Good Reasons to Trust Testamentary Trusts

New legislation that took effect on January 1, 2016, impacts the taxation of testamentary trusts. While there are aspects to the new rules that have negative consequences for taxpayers, testamentary trusts remain an important and effective estate planning tool.

A chilling effect

Perhaps the most talked about aspect of the new law affecting testamentary trusts is the imposition of a flat (top) rate of tax. All testamentary trusts (those which come into existence as a result of death), whether they are created by Will or by way of a beneficiary designation under a life insurance policy, will be taxed as of January 1, 2016 like inter-vivos trusts (those created during one's lifetime), at the highest tax rate.

There are two exceptions to the new rule:

1. **Qualified Disability Trusts** – A testamentary trust created for an individual who qualifies for the Disability Tax Credit under the federal Income Tax Act ("ITA") may be designated jointly by the trustee and the beneficiary as a Qualified Disability Trust ("QDT"), annually, if so eligible. The QDT designation will allow the trust to be taxed at marginal tax rates, so long as the beneficiary is eligible for the Disability Tax Credit.
2. **Graduated Rate Estates** – Where an executor has not completed the distribution of estate assets to the beneficiaries under the Will, and where the Will permits the discretionary holding of assets for up to 36 months by the executor, the executor may designate the estate (or as much of it that remains undistributed) as a Graduated Rate Estate ("GRE"). While undistributed, the estate can benefit from the marginal tax rates, but not for longer than 36 months from the date of death. Income generated in the undistributed estate beyond 36 months after the date of death will be taxed at the highest tax rate.

Benefits of testamentary trusts

Testamentary trusts continue to provide a number of benefits that make them a useful estate planning tool, including the following:

Protecting assets

Where a surviving spouse remarries or becomes vulnerable to undue influence, the assets held in a testamentary spousal trust are safe because the trustee maintains legal control and management of the trust capital. Where an adult child is a spendthrift, vulnerable, or easily influenced, the assets are protected, since only the trustee has access to the trust capital and income. Similar protection of assets is available, to a great extent, depending on circumstances and on the language used in drafting the trust in the Will, upon marital or relationship dissolution of an adult child beneficiary.

Minimizing beneficiaries' income tax and probate tax

Although testamentary trusts are now taxed at the top tax rate (subject to the two exceptions previously discussed), some income-splitting can still be achieved between the beneficiary and the trust (which is a separate taxpayer), where the beneficiary is subject to a lower marginal rate of tax.

Where the trust owns qualifying small business shares, the available lifetime capital gains exemption can potentially be multiplied by the number of beneficiaries upon disposition of those shares by the trust. Upon the death of a beneficiary of a testamentary trust, the assets held in the trust would not fall to the estate of the deceased beneficiary, and therefore, the deceased beneficiary's estate would not be liable for probate tax on those assets.

Guiding and controlling the distribution

The terms of the trust govern how much, when, under what circumstances and to whom (where there are discretionary beneficiaries) income and/or capital of the trust are to be distributed. Providing incentive provisions in the terms of trust allow you to encourage your loved ones – your beneficiaries – to adopt the lifestyle, and, to uphold the values, which you wish to leave as your legacy, particularly with respect to education, work ethic and philanthropic aspirations.

Taking advantage of testamentary trusts in 2016 and beyond

Despite the new negative tax rules affecting testamentary trusts, these ownership structures, which are created at death, remain useful estate planning vehicles. Explore the opportunities testamentary trusts offer in your overall estate plan with your tax and estate planning professionals.

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