TD Waterhouse
Wealth of Experience

Testamentary Trust as an Estate Planning Tool

The purpose of this article is to explore how a testamentary trust may be used in estate planning, and to identify situations where its use may be most appropriate.

What is a testamentary trust?

A testamentary trust is a trust that is established on the death of an individual (called the "testator" or "testatrix" if feminine), typically through a Will. This is in contrast with an inter vivos trust, which is created during the lifetime of the settlor (i.e. the person who created the inter vivos trust).

Tax treatment of testamentary trusts

Like an inter vivos trust, a testamentary trust is treated as a separate taxpayer. However, unlike inter vivos trusts, which are taxed at the highest tax bracket, testamentary trusts enjoy graduated tax rates accorded to an individual taxpayer. This distinguishing feature makes the testamentary trust a useful income splitting tool in estate planning.

Testamentary trusts in estate planning

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

- Education and support for children and grandchildren.
- Support for a beneficiary with special needs.
- Income to a loved one for life, without the burden or responsibility of managing the assets.
- Ongoing support to a favourite charity.
- Holding in trust an important asset such as a cottage or a family business.

In addition, the testamentary trust can in some situations provide significant tax advantages for the beneficiaries.

Here is a brief outline of how this works:

- The terms of your Will provide for the creation of a testamentary trust.
- On your death, assets are transferred to the testamentary trust.
- The trustees (who can be the executors of your Will) become the legal owner of the assets, but the enjoyment of the assets is reserved for the beneficial owners who are designated in the Will.
- Each year, a decision can be made to have the trust pay tax on its income, or to allocate some or all of the income to the beneficiary(ies):

    - Any investment income earned on the assets which are retained in the trust will be taxed at the same graduated tax rates as an individual. Thus, if the beneficiaries are already in a high tax bracket, the trustee can provide for income to accumulate in the trust (subject to any time limits on how long such accumulation can occur, pursuant to the applicable provincial legislation), while tax-free capital distributions can be made to the beneficiaries.

    - On the other hand, if the beneficiaries are children or individuals who have little or no other income, it may be advantageous for the income to be paid or payable to the beneficiaries, in which case it will be taxed in their hands, at their own marginal tax rate. Thus, beneficiaries will enjoy the first $10,382 (for 2010) of income tax-free due to the federal basic personal amount provided they do not have any other income.

    - If there are multiple beneficiaries, separate trusts can be set up for each of them, to maximize the amount that can be taxed at the lowest tax bracket.

Considerations before setting up a testamentary trust

- **Type of assets:**

a. Non-income producing assets

   i. If minimization of taxes is the key motivation for setting up a testamentary trust, it may not be appropriate to include assets which produce no income (e.g. principal residence or a cottage) and hence no income tax liability.

   ii. However, there may be non-financial considerations which warrant the inclusion of non-income producing assets, such as ensuring that the property is enjoyed by a succession of beneficiaries.

b. Registered assets

   RSP/RIF assets can be transferred directly to a surviving spouse or common-law partner or to a qualified child or grandchild on a tax deferred basis. This may be more beneficial than putting the RSP/RIF assets into a testamentary trust since taxes on the RSP/RIF assets cannot be deferred and must be paid upfront leaving less in the testamentary trust.

- **Additional probate and legal fees:**
  Since the testamentary trust is generally created pursuant to the Will, assets that are rolled into the testamentary trust can attract probate and legal fees. However, it is possible that the ongoing tax savings may outweigh these one-time costs.

- **Capital gains tax:**
  Assets transferred to a testamentary trust at death may be subject to a deemed disposition which may create a capital gains tax liability for the deceased. The estate will be responsible for the taxes (unless the testamentary trust qualifies as a testamentary spousal trust).

- **Tax bracket of the beneficiary:**
  If the trust beneficiary has high income, the presence of a testamentary trust creates a separate taxpayer which is taxed at the same graduated tax rates as an individual. This enables the trustee to make full use of the lower tax brackets by generating taxable trust income of up to approximately $127,021 (in 2010).

- **The 21-year deemed disposition rule:**
  Every 21 years, the trustee must report all accrued capital gains on all properties held in a trust. There will be a deemed disposition that triggers taxable capital gains. It is necessary to ensure there is cash flow to pay the resulting tax bill.

Ideal situations for using testamentary trusts

Beneficiaries in high tax bracket

Example: Mrs. Rich, an 80 year old widow has an only child Francis, a doctor who is in a 46% tax bracket. Francis has two daughters, Amy and Beryl, who are in their teens. Mrs. Rich has amassed $1 million of assets; her lifestyle is adequately funded by her regular income sources and in all likelihood, Francis will inherit the $1 million. Francis is a high income earner and has no immediate need to touch these funds in the event that he inherits the money. Mrs. Rich can leave the estate to a trust for the benefit of Francis, Amy and Beryl. Francis can be one of the trustees. The trustees will confirm each year the allocation of income, so as to take advantage of the federal basic personal amounts of each child and the graduated tax brackets of the testamentary trust.

Second marriages

Example: Allie and Jesse are married and have children from their previous marriages. Allie wants to leave her assets to Jesse upon her death. However, Jesse’s children are not on good terms with Allie! The problem for Allie is that if she leaves all her assets to Jesse when she dies, the assets will eventually go to Jesse’s own children upon Jesse’s death. To avoid this, Allie can set up a testamentary trust, naming Jesse as the income beneficiary; and providing that, upon Jesse’s death, Allie’s estate will be transferred to her own children (from her first marriage).

Spendthrift beneficiaries

Example: Mr. C lacks faith in the ability of his son, David, to manage money. Instead of making David the beneficiary of his life insurance policy, he opts to take out a $1 million policy, naming his estate as beneficiary and providing in his Will for the insurance proceeds to flow into a testamentary trust that permits David to receive regular payments of capital and income spread out over a specified number of years.

Physically or mentally infirm beneficiaries

A discretionary testamentary trust can be established to ensure that any government benefits that a physically or mentally infirm beneficiary is currently receiving will not in any way be affected by the trust income that the same individual receives. This need arises because infirm individuals are subject to an income test in order to qualify for most governmental disability payments.

A discretionary trust is a trust where the trustee has complete authority to decide whether to pay all, part, or none of the income and/or capital to a beneficiary.

In Ontario this is known as a "Henson" trust. Because the trust is discretionary, the result is that one could not point to the assets of the trust or to the income from the trust and determine an amount to which the beneficiary is necessarily entitled. Sometimes, out of a sense of extra caution, the infirm beneficiary will also not be the sole beneficiary of the trust; rather, a number of people may be named as discretionary beneficiaries.

When is it appropriate to name a corporate executor to manage a testamentary trust?

One of the issues in planning a testamentary trust is finding the right person or persons to act as the trustee(s). Factors affecting this decision can include: value of the assets, complexity of the terms of the trust, nature of the relationships amongst the beneficiaries, geographical location of the various parties and desire for the involvement of an impartial third party.

As a trust can remain in existence for generations, sometimes it may be appropriate to use a corporate trustee rather than a trusted friend or family member.

Last revised: January 22, 2010