Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Testamentary trusts

A tool that may help you achieve your estate planning objectives

It's common to distribute your assets on death outright to your loved ones. A testamentary trust is an alternative to a direct or outright distribution of estate assets. It allows you to control the timing and distribution of assets to your beneficiaries. The assets held in the trust are invested and managed by the trustee of the trust, who distributes the income and capital to the beneficiaries in accordance with your wishes stated in your Will. This article provides an overview of testamentary trusts and discusses some of the reasons you may want to consider using such a trust. This article also discusses the taxation of testamentary trusts and other considerations.

What is a testamentary trust?

A testamentary trust is a trust or estate that is generally created on and as a result of the death of an individual (the testator). If any property is contributed to the trust by anyone other than a deceased individual as a consequence of that individual's death, it would not be a testamentary trust. The terms of the trust are established in the deceased person's Will, by court order in relation to the deceased's estate, or by a separate trust document.

Directions for the creation of a testamentary trust and the terms of the trust should be specified in your Will or, in the case of a testamentary insurance trust, in a separate trust document. The Will or trust document should identify, among other things, the amount of money or other property to be held in the trust, the beneficiaries of the trust property, the trustees and their powers, the duration of the trust, and when and how distributions are to be made.

Testamentary trusts may have a lifespan of a few years or may continue for many years after the initial administration of your estate has been completed.

Testamentary spousal or common-law partner trust

If your spouse or common-law partner is a beneficiary of the testamentary trust, consider setting up a testamentary spousal or common-law partner trust, where the assets may roll over to the trust at their adjusted cost base (ACB). Speak to your RBC

advisor for a copy of the article on testamentary spousal or common-law partner trusts if you are interested in learning more about them.

Non-financial benefits of a testamentary trust

Despite the changes to the tax treatment of testamentary trusts that occurred in 2016, testamentary trusts still provide significant estate planning opportunities and should be considered for reasons other than taxation. Testamentary trusts can be used to create solutions to complex family situations — a child with a disability, a beneficiary who can't manage their finances, grandchildren in need, a second marriage, etc.

Protecting beneficiaries with special needs

If you have a child with a disability, you may want to ensure they're well taken care of, both physically and financially, after you're gone. A testamentary trust may allow you to set aside funds and name a trusted party to take care of your child's financial needs. In addition, if your child would otherwise qualify for provincial disability support, leaving the funds directly to that child may jeopardize the child's eligibility for this support. In some provinces and territories, you may be able to leave significant funds in a testamentary Henson trust and still allow your beneficiary with a disability to qualify for provincial disability support. If you would like more information on Henson trusts, ask your RBC advisor for a copy of the article on that topic.

Trust for minor children or beneficiaries who can't manage their finances

Funds left outright to a minor child cannot be paid directly to the minor child, as they do not have the legal capacity to manage those funds. Depending on the governing provincial/territorial legislation, the funds may have to be paid to a provincial/territorial body, such as the Office of the Children's Lawyer or the Public Guardian and Trustee or a court-appointed guardian of property, to hold and manage the funds until the child reaches the age of majority. The use of the funds may be restricted. As well, this may result in excessive time, costs and complexity in managing the child's estate. These potential difficulties may be avoided by establishing a testamentary trust in your Will for the benefit of your minor children and designating a trustee(s) to manage the trust funds. You may specify in your Will what the trust funds are to be used for and when they can be used. Alternatively, you may leave those decisions to the discretion of your chosen trustee(s).

Even if you don't have minor children, you may have a particular child or person you wish to benefit who may not be good at handling their financial affairs. A testamentary trust may allow you to ensure the beneficiary does not exhaust the trust assets too quickly.

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Providing for education and other expenses of children and grandchildren

You may want to establish a trust for a very specific purpose, such as to fund the educational expenses of your children or grandchildren. Establishing a trust allows your trustee(s) to control how the inherited funds are used.

Control over the timing of distribution of assets

If you have a significant estate and your children or other beneficiaries are relatively young, you may feel it would not be a good idea to leave a significant amount of money to your beneficiaries until they've reached a certain level of maturity. You may feel they're too young to handle a sizable estate before a certain age (age 30 or 35, for example). Establishing a trust may allow you to control the timing of distributions of assets to your beneficiaries.

Planning for blended/modern families

If you're in a second marriage or common-law relationship and you have children from a previous marriage or you have children from different relationships, a testamentary trust may be a suitable vehicle to provide for all of your desired beneficiaries who are part of your family. For example, you can create a testamentary trust that provides for your spouse during their lifetime and, on the spouse's death, distributes the trust assets to your children from your previous marriage or relationship. Alternatively, you may want to establish more than one testamentary trust for different family members that are managed by different trustees.

To preserve continuity of ownership (e.g. cottage property, family business)

If your family owns a cottage and you would like to ensure, as much as possible, that it's kept in the family for future generations, you may consider establishing a testamentary trust to hold the property, instead of leaving it outright to your children. The concept of holding a cottage or other vacation property in a trust is discussed in the article on succession planning for your Canadian vacation property. If you are interested, ask your RBC advisor for a copy.

Other assets that you wish to preserve ownership of, such as shares of a family business, may also be held in a testamentary trust.

Wealth protection and management

The family you leave behind may be accustomed to having you take care of the financial affairs. Establishing a testamentary trust with a capable trustee(s) may be a way to preserve and protect your wealth for your intended beneficiaries. The trustee(s) can manage your investments and your other assets to provide for your family. If you do not have an appropriate individual to act as trustee and 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 can either be appointed while the settlor is alive, or be appointed by a trustee(s) as agent after the settlor's passing, according to a fee schedule similar to compensation that may be payable to family members 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

If the testamentary trust is properly structured, it may be possible to protect the assets in the trust from the creditors of the beneficiaries, including marital creditors.

Providing for successive generations

You may want to provide for more than one generation or may wish to skip a generation and provide for your grandchildren and not your children. A testamentary trust can protect assets across generations.

Fulfilling charitable intentions

Your assets may be more than enough to provide for your family during their lifetime. You may wish to provide the assets that remain after your family members' deaths to your favourite charity. This may be accomplished by establishing a testamentary trust for the benefit of your family members with any remaining assets after their death going to the charity of your or your trustee's(s') choice.

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.

Taxation of testamentary trusts

For Canadian tax purposes, a trust, which includes an estate, is taxed like an individual. Prior to 2016, a testamentary 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. An estate that designates itself as a "graduated rate estate" (GRE) will generally be subject to graduated rate taxation for the first 36 months of its existence. As well, graduated rates will continue to apply in respect of testamentary trusts for the benefit of individuals with a disability who are eligible for the federal disability tax credit (DTC), where the trust and the qualifying beneficiary have jointly elected for the trust to be a "qualified disability trust" (QDT) for a particular taxation year.

As a result of the changes in 2016, every dollar of income generated and taxed in a testamentary trust that does not meet one of the two exceptions is taxed at the top marginal tax rate. The negative tax effects, however, may be reduced by taking certain steps. For example, where the terms of the trust allow income to be distributed to the beneficiaries, the trustee can elect to pay out the trust income or make it payable to the beneficiaries. In this case, the income will be taxed in the hands of the beneficiaries at their marginal tax rates. This may result in some tax savings if the beneficiaries' marginal tax rates are lower than the trust's tax rate. Also, the trustee may choose to invest in tax-efficient investments.

All testamentary trusts, except for GREs, will be required to have a December 31 year-end. A testamentary trust, including an estate, 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.

GRE

A GRE of an individual is an estate that arises on and as a consequence of the individual's death and satisfies all of the following conditions:

- the estate is a testamentary trust for tax purposes;
- no more than 36 months have passed since the deceased's date of death;
- the estate designates itself, in its T3 return for its first taxation year (or if the estate arose before 2016, for its first taxation year after 2015), as the individual's GRE;
- no other estate is designated as a GRE of the individual (there can only be one GRE); and
- the estate includes the deceased individual's Social Insurance Number in its T3 return for each taxation year of the estate that ends after 2015.

GRE status is important for an estate to benefit from the graduated tax rates that apply to the income earned and taxed in the estate. It is also a crucial requirement to take advantage of certain estate and post-mortem tax planning strategies. For example, a net capital loss realized after the date of death but in the first taxation year of the estate can be carried back and applied to the year of death if the estate is a GRE. In addition, if the estate is a GRE, the executor will have more flexibility in determining in what year and what return to claim the charitable donation tax credit when a donation is made in an individual's Will. A discussion of all of the advantages of GRE status is beyond the scope of this article and only a couple of examples are mentioned here.

QDT

A QDT is a testamentary trust that jointly elects, together with one or more beneficiaries under the trust, in its T3 return for the year to be a QDT for the year. In addition, all of the following conditions have to be satisfied:

- the election must include each electing beneficiary's Social Insurance Number;
- the electing beneficiary must be an individual, named as a beneficiary (e.g. John Doe) in the instrument that created the trust. For example, if the deceased set up the trust for "my issue," then the beneficiary cannot elect to have the trust treated as a QDT;
- the electing beneficiary must be eligible for the DTC for the year;
- the electing beneficiary must not make a QDT election in respect of any other trust for the year;
- the trust must be factually resident in Canada for the year (i.e. not a non-resident trust that is deemed to be resident in Canada); and

GRE status is important for an estate to benefit from the graduated tax rates that apply to the income earned and taxed in the estate. It is also a crucial requirement to take advantage of certain estate and post-mortem tax planning strategies.

- the requirement to pay a recovery tax cannot apply to the trust for the year (a detailed discussion on the recovery tax is beyond the scope of this article but is briefly mentioned later).

An electing beneficiary is an individual beneficiary under the trust who qualifies for the federal DTC, and who has jointly elected with the trust for the trust to be a QDT for the year.

This means a testamentary trust can be a QDT in one year but not in another year. It is an annual election that gives the testamentary trust its status as a QDT.

Recovery tax, mentioned previously, is generally a claw-back of tax savings enjoyed by a QDT for income taxed at graduated tax rates in a previous year, but where that capital was or will be subsequently distributed to a non-electing beneficiary.

A QDT will have to pay a recovery of tax if:

- none of the beneficiaries at the end of the year are an electing beneficiary for a preceding year;
- the trust ceased to be resident in Canada; OR
- a capital distribution is made to a non-electing beneficiary.

Essentially, a QDT will be required to pay a "recovery tax" when it distributes income that has been taxed at graduated tax rates to any beneficiary other than the eligible beneficiary. This puts the trust back into the same position it would have been in if that income was retained in the trust and taxed in the trust at the top marginal tax rate.

Losing testamentary trust status

For a trust to be a GRE or a QDT, it is very important to maintain its testamentary status. Losing this status will result in the loss of all of the tax benefits enjoyed by these trusts, such as the loss of graduated tax rates. As mentioned previously, a trust, including an estate, can lose its status as a testamentary trust for tax purposes (commonly referred as "tainted") if any property is contributed to it by anyone other than a deceased individual as a consequence of that individual's death. The tainting of a trust can occur in a

number of situations. For example, if the assets are not distributed to the beneficiaries according to the terms of the Will, the trust may lose its testamentary status. A testamentary trust may become an inter vivos trust if the trust incurs a debt or other obligation to pay an amount to a beneficiary or any other person that does not deal at arm's length with a beneficiary (this does not include a situation where the trust owes funds to a beneficiary under the terms of the trust).

21-year deemed disposition rule

It's important to be aware of the deemed disposition rules for trusts. In general, a trust is deemed to dispose of certain capital property at fair market value 21 years after the day the trust was created, and every 21 years thereafter, and to have reacquired the capital property at fair market value. There are exceptions to the 21-year deemed disposition rule for certain trusts. In the context of testamentary trusts, an exception to this rule applies to a testamentary spousal or common-law partner trust where the first deemed disposition of the trust property is deferred until the death of the spouse or common-law partner.

Where the rule applies, if the trust property has appreciated in value, any accrued capital gains will be deemed to be realized on the 21st anniversary of the trust and will be taxable to the trust. The realized gains cannot be deducted from the trust income and taxed in the beneficiaries' hands, but must be taxed in the trust.

Given the significant tax liabilities that may arise on the 21st anniversary of the trust, it's important to consult with a qualified legal and tax advisor when drafting the terms of a testamentary trust. The terms of the trust may provide the trustee with the power and flexibility to implement strategies to minimize the effect of this deemed disposition.

Next steps in establishing a testamentary trust

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 your Will or to create 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." Therefore, assets that are currently held as joint tenants with right of survivorship (JTWROS) may need to be changed to sole ownership. Note that if assets are held JTWROS with non-spouses who have beneficial ownership, capital gains may be triggered when ownership is changed to you only. Therefore, a thorough cost-benefit analysis needs to be undertaken.

Given the significant tax liabilities that may arise on the 21st anniversary of the trust, it's important to consult with a qualified legal and tax advisor when drafting the terms of a testamentary trust.

Designated beneficiaries of RRSP/RRIF assets may have to be removed so that these assets pass through your estate. Note that an exception exists with insurance policies. That is, it is possible to transfer a death benefit payable from an insurance policy to a testamentary trust without the assets forming part of your estate and without probate taxes applying. In addition, it may be possible in some provinces/territories to designate a trust or trustee as a beneficiary on an RRSP/RRIF plan.

Probate concerns

Probate tax may be incurred prior to creating a testamentary trust. The probate tax is incurred since the testamentary trust assets will form part of the deceased's estate. It's through a specific provision of the deceased's Will that the deceased's assets are transferred to the testamentary trust. Hence, this is just another factor that must be assessed prior to deciding whether a testamentary trust makes economic sense. All provinces except for Alberta, Quebec and Manitoba levy potentially significant probate taxes. Probate fees in all three territories are nominal.

Legal, accounting and trust administration fees

The creation of a testamentary trust will result in annual fees. It's imperative that a cost-benefit analysis be done to ensure this structure is a viable option for you and your beneficiaries.

Conclusion

It's important to consider all of the costs and complexities involved in setting up and administering a testamentary 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 why a testamentary 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.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance 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 tax, legal and/or insurance advisor before acting on any of the information in this article.

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