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The Future Of Testamentary Trusts

JAMIE GOLOMBEK, CA, CPA, CFP, CLU, TEP
Managing Director, Tax & Estate Planning
CIBC Private Wealth Management

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In June 2013, the government formally launched a consultation paper that may lead to the elimination of the graduated tax rate system for testamentary trusts and estates. The proposed measures, if adopted, would come into play starting in 2016 and would effectively abolish a common estate planning technique used by wealthy individuals to reduce tax on the investment income earned from their assets, by their beneficiaries, for years after their death.

A testamentary trust is a type of legal arrangement in which one person, typically known as the trustee, holds and manages the deceased's property for the benefit of the beneficiary. It arises as a consequence of death of an individual. For tax purposes, an estate is also a testamentary trust that arises upon death and generally lasts until the estate representative has fully administered the assets and then distributed them to the beneficiaries who are entitled under the will or intestacy of the deceased.

For tax purposes, both trusts and estates are considered to be individuals and must file returns that require them to pay tax on any taxable income that is not paid to the trust's beneficiaries. In 2013, testamentary trusts and estates pay tax at graduated tax rates starting at 15% federally for income under $43,561 and ultimately rising to 29% once income reaches about $135,000. Each province other than Alberta, which has a 10% flat provincial tax, also applies its own set of graduated tax rates to the testamentary trust's income.

The government specifically cited the use of multiple testamentary trusts, tax-motivated delays in completing the administration of estates, and avoidance of the Old Age Security clawback as offensive testamentary trust planning, which "raise questions of fairness, and negatively affect government tax revenues." As a result, the government proposes to change the tax law to apply flat top-rate taxation to testamentary trusts created by will as well as to estates "after a reasonable period of administration" of 36 months.

For example, suppose you have a will that leaves all funds to your spouse who pays tax at the highest marginal rate. If your spouse were to invest the inherited funds in a non-registered account that earned $100,000 of ordinary income, your spouse would pay tax of almost $50,000 (assuming the top marginal tax rate in Ontario for 2013). If instead your will directed that the funds be put into a testamentary trust for the benefit of your spouse, the income could be taxed in the trust. The trust would pay about $30,000 of tax on $100,000 of ordinary income (assuming Ontario graduated tax rates for 2013). Use of a testamentary trust could, therefore, yield tax savings of approximately $20,000 annually. If the measures proposed in the government's consultation paper are implemented, the tax savings would be eliminated.

The government is inviting written comments on the proposed changes until December 2, 2013. Although the proposals may curtail the tax benefits available for testamentary trusts in the future, there are numerous other reasons why a testamentary trust may still make sense in your estate plan, including:

- **Administration and management of inheritances for minor beneficiaries until they reach the age of majority.**
- **Control** over the timing and amount of distributions to your beneficiaries. For example, you can specify that 50% of an inheritance would be distributed when the beneficiary reaches age 25 and the remainder at age 30.
- **Flexibility** in structuring payments to your beneficiaries. The trustee can be given discretion as to the amount and timing of distributions to your beneficiaries, which may be particularly useful for spendthrift or incapacitated beneficiaries, who may not have the responsibility or capacity to manage funds themselves.

- **Preservation** of a family inheritance. For example, your will may specify that income from the assets in your estate will be available to provide for the needs of your spouse during his or her lifetime but that the estate assets will ultimately go to your children upon your spouse's death, preserving the assets for the next generation.
- **Professional investment management** may be stipulated in the trust agreement, allowing funds to be handled by an experienced investment manager, rather than by beneficiaries who may be novice investors or prone to making poor investment decisions.
- **Motivation** of behaviour for a beneficiary. An "incentive trust" is generally designed to make distributions if a beneficiary engages in desired behaviours. For example, the trust agreement might stipulate that distributions will be made if a beneficiary completes post-secondary education, thus incenting the beneficiary to attend school. As another example, a beneficiary might be encouraged to work if trust distributions will be made in proportion to the beneficiary's income from employment or self-employment.

Establishing a trust is complex and the rules vary from province to province, so you should get professional legal advice prior to setting up a testamentary trust.

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