The Navigator

Wealth Management

RBC Wealth Management Services

Testamentary trusts

A reason to consider amending your Will

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 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 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.

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

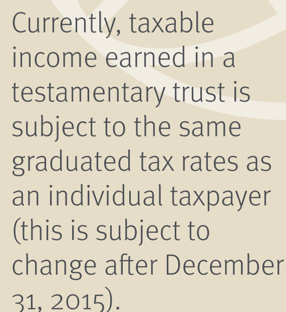
What is a testamentary trust?

A testamentary trust is a trust or estate that is generally created on the day a person dies. 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, in the case of a testamentary insurance trust funded by a death benefit on the individual's death.

Generally, this type of trust is only created by a deceased individual and comes into existence or is funded on the death of the individual. A testamentary trust can lose its status as a testamentary trust for tax purposes if any property is contributed to it by anyone other than the deceased individual as a consequence of that individual's death.

Directions for the creation of a testamentary trust and the terms of the trust should be specified in your Will. The Will 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.

It is common practice (but not mandatory) to have the executor of your estate also be the trustee of any testamentary trusts created. Testamentary trusts may have



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).

a lifespan of a few years or may continue for many years after the initial administration of your estate has been completed. For more information on appointing an executor or trustee, or for any estate planning questions, please speak with your RBC advisor, who can arrange an introduction to an RBC Estate & Trust Services advisor.

Since generally 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), probate taxes will likely have to be paid. Furthermore, once your testamentary trust is established, annual trust tax returns may be required. Probate taxes and the additional costs and complexities of preparing annual trust tax returns are two reasons that may deter you from establishing a testamentary trust.

Testamentary spousal trust

If a spouse is a beneficiary of your testamentary trust, consider setting up a testamentary spousal 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 "Testamentary Spousal Trusts" if you are interested in learning more about testamentary spousal trusts.

Taxation of testamentary trusts

Before January 1, 2016

One of the benefits of having a testamentary trust has been the income tax advantages for the surviving 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 46% (top marginal tax rate varies by province). 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% of the inheritance or $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.

	Inheritance transferred to the adult child outright	Inheritance transferred to a testamentary trust*
Taxable income	$25,000	$25,000
Tax payable	($11,500)	($5,000)
Trust tax return fees	$0	($500)
Net income	**$13,500**	**$19,500**

*It is assumed that trustee fees are nil and the trust is taxed at 20%.

The graduated rates for testamentary trusts will be replaced with flat top-rate taxation that's currently used for most inter-vivos trusts, subject to two exceptions.

As you can see in the table, the adult child enjoys an overall savings of $6,000 ($19,500 – $13,500) per year by earning investment income through a testamentary trust.

However, there are some things you need to keep in mind: the basic personal exemption is not available when completing a tax return for any trust including a testamentary trust, and transferring assets to the estate to establish the testamentary trust could result in upfront probate taxes. In our example, the estate could owe up to $7,500 (based on Ontario's probate tax of 1.5%, the highest in Canada: $500,000 x 1.5% = $7,500). This probate tax would eliminate the tax savings of $6,000 and result in an additional cost of $1,500 in the first year; whereas transferring the inheritance directly to the child without it passing through the estate on the death of the parent (using non-registered accounts held in joint tenancy with right of survivorship [JTWROS] – not available in Quebec – or beneficiary designations, etc.) would not be subject to probate. In addition, as discussed later on, after December 31, 2015, testamentary trusts will be subject to flat top-rate taxation, so there will be no tax savings in taxation years after this date.

On a positive note, any assets remaining in a testamentary trust after the death of the primary beneficiaries can avoid a second probate tax. That is, assets remaining in the testamentary trust that are distributed according to the terms of the trust to contingent beneficiaries after the death of the primary beneficiaries do not form part of the estate of the primary beneficiaries.

In addition, if the income earned and capital gains realized within the testamentary trust are paid out or made payable to the beneficiaries, then it is not taxed within the trust. Instead any income and realized capital gains paid or made payable to the beneficiaries are taxable to the beneficiaries on their personal tax return at their marginal tax rates. If the beneficiaries have a higher marginal tax rate than the trust, the trustee can elect to have the amounts paid to the beneficiaries taxed in the testamentary trust at graduated tax rates. This election serves to decrease the tax owed by the beneficiary on the income they receive from the trust. After December 31, 2015, this election will no longer be available unless the trust has losses carried forward from prior years.

After December 31, 2015

The 2014 federal budget eliminated graduated tax rates that currently apply to testamentary trusts, certain estates and grandfathered inter-vivos trusts beginning in 2016. The graduated rates for testamentary trusts will be 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" 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.

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 2016 and later tax years.

As a result of the new measures in the budget, the tax benefits of testamentary trusts mentioned in the previous section of this article will generally only be available for a

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limited time. You should be aware, however, that while the 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 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 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 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 qualified disability trust.
- 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.

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.

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 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. 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

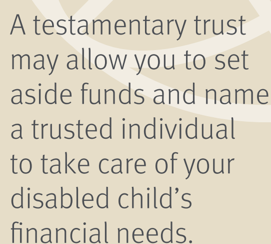
Despite the changes to the tax treatment of testamentary trusts, testamentary trusts still provide significant estate planning opportunities and should be considered for reasons other than taxation. Testamentary trusts can be used to create solutions to complex family situations – a disabled child, a 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. In some provinces, you may be able to leave significant funds in a testamentary Henson trust and still allow your disabled beneficiary to qualify for provincial disability support. If you would like more information on Henson trusts, ask your RBC advisor for a copy of our article "Henson Trusts."

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. Depending on the governing provincial legislation, the funds may have to be paid to a provincial 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



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.

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 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

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.

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 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 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.

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 do not have 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 held in JTWROS may need to be changed to sole ownership. Note that if assets are held in 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.

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 being paid.

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 is 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 and Quebec levy potentially significant probate taxes.

It is important to consider all of the costs and complexities involved in setting up and administering a testamentary trust.

Legal, accounting and trust administration fees

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

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 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 a qualified legal and tax advisor to determine how to achieve your estate planning objectives.

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

Wealth Management

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