The Navigator

Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Testamentary spousal trusts

It is common to distribute your assets on death outright to your surviving spouse. A testamentary spousal trust is an alternative to an outright distribution of your estate assets to your spouse. It may allow you to have more flexibility in dealing with complex family situations. A testamentary spousal trust is also a means of protecting and maintaining control of your assets on death as the trustee you choose invests and manages the assets held in trust. This article discusses reasons you may want to consider amending your Will and reviewing the current ownership structure of your assets to provide for a transfer of some or all of your assets to a testamentary spousal trust.

What is a testamentary spousal trust?

A testamentary spousal trust is a trust that is established for the benefit of your surviving spouse or common-law partner through provisions in your Will. For the purposes of this article, any reference to “spouse” includes a common-law partner. If properly structured, a testamentary spousal trust may allow for a deferral of the capital gains tax liability that may otherwise arise upon your death. A properly structured trust will also avoid the 21-year deemed disposition rule that generally applies to trust assets. In addition to these tax benefits, a testamentary trust may allow you to protect and control the assets on death.

What criteria must be met?

In order to qualify as a testamentary spousal trust under the Income Tax Act (ITA), the following criteria must be met:

- The transfer of the property occurs as a consequence of your death, to a trust created by provisions in your Will;
- The surviving spouse is entitled to receive all of the income from the testamentary spousal trust that arises during the surviving spouse’s lifetime;
- No other person may receive or otherwise obtain the use of any of the income or capital of the testamentary spousal trust during the surviving spouse’s lifetime. Simply put, only the surviving spouse should have access to the testamentary spousal trust funds until they die. However, restrictions can be imposed on making distributions of capital to your spouse;
- The capital property transferred to the spousal trust must “vest indefeasibly” in the spouse or 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. Vesting simply means that the beneficiary has a right to an asset and no future event can deny them of that right; and

- The deceased must be resident in Canada immediately before death and the trust created by the deceased's Will must be resident in Canada immediately after the time the property "vests indefeasibly" in the trust. The trust must be factually resident in Canada (i.e., not a factually non-resident trust that is deemed to be resident in Canada). A trust is generally considered to reside where the trustee, executor, administrator, heir or other legal representative who manages the trust or controls the trust assets resides.

Reasons to consider a testamentary spousal trust

Second marriages

Second marriages add an additional level of complexity 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 situation. The possible benefits of a testamentary spousal trust are illustrated in the following example:

You wish to provide for your second spouse but on their death you want your assets to go to your children from your first marriage. If the assets are given to your second spouse outright, then on their death, the assets would form part of their estate and could end up in the hands of their children.

If faced with this situation, you may want to consider using a testamentary spousal trust as a component of your estate planning strategy. The assets transferred to the trust would be held in trust for your spouse for their lifetime. All the income from the assets would be paid to your spouse for their 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 the replacement trustees especially in a second marriage scenario where your surviving spouse and children may have conflicting interests. A corporate trustee may be considered in this scenario.

On the death of your surviving spouse, the remaining assets of the testamentary spousal trust could be paid out to your children from your 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 plan, you have the potential to satisfy both of your estate planning needs: supporting your second spouse and providing an inheritance to your children from your first marriage.

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

Note that a testamentary spousal trust may even be useful if this is your first marriage. In the event that your spouse remarries after your death, this strategy can help ensure that your assets pass to your children on your spouse's death and not to their new spouse.

It is also important that you speak with a qualified legal advisor about any support or maintenance obligations with respect to your spouse under provincial legislation or contract that may impact your ability to use this type of trust as an estate planning vehicle.

Spouse lacks financial expertise

If your surviving spouse lacks financial expertise, you may have concerns about how your assets will be managed after your death. You may want to appoint a corporate trustee to manage the trust assets to ensure the assets are protected from inappropriate investment and risk.

Wealth protection

A testamentary spousal trust may help protect your assets from your surviving spouse's creditors. To maximize creditor protection, you may not want to name your spouse as a trustee of the trust. If you wish to appoint your spouse as trustee, they should not be the sole trustee or have control over the other trustees' actions. In addition, you may want to preclude the distribution of capital to your spouse. If your intention is to allow your spouse to have access to some or all of the trust's capital, you may wish to limit the trustee's power to distribute capital to your spouse or subject this power to restrictions. You should speak with a qualified legal professional regarding creditor protection.

Control over business assets

You may want your spouse to benefit from your business during their lifetime but may also want your children to manage and ultimately inherit your business. Transferring the shares of your business to a testamentary spousal trust allows you to defer the tax liability on these shares until your spouse's death, provide income to your spouse from the business during their lifetime and facilitate the succession of the business to your children.

A testamentary spousal trust may not be appropriate in circumstances where your children are feuding with your spouse. The family discord and the fact that the business will not vest to your children until your spouse's death may cause problems in the efficient running of the business. For example, the desire of the children to reinvest the earnings back into the business and keep the dynasty alive might clash with your spouse's income requirements. It is important to discuss your estate plan with your successors to ensure that your business is successfully transitioned.

Taxation of a testamentary spousal trust

In general, on your death, you are deemed to dispose of your capital property at fair market value (FMV), triggering the realization of any accrued capital gains. It is possible to defer these gains where your capital property is transferred to a surviving spouse or qualifying spousal trust. In such a case, your assets can be transferred to the testamentary spousal trust at your adjusted cost base so that capital gains are deferred until the assets are sold or the death of your surviving spouse, whichever occurs first.

To qualify as a spousal trust, the beneficiary spouse must be entitled to receive all of the income earned in the trust during their lifetime. This means that your spouse must have a legal right to enforce payment of the income and no one can withhold it from them. As a result, income earned by a testamentary spousal trust must generally be paid or made payable to your spouse annually. The income paid or made payable to your spouse will generally be taxed in their hands at their marginal tax rate.

Note that it is possible to draft a testamentary spousal trust that provides the spouse with discretion to recapitalize this income in the trust. Your spouse may want this option if they are concerned about having the additional income impact their income-tested government benefits. As long as the discretion to leave income in the trust can only be exercised by the spouse, this power will not preclude the trust from qualifying as a testamentary spousal trust. Also, if the trust does not contain an express discretion on the part of the spouse, it may remain possible to leave the income in the trust if the spouse signs a written disclaimer giving up all rights to the receipt of income. In such a case, the income earned and retained in the trust would be taxed in the trust at the top marginal tax rate (unless the spousal trust is a Qualified Disability Trust (QDT), in which case the income may be taxed at graduated tax rates. For more information on QDTs, please refer to our article titled, "Testamentary Trusts").

On your spouse's death, there will be a deemed disposition of the trust assets at FMV. When a trust qualifies as a spousal testamentary trust, it is not subject to the 21-year deemed disposition that normally applies to trusts but instead is subject to a deemed disposition only on the death of the surviving spouse. The gains realized as a result of your spouse's death will be taxed in the trust at the top marginal tax rate in the trust's province of residence. An election may be available to have the deemed gain arising from your spouse's death to be taxed in your spouse's terminal tax return at their marginal tax rate as opposed to in the trust if certain conditions are met, which include:

1. Your spouse is a resident of Canada immediately before their death;
2. The trust is a testamentary spousal trust;
3. The trust was created by the Will of a person who died before 2017;
4. The trustee of the testamentary spousal trust and the executor/liquidator of your spouse's estate make a joint election in a prescribed form; and
5. The trust's tax return and the deceased's tax return both include a copy of the joint election.

Registered retirement assets and the 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 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 may offer some protection to an estate plan that contemplates the surviving spouse will not recklessly deplete the RRSP/RRIF assets and will designate certain beneficiaries to ultimately receive the proceeds on the death of the surviving spouse.

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 transferred, tax-deferred, to your spouse. For example, you may be concerned about a possible re-marriage by your surviving spouse, or you may be in a second marriage. In these cases, you may prefer to designate your estate as the beneficiary of your RRSP/RRIF and have the assets pass through your estate into a testamentary spousal trust created under your Will. As a result, probate fees, in addition to income tax, may have to be paid on the RRSP/RRIF assets.

Probate concerns

In general, only assets passing through your estate can be transferred to a testamentary trust (an exception exists for insurance proceeds that may be paid directly to the trust, rather than through the estate). As a result, probate taxes may have to be paid on the value of these assets. This is one factor that may be considered prior to setting up a testamentary spousal trust.

Given that a testamentary spousal trust is generally funded with assets that pass through the estate, it is important to review the ownership structure of your assets to ensure that the assets intended to form part of the trust fall into the estate and do not pass outside of the estate. For example, if you hold a non-registered account jointly with your spouse and you want your portion of those assets to go into a trust for the benefit of your spouse on death, you may wish to divide the assets into two separate accounts in each of your names. Potentially probate fees may be incurred prior to setting up a testamentary trust.

Probate fees payable on the assets passing to a testamentary spousal trust may be a one-time expense. Any assets remaining in a testamentary trust upon the death of your spouse can avoid a second probate fee. The assets remaining in the testamentary spousal trust that are distributed to the other beneficiaries after your spouse's death do not form part of your spouse's estate and are not subject to probate fees.

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 your 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 they remarry 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. However, you would not benefit from tax-deferral on the transfer of assets to this trust.

It is worth keeping in mind that the testamentary spousal trusts involve annual legal, accounting and trust administration fees, so a cost-benefit analysis is important.

Conclusion

A testamentary spousal trust is an estate planning tool which can ensure your wishes and intentions regarding the use of the inheritance and who ultimately receives your assets will be respected. For more information on testamentary spousal trusts, including whether it makes sense for you to incorporate one as part of your estate plan, speak to your qualified legal advisor.

This article outlines strategies, not all of which will apply to your particular circumstances. The information is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified legal and/or tax advisor before acting on any of the information in this article.

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