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Testamentary Trusts

A Reason to Consider Amending Your Will

WEALTH MANAGEMENT

Currently there are many people that have structured their financial affairs so that upon their death their assets are distributed outright to loved ones such as spouses and/or children. For example, non-registered assets set up in the form of Joint Tenancy with Right of Survivorship (JTWROS – not available in Quebec), registered assets such as RSPs, RIFs 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 one's estate (probate tax is negligible in Quebec and Alberta). Sometimes even for those assets that do pass through one's estate, many individual's Will simply states that the estate assets are to be provided outright to their beneficiaries although usually with the exception of minor children. However, for reasons discussed in this article, certain individuals may want to reconsider the current structure of their assets and consider amending their Will to provide for a transfer of some or all of their estate assets into a* ***testamentary trust*** *for the benefit of their spouse and/or children.*

WHAT IS A TESTAMENTARY TRUST?

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

In a trust you specify 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 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.

Note that since only assets passing through one's 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 the 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 people avoid establishing testamentary trusts.**

HOW IS A TESTAMENTARY TRUST TAXED?

One of the major benefits of establishing a testamentary trust are 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 the 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 $250,000. 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 $12,500 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 $12,500 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	$12,500	$12,500
Tax Payable	($5,750)	($2,756)
Trust Tax Return Fees	$0	($500)
Net Income	**$6,750**	**$9,244**

(*) It is assumed that trustee fees will not be charged.

As you can see by the above table, the adult child enjoys an overall savings of **$2,494 [$9,244 - $6,750] 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 $3,750 [based on Ontario probate tax of 1.5% that is the highest in Canada - $250,000 x 1.5% = $3,750] 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 $2,494 in the first year and will result in an additional cost the first year. However, everything else being equal, the tax savings of approximately $2,494 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 $36,000** (approximate lowest tax bracket threshold) 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 an individual would consider amending their Will to include a provision for a testamentary trust.

For example, assume a widowed mother has an RSP where her adult daughter (not disabled) is the designated beneficiary. Upon her death, the fair market value of the RSP will be taxed on the mother's final tax return and the assets inside the RSP 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 RSP and amend her Will so that these RSP 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.

CAN MY RSP/RIF BE HELD WITHIN A TESTAMENTARY TRUST FOR THE BENEFIT OF MY SPOUSE?

It is not possible to transfer the assets of an RSP/RIF on a tax-deferred basis into a surviving spouse's RSP/RIF and have these RSP/RIF assets subject to the restrictions set out in a testamentary trust. Under our Income Tax Act, assets within an RSP/RIF can be transferred to a surviving spouse's RSP/RIF on a tax-deferred basis. However, once these assets are rolled into the surviving spouse's RSP/RIF, the surviving spouse is free to do whatever they wish with these assets. The deceased spouse on the use of these RSP/RIF assets by the surviving spouse can invoke no conditions or restrictions.

However, what if a spouse feels that it is more important to them that the use of their RSP/RIF assets be subject to certain conditions – they may be concerned about a possible remarriage by their surviving spouse or they may be in a second marriage? In this case, the spouse would not be the designated beneficiary on the RSP/RIF and the Will would be worded appropriately so that these assets can pass through their estate and into a testamentary trust. As a result, probate taxes may have to be paid on the RSP/RIF assets and since the RSP/RIF assets were transferred into a testamentary trust and not the surviving spouse's RSP/RIF, **the RSP/RIF will be fully taxable at death, which can be very punitive.** As you can see, a spouse in this dilemma will have to make a choice as to what is more important to them – the tax deferred rollover aspect of an RSP/RIF at death or subjecting the use of the RSP/RIF to certain restrictions – unfortunately they cannot have both.

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

There is nothing stopping the testator from appointing the spouse or an adult child beneficiary of the testamentary trust, to also be the trustee. That is, they may want their 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 the spouse or adult child use of the annual income earned within the trust but also allow the capital of the trust to be accessed or encroached upon by the spouse or adult child 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 sole ownership of the testator. 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 RSP/RIF 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 (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.

Note: The above information is based on the current and proposed tax law in effect as of the date of this article. The article is for information purposes only and should not be construed as offering tax or legal advice. Individuals should consult with qualified tax and/or legal advisors before taking any action based upon the information contained in this article.