REFERENCE GUIDE

Testamentary Trusts

September 2011

Although this material has been compiled from sources believed to be reliable, we cannot guarantee its accuracy or completeness. All opinions expressed and data provided herein are subject to change without notice. The information is provided solely for informational and educational purposes and is not intended to provide, and should not be construed as providing individual financial, investment, tax, legal or accounting advice. Professional advisors should be consulted prior to acting on the basis of the information contained in this reference guide.

© 2011 United Financial, a division of CI Private Counsel LP. All rights reserved.

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, and especially testamentary trusts, are an important estate planning tool for a broad range of individuals and can save on taxes and give peace of mind.

This reference guide provides an overview of testamentary trusts, including the benefits they can provide as well as what 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). A testamentary trust can, in some circumstances, 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 with life insurance proceeds.

A common example of a testamentary trust is where a testator's will states that certain property or a certain portion of the estate is to be held in trust by a trustee to provide for the testator's children. A spousal trust is another example of 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.

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

What are the benefits of a testamentary trust?

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

- **Reducing the total income tax payable** on the future income earned on the inheritance.
- **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.

September 2011

© 2011 United Financial, a division of CI Private Counsel LP. All rights reserved.

Each of these is discussed in detail below.

REDUCING TAXES

Under the Income Tax Act, all trusts, including testamentary trusts, must file annual income tax returns and pay tax on income and capital gains that are not paid or payable to a beneficiary during the year. However, unlike lifetime trusts which are taxed at the highest marginal tax rate, testamentary trusts are taxed at the same graduated marginal rates that apply to individuals. This presents considerable planning opportunities for reducing taxes, by allowing greater access to the lower marginal rates.

If a beneficiary in a high marginal tax bracket were to inherit assets directly from an estate, the income produced by those assets would be added to the beneficiary's other income (such as salary or investment income), so that most or all of this additional income may be subject to the highest rate of tax.

If, on the other hand, the same assets are held in a testamentary trust for the benefit of the beneficiary, the income produced by the assets may be considered income of the trust, rather than the income of beneficiary, with the trust paying tax on that income at graduated marginal rates. Subject to the terms of the will or trust, if the trustees file the appropriate elections, even income that is actually paid out to the beneficiary may be taxed as if it were the trust's income.

- Example: If assets being left to a beneficiary will produce $35,000 of income, and the beneficiary is already in the highest bracket, an outright gift of the assets to the beneficiary would result in the $35,000 being taxed at the highest marginal tax rate, which ranges from about 39% to 50%, depending on the beneficiary's province of residence. On the other hand, if that income were in a testamentary trust, the income would be taxed at the lowest marginal rate, which would range from about 22% to30%, depending on the province. The tax payable by the testamentary trust would be similar to the amount a person who earned only $35,000 would pay (except that trusts are not allowed to claim the personal tax credits). The beneficiary would still be able to receive the income net of tax.

The tax savings can be significant. If the beneficiary is taxed at the highest marginal rate, and the testamentary trust established in the will for the beneficiary earns enough income to use up its low marginal tax bracket (for example, the trust earns approximately $35,000 per year), the tax savings can be $4,500 to $8,800 each year, depending on the province.

Testamentary trusts can also be used to save taxes by splitting income among several beneficiaries. If there are more beneficiaries taxed in lower brackets (such as a beneficiary's minor children), the tax savings could be increased since more of the income would be taxed at the lower tax rates.

© 2011 United Financial, a division of CI Private Counsel LP. All rights reserved.

- 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.

A testamentary trust can still provide significant benefits even if a beneficiary is taxed in the middle tax bracket and the trust earns less than $35,000 in income.

We generally recommend that a testamentary trust be created if it will likely hold at least $300,000. In this way, the trust can generate enough income to make the tax savings worthwhile.

Note that there are some ongoing expenses involved in maintaining a 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.

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.

Caution regarding improper property transfers and loans

To ensure that a testamentary trust continues to maintain its tax-advantaged status, it is vital to ensure that other individuals do not add property to an existing testamentary trust. If there is an improper transfer of property to a testamentary trust, the trust ceases to be a testamentary trust and is, from then on, considered to be an inter vivos trust. This means that all of the income of the trust would be taxed at the highest marginal tax rate, rather than based on graduated marginal tax rates.

Pursuant to draft amendments to the tax legislation, the same adverse consequences could also arise if a beneficiary of a testamentary trust (or certain other individuals connected to the beneficiary) makes loans or advances funds to the trust in certain circumstances. These amendments, which would be effective for trust taxation years after December 20, 2002, are intended to prevent inappropriate income splitting using testamentary 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.

© 2011 United Financial, a division of CI Private Counsel LP. All rights reserved.

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 INHERITANCE FROM CREDITORS

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 draft 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, the trustees could distribute income and capital to or for the benefit of the beneficiary's family members, if they are also beneficiaries. 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 a number of different beneficiaries, which can make it 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 siblings as co-owners may cause considerable difficulties, particularly if they (or their families) do not all get along.

© 2011 United Financial, a division of CI Private Counsel LP. All rights reserved.

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.

- **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. As the children grow older, the trust could then also become an effective tax saving vehicle, as described earlier.

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 future children (and even grandchildren) could be included as potential income and capital beneficiaries. This allows greater opportunity for income splitting among the beneficiaries.

© 2011 United Financial, a division of CI Private Counsel LP. All rights reserved.

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. 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 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

© 2011 United Financial, a division of CI Private Counsel LP. All rights reserved.

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, and giving this trustee the decision-making authority over investments and capital payments out of the trust, 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:** Based on recent case law, 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. This should be monitored, as case law is evolving in this area.

PAYMENTS OF INCOME

For maximum flexibility, the trustees of each 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. Also, part of the income could be paid to the child, but taxed in the child's trust.

To ensure that the payment of income is completely discretionary, we recommend that the word "shall" or other directive words not be used in the clause in connection with payments out of the trust.

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.

© 2011 United Financial, a division of CI Private Counsel LP. All rights reserved.

PAYMENT OF CAPITAL

Trusts provide considerable flexibility with respect to structuring the payment of the capital of the trust to the 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 tax and other 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 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.

As noted in connection with discretionary payments of income, where it is intended that payments of capital should be discretionary, the provisions in the will should be carefully worded to avoid the use of directive words such as "shall pay".

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

ON THE DEATH OF THE CHILD

The will might provide that on the 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).

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

© 2011 United Financial, a division of CI Private Counsel LP. All rights reserved.

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.

Summary

Testamentary trusts can offer considerable benefits to many individuals. If the tax savings, creditor protection, or other estate planning opportunities described above are of interest, a testamentary trust may be an appropriate part of your wealth plan.

© 2011 United Financial, a division of CI Private Counsel LP. All rights reserved.