CI ASSANTE PRIVATE CLIENT

REFERENCE GUIDE

WEALTH PLANNING GROUP

TESTAMENTRY TRUSTS

CI Assante Private Client, a division of CI Private Counsel LP

While most people have heard about trusts, many do not really know what they are or what benefits they offer and often incorrectly believe that trusts are only for wealthy individuals. In fact, trusts, including testamentary trusts, are an important estate planning tool for a broad range of individuals. Trusts can give peace of mind and in certain circumstances they can generate tax saving opportunities.

This reference guide provides an overview of testamentary trusts, including, an explanation of how they are taxed as well as a summary of the benefits they can provide and the points to consider when planning a testamentary trust.

What is a trust?

A trust is an obligation that binds a person (the trustee) to deal with certain property (the trust property), which the trustee controls, for the benefit of specified persons (the beneficiaries).

To create a trust, a person, referred to as a settlor, transfers legal ownership of property to the trustee(s), and provides instructions to the trustee(s) regarding how the property is to be used for the benefit of the beneficiaries. This arrangement can be made either in a trust agreement (in the case of a lifetime or *inter vivos* trust) or in a will (in the case of a testamentary trust). In some circumstances, a testamentary trust can also be created in other documents that take effect on an individual's death.

A testamentary trust is a trust that arises on and as a consequence of an individual's death, so it only becomes effective on the death of the person making the will (the testator). Most often, a testamentary trust is created with funds or assets from the estate, but it can also be funded directly with life insurance or retirement plan proceeds.

A common example of a testamentary trust is where a testator's will states that certain property is to be held in trust by a trustee to provide for the testator's child. However, a testamentary trust can be as simple as the trust that is created upon death by the estate of a testator and which continues until the testator's assets are distributed either outright to the beneficiaries or to the trusts established under the testator's will. A spousal trust is another example of a testamentary trust, where property is held in trust for a surviving spouse. This is dealt with in more detail in our reference guide on spousal trusts.

If a testamentary trust may have trustees or beneficiaries resident in Quebec, please refer to our reference guide on testamentary trusts in Quebec.

How is a testamentary trust taxed?

Under the *Income Tax Act*, all trusts, including testamentary trusts, must file annual income tax returns and pay tax on income and capital gains retained in the trust and not paid or payable to a beneficiary during the year. Amendments to the *Income Tax Act* effective January 1, 2016 changed the tax treatment of testamentary trusts including the income tax rates that apply to these trusts. These amendments have substantially impacted how testamentary trusts are used in estate and tax planning.

Prior to the implementation of these amendments, testamentary trusts were taxed at the same graduated rates that apply to individuals and this created considerable planning opportunities for reducing taxes. Since the income earned within a testamentary trust was taxed on a separate tax return at the graduated tax rates, a significant potential income splitting opportunity arose for a beneficiary of a testamentary trust.

Under the new rules, a testamentary trust continues to be a separate taxpayer for tax purposes. However, all income retained in a testamentary trust is now taxed at the highest tax rate applicable to the province of residence of the trust. The elimination of the graduated tax rates for testamentary trusts means that in most cases they can no longer be used to generate tax savings by simply taxing the trust income in the trust. With that said, it is important to note that tax saving opportunities may still arise from using testamentary trusts, as described below under the heading “What are the benefits of a testamentary trust?”.

These new rules also limit the ability to tax income that was actually paid to a beneficiary as if it were the trust’s income. The designation of this income to the trust will now only be allowed when the trust would have no taxable income after making the designation. Therefore, such a designation will only be made if the trust has some form of loss carry forward that can be applied to the designated income so that the taxable income of the trust will be zero after the designation is made.

There are two exceptions to the general rules regarding the changes in the tax treatment of testamentary trusts:

1. The graduated tax rates continue to apply for the first 36 months of an estate. This will be known as a graduated rate estate (a GRE).

   There can only be one GRE for the deceased individual. The estate must also designate itself as the deceased individual’s GRE in its first taxation year that ends after 2015. Estates which take over 36 months to administer will face a loss of GRE status. The estate will be deemed to have a year end when it ceases to be a GRE and is then required to select a December 31 fiscal year end.

   GRE status is important not only because of the graduated tax rates that will apply to the income earned and retained in the estate, but because it will determine the post-mortem estate and tax planning strategies that are available. For example, the classification of an estate as a GRE will have an impact on the ability to carry back losses incurred in the first taxation year of an estate to the terminal return. Under the new legislation, such a loss can only be carried back from a GRE to the terminal return. This may result in capital losses being trapped in a non-GRE and could impact common tax planning techniques associated with private corporation shares.

   Similarly, the classification of an estate as a GRE will have an impact on charitable donations made in an individual’s will. Under the new legislation, such a donation will be deemed to have been made when the property is actually transferred to the charity. However, if the estate is a GRE more flexibility exists, as the donation can be applied to the taxation year of the estate in which the donation is made, a prior taxation year of the

estate or the final two taxation years of the individual. If the estate is not a GRE at the time the donation is made, the ability to apply the donation to prior years will be lost, except in certain situations involving donations by an estate that was formerly a GRE but lost its status simply due to the estate administration extending beyond 36 months. For more information on the rules that apply to charitable giving, see our reference guide on that topic.

2. The graduated tax rates also continue to apply in respect of testamentary trusts for the benefit of disabled individuals who are eligible for the disability tax credit. This type of testamentary trust is known as a qualified disability trust (a QDT). To obtain QDT status, the trust makes an annual election jointly with a beneficiary of the trust who qualifies for the disability tax credit.

   There can only be one QDT per disabled beneficiary. However, a regular testamentary trust which no longer has the benefit of graduated tax rates can later become a QDT if the capital beneficiary of the trust subsequently becomes disabled and is also eligible for the disability tax credit.

   The tax relief granted to QDTs is not absolute. QDTs are subject to a recovery tax triggered in a year when (i) the trust ceases to qualify as a QDT, or (ii) a capital distribution is made to beneficiary other than the disabled beneficiary who elected that the trust be designated as a QDT. This tax is intended to recover tax savings obtained by the QDT due to the application of graduated rates in prior years.

The ability to benefit from income splitting by taxing trust income in the trust at graduated tax rates will continue to be available for GREs and QDTs. However, since January 1, 2016, all other testamentary trusts and non-GRE estates will be subject to tax at the highest marginal tax rate on income retained in the trust.

What are the benefits of a testamentary trust?

Regardless of the changes that have been made to the taxation of testamentary trusts, they continue to provide significant income splitting opportunities in many circumstances. Furthermore, the many non-tax benefits of testamentary trusts were unaffected by these changes.

The benefits of using testamentary trusts can be summarized as follows:

- **Continued income tax savings** by using the marginal tax rates of additional trust beneficiaries and by taking advantage of the graduated tax rates during the first 36 months of an estate.

- **Helping to protect the beneficiaries' inheritance** from claims by present and future creditors of the beneficiaries and possibly from marital or family property claims.

- **Ensuring that the testator's wishes and intentions will be respected** regarding the use of the inheritance.

Each of these benefits is discussed in detail below.

CONTINUED INCOME TAX SAVINGS

Testamentary trusts can still be used to save taxes in situations where trust income can be split among different beneficiaries. If there are beneficiaries taxed in lower brackets (such as a beneficiary's minor children), potential tax savings could result since the income could be taxed at lower tax rates.

- Example: A parent could make a will leaving a child's share of the parent's estate to a trust created for the child and the child's children, including any future children. Income from the trust could then be used to pay for special expenses of the minor grandchildren, with the income taxed as if the grandchildren earned it. Since the minor grandchildren would likely earn little or no other income, the income used for their benefit would be taxed at low rates.

There are certain ongoing expenses involved in the administration of a testamentary trust. Generally, the greatest expenses are for the preparation of the annual tax returns for the trust and for documenting the various decisions of the trustees (such as deciding how much and to whom income is to be distributed). Fees may also be charged by the trustees. When deciding whether or not to incorporate a testamentary trust in an estate plan, these expenses need to be weighed against the possible tax savings and other benefits that will ultimately be realized from this planning strategy.

One aspect of using testamentary trusts that requires consideration, from a tax perspective, is that every 21 years the trust will be deemed to dispose of all its capital property and tax must be paid on any accrued gains. To address this, trusts generally give the trustees the power to wind up the trust or to transfer property out of the trust to appropriate beneficiaries, as these can be done without triggering tax. If property is distributed to beneficiaries, the capital gains would then be deferred until the beneficiary disposes of the property.

Under the new rules, a tax saving opportunity will be available in the 36 month period following the testator's death. If the testator's estate is a GRE, the graduated tax rates will apply to the income earned and retained by the estate. Therefore, when planning an estate, consideration could be given to taking maximum advantage of the graduated rates that apply during that period.

To achieve this, the testator's will could authorize that the estate may be kept open for this period, if determined beneficial. This will provide evidence of the testator's intent both to the trustee as well as to the beneficiaries who may be pressing for a faster completion of the administration of the estate.

Caution regarding improper property transfers

As noted above, a testamentary trust is a trust that arises on and as a consequence of the death of an individual. Any assets transferred to the testamentary trust by someone other than the individual whose death led to its creation could jeopardize the trust's tax status as a testamentary trust. For those testamentary trusts which continue to benefit from the graduated tax rates, such

as GREs and QDTs, the loss of testamentary trust status would mean that all of the income of these trusts would be taxed at the highest tax rate rather than the graduated tax rates. Therefore, care should be taken that the preferred tax status of these trusts is protected by avoiding any improper transfers of property to these trusts.

Caution if foreign beneficiaries

If there are or will be beneficiaries resident outside Canada, it would be important to consult with professional advisors familiar with the tax laws of the country where the beneficiary resides. Ideally, it would help if the professional advisors are also familiar with Canadian tax laws. There generally is no Canadian tax advantage to creating a trust for a person resident outside Canada. In some jurisdictions, there may be tax advantages for the beneficiary under the tax regime applicable to the beneficiary; in other jurisdictions, there may be adverse tax consequences for the beneficiary. These potential issues should be explored with the appropriate tax advisors.

HELPING TO PROTECT THE BENEFICIARIES' INHERITANCE

If property is left to a beneficiary who has debts or liabilities, the ultimate beneficiary of the inheritance may end up being the beneficiary's creditors. If this is a concern, leaving the property to a trust for the beneficiary may help to protect the inheritance if the trust is drafted appropriately. For example, the trust can include specific instructions regarding matters such as who is to manage the assets of the trust, to ensure that the trustees control the assets, and not the beneficiary alone. The trust could also give the trustees complete discretion regarding payments of income and capital from the trust, so that the trustees would have the ability to distribute the income and capital in a way that would truly benefit the beneficiary. Alternatively, if members of the beneficiary's family are also beneficiaries of the trust, the trustees could distribute income and capital to or for their benefit. In this way, the creditors of the beneficiary would not be able to access the funds or property held in the trust, so the inheritance would be protected from the beneficiary's creditors (and/or the beneficiary's spending habits).

As a result of several court cases, it seems that protection from marital (or family) property claims by the use of trusts is not quite as certain as protection from creditors. However, the use of a testamentary trust for the share of a beneficiary would still provide more opportunity for protection than leaving assets to the beneficiary outright.

ENSURING THAT THE TESTATOR'S WISHES AND INTENTIONS WILL BE RESPECTED

Testamentary trusts are very flexible tools that offer the testator the ability to exercise significant control over how property left on death is to be used, including which heirs are to benefit and when. Ideally this ability can be used to guide beneficiaries, minimize family disputes and maximize the benefit of the beneficiaries' legacies.

The following examples demonstrate how testamentary trusts can be used to achieve these goals:

- **Cottages**: Family cottages often have great emotional value to beneficiaries, which can make them very difficult for testators to deal with in their wills. Leaving the cottage to

one person may cause hard feelings or family strife. On the other hand, leaving it to a number of beneficiaries as co-owners may cause considerable difficulties, particularly if they (or their families) do not all get along.

A possible solution is to leave the cottage in trust for the family, along with additional funds to enable the trustees to pay for expenses such as taxes, maintenance, and repairs. While the trust may not completely eliminate disputes, it may help to address some of the important issues and perhaps reduce the number of disputes.

- **Children with disabilities or special needs**: Families with children who have disabilities often use trusts to ensure that the property they leave behind will benefit the child. Often children with disabilities or special needs are supported by provincial social assistance benefits as adults. Leaving an inheritance to the child directly could result in these benefits being denied or reduced, so that the child would not experience any improvement in his or her quality of life as the family typically wishes.

  Having the inheritance pass instead to a testamentary trust for the special needs beneficiary, structured to take into account the applicable provincial legislation (which generally means ensuring that distributions of income and capital are completely discretionary), can help to improve the child's quality of life without jeopardizing the child's entitlement to government benefits.

  However, if the disabled child does not qualify for the disability tax credit, the testamentary trust will not qualify as a QDT. Therefore, since January 1, 2016, all of the income earned and retained in the trust will be taxed at the highest tax rate. If the trustee distributes the income to the disabled child to avoid this outcome, this may affect the child's eligibility to receive provincial disability support.

  Accordingly, if the disabled child does not qualify for the disability tax credit, this will need to be factored into the design of the trust as well as its administration to protect the disability support payments that the child may be receiving from other sources.

- **Minor children or adult children with limited financial knowledge or abilities**: Testamentary trusts are ideal tools for providing for minor children or for adult children who may not have the financial knowledge or ability to properly handle an inheritance. For minor children or younger adults, the use of a testamentary trust helps to ensure that funds are available for the benefit of the child, including the child's care, support, and education, while also providing some protection for the inheritance.

- **Benefitting only blood relatives:** Individuals who feel strongly that assets inherited by a child should stay in the family and only flow to the child's own children, or to other blood relatives, on the child's subsequent death can only accomplish this by using a testamentary trust, with appropriate terms and conditions, in their estate plan.

  This degree of control is not possible in situations where property is left outright to a child, since any remaining inherited property would flow according to the terms of the child's will when the child dies, independently of any wishes the parent might have had.

Planning a testamentary trust

There are a number of important matters that must be considered when planning and establishing a testamentary trust for intended beneficiaries. For the purposes of this discussion, it is assumed that a testamentary trust is being established for the benefit of a minor or adult child. However, the same considerations would generally apply if the trust was being established for the benefit of other individuals, whether related or not.

BENEFICIARIES OF THE TRUST

The intended beneficiaries of the trust should be clearly spelled out. If desired, each child's trust could provide that the child and his or her present and/or future children (and even grandchildren) could be included as potential income and capital beneficiaries. This allows greater opportunity for income splitting among the beneficiaries.

TRUSTEES OF THE TRUST

The trustees of the trust play an important role, since they are responsible for the management and investment of the trust assets, for filing the annual tax returns for the trust, and for making decisions regarding payments of income and capital to the beneficiaries.

Unless otherwise specified in the will, the executors (or alternate executors) would be the trustees of each child's trust, which may not always be the most suitable choice. It may therefore be desirable to name separate trustees for the child's trust. In addition, given the potential long-term duration of the trust, it would be advisable to either name alternate trustees for the child's trust or include a mechanism for the appointment of alternate trustees in case one or more of the primary trustees should die, resign, or be unwilling or unable to act or continue to act. If appropriate, the testator may consider appointing the child (once they attain a certain age specified by the testator) to be the trustee of their own trust. Setting up the trustees in this way will allow the child to have the appropriate control in dealing with the trust while alive (if he or she is named as a trustee) and will also permit the child's trust or subsequent trusts for the child's children to continue in the longer term with appropriate trustees.

Some of the factors to consider in selecting appropriate trustees and alternate trustees include:

- **Ability and willingness to act:** Given the responsibilities involved, the trustees selected should have the appropriate skills and knowledge to be able to act effectively in handling all aspects of the trust, or should at least be aware that they could (and should) retain professional assistance when needed. The trustees should also understand the nature and extent of their role and be willing and able to act for the duration of the trust, which could be many years, especially if the trust is to continue for the lifetime of the child and possibly beyond that for the benefit of further generations.

- **Potential conflict of interest:** Naming another child or other children as trustees could give rise to possible conflict of interest concerns if that child or those children are to benefit once the beneficiary child has died. For example, the children may refuse to allow payments of capital to the beneficiary child, since such payments would reduce

their ultimate inheritance, or they may choose long-term investments that benefit their own interests, to the detriment of the beneficiary child, who may need investments that produce higher current income.

- **General suitability:** Given the extent and potential duration of the trustees' responsibilities, there should be no concerns about the trustees' ability to deal with the beneficiaries, or with the level of control and involvement that the trustees would have regarding the management and administration of the trust and its assets.

- **Maintaining trust assets:** Appointing a beneficiary child as a trustee and giving him or her the discretion to make payments of capital from his or her trust may give rise to concerns that the child will leave little or no assets remaining in the trust. While this may be appropriate in some circumstances, this can be a concern if one of the purposes of the testamentary trust is to protect the inheritance, either for the lifetime of the child, or for the benefit of other beneficiaries once the beneficiary child has died. Some options to address these potential concerns include:

  - not naming the beneficiary child as a trustee

  - appointing an independent party as a co-trustee or protector and/or

  - not allowing capital payments out of the trust, or restricting the ability to make capital payments to only limited circumstances.

- **Residence of the trust:** The residence of a trust for tax purposes is where its central management and control take place. This is always a question of fact involving a consideration of numerous factors. If a testamentary trust is considered resident in a country other than Canada, considerable tax complexities would arise for the trust and its beneficiaries. Accordingly, when appointing trustees, it would be important to ensure that the child's trust is resident in Canada for tax purposes by ensuring that the majority of the trustees who will be responsible for its central management and control are in Canada.

PAYMENTS OF INCOME

For maximum flexibility, the trustees of a child's trust could be given complete discretion to pay as much of the income of the trust to (or for the benefit of) any beneficiary of the child's trust as the trustees consider advisable. For example, the income of the child's trust could be paid to the child or to any of his or her children (or grandchildren if also named as potential beneficiaries). Alternatively, the income could be used to pay their expenses.

If the trustees are given absolute discretion with respect to the payment of income, this would provide them with the ability to minimize any adverse consequences that might result from the new rules regarding the taxation of testamentary trusts. The trustees would have the authority to pay the income to the beneficiary or beneficiaries to be taxed in their hands at their marginal tax rates rather than in the trust at the highest tax rate if it makes sense to do so after considering all relevant factors.

Note that for tax purposes, capital gains are generally treated as income. Under trust law, however, capital gains are considered to be capital, so that the trustees could only distribute these to capital beneficiaries of the trust. If desired, however, the trust document (which would generally be the will, in the case of a testamentary trust) can define what is to constitute income of the trust for trust purposes. Accordingly, depending on the particular objectives of the trust, the income of the trust could be defined to include capital gains. This would make the treatment of these amounts the same for both trust and tax purposes and could also facilitate desired distributions to beneficiaries.

PAYMENT OF CAPITAL

Trusts provide considerable flexibility with respect to structuring the payment of the capital of the trust to a child or other beneficiaries. For example, the trust could direct the trustees to pay certain portions of the capital of the trust to the child at specified ages. Such a staged distribution is commonly considered for a younger or financially inexperienced beneficiary, with the hope that the beneficiary will be able to handle the inheritance appropriately by the time he or she reaches the final age specified.

However, a staged distribution may preclude or limit the opportunities to make the most of the benefits of testamentary trusts described earlier, since the trust would have to be wound up at the specified final age, regardless of the beneficiary's circumstances at the time.

The best way to maximize the advantages of a testamentary trust for the benefit of the child or other beneficiaries would be to set up the trust to provide for only discretionary payments of capital. This means that the trustees would have the complete discretion to determine when (or whether) the capital would be distributed and to which beneficiaries. Accordingly, the trustees could make, or decline to make, payments of capital, depending on the needs, wishes or circumstances of the beneficiaries at the time. This can provide some protection of the assets, and, from the beneficiaries' perspective, can also allow the beneficiaries to maximize their inheritance through the potential tax savings and other benefits offered by testamentary trusts. The trustees would also be allowed to distribute all of the assets of the trust and, if permitted in the will, to wind up the trust at any time.

If desired, a combination of these capital payment options could be used.

ON THE DEATH OF A CHILD

The will might provide that on a child's death, that child's trust could continue for the benefit of that child's children (and grandchildren, if desired).

Alternatively, the assets of the trust could be divided equally among the deceased child's children (and grandchildren, if desired), with the shares of younger beneficiaries held in a separate trust until they reach an age where it is felt they could handle an inheritance. In this case, the trustees of such trusts might be given the discretion to pay or apply income and/or capital for the benefit of the beneficiary (or beneficiaries), which may be for any purposes they see fit, or restricted to certain purposes only (such as education and/or medical expenses). Again, when planning these trusts, the changes to the taxation of testamentary trusts should be considered so that, when it makes sense to do so, the trustees will have the authority to pay the

trust income to the beneficiaries to be taxed in their hands at their marginal tax rates rather than in the trust at the highest tax rate.

If the child leaves no children or grandchildren alive on his or her death, then the will could direct that the assets in the deceased child's trust be divided among remaining children of the testator (or, if there are none alive, then among the children or grandchildren of such other children of the testator) and be added to any trusts in place for them. Alternatively, the will could direct the assets to other beneficiaries of the testator's choosing (i.e. their preferred charities).

Summary

Testamentary trusts continue to offer considerable benefits to many individuals. If the estate and tax planning opportunities described above are of interest, a testamentary trust may be an appropriate part of your wealth plan. If you included testamentary trusts in your planning before January 1, 2016, you should review your existing planning with your lawyer to determine whether or not it continues to be appropriate and meet your needs.

For more information, we encourage you to speak to your advisor or visit us at assante.com

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