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Taxation of Estates and the Use of Testamentary Trusts

Succession planning not only gives us the opportunity to provide for our loved ones, but also gives us the opportunity to save them a significant amount of income tax in the early years of an estate and in some cases for longer. One of the simplest, yet most often overlooked, tools for protecting the assets of the estate and the interests of the beneficiaries of the will is the Testamentary Trust.

A Testamentary Trust is created upon your death via a clause you place in your will. In that clause you stipulate that a certain portion of your estate will be held within a Testamentary Trust for the benefit of one or more beneficiaries. You may establish separate Testamentary Trusts for each beneficiary. You name a trustee for each Testamentary Trust. The trustee can be your executor(s), another person, group of people or another legal entity. You can establish parameters that are either constrained or flexible as to operation of the Trust. You will likely want to give the trustee maximum flexibility as to how the money in the trust is invested. Disbursement constraints will probably be dictated by the age and personality of the beneficiary. For example, you may choose to place no constraints on the disbursement of after-tax income or capital if your spouse is the beneficiary, while you might limit the scope of distributions of income or capital to a minor child or young adult.

Tax Treatment of Estates

For the first 36 months of an estate's existence it can designate itself, or one of its components such as a single Testamentary Trust, as a Graduated Rate Estate and thus qualify for preferential tax treatment. This provides executors with a reasonable period of time to organize the assets of the estate and prepare them for distribution while enjoying the benefit of the best tax treatment on income earned by the estate. After this 36-month period, the Estate or Testamentary Trust will be required to switch to a December 31st year-end and will pay tax on non-distributed income at the top marginal tax rate. Testamentary Trusts established for individuals eligible for the Disability Tax Credit will continue to enjoy the graduated tax rate system indefinitely. Testamentary Trusts with a beneficiary under the age of 21 can have the beneficiary report the income of the Trust on their personal tax return while retaining the income in the Trust, provided that money is distributed to the beneficiary by their 40th birthday.

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Tax Benefit

A near-universal benefit of a Graduated Rate Estate will be the potentially significant tax saving during the first 36 months of its existence. This comes about because the trust is treated as an independent legal entity and is taxed using the same tax brackets and rates as any individual. It does not qualify for any personal exemptions. Nonetheless, the fact that its first $41,536 of taxable income is taxed at only 20.05% (using 2016 Ontario tax rates) can provide potentially huge tax savings for a beneficiary who would otherwise be adding the income earned by the Testamentary Trust to their own income. For example, a beneficiary with a taxable income of $80,000 would pay about $18,000 in income tax. With an additional $20,000 of taxable income from an inheritance that same individual would pay about $26,000 in taxes, some $8,000 more. If that $20,000 of income were taxed in a Testamentary Trust instead, the trust would pay about $4,000 in tax. This represents a tax saving to the beneficiary of $4,000 in each of the three years of the graduated tax rate system. This can be magnified if the Graduate Rate Estate has multiple beneficiaries.

If the beneficiary is the spouse of the deceased, the trust has the option of taking on the adjusted cost base of securities held by the deceased, thus continuing to defer the payment of tax on unrealized capital gains. Alternatively, the trust can choose to crystalize gains and losses in the deceased's portfolio, perhaps to make use of the deceased's capital loss carry-forwards.

The maximum tax saving per Graduated Rate Estate is achieved at about $250,000 of annual income to the trust. At this level the tax saving for a beneficiary already in the top marginal tax bracket vs. receiving that income directly is about $27,000 per annum.

If the beneficiary is collecting Old Age Security or collects other social benefits that are subject to income-tested “clawback” reductions when the beneficiary's income rises, the tax saving can become more pronounced.

If the beneficiary’s taxable income is less than $41,536 per year and would remain so if income from the inheritance were added on, there would be no tax saving for that beneficiary from utilizing a Testamentary Trust. The ability to constrain disbursements and some of the protections the trust provides to the beneficiary may make the use of a Testamentary Trust an attractive option nonetheless.

Operational Considerations

When contemplating building Testamentary Trusts into your will, there are a number of things you need to consider. You should name a trustee and an alternate trustee who are well positioned to see at least a significant portion of the mandate through.

Each Testamentary Trust must file its own T3 trust income tax return. This is a different, though no more complex, type of tax return from the T1 personal income tax return. A trust is normally considered a resident of the province of its trustee. As a matter of administrative simplicity the trustee of a Testamentary Trust should seriously consider immediately adopting the calendar year as the reporting period for the Testamentary Trust. This will align the trust with the reporting period on all the investment income t-slips it will receive. Assets held in a Testamentary Trust are subject to deemed disposition for tax purposes after 21 years. This means that any appreciation in value of an asset would be required to be taxed as a capital gain no less frequently than 21 year intervals. This may present some challenges for an asset such as a family cottage, it would be of considerably less significance for an actively-managed investment portfolio.

Each Testamentary Trust will be a stand-alone independently operated investment portfolio. In order to achieve adequate economies of scale in terms of management and accounting costs we would generally suggest that a practical minimum size for a Testamentary Trust should be $150,000.

Providing for the creation of one or more Testamentary Trusts in your will does not necessarily dictate that the executor must see this through. The flexibility should be provided for the executor to forego the creation of one or more Testamentary Trusts if practical considerations suggest that there would be no point in creating the trust. Situations could evolve such as the beneficiary needing the inheritance to pay off a mortgage or other debts, or if the deceased had used up a significant portion of their estate on health care needs since the will was written.

Generally speaking, for assets to flow into a Testamentary Trust they need to pass via a will. This would likely also make them subject to such estate processing costs as probate fees which run at about a 1.5% rate in Ontario. However, these assets will only be subject to probate costs once.

It should be noted that assets held in a Testamentary Trust are protected against creditors and litigants of the beneficiary.

Testamentary Trusts can be used as a multi-generational tax and succession planning tool. For example, a Testamentary Trust can be set up in your will to provide income and possible capital, if required, to your spouse during their lifetime. Your will can also dictate that upon the passing of your spouse the original Testamentary Trusts is then moved into one or more new Testamentary Trusts for the benefit of your children.

Conclusion

From a tax minimization perspective, it will likely often be optimal to retain as many assets as possible for up to three years in the Estate to enjoy the preferential tax treatment afforded to the one Graduated Rate Estate exemption any Estate can designate. As the third anniversary of the establishment of the Estate approaches it would be prudent to distribute assets to the beneficiaries or such Testamentary Trusts as the will established.

Testamentary Trusts are an important and potentially highly beneficial succession planning tool. We have highlighted the key considerations, but the information contained herein should not be considered legal advice. We would be pleased to discuss with you in greater detail your succession objectives and provide information for you to discuss with your estate planning lawyer.

If you have any questions or wish to discuss any of these matters, please give us a call or e-mail us at Graham.Tench@nbc.ca or Denis.Lheureux@nbc.ca.

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