EDUCATIONAL BULLETIN

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Testamentary Trusts

A Reason to Consider Amending Your Will

Many people have structured their financial affairs so that upon their death their assets are distributed outright to loved ones such as spouses and/or children. Outright distributions include non-registered assets set up in the form of Joint Tenancy with Right of Survivorship (JTWROS – not available in Quebec) and registered assets such as RRSPs, RRIFs and life insurance contracts may have designated beneficiaries on the account. Many people structure their assets as JTWROS or with designated beneficiaries primarily to avoid probate tax since these assets do not pass through their estate (probate tax is negligible in Quebec and Alberta). Sometimes even for those assets that do pass through their estate, many individuals' Wills simply state that the estate assets are to be provided outright to their adult beneficiaries.

However, for reasons discussed in this article, you may want to reconsider the current structure of your assets and consider amending your Will to provide for a transfer of some or all of your estate assets into a testamentary trust for the benefit of your spouse and/or children.

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

WHAT IS A TESTAMENTARY TRUST?

In most circumstances, a testamentary trust is a trust established under your Will. Only assets passing through your estate, after death, can be transferred to a testamentary trust. In this way, a testamentary trust is only established after death.

In your Will, directions for a testamentary trust would be specified, including an amount of money or other property to be held for a specified period for beneficiaries you have identified and on the terms directed by you. For example, you may wish to benefit your children by leaving them a portion of your estate but you may feel that they should not receive their inheritance until they are old enough to manage it responsibly. You would direct your chosen trustees to hold and invest their inheritance in a testamentary trust for your children until they reach an age you consider appropriate. Alternatively, you can give your trustee full discretion on the amount and timing of trust distributions to the beneficiaries.

It is common practice (but not mandatory) to have the executor of your estate also be the trustee of any testamentary trust that may have been created. Testamentary trusts may have a life span of a few years or may continue for many years after the initial administration of your estate has been completed.

If a spouse is a beneficiary of your testamentary trust, consider setting up a testamentary spousal trust where the assets may roll over to the trust at Adjusted Cost Base (ACB). Speak to us for a copy of the article "The Testamentary Spousal Trust" if you are interested in learning more about Testamentary Spousal Trusts.

Note that since only assets passing through your estate can be transferred to a testamentary trust, probate taxes will likely have to be paid (an exception exists for an insurance testamentary trust). Furthermore, once your testamentary trust is established, annual trust tax returns are generally required to report investment income earned within the trust. Probate taxes and the additional costs and complexities of preparing annual trust tax returns are two of the main reasons why you might consider not establishing testamentary trusts.

HOW IS A TESTAMENTARY TRUST TAXED?

One of the major benefits of establishing a testamentary trust is the income tax advantages for the surviving beneficiaries associated with a testamentary trust. These income tax benefits are not available to beneficiaries that receive outright inheritances. Taxable income earned in a testamentary trust can be subject to the same graduated tax rates as an individual taxpayer. However, the basic personal exemption is not available when completing a tax return for any trust including a testamentary trust. Since the income earned within a testamentary trust is taxed on a separate tax return at graduated tax rates, an income splitting opportunity arises for your beneficiary.

For example, let's assume an adult child is in the top marginal tax bracket of approximately 46% (top marginal tax rate varies by province). Upon the parent's death, this child is expected to receive an inheritance of approximately $500,000. Currently, the parent's Will does not have a provision for a testamentary trust. Further assume that this inheritance will be invested by the child and will produce annual taxable income of 5% of the inheritance or $25,000 per year. The investment income generated from the inheritance will be included on the child's personal tax return and tax will be payable at their marginal tax rate of 46%. However, what if the inheritance was transferred into a testamentary trust for the child's benefit? In this case, the $25,000 investment income can be taxed on a separate trust tax return at graduated tax rates. The following table illustrates the income tax benefit of investing an inheritance through a testamentary trust for the child's benefit compared to the child directly investing the inheritance in their own personal name.

	Inheritance transferred to adult child outright	Inheritance transferred to testamentary trust (*)
Taxable Income	$25,000	$25,000
Tax Payable	($11,500)	($5,500)
Trust Tax Return Fees	$0	($500)
Net Income	$13,500	$19,000

(*) It is assumed that trustee fees will not be charged and the trust is taxed at 22%.

As you can see by the above table, the adult child enjoys an overall savings of $5,500 [$19,000 - $13,500] per year by earning investment income through a testamentary trust. However, to paint a true picture, transferring assets to the estate to establish the testamentary trust could result in up front probate taxes of up to $7,500 [based on Ontario probate tax of 1.5% that is the highest in Canada - $500,000 x 1.5% = $7,500] compared to transferring the inheritance directly to the child without it passing through the estate on the death of the parent (i.e., JTWROS, beneficiary designations, etc). This probate tax would eliminate the tax savings of $5,500 in the first year and will result in an additional cost the first year. . However, everything else being equal, the tax savings of approximately $5,500 will continue to occur year after year with the testamentary trust whereas probate taxes are generally only a one-time tax liability.

Note that if the surviving beneficiary is expected to have taxable income from all sources of less than $35,000 (approximate average of lowest tax bracket threshold for all provinces) then there is likely no income splitting benefit of a testamentary trust.

Note that any assets remaining in a testamentary trust after the death of the beneficiary can avoid a second probate tax. That is, assets remaining in the testamentary trust that are distributed to contingent beneficiaries after the death of the primary beneficiaries (i.e., spouse or children) do not form part of the estate of the primary beneficiary.

What if the income earned within the testamentary trust is paid out of the testamentary trust to the beneficiary and they are in the top marginal tax bracket? Normally, income paid out of a trust to the beneficiary is not taxed within the trust but taxable to the beneficiary on their personal tax return. However, given this result would cause a higher rate of income tax than if the income was retained and taxed in the testamentary trust, the trustee can actually elect to have income that is paid to a beneficiary to be taxed within the testamentary trust at graduated tax rates. This election will serve to decrease the tax payable by the beneficiary on the income they receive from the trust.

WHAT ARE SOME NON-FINANCIAL BENEFITS OF A TESTAMENTARY TRUST?

In addition to the tax benefits discussed above, there may be other non-tax motivated reasons why you would consider amending your Will to include a provision for a testamentary trust.

For example, assume a widowed mother has an RRSP where her adult daughter (not disabled) is the designated beneficiary. Upon her death, the fair market value of the RRSP will be taxed on the mother's final tax return and the assets inside the RRSP will pass directly to the daughter (although no longer in registered form) avoiding probate taxes. However, the mother may fear that these assets:

- Will be invested poorly by the daughter;
- Will be spent irrationally by the daughter;
- Will be subject to creditors of the daughter; and/or
- Will be accessible to the daughter's spouse.

Due to the mother's possible concerns, she may consider not naming the adult daughter as the designated beneficiary on her RRSP and amend her Will so that these RRSP assets pass through her estate and into a testamentary trust for the daughter's benefit. Although probate taxes may now have to be paid, the testamentary trust allows for the following:

- The mother can now appoint a trustee to manage these assets for the daughter's benefit.
- The mother is able to provide instructions in her Will for the amount of income and timing of the income to be paid to her daughter from these assets.
- The assets in the testamentary trust may be protected from potential creditors of the daughter.
- The assets in the testamentary trust can potentially be shielded from the daughter's spouse.

WHAT IF I DON'T WANT TO RESTRICT MY BENEFICIARIES IN USING MY INHERITANCE?

There is nothing stopping you from appointing your spouse or an adult child beneficiary of the testamentary trust, to also be the trustee. That is, you may want your beneficiaries to have full use and control of their inheritance. However, possibly due to the tax reasons explained previously, there may be a benefit of transferring the inheritance to a testamentary trust instead of an outright distribution to the beneficiary.

In this case, the provisions of the testamentary trust can allow your spouse, adult children or other adult beneficiaries use of the annual income earned within the trust but also allow the capital of the trust to be accessed or encroached upon by them at their own discretion.

WHAT DO I NEED TO DO NOW SO THAT A TESTAMENTARY TRUST IS ESTABLISHED AFTER MY DEATH?

First, your Will needs to be amended to provide for the establishment of a testamentary trust. This amendment will involve a meeting with a lawyer familiar with estate planning. As a result, there will be professional fees incurred to amend the Will or to create a new Will if there is not a valid Will already in place.

Second, your assets that you currently own may need to be restructured so that upon your death they will "flow through your estate". Therefore, assets that are currently in JTWROS must be put into your sole ownership. Note that if there are non-spouses currently on the JTWROS, capital gains may be triggered on the unwinding of a JTWROS so a thorough cost/benefit analysis needs to be undertaken.

Designated beneficiaries on RRSP/RRIF assets may have to be removed so that these assets pass through the estate. Note that an exception exists with insurance policies. That is, it is possible to transfer a death benefit payable from an insurance policy into a testamentary trust without the assets forming part of your estate and without probate taxes being paid.

Having said all of the above, you and/or your beneficiaries may want to keep your financial affairs simple. As a result, although the "numbers" may conclude that a testamentary trust may be the best solution for a beneficiary from an income tax savings standpoint, one's financial affairs will become a little more complicated if pursuing the testamentary trust strategy (i.e., amendment to Will, probating the Will at the first to die, longer time to transfer the assets to beneficiaries, potential challenges to the Will, annual trust tax returns, etc). As a result, some individuals may still prefer the outright distribution route (such as JTWROS or designated beneficiary) due to its simplicity and avoidance of probate taxes. However, if there are individuals who want to seek all opportunities to reduce the overall tax of their family after their death and are cognizant of the potential complexities, then a testamentary trust provision in the Will may be an avenue to consider.

PROBATE CONCERNS

Probate fees may be incurred prior to setting up the testamentary trust. The probate taxes are incurred due to the fact that the assets will form part of the deceased's estate. It is through a specific provision of the deceased's Will that will allow the transfer of the deceased's assets into the testamentary trust. Hence, this is just another factor that must be assessed prior to deciding whether a testamentary trust makes economic sense.

LEGAL, ACCOUNTING AND TRUST ADMINISTRATION FEES

It must be acknowledged that the creation of a testamentary 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 us at RBC. Bear in mind that the calculator cannot anticipate every detail of your personal situation, and is not intended to replace professional advice.

› FOR MORE INFORMATION, PLEASE CONTACT US.

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