Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Testamentary trusts for residents of Quebec

A reason to consider amending your Will

Please contact us for more information about the topics discussed in this article.

It is 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 of 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 discusses reasons why you may want to consider amending your Will and reviewing your current ownership structure to provide for a transfer of some or all of your assets to a testamentary trust.

This article outlines several 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 tax and/or legal advisor before acting on any of the information in this article.

What is a testamentary trust?

A testamentary trust is a trust created under your Will as a result and consequence of your death. Only assets passing through your estate can be transferred to a testamentary trust.

As such, a testamentary trust can only be established following your death. In order to properly set up a testamentary trust, your Will should provide the following:

- a dollar amount, percentage of the residue, specific asset(s) or the value of assets to be held in trust;
- the specified period of time during which the assets are to be held in trust;

- the person(s) you have identified as your beneficiary(ies);
- the terms of distribution of the income and capital from the trust;
- the person(s) you have identified as the administrator of the trust (trustee or trustees).

For example, while you may wish to provide for your children following your death, you may feel that they are too young to manage money or assets responsibly. As such, you could direct your trustee(s) to hold and invest your children's share of their inheritance in a testamentary trust for their benefit until they reach the age you consider appropriate. It should be noted that you always have the option of drafting your Will in a manner that allows the trustee(s) you select for the trust discretion with respect to the amounts and timing of trust distributions to the beneficiaries. It is common practice (but not mandatory) to have the liquidator of your patrimonial succession to also be the trustee of any testamentary trust that may have been created. The trustee and the beneficiary may be the same person, but, in such case, the law requires that an independent person with no beneficial interest in the trust must act jointly with the trustee. Testamentary trusts may have a life span of a few years or may continue for many years after the initial administration of your succession has been completed. For more information on appointing an executor or trustee, or with any estate planning questions, please speak with your RBC advisor who can arrange an introduction to an RBC Estate & Trust Services advisor.

Note that once the testamentary trust(s) are established, annual trust tax returns are generally required to report the investment income earned within the trust. The additional costs and complexities of preparing annual trust tax returns are two of the main factors that you should consider before establishing testamentary trusts.

Taxation of testamentary trusts

Before January 1, 2016

One of the major benefits of having a testamentary trust has been the income tax advantages for the beneficiaries, which are not available to beneficiaries that receive outright inheritances. Currently, taxable income earned in a testamentary trust is subject to the same graduated tax rates as an individual taxpayer (this is subject to change after December 31, 2015). 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 beneficiaries.

For example, let's assume an adult child is in the top marginal tax bracket of approximately 50% (top marginal tax rate for a resident of Quebec). Upon the parent's death, this child is expected to receive an inheritance of approximately $500,000. Further assume that this inheritance will be invested to earn annual taxable income of 5% interest income ($25,000) per year. The following table illustrates the income tax benefit prior to January 1, 2016 of investing an inheritance through a testamentary trust for the child's benefit compared to the child directly holding the inheritance and investing it.

> You could direct your trustee(s) to hold and invest your children's share of their inheritance in a testamentary trust for their benefit until they reach the age you consider appropriate.

As you can see in the table, the adult child enjoys an overall savings of $4,750 [$17,250 - $12,500] per year by earning investment income through a testamentary trust. Note that the basic personal exemption is not available when completing a tax return for any trust including a testamentary trust.

	Inheritance transferred to adult child outright	Inheritance transferred to testamentary trust[1]
Taxable income	$25,000	$25,000
Taxes payable	($12,500)	($7,250)
Trust tax return fee	$0	($500)
Net after-tax income	**$12,500**	**$17,250**

1) It is assumed that trustee fees are nil and the trust is taxed at a combined rate of 29%.

If the beneficiary is expected to have taxable income from all sources of less than approximately $41,500 (lowest tax bracket in the province of Quebec excluding the impact of the personal exemptions) then there is likely no income splitting benefit of using a testamentary trust.

What if the income earned within the testamentary trust is paid out of the testamentary trust to the beneficiaries and they are in the top marginal tax bracket? Normally, income paid out of a trust to the beneficiaries is not taxed within the trust but taxable to the beneficiaries on their personal tax returns. However, this means that the income paid out to the beneficiaries will be taxed at a higher tax rate than it would be if the income was retained and taxed inside the testamentary trust. In this case, the trustee can elect to have income paid to the beneficiaries taxed in the

testamentary trust at graduated tax rates. This election serves to decrease the tax owed by the beneficiaries on the income they receive from the trust.

After December 31, 2015

The 2014 federal budget has eliminated graduated tax rates that currently apply to testamentary trusts, certain estates and grandfathered inter-vivos trusts beginning in 2016. The government of Québec has announced its intention to harmonize its legislation to take in account the same changes. The graduated rates for testamentary trusts will be replaced with flat top-rate taxation that is currently used for most inter-vivos trusts, subject to two exceptions. An estate that designates itself as a "graduated rate estate" 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 disabled individuals who are eligible for the federal Disability Tax Credit where the trust and the qualifying beneficiary have jointly elected for the trust to be a "qualified disability trust" for a particular taxation year. More detailed rules regarding this exception are expected to be released in the coming months.

In addition, all testamentary trusts, except for graduated rate estates, will be required to have a December 31 year-end. (There are other related measures that are beyond the scope of this article.) These measures will apply to both existing and new trust arrangements for the 2016 and later tax years.

As a result of the new measures in the federal budget, the tax benefits of testamentary trusts mentioned in the previous section of this article will generally only be available for a limited time. You should be aware, however, that while the proposed measures may increase the amount of tax the trust will pay on investment income, the negative tax effects 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 to the beneficiaries. In this case, the income will be taxed at their marginal tax rates. This may result in some tax savings, if their marginal tax rate is lower than the trust's tax rate. Also, the trustee may choose to invest in tax-efficient investments.

Graduated rate estate

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

- the estate is a testamentary trust;
- no more than 36 months have passed since the deceased's date of death;

The graduated rates for testamentary trusts will be replaced with flat top-rate taxation that is currently used for most inter-vivos trusts.

- the estate designates itself, in its T3 return of income for its first taxation year (or if the estate arose before 2016, for its first taxation year after 2015), as the individual's graduated rate estate;
- no other estate is designated as a graduated rate estate of the individual (there can only be one graduated rate estate); and
- the estate includes the deceased individual's Social Insurance Number in its return of income for each taxation year of the estate that ends after 2015.

Qualified disability trust

A qualified disability trust is a testamentary trust that jointly elects, together with one or more beneficiaries under the trust, in its T3 return of income for the year to be a qualified disability trust for the year. In addition, for the trust to be a qualified disability trust for the year:

- the election must include the electing beneficiary's Social Insurance Number;
- the electing beneficiary must be eligible for the disability tax credit;
- the electing beneficiary must not make an election in respect of any other trust;
- the trust must be factually resident in Canada (i.e., not a non-resident trust that is deemed to be resident in Canada);
- the trust must be resident in Canada for the year (and not just the end of the year); and
- 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 disability tax credit, and who has jointly elected with the trust for the trust to be a qualified disability trust for the year.

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

Recovery tax, that was mentioned previously, is generally a claw back of tax savings enjoyed by a qualified disability

trust for income taxed at graduated rates in a previous year but where that capital was or will be subsequently distributed to a non-electing beneficiary.

- A qualified disability trust 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.

21 year deemed disposition rule

It is important to be aware of the deemed disposition rules for trusts, including testamentary 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. An exception to this rule applies to a testamentary spousal trust, where the first deemed disposition of the trust property is deferred until the death of the spouse beneficiary. 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 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 is important to consult with a professional legal and tax advisor on planning strategies that may be implemented to minimize the effect of this deemed disposition.

Non-financial benefits of a testamentary trust

Despite the changes to the tax treatment of testamentary trusts, 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 disabled child, a spendthrift beneficiary, grandchildren in need, a second marriage etc.

Protecting beneficiaries with special needs

If you have a disabled child, you may want to ensure that they are well taken care of, both physically and financially, after you are gone. A testamentary trust may allow you to set aside funds and name a trusted individual to take care of your disabled 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.

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Trust for minor children or spendthrift beneficiaries

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. Where a minor child in Quebec owns a patrimony totaling more than $25,000 (as of the date of writing) in value, such assets would be administered by a court-appointed tutor until the child reaches the age of majority (18 years of age). (The tutor is most likely to be one of the child's parents.) The tutor's administration would be overseen by the Public Curator. The investment and distribution 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 do not 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, or who may have addiction issues. A testamentary trust may allow you to ensure that the beneficiary does not exhaust the trust assets too quickly.

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 timing of distribution of assets

If you have a significant estate and your children or other beneficiaries are relatively young, you may feel that it would not be a good idea to leave a significant amount of money to your beneficiaries until they have reached a certain level of maturity. You may feel that they are too young to handle a sizable estate before the age of 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 are 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 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 and not to your spouse's children or heirs. 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 is 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 our article "Canadian Vacation Property Succession Planning." If you are interested, ask your RBC advisor for a copy.

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

Wealth protection and management

The family that 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.

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. You should consult with your legal advisor if this is important to you and your family.

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.

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Fulfilling charitable intentions

Your assets may be so significant that there is 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.

Beneficiary as a trustee of the testamentary trust

If the purpose of the testamentary trust is not to restrict your beneficiary's access to the inheritance but rather to take advantage of the other personal motivations listed above, you may name your beneficiary as trustee of the testamentary trust but he or she must do so jointly with an "independent" trustee (someone who does not have a beneficial interest in the trust). The independent trustee may be a professional, perhaps an accountant or a lawyer, chosen by the beneficiary. In such case, the trustees may distribute as much of the income and capital of the trust as they may deem appropriate in order to provide generously for the comfort and well-being of the beneficiary. However, the appointment of an independent trustee should be a careful consideration as he or she does, in law, have some control over the assets held in trust.

Next steps in establishing a testamentary trust

Your Will needs to be reviewed and amended to provide for the establishment of a testamentary trust. This amendment will involve a meeting with a notary and/or lawyer. As a result, there may be professional fees incurred to amend your Will or to create a new Will if you do not already have a valid Will.

Legal, accounting and trust administration fees

Operating a testamentary trust will result in annual accounting and trust administration fees. It is imperative that a cost-benefit analysis be done to ensure that this structure is a viable option for you.

It is 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. If there are reasons why a testamentary trust makes sense for you and your family, you should consult with a qualified legal and tax advisor to determine how to achieve your estate planning objectives.

Wealth Management

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