take advantage of tax-deferred growth inside the registered plan.

This strategy is also available for RRIF assets using an election under 146.3(6.1) of the ITA.

Let's illustrate with an example. Mr. Smith died with an RRSP worth $1,000,000. Mr. Smith's Will bequeathed all of his property to a spousal trust in favour of Mrs. Smith. Mrs. Smith is 60 years old with non-registered assets of $1,000,000. Mr. and Mrs. Smith have named their children as the ultimate beneficiaries of their estate. The following table compares using the above mentioned strategy (see the heading "STRATEGY") vs. paying tax on Mr. Smith's RRSP and transferring the after-tax funds into a testamentary trust, thereby ignoring probate fees (see the heading "NO STRATEGY"). With the strategy, Mr. Smith's registered plan of $1,000,000 would be transferred to the testamentary trust. Mrs. Smith will use her non-registered assets to make a contribution to her RRSP in the amount of $1,000,000. If the assets have accrued capital gains, then a capital gain would be triggered. If the investments have accrued losses, then the investments should be disposed of to trigger the capital loss and the funds should be transferred to the registered plan. In order to avoid the superficial loss rules, the securities in a loss position should not be reacquired in the 30-day period, before or after the disposition.

	STRATEGY		NO STRATEGY	
	Spouse's Registered Plan	Trust Assets	Spouse's Assets Non-Registered Plan	Trust Assets
Assets	(1) $1,000,000	(2) $1,000,000	$1,000,000	(3) $540,000
Income at 5%	50,000	50,000	50,000	27,000
Taxes Payable	(4) 0	(5) 12,500	(5) 12,500	(5) 6,750
Net Income	50,000	(6) 37,500	(6) 37,500	20,250
Net Income Reinvested	50,000	(6) 0	(6) (7) 20,250	(7) 0
Total	1,050,000	1,000,000	1,020,250	540,000

(1) Assumes no capital or gain or loss on transfer of non-registered assets to spouse's registered plan

(2) No tax on $1,000,000 since spouse made election to transfer $1,000,000 to her RRSP

(3) Tax on $1,000,000 at a rate of 46% reduces assets to $540,000. The tax is payable since RRSP assets are transferred to trust not to the surviving spouse's RRSP

(4) Since income is earned in a registered plan, there is no tax until withdrawals are made from the registered plan

(5) Tax at a rate of 25%

(6) Assumes spouse's income under "STRATEGY" is equal to income retained in "NO STRATEGY".. Also, net income was not reinvested and used to pay Mrs. Smith's living expenses in either case.

(7) $20,250 is paid out to Mrs. Smith from the trust and re-invested in her non-registered account

As you can see from the table, the net income from the trust is higher when the strategy is used. In addition, the assets accumulated in the registered plan grow at a faster rate because of the tax deferral when compared to the non-registered plan. The following tables compare the benefit of using the strategy versus not using the strategy after one year and after 12 years. At age 72, Mrs. Smith has to convert the RRSP to a RRIF and begin to receive minimum payments.

At The End of Year One:

	STRATEGY	NO STRATEGY	DIFFERENCE
Spouse's Assets	$1,050,000	$1,020,250	$29,750
Trust Assets	$1,000,000	$540,000	$460,000
After-Tax Income Distributed to Spouse	$37,500	$37,500	$0

At the End of 12 Years (At Time of Converting to a RRIF):

	STRATEGY	NO STRATEGY	DIFFERENCE
Spouse's Assets	$1,795,856	$1,299,700	$496,156
Trust Assets	$1,000,000	$540,000	$460,000
After-Tax Income Distributed to Spouse	$450,000	$450,000	$0

When Mrs. Smith dies, the RRIF would be included in her income and subject to tax at that time. Assuming Mrs. Smith dies at the age of 72, the following table illustrates the benefit of using using the strategy versus not using the strategy after the death of both Mr. and Mrs. Smith.

If Surviving Spouse Dies at Age of 72:

	STRATEGY	NO STRATEGY	DIFFERENCE
Spouse's Assets	$1,795,856	$1,299,700	$496,156
Tax on death	-826,094	0*	-826,094
Net after tax	$969,762	$1,299,700	-329,938
Trust Assets	$1,000,000	$540,000	$460,000
Total Assets	$1,969,762	$1,839,700	$130,062

*** assumes no taxable capital gains**

This strategy results in more assets accumulated over time and a deferral of tax. However, your surviving spouse has to pay tax in the future as funds are withdrawn from the registered plan or at the time of death. If the spouses have different ultimate beneficiaries in their own estate plan, there might be inequities in the amount of assets available for distribution. This might lead your spouse to refuse to sign the joint tax election, causing your estate to pay more tax in your final tax return, and leaving less for your children or other residual beneficiaries. Consequently, in order for this strategy to work as intended, it is often advisable to ensure that the testamentary spousal trust would provide for capital encroachment to pay any increased tax liability of your spouse. If your Will is structured in a manner that depends on this strategy, you may want to consider entering into a marriage contract to ensure your spouse agrees to this strategy and will sign the joint tax election at time of your death.

You should consult your legal and tax advisor to determine whether the strategy of combining a testamentary trust and RRSP/RRIF is suitable for you. The Canada Revenue Agency (CRA) has discussed this strategy in a French document, namely CRA view 2006-0201261E5 (the CRA has not translated this document at this time).

Other Considerations

If a testamentary spousal trust is set up and any of the specific ITA requirements are not met, then the trust will be "tainted", meaning it no longer qualifies as a testamentary spousal trust. Special consideration needs to be applied when drafting the Will to ensure the terms in the ITA are met. Some common errors that taint testamentary spousal trusts include having a condition that the surviving spouse may not receive the income from the trust if he/she remarries, or allowing income or capital to be distributed to someone other than a spouse during the surviving spouse's lifetime. In addition, loans to other individuals from the trust may also taint the trust.

It is possible to create more than one testamentary trust under your Will. One trust could be a testamentary spousal trust that adheres to the restrictions outlined in the ITA and that allows you to transfer some assets into this trust on a rollover basis. Another trust might name your spouse and other beneficiaries to benefit from the trust, and you could have your own terms and restrictions for this trust. This would allow you to provide for other beneficiaries during your spouse's lifetime, and for even more income to be taxed at graduated marginal tax rates in each testamentary trust.

Probate Concerns

Potentially probate fees may be incurred prior to setting up a testamentary trust. Probate fees are incurred where assets form part of your estate, which must happen before the provisions of your Will can transfer your assets into a trust. This is a factor that should be assessed prior to deciding if a testamentary spousal trust makes economic sense. Keep in mind that the tax savings every year from a testamentary trust may outweigh the one-time cost of probate fees.

Note however that any assets remaining in a testamentary trust upon death of the last spouse or income beneficiary can avoid a second probate fee. For example, the assets remaining in a testamentary spousal trust that are distributed to the other beneficiaries after the death of the last spouse do not generally form part of the estate of the last spouse.

Legal, Accounting and Trust Administration Fees

It must be acknowledged that the creation of a testamentary spousal trust will result in annual fees. It is imperative that a cost-benefit analysis be done to ensure that this structure is a viable option for you.

Testamentary Trust Calculator

As mentioned above, there are various costs associated with setting up a testamentary trust such as probate taxes (which should be taken into account where they could otherwise be avoided), legal fees, and ongoing accounting and trust administration fees. It is important to consider these costs and the benefits of setting up a testamentary trust prior to proceeding to ensure that the testamentary trust makes sound financial sense. In order to assist you with this calculation, we have a calculator that can estimate the potential annual tax savings that may be achieved with a testamentary trust. If you require further assistance with this calculation, please speak to your advisor at RBC. Bear in mind that the calculator cannot anticipate every detail of your personal situation, and is not intended to replace professional advice.

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