August 2015

# Planning from the Grave — Testamentary Trusts

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One of the main functions of your will is to name the beneficiaries who will inherit the assets that make up your estate. When choosing beneficiaries, there are many reasons why it can make sense to include trusts in your estate plan. A trust is an arrangement in which property is managed by one person for the benefit of another. Rather than leaving an asset directly to a beneficiary under your will, you could create a trust and name a trustee who would manage the assets on behalf of the beneficiary under terms you specify.

Trusts are frequently used for gifts or bequests to minor beneficiaries, who have not yet reached the age of majority (which is 18 or 19 years of age, depending on the province or territory of residence). Since the beneficiary cannot legally manage the funds, someone must be appointed to do this on behalf of the child until the child reaches the age of majority. When leaving an inheritance for a minor beneficiary in your will, you can specify that assets be left in trust for the benefit of a child and designate a trustee who would manage the trust funds. Generally, you can also do this outside your will by designating a trustee as a beneficiary for life insurance and Registered Retirement Savings Plans (RRSP), Registered Retirement Income Funds (RRIF) and Tax-Free Savings Accounts (TFSA) proceeds of non-insurance plans.[1]

Whether you name a trustee through your will or a beneficiary designation, this creates what is commonly known as a "testamentary trust," a term under the *Income Tax Act* meaning that the trust arises as a consequence of your death. You can outline directly in your will, or through the beneficiary designation, the terms the trustee must abide by, such as how trust property should be managed and when property can be distributed.[2]

Leaving assets in a trust, rather than naming direct beneficiaries who will receive assets outright upon your death, can help solve some common estate planning mistakes.

## MISTAKE #1: GIVING IT ALL AWAY AT ONCE

Emily wants to fund post-secondary education expenses for her 18-year-old son, Andrew. She has earmarked $100,000 and plans to use the funds to pay for Andrew's annual tuition and living expenses while he attends school and establishes his career. As part of her estate planning, Emily has decided she wants Andrew to have these funds if she were to pass away.

Suppose Emily leaves a bequest of $100,000 to Andrew in her will. The estate administrator would pay $100,000 to Andrew and he could use the funds for his education and living expenses, as Emily intended; however, there won't be any limits as to how Andrew spends the funds. If Andrew decides he'd really rather have a nice sports car, there is nothing preventing him from spending the entire $100,000 on this purchase.

Rather than giving the money to Andrew all at once, it may be better for Emily to leave the $100,000 in the care of a trustee who would manage the funds on Andrew's behalf for specified purposes. For example, the trustee could be given discretion to pay for expenses related to Andrew's support and education. The trust terms could also specify an age at which the trustee would transfer any remaining funds to Andrew, such as when he reaches age 30. This would delay final distribution of the funds until a time when Andrew might be in a better position to make responsible financial decisions.

## MISTAKE #2: LETTING YOUR BENEFICIARIES' INHERITANCES BE ERODED

Testamentary trusts are not necessarily only beneficial for minors. Even if you don't have any concerns about the ability of a beneficiary to be financially responsible, leaving assets in trust may provide opportunities to reduce taxes and may help protect inheritances from claims of third parties.

A testamentary trust is treated as a separate taxpayer. Until the end of 2015, a testamentary trust enjoys the same graduated tax rates as an individual. This means that income on trust assets is subject to tax rates that can be as low as approximately 20%, depending on the province. This can mean an overall reduction of total possible taxes for beneficiaries who already pay tax on their annual income at high marginal rates.

After 2015, graduated rate taxation for testamentary trusts and estates will be significantly curtailed. Starting in 2016, flat top-rate taxation will apply to testamentary trusts regardless of when they were established (with one important exception, discussed below) and will also apply to estates "after a reasonable period of administration" of 36 months from the date of death. Consequently, the benefits of graduated rate taxation would generally not be available to testamentary trusts, and would be limited to the first three years of an estate. Given this limitation, you may want to speak with your tax and legal advisors on the costs and benefits, tax and otherwise, of transferring your assets to beneficiaries through your estate or through testamentary trusts or direct beneficiary designations on registered plans and insurance policies.

The government did recognize, however, that the existing graduated rate tax system for testamentary trusts was an important tool in preserving access by disabled beneficiaries to income-tested benefits, such as provincial social assistance benefits. As a result, there is an important exception to the new rules for testamentary trusts. Flat top rate taxation will not apply to testamentary trusts with at least one beneficiary who is eligible for the federal disability tax credit. For these trusts, commonly referred to as Qualified Disability Trusts (QDTs), graduated rates will continue to be available.

Let's look at an example of how a QDT may be useful in an estate plan. Imagine that Mark is married to Anne, who is eligible for the federal disability tax credit.

Suppose Mark names Anne as the beneficiary of his life insurance policy and, after Mark's death in 2016, Anne invests the insurance proceeds to earn $100,000 of taxable investment income annually. If Anne already has other income that puts her in the highest tax bracket, she would pay combined federal and provincial income tax on the investment income ranging from about $44,000 to $55,000 annually, depending on her province of residence.

If Mark, instead, leaves the insurance proceeds to a QDT for Anne, the $100,000 of annual income could be taxed inside the QDT. The QDT isn't taxed at the top marginal tax rate like Anne is on the additional income, but rather is taxed at progressive, graduated rates, provided that that the trustee and Anne jointly elect each year for the trust to be a QDT.

The result is that only about $25,000 to $31,000 of tax would be payable on trust income annually, depending on the province, which could yield tax savings of $16,000 to $25,000 each year after Mark's death. After the income is taxed inside the trust, it could then be paid out to Anne as a non-taxable distribution. While this example illustrates savings from life insurance policy proceeds, tax savings can be realized when any income-generating asset is placed into testamentary trust.

Prior to 2016, use of testamentary trusts was a common estate planning technique to minimize taxes for beneficiaries. As noted above, however, starting in 2016 tax minimization opportunities are limited to estates in the first 36 months after death and to QDTs, so tax erosion will not be a significant consideration when deciding to implement a testamentary trust in many cases after 2015.

Taxes aren't the only way your beneficiaries' inheritances can be eroded. When your beneficiaries inherit assets directly, the assets may become subject to certain legal claims against the beneficiary. For example, if you leave assets to a beneficiary who later goes into bankruptcy, the inherited assets may become subject to creditor claims. Also, if a beneficiary divorces, inherited assets may be subject to claims by the beneficiary's former spouse. Leaving assets in trust for your beneficiaries can sometimes protect the beneficiaries' inherited assets from these claims. Of course, this area is complex, and the rules vary from province to province, so be sure to get professional legal advice when pursuing strategies in this area.

## MISTAKE #3: CHOOSING THE WRONG TRUSTEE

Even among those who use trusts in their estate plans, many people end up simply naming a family member or friend as a trustee. A common mistake is choosing a trustee who is approximately the same age as you. As you grow old, the trustee will grow old as well. And when you eventually pass away, the trustee may be unable to act or even deceased. Choosing to involve a corporate trustee, such as CIBC Trust, can prevent this situation. Unlike a living person, a corporate trustee will exist indefinitely and can continue to serve as trustee for as long as one is needed.

Often a family member is chosen as trustee under the assumption that this is a less costly option than using a professional trustee; however, this is not necessarily the case. Any trustee, including a friend or family member, is entitled to receive compensation for providing trust services. Each province sets guidelines for the amount of compensation a trustee can charge.

Let's look at another example to illustrate why the choice of a trustee is so important. Suppose Robert wants to leave an inheritance for his daughter, Rachel, who is currently eight years old. Robert is divorced and doesn't want his ex-wife (who has custody of Rachel) to manage Rachel's inheritance if he were to pass away while Rachel is still a minor. Robert is considering creating a trust for Rachel under his will and naming his sister, Karen, as trustee.

Being a trustee can be a complex and time-consuming job. Karen would need to make many decisions, such as choosing appropriate investments and deciding on the amount and timing of distributions to Rachel. Physical custody and management of the assets would also be Karen's responsibility, and she would need to undertake tasks such as completing paperwork to open accounts, buying and selling assets, and making ongoing payments and withdrawals. If real estate were involved, property management could also require her to complete tasks such as paying household bills, repairs and maintenance. Karen must also ensure that proper accounting records are maintained for all trust financial activities and annual tax returns are filed for the trust. Does Karen have the necessary skills, knowledge and time to perform these tasks?

Robert would be well-advised to consult with Karen before naming her as trustee to see if she would be willing to act in this capacity. Too often, people simply assume their family and friends would be honoured to help. In truth, Karen may not want to perform this time–consuming role, particularly since it could last for ten years (until Rachel reaches age 18), or even longer. During that time, Karen would need to communicate with Robert's ex-wife, who has custody of Rachel, which could also be uncomfortable for Karen. As a trustee, Karen would also be liable for any errors in trust administration — a risk she may not want to assume. And what if Karen were to become incapacitated or die during the trust term? If Karen were unwilling or unable to perform the trustee role, then the court would appoint a new trustee if Robert had not named an alternate trustee in his will.

Naming a professional trustee can help to prevent some of these issues. CIBC Trust and its predecessors have nearly 100 years of experience in acting as trustee for numerous clients and can administer the trust efficiently. They have expertise dealing with legal issues, tax filings, investment decisions and discretionary payments while balancing the needs of all beneficiaries. You can appoint CIBC Trust as the trustee of a testamentary trust, either alone or as a co-trustee along with another individual.

If you have been appointed as a trustee and find yourself in need of assistance in carrying out your duties, CIBC Trust also offers "Agent for Trustee" services. This allows you to maintain decision-making authority, but delegate the burden of handling the administrative duties to CIBC Trust.

Since trust and tax laws are very complex, advice should be obtained from legal and tax professionals prior to implementing any trusts. Your CIBC financial advisor can provide more information about having CIBC Trust act as a trustee or about Agent for Trustee services.

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[1] In Quebec, you can only designate beneficiaries for life insurance products.
[2] In Quebec, creating a testamentary trust with insurance proceeds requires a formal trust created in the will.