Estate Planning For Spouses and Children

Using Testamentary Trusts

BMO Private Wealth

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A testamentary trust provides a means of transferring and holding property under the terms of your Will. When structured properly, it can provide protection from creditors, guide the management and use of your wealth after death, and serve as a strategy to minimize or defer various taxes.

The mechanics of a testamentary trust

The term "testamentary trust" symbolizes a relationship which is created when the testator (the person who initially owns the property, has written the Will, and who has passed away) transfers possession and legal ownership of the property to another party under the terms of their Will for the benefit of someone else (the beneficiary or beneficiaries) according to the terms set out in the Will.

The trust is not a legal entity, but is considered a separate taxpayer for income tax purposes. It is the trustee who represents the trust because he or she has the legal rights to the property. Only the trustee can take actions on behalf of the trust, and the trustee must act according to the intentions of the testator as expressed in their Will. The beneficial ownership vests in the beneficiaries on the terms set out in the Will, and the trustee's actions are rooted in his or her fiduciary duty to act in the best interests of the beneficiaries. It is this separation of the legal and beneficial ownership that gives the trust its flexibility in the control and protection of the trust property, as well as in its management and distribution.

Taxation of a testamentary trust

Generally, when a resident of Canada dies their capital property is deemed to be disposed of at fair market value as of the date of their death, and a capital gain or loss is recognized at that time and taxed on his or her terminal tax return. An exception exists where the assets are being transferred to a spouse (either by marriage or common-law partner) or to a trust for the exclusive benefit of the surviving spouse for his or her remaining lifetime. In those cases, the spouse or the spousal trust is deemed to have received the assets on a "roll-over basis" (i.e., at the same adjusted cost base as the deceased), unless an election is made otherwise.

Since 2016, trusts created in your Will can no longer take advantage of graduated rates beyond a period of three (3) years after the date of death if your estate elects to be designated as a Graduated Rate Estate ("GRE"). An exception exists for a Qualified Disability Trust ("QDT") – a testamentary trust created for an individual who qualifies for the Disability Tax Credit ("DTC") under the Income Tax Act, and which is designated jointly by the trustee and the beneficiary as a QDT annually, if so eligible.

However, all trusts continue to have tax-related (in addition to non-tax related) benefits. Any income paid or payable to a trust beneficiary in a year is taxed in the hands of the beneficiary, provided the trust claims the offsetting deduction from its income. Consequently, when a beneficiary's rate of tax is lower than that of the trust, then, depending on the particular circumstances, income-splitting and a tax reduction can be achieved.

A personal trust is generally subject to a deemed disposition of its assets every 21 years from the date of death, although this rule does not apply to certain trusts, including a spousal trust (i.e., where the sole beneficiary of the trust is the spouse during their remaining lifetime). The preferential tax treatment afforded to spousal trusts is described in more detail in this article.

The testamentary spousal trust

Including a trust for the benefit of one's spouse in a Will (a testamentary spousal trust) may be an appropriate estate planning tool in order to meet a variety of objectives, including: asset protection; probate minimization; and addressing second marriage and blended family situations. The following highlights other considerations with respect to spousal trusts:

Asset protection

By transferring some, or all of your wealth to a testamentary spousal trust, you can ensure that these assets are protected from claims by creditors of your spouse. In order to make the most of this creditor protection, it is important to ensure that access to the capital of the trust is beyond the control of your spouse. Consequently, your spouse should not be the sole trustee or otherwise be in a position to influence the distribution of the capital, such as a requirement that he or she be part of any majority decisions by the trustees. If your spouse is to be the sole trustee, you may wish to preclude your spouse from being entitled to any capital during his or her lifetime and only receive the income.

Similarly, a testamentary spousal trust may be an effective strategy to protect these assets in the event that the surviving spouse remarries or becomes vulnerable to undue influence. The assets held in the testamentary spousal trust are protected because it is the trustee that maintains legal control and management of the trust capital. Again, the part that your spouse plays as a trustee of the spousal trust will dictate the degree to which these objectives can be met.

Second marriages/Blended families
A spousal trust is often used to deal with more complex family structures, such as when your spouse is not the parent of your children. The spousal trust is created to benefit your surviving spouse during his or her lifetime with mandatory income distributions, and distributions of the capital at the trustee's discretion.

Such a structure is effective in ensuring that your surviving spouse is able to maintain his or her standard of living while preserving the capital (to the extent that you so dictate in the Will) for the benefit of your own children. Upon your spouse's death, the children would receive all of the capital property remaining in the spousal trust.

Business assets
You may want to provide your spouse with income from your business during his or her lifetime, while ensuring that the control and ultimate ownership of the business assets remain with your children. By taking advantage of the roll-over to a testamentary spousal trust, you can defer the tax liability that might otherwise arise on the disposition of your business assets (including any private company shares) until the death of your spouse while providing him or her with income from the business. However, be mindful of a conflict that may arise between the interest of your spouse in receiving income and the desire of the children, as the ultimate owners, to reinvest earnings back in the business for future growth.

Taxation of testamentary spousal trusts
In order to meet the requirements to receive preferential treatment under the Income Tax Act, a testamentary spousal trust must meet certain conditions:

- The surviving spouse and the deceased must be a resident of Canada at the time of death and the trust created by the deceased's Will must be one that is deemed to be resident in Canada;
- The transfer of property to the trust must occur as a consequence of death;
- During his or her remaining lifetime, the surviving spouse must be entitled to receive all of the income from the trust and be the only one entitled to receive any distributions of capital from the trust. Distributions of capital to the spouse may be at the discretion of the trustee(s) or there may be no access to capital permitted at all; and
- The capital property must "vest indefeasibly" in the spousal trust within 36 months of the deceased's death.

If these conditions are met, your assets may be "rolled over" to the spousal trust – in other words, the assets are transferred to the spousal trust at your adjusted cost base so that the capital gains are deferred until the earlier of the date of your spouse's death or the date the assets are sold. In addition, the assets in the spousal trust will not be subject to the "deemed disposition" that will otherwise occur every 21 years. It is only on the death of the surviving spouse that the deemed disposition will occur and the resulting gains taxed in the trust at the top marginal rate, unless an election is made in certain circumstances to have the deemed gains taxed on the spouse's terminal tax return at his or her marginal rate.

Spousal trusts and RRSPs and RRIFs
By their very nature RRSPs and RRIFs have the benefit of a spousal roll-over – where the spouse is named as the beneficiary or successor annuitant he or she can receive the funds into his or her registered account with no immediate tax consequences. However, if an RRSP or RRIF account is placed into a testamentary spousal trust, it loses this advantage; typically resulting in taxation of the funds as regular income in the year of death. Therefore it is not generally recommended to transfer these accounts into a spousal trust unless dictated by specific needs or circumstances of the spouse. A marriage contract or cohabitation agreement may be effective to ensure that the RRSP or RRIF funds are preserved (except for required RRIF withdrawals), and that beneficiary designations are maintained for the intended ultimate beneficiaries.

Spousal trusts and TFSAs
Unlike an RRSP or RRIF, no tax will be payable by the deceased's estate in respect of a TFSA, and the fair market value of the TFSA at death will be received tax-free by the beneficiaries. If transferred into a spousal trust, those savings will no longer accumulate tax-free. This tax-free status will only be retained if directly "rolled over" to your surviving spouse's TFSA. For more information, ask your BMO financial professional for a copy of the publication, *Designating Beneficiaries: Tax-free Savings Accounts*.

Deciding to transfer a TFSA into a spousal trust depends on whether your priority is to minimize the immediate tax burden or to access certain asset protections and exercise control.

Family law considerations
While a testamentary spousal trust may afford the surviving spouse many benefits, before implementing a testamentary spousal trust strategy, seek legal advice regarding the family law rights of a surviving spouse in your province. In Ontario for example, spouses who are married to one another "equalize" their property on separation.[1] The regime requires that they value their assets and debts at marriage and at separation, with any increase in their respective net worth between those two dates (their "net family property") being equalized. Most importantly,

the governing legislation (the Family Law Act) treats death as it does a "separation." It furnishes the surviving spouse with an option to take their entitlement under the deceased spouse's Will or to elect an equalization of net family property. As we have seen, the beneficiary of a testamentary spousal trust is not the legal owner of the property – only the beneficial owner for his or her remaining lifetime. The availability of the election under the Family Law Act means that your surviving spouse may defeat your intention for a testamentary spousal trust by making such an election and receiving his or her equalizing share of your estate outright. Similar legislation may prevail in other provinces or territories, whether for married spouses or for common-law partners. Accordingly, legal advice – including the advisability of a marriage contract or cohabitation agreement – is critical when considering a testamentary spousal trust for some or all of your assets.

Testamentary trusts for children and grandchildren

If you wish to transfer your wealth to your children or grandchildren, but they are minors, or you have concerns about their ability to manage the wealth, or you worry that your children may not protect and preserve the wealth due to a spendthrift lifestyle or marital difficulties, using atestamentary trust as a vehicle to transfer your wealth may offer a solution.

Since a minor beneficiary cannot legally receive the funds, a trustee must be appointed to do this on behalf of the child until he or she reaches the age of majority. The terms of the trust should provide that funds can be paid to the surviving parent or guardian for the benefit of the child until he or she reaches the age of majority.

Trusts can also provide control over the timing and amounts of the distributions to beneficiaries beyond the age of majority. This may be particularly useful for large inheritances, or for beneficiaries who may not have the skills or capacity to manage the funds for themselves. A discretionary trust can provide the trustee with flexibility in determining the amount and timing of payments to beneficiaries, including whether such payments are made from income or from capital. A trustee may even have discretion to make choices among the beneficiaries, allocating distributions based on circumstances that prevail at that time. Although recent changes to the tax law have eliminated access to the graduated tax rates on income retained and taxed within a testamentary trust, trusts created in your Will, such as a trust for each adult child's family, may still provide income-splitting opportunities since they can be used to "sprinkle" income on a discretionary basis to family members in the lower tax brackets.

Even if there are no concerns about the ability of a beneficiary to be financially responsible, leaving assets in a discretionary trust may help protect inheritances from third-party claims (for example, creditor or family law claims against the beneficiary).

A discretionary trust can also be used to preserve income and/or asset-tested government benefits for disabled beneficiaries when properly structured as a Henson trust. For more information on planning for beneficiaries with disabilities, ask your BMO financial professional for a copy of the publication, Special Needs Beneficiaries Require Special Estate Planning.

Beneficiary distributions from a trust

Parents often struggle to decide the appropriate age that distributions of capital should be made by the trustee to the beneficiary child after he or she reaches the age of majority. One option is to provide for the capital to be distributed at prescribed intervals or upon the happening of certain events – for example, one-half at age twenty-five and the remainder at age thirty. However, such prescribed distributions set out in the Will may negatively impact the protection of the trust assets from third-party claims. Another challenge for parents is deciding on what occasions or for what purposes distributions of capital may be made by the trustees to the beneficiaries before those milestones are met. Should capital be made available for the purchase of a first home, or for starting a business? Because it is not possible to foresee the future, it may often be most desirable to leave such decisions to the discretion of the trustee. The parameters of this discretion may be prescribed in the Will or the discretion may be absolute, depending on the purposes for which the trust was established and the circumstances of the beneficiaries. In every case where a discretionary trust is appropriate, it is critical to make provision for alternate beneficiaries on the death of the primary beneficiary in the case of a lifetime trust or should he or she not survive to the prescribed age, where an earlier distribution date is contemplated.

For more information on the exercise of trustee discretion, ask your BMO financial professional for a copy of the publication, *"Letters of Wishes" for Wills and Discretionary Trusts*.

Including the house in the trust for your spouse or children

Individuals may wish to ensure that their surviving spouse or young children are able to continue to reside in their family home or to use the family cottage for as long as they wish or are able. In the case of a surviving spouse, it is important to provide which expenses will be paid from the trust and which will be the responsibility of the spouse. The circumstances in which the trustees may terminate the right to live in the house or when the beneficiary may be deemed to have abandoned the property should also be outlined in the Will so that the property may be sold before its value is diminished due to neglect. As in the case of business assets held in a testamentary spousal trust, family

conflict may arise where the family home or cottage is held in a testamentary spousal trust – the adult children may not be interested in having capital of the trust spent to maintain the property if it could otherwise be invested elsewhere for greater capital appreciation down the road.

The Principal Residence Exemption ("PRE") provides that where an individual ordinarily inhabits a residential property, he or she may claim the PRE upon disposition of that property to reduce or eliminate any capital gains tax otherwise payable. Until 2016, the PRE was available to a personal trust that owned such a property for the benefit of a beneficiary who was a natural person. Changes in the Income Tax Act introduced in 2016 restricted the availability of the Principal Residence Exemption to only certain personal trusts identified as "Qualifying Trusts." These exceptions include a spousal trust and a trust for a minor child whose parents are deceased. However, once the surviving spouse is no longer alive, the trust will no longer qualify for the PRE. Similarly, once the minor child attains the age of majority, that trust will constitute a family trust and no longer be a Qualifying Trust for the purposes of the PRE. This means that where a trust is created in a Will to hold a home for the benefit of minor children, once the youngest living child attains the age of majority, it may be prudent for the trustee to "roll out" the home from the trust to one of the capital beneficiaries residing in the home who would then be able to use the PRE when it is sold in the future.

Reviewing the structure of your assets

It is important to remember that testamentary trusts are generally funded with assets that pass through the estate. (An exception is a Life Insurance Trust. For more information, ask your BMO financial professional for a copy of the publication, *Life Insurance Trusts: The Whys and Whens*). In order to pass through your estate, assets must be registered in your own name. Your proportionate share of a capital asset registered as "Tenants-in-Common" will form part of your estate. However, capital assets such as real property and non-registered investment accounts are often owned between spouses as joint tenants with right of survivorship ("JTWROS"). These can pass outside of the estate to the surviving joint owner in all provinces and territories except Quebec, where the right of survivorship is not recognised.

If all assets are owned JTWROS or have designated beneficiaries, a grant of probate may be avoided on the death of the first-to-die spouse. This may result in reduced costs and administration for the surviving spouse. However, these assets will not be available to fund a testamentary trust for the surviving spouse or for children. In order for that to happen, the JTWROS accounts must be divided into two accounts – one in the name of each spouse. Legal title to real property would need to be re-registered in the name of the spouses as tenants-in-common, in which case only the deceased spouse's proportionate interest in the property would be held in the testamentary trust. As such, a cost/benefit analysis should be undertaken before including a testamentary spousal trust or a testamentary trust for other beneficiaries while the spouse is alive.

Seek advice

A testamentary trust for a surviving spouse or for children and grandchildren is an important and flexible estate planning tool which can yield many benefits and ensure that your intentions regarding your family's inheritance are preserved. However, the many potential drawbacks for the unwary mean that your Will should be drafted by a legal advisor specialising in estate planning, as well as obtaining tax and family law advice.

For more information, please speak with your BMO financial professional.

[1] Matrimonial property laws in Quebec differ from the common-law provinces' matrimonial or family law regimes in the rest of Canada. This article does not focus on issues pertaining to Quebec Civil Code. It is advised to seek professional legal advice if you and your spouse are in a matrimonial or civil union in Quebec.

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