Tax, Retirement & Estate Planning

ADVISOR CONSULTING

TESTAMENTARY TRUSTS AS ESTATE PLANNING TOOLS

Testamentary trusts are useful tools in estate planning to ensure that an individual's wishes are met and to preserve estate assets, or to support family or a favourite charity.

WHAT IS A TESTAMENTARY TRUST?

The federal Income Tax Act defines a testamentary trust as a trust or an estate arising as a consequence of the death of an individual and created by the deceased individual.

The trust is usually created in the deceased person's will or by a court order. A trustee or trustees, who own and control property previously owned by the deceased, are appointed for the benefit of one or more persons, the beneficiary, or beneficiaries. The appointed trustee must act in the best interest of the beneficiaries. The relationship is governed by provincial law and the terms of the will or other document.

TESTAMENTARY TRUSTS AND ESTATE PLANNING

A testamentary trust can be a useful tool to achieve a number of important estate planning objectives, including:

- Maintaining control over the timing and amount of distributions to beneficiaries such as minors or spendthrift individuals;
- Providing support to a beneficiary with special needs such as a physical or mental disability;
- Potential income splitting if one or more beneficiaries are not in the top marginal tax bracket, which reduces the amount of tax paid overall;
- Preserving an inheritance in a blended family, where the surviving spouse is provided for during his or her lifetime, with the remaining assets passing to the deceased's children after the surviving spouse's death;
- Supplying income to a family member or friend for life;
- Providing ongoing support to a favourite charity;
- Holding an important asset such as a cottage or a family business; and
- Providing potential creditor protection for beneficiaries, including safeguarding assets against a division of property in the event a beneficiary's divorce.

TAX TREATMENT OF TESTAMENTARY TRUSTS

A testamentary trust is a separate legal entity for tax purposes. Prior to January 1, 2016, any income retained in a testamentary trust was taxed at the graduated tax rates available to an individual, which made testamentary trusts useful income-splitting tools. Commencing on January 1, 2016, all income retained in a testamentary trust will be taxed at the highest tax rate applicable in the province where the trust resides.

Graduated rates continue to apply for the first 36 months of an estate that is a testamentary trust. If the estate exists for more than 36 months after the death, income earned after that time and retained in the trust or estate is subject to the highest marginal tax rate.

Also, subject to certain conditions, graduated rates continue to be available for testamentary trusts with beneficiaries eligible for the Disability Tax Credit.

Testamentary trusts must make income tax instalments and have a calendar taxation year-end.

However, income that is not retained in the trust but is paid to one or more of the beneficiaries can be taxed in a beneficiary's hands. This allows for some income tax benefit where a beneficiary is in a lower tax bracket.

CONSIDERATIONS BEFORE SETTING UP A TESTAMENTARY TRUST

Registered assets

Registered Retirement Savings Plan (RRSP) or Registered Retirement Income Fund (RIF) assets can be transferred directly to a surviving spouse or common-law partner or to certain financially dependent children or grandchildren on a tax-deferred basis. The rollover may be more beneficial than transferring the RSP/RIF assets into a testamentary trust, since there will be taxes on the transferred RSP/RIF.

Ongoing administration costs

A testamentary trust will incur some administrative expenses such as legal/accounting fees and annual tax filings for the duration of its existence. These ongoing expenses would not be incurred if the assets were distributed directly to beneficiaries.

Capital gains tax

Assets transferred to a testamentary trust are usually subject to a deemed disposition, which may create a capital gains tax liability. However, assets that are transferred to a pure spousal trust, meaning only the spouse can benefit during his or her lifetime, may not be subject to a deemed disposition.

IMPACT OF CAPITAL GAINS TAX UPON THE DEATH OF A BENEFICIARY

Where a spousal trust has been created, a deemed year-end will be triggered when the second spouse dies and deemed capital gains arising on the death of this partner will be taxed in the trust. It is possible to elect to have the gains taxed in the second spouse's estate in certain limited circumstances.

THE 21-YEAR DEEMED DISPOSITION RULE

Every 21 years, a trust must report all accrued capital gains on all assets held by it and there will be a deemed disposition of all capital property held within the trust, thereby triggering taxable capital gains. Often the terms of the trust permit the trustee to transfer trust property to the beneficiaries on a rollover basis. If there is a possibility that the trust continues for more than 21 years, it is necessary to ensure there is sufficient liquidity to pay the resulting tax bill. It should be noted that, in the case of a pure spousal trust, there is a deferral of the deemed disposition until the death of the surviving spouse.

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