Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Testamentary spouse or common-law partner trusts (testamentary spousal trusts)

It is common to distribute your assets on death outright to your surviving spouse or common-law partner (for the purposes of this article, any reference to "spouse" includes a common-law partner). A testamentary spousal trust is an alternative to a direct or an outright distribution of your estate assets to your spouse. It allows you to have more flexibility in dealing with complex family situations. The assets held in the trust are invested and managed by the trustee of the trust, who distributes the income and capital in accordance with the wishes stated in your Will. This article discusses some of the reasons you may want to consider using such a trust, how these trusts are taxed and other considerations.

What is a testamentary spousal trust?

A testamentary spousal trust is a trust established for the benefit of your surviving spouse through provisions in your Will. Similar to the tax treatment of an outright transfer of assets to your surviving spouse, a properly structured testamentary spousal trust may allow for a deferral of the capital gains tax liability upon your death. The 21-year deemed disposition rule that generally applies to trust assets does not apply to a testamentary spousal trust. In addition to these tax benefits, a testamentary trust may allow you to protect and control the assets after 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 your Will;
- Your surviving spouse is entitled to receive all of the income from

the testamentary spousal trust that arises during their 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 spousal trust within 36 months of the deceased's death and before the death of the surviving spouse. Although not defined in the ITA, generally property vests indefeasibly in a trust when the trust acquires absolute and unconditional legal or beneficial ownership in the property; 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 its real business is carried on, which is where the central management and control of the trust actually takes place. Usually the management and control of the trust rests with, and is exercised by, the trustee, executor, liquidator, administrator, heir or other legal representative of the trust.

Non-financial benefits of a testamentary spousal trust

Subsequent marriages

Subsequent 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, among many, that may be useful in this situation. The possible benefits of a testamentary spousal trust are illustrated in the following example.

You wish to provide for your current spouse but on their death, you want your assets to go to your children from a previous marriage or relationship. If the assets are given to your spouse outright, on their death, the assets would form part of their estate and could end up in the hands of their children or heirs. 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 of the income from the assets would be paid to your spouse for their support. The trustee you choose to manage the trust could also be given discretion in regards to the encroachment of the capital of the trust. It's imperative that you carefully consider your choice of trustees, especially in a subsequent marriage scenario where your surviving spouse and children may have conflicting interests. This is discussed in more detail in the next section.

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On the death of your surviving spouse, the remaining assets of the testamentary spousal trust could be distributed to your children from your previous marriage, or the assets may be paid out to successive testamentary trusts for your children, as established in your Will. In essence, with the testamentary spousal trust as a component of your estate plan, you have the potential to satisfy two key estate planning goals: supporting your spouse and providing an inheritance to your children from a previous marriage.

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

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

Spouse lacks willingness or expertise to manage the assets

Your surviving spouse may be accustomed to having you take care of the financial affairs or may lack financial expertise or the willingness to manage your estate left to them. Establishing a testamentary spousal trust with a capable trustee(s) may be a way to preserve and protect your wealth for your spouse and eventually other intended residual beneficiaries. The trustee(s) can manage your investments and your other assets to provide for your spouse. If you do not have an appropriate individual to act as trustee and to manage your assets, you may consider appointing a corporate trustee.

The role of a trustee is an extremely important one, involving several key legal obligations and fiduciary duties, as well as significant managerial and administrative responsibilities. Trustees are faced with many complexities and obligations and may feel burdened by the tasks of administering a trust, or simply lack the time or expertise to undertake the role.

A trust company, like RBC Royal Trust, can help by acting as the trustee, co-trustee or as an agent for the named trustee to manage the trust assets. Some of the advantages of a corporate trustee include neutrality, availability, expertise and continuity for long-standing trusts. Appointing a corporate trustee can help ensure the administration of the trust is done in accordance with the relevant laws. It can relieve your family members and friends of the burden of administering the trust assets and mitigate any potential conflict among your trustees or with beneficiaries. A corporate trustee is appointed in the testator's Will. Fees are determined at that time and the fee agreement is incorporated into the Will. Alternatively, the trustee may opt to retain a corporate trustee as their agent at the time they are called upon to act. A fee agreement is entered into at that time. Fees are generally similar to compensation that may be payable to family members, friends or other trusted professionals acting as trustee.

If you have questions about who to appoint as a trustee or the typical responsibilities of a trustee, please speak to your RBC advisor to find out more about the services provided by RBC Royal Trust.

Creditor protection

A testamentary spousal trust may help protect your assets (but not the income) from your surviving spouse's creditors. To achieve this, 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. In this case, 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. You should speak with a qualified legal professional regarding creditor protection.

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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 and your spouse have different plans for the business. 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 your business is successfully transitioned.

Taxation of a testamentary spousal trust

In general, on your death, you're deemed to dispose of your capital property at fair market value (FMV), triggering the realization of any accrued capital gains or losses. It is possible to defer these gains or losses 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, on an asset-by-asset basis, at your adjusted cost base so that capital gains and losses are deferred until the assets are sold or the death of your surviving spouse, whichever occurs first.

As mentioned, 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. For this purpose, the income of the trust is its income calculated under the rules of trust law rather than under calculation provisions in the ITA, less certain dividend amounts (such as capital dividends or capital gains dividends). Under trust law, capital gains are not considered income. Your spouse must have a legal right to enforce payment of the income and no one can withhold it from them. Any discretion in respect of the distribution of all or part of the income of the trust must be solely in the hands of your spouse.

It is possible to draft a testamentary spousal trust that provides your spouse with discretion to waive their right to income of the trust. As long as the discretion to leave income in the trust can only be exercised by your spouse, and it is done before the income is payable, this power will not preclude the trust from qualifying as a testamentary

spousal trust. Even if the terms of the trust don't contain an express provision to allow such discretion by your spouse, it may remain possible to leave the income in the trust if your spouse indicates to the trustee in writing that they do not wish to receive such income for a particular year.

Despite any direction by your spouse for a particular tax year to retain the income in the trust, the trust income for that year would still become payable to the spouse. Consequently, such income would be included in computing the income of the spouse for that year regardless of whether the income was paid to the spouse, unless the trust made an election for the year in question to have the income taxed in the trust (only available in limited circumstances).

For Canadian tax purposes, a testamentary spousal trust is taxed like an individual. Prior to 2016, a testamentary spousal trust benefited from the same graduated tax rates applicable to individuals. January 1, 2016, saw the elimination of the graduated tax rates for most testamentary trusts. The graduated tax rates for testamentary trusts were replaced with flat top-rate taxation that's currently used for most inter vivos trusts, subject to two exceptions, a "graduated rate estate" (GRE) and a "qualified disability trust" (QDT). A testamentary spousal trust cannot be a GRE. Only an estate can be a GRE, but it may be possible for a testamentary trust to also be a QDT. For more information on GREs or QDTs, ask your RBC advisor for the article on testamentary trusts.

As a result of the changes in 2016, every dollar of taxable income generated and taxed in a testamentary spousal trust is taxed at the top marginal tax rate. However, the annual income paid or made payable to your spouse will be taxed in their hands at their marginal tax rate instead of in the trust.

Distributions of capital, if any, are generally received tax-free by your spouse. The trustee may be able to choose to make the capital distribution in cash or in-kind. From an income tax perspective, if the trustee makes the distribution in-kind to a Canadian resident beneficiary, this can generally be done on a tax-deferred basis. Capital distributions to a non-resident beneficiary must be done at FMV, triggering a taxable disposition in the trust.

All testamentary trusts, except for GREs, will be required to have a December 31 year-end. The testamentary spousal trust may be required to file an annual T3 Trust Income Tax and Information Return (T3 return). The T3 return is due within 90 days from the end of the trust taxation year.

On your spouse's death, there will be a deemed disposition of the trust assets at the FMV at the end of the day of death and there will also be a deemed year-end. A spousal testamentary trust 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 spouse beneficiary. 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.

Despite any direction by your spouse for a particular tax year to retain the income in the trust, the trust income for that year would still become payable to the spouse.

Where the testamentary spousal trust was created by the Will of a person who died before 2017, a joint election may be available to have the deemed gain arising from the spouse beneficiary's death be taxed in the spouse's terminal tax return at their marginal tax rate as opposed to in the trust, if all of the following conditions are met:

- The spouse beneficiary is a resident of Canada immediately before their death;
- The trust is a post 1971 testamentary spousal trust immediately before the spouse beneficiary's death; and
- A copy of the joint election is filed with both the final T1 Return of the spouse beneficiary and the T3 Trust Income Tax and Information Return for the tax year of the trust to which the deemed year-end applies.

Losing testamentary trust status

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 re-marry 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. A tainted spousal trust would not be eligible for the tax-deferred rollover of the testator's assets.

Registered retirement assets and a testamentary spousal trust

Although it may be possible to designate a trust as beneficiary or a trustee for a beneficiary on an RRSP/RRIF, it's not possible to transfer your RRSP/RRIF on a tax-deferred basis to 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's 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 subsequent 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.

If your spouse is financially dependent on you because of a mental impairment, it may be possible to defer the tax on your RRSP/RRIF proceeds by having the assets pass to a lifetime benefit trust (LBT) set up under your Will for the benefit of your spouse. A testamentary spousal trust cannot be an LBT because one of the requirements of an LBT is that the trustee must have the discretion to distribute amounts to the beneficiary and are required to consider the needs of the beneficiary in determining whether to pay amounts to the beneficiary. This would not satisfy the requirements of a testamentary spousal trust where the spouse has a right to the income of the trust. For more information on LBTs and beneficiary designations with respect to your RRSP/RRIF, please ask your RBC advisor for a copy of the article on estate planning for your RRSP/RRIF.

Next step in establishing a testamentary spousal trust

First, your Will needs to provide for the creation of a testamentary spousal trust. This will involve a meeting with a lawyer familiar with estate planning. As a result, there will be professional fees incurred to amend your Will or draft a new Will if you don't have a valid Will already in place.

Second, the assets you currently own may need to be restructured so that upon your death, they will "flow through your estate" and into the testamentary spousal trust. Therefore, assets currently held as joint tenants with right of survivorship (JTWROS) may need to be changed to sole ownership. 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.

A testamentary spousal trust cannot be an LBT because one of the requirements of an LBT is that the trustee must have the discretion to distribute amounts to the beneficiary and are required to consider the needs of the beneficiary in determining whether to pay amounts to the beneficiary.

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 where you stipulate your own terms and restrictions. This would allow you to also provide for other beneficiaries during your spouse's lifetime. However, you would not benefit from tax-deferral on the transfer of assets to this other testamentary trust.

Probate concerns

Since assets generally have to pass through your estate to be transferred to a testamentary spousal trust created by your Will (except for insurance proceeds or RRSP/RRIF beneficiary designations that may be paid directly to the trust, rather than through the estate), you may have additional probate costs in some provinces. All provinces except for Alberta, Quebec and Manitoba levy probate fees that are not nominal. Probate fees in all three territories are nominal. The probate fees apply to the assets that form part of your estate and then, through specific provisions in your Will, are transferred to the testamentary spousal trust. Hence, this is another factor that must be assessed prior to deciding whether a testamentary spousal trust makes economic sense.

Legal, accounting and trust administration fees

It's worth keeping in mind that a testamentary spousal trust is another separate taxpayer and arrangement that involves additional annual legal, accounting and trust administration fees, so a cost-benefit analysis is important.

Conclusion

A testamentary spousal trust is an estate planning tool that can ensure your wishes and intentions regarding the use of the inheritance and who ultimately receives your assets will be respected. It's important to consider all of the costs and complexities involved in setting up and administering a testamentary spousal trust. You may still prefer an outright distribution of your estate due to its simplicity and potential to minimize probate fees. If there are reasons that a testamentary spousal trust

makes sense for you and your family, you should consult with qualified legal and tax advisors to determine how to achieve your estate planning objectives.

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