TD Wealth

Using a testamentary trust in your estate planning

Testamentary trusts can be useful tools in estate planning to help fulfill your wishes, preserve your estate assets, as well as support loved ones or charities upon death.

What is a testamentary trust?

Generally, a testamentary trust is a trust that takes effect upon the death of the "settlor" and is established by the deceased's Will or a Court Order. One or more trustees are appointed to take legal ownership and control of property previously owned by the deceased for the benefit of one or more beneficiaries. The appointed trustees are required to act in the best interest of the beneficiaries.

A testamentary trust is a separate entity for tax purposes and must file a separate tax return. The relationship between the trustees and the beneficiaries is central to the creation of the trust. This relationship is governed by statute, the common or civil law, and where there is one, the deceased's Will or another testamentary trust instrument.

Tax treatment of testamentary trusts

As of January 1, 2016, income retained in a testamentary trust is taxed at the highest combined federal and provincial tax rates based on the province of residence of the trust.

There are two exceptions to this tax treatment. First, graduated rates apply for the first 36 months of a testamentary trust that designates itself as a "graduated rate estate" ("GRE") arising as a consequence of an individual's death.

If the estate has not been distributed within 36 months after death, income earned and retained by the trust or estate will be taxed at the highest marginal tax rate. The trust will also have a deemed taxation year-end immediately before the end of the 36 months, and will be subject to a calendar year-end thereafter. However, graduated rates will continue to be available for testamentary trusts with beneficiaries who are eligible for the Disability Tax Credit, where the trust and the qualifying beneficiaries have jointly elected for the trust to be a "qualifying disability trust" for a particular taxation year.

Current Tax Rules versus Old Tax Rules[1]

	Current Rules (Effective after December 31, 2015)	**Old Rules** (Before January 1, 2016)
Estates (arising on and as a consequence of an individual's death)	Income taxed at graduated tax rates for the first 36 months of an estate[2]	Income taxed at graduated tax rates
Testamentary Trusts for named beneficiaries eligible for the Disability Tax Credit	Income taxed at graduated tax rates[3]	Income taxed at graduated tax rates
All Other Testamentary Trusts	Income taxed at the highest marginal tax rate	Income taxed at the highest marginal tax rate

[1]The term "income" in the table above refers to income that is retained in the trust and not distributed to beneficiaries.
[2]This is the case if the estate is designated as a "graduated rate estate" through a particular filing process.
[3]Only one Qualified Disability Trust is permitted for each disabled individual.

These benefits will remain for the first 36 months of a GRE. Meanwhile, despite the fact that testamentary trusts and estates no longer provide the same tax benefits, there are still several instances where establishing a testamentary trust may prove to be beneficial.

Testamentary trusts in estate planning

A testamentary trust can be a useful tool for you to achieve several important estate planning objectives such as:

- Maintaining control over the timing and amount of distributions to beneficiaries (e.g., minors, spendthrift individuals, etc.);
- Providing support to a beneficiary with special needs (whether physically or mentally infirm);
- Potential income splitting among beneficiaries of the discretionary testamentary trust if one or more beneficiaries are not in the top marginal tax bracket, thereby reducing the overall tax payable for your children and/or your family;

- 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 your children after the surviving spouse's death;
- Supplying income to a loved one — without the burden or responsibility of managing the assets;
- Providing ongoing support to a favourite charity;
- Holding in trust an important asset such as a cottage or a family business;
- Making potential creditor protection available for beneficiaries, which could include safeguarding certain assets of the estate during a division of property in the event of a beneficiary's marriage breakdown.

Considerations before setting up a testamentary trust

Registered assets

Registered Retirement Savings Plan (RRSP)/Registered Retirement Income Fund (RRIF) assets can be transferred directly to a surviving spouse or common-law partner (hereinafter referred to as "Partner"), or to certain financially dependent children/grandchildren on a tax-deferred basis. This rollover may be more beneficial than transferring the RRSP/RRIF assets into a testamentary trust since tax on the transferred RRSP/RRIF assets typically cannot be deferred, and will become payable, leaving less in the testamentary trust.

Ongoing legal and accounting fees

Maintaining a testamentary trust will require administrative expenses such as legal/accounting fees and annual tax filings for the duration of the trust's existence. These ongoing expenses would not be incurred where assets are distributed outright to beneficiaries.

Capital gains tax

Assets transferred to a testamentary trust at death are generally subject to the deemed disposition tax rules. This may create capital gains tax for the deceased. However, assets transferred to a Partner, or qualified testamentary spousal trust may not be subject to the deemed disposition rules.

The 21-year deemed disposition rule

Every 21 years, the trustees of a trust must report all accrued capital gains on all capital property held in the trust. At that point, there will be a deemed disposition of all capital property held within the trust at fair market value, potentially triggering taxable capital gains.

In light of this deemed disposition rule, the terms of the trust may permit the trustee to transfer trust property to the beneficiaries on a rollover basis so long as certain conditions are met. If there is a possibility that the trustees may continue the trust for more than 21 years, it may be necessary to ensure that there is sufficient cashflow to pay the resulting tax bill, or that other tax planning strategies are implemented.

When is it appropriate to name a corporate trustee 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 involved in this decision can include: value of the assets, complexity of the terms of the trust, nature of the relationships among the beneficiaries, geographical location of the various parties, and desire to have an impartial third party involved.

A trust can demand a significant amount of time and energy from a trustee and can exist for generations. Therefore, rather than appoint a trusted friend, individuals may engage the services of a trust company, to act as trustee or co-trustee of the trust.

Benefits of such an arrangement can include the assistance of an experienced and knowledgeable team of specialists who work together managing the trust in a cost-effective and timely manner. Most importantly, beneficiaries generally work with one specialist who coordinates all of the services with a clear understanding of the goals of the trust and sensitivity to family issues.

Considerations

Work with your TD advisor to review how the following fits into your overall Wealth plan;

- About the impact of the tax rules on a testamentary trust you may wish to establish.
- Whether your circumstances involve an opportunity for the effective use of a testamentary trust.
- To assess the alternatives to setting up a testamentary trust.
- Whether your estate and your intended beneficiaries could benefit from the services of a corporate trustee.

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