Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Testamentary trusts for residents of Quebec

A tool to help you achieve your estate planning objectives

On the passing of an individual, assets are typically distributed to loved ones. There are different manners in which the assets of a deceased can be distributed, such as a direct or outright ownership, or alternatively to a testamentary trust created for the benefit of one or several beneficiaries. Testamentary trusts allow you to control the timing and manner in which the assets held by the trust are distributed to your beneficiaries. In particular, a trustee(s) is appointed to invest and manage the assets held in the trust. The trustee will distribute the income and capital to the beneficiaries in accordance with the wishes set out in your Will.

This article provides an overview of testamentary trusts and various reasons that this structure may be of interest to you. Details relating to the taxation of testamentary trusts are also provided, in addition to other considerations.

What is a testamentary trust?

A testamentary trust is a trust or an estate that's created on, and as a result of, the death of an individual (the testator). In order to qualify as a testamentary trust, no one other than the deceased can contribute property to the trust.

The provisions of the Will create the testamentary trust and set out the terms under which the assets can be distributed. In the case of a testamentary insurance trust those terms may be set out in a separate trust document. The Will or trust document should provide the amount of money or the nature of the property to be held in the trust, name the beneficiaries and trustees, outline the trustees' powers, specify the duration of the trust, and outline the terms by which distributions can be made.

The lifespan of a testamentary trust is generally determined based on the reasons behind the creation of the trust. Some trusts may only last a couple of years, and some may last for several generations beyond the completion of the initial administration of your estate.

Testamentary spousal trust

If your spouse is intended to be a beneficiary of the testamentary trust, you may consider setting up a testamentary spousal trust. Note that for the purpose of this article, a spouse includes a person with whom you cohabit in a conjugal relationship for a minimum of 12 months. In this case, your assets may rollover on a tax deferred basis to the trust at your adjusted cost base (ACB). Speak to your RBC advisor to obtain a copy of the article on testamentary spousal or common-law partner trusts if you're interested in learning more about this topic.

Non-financial benefits of a testamentary trust

Notwithstanding the changes to the tax treatment of testamentary trusts, these trusts continue to provide significant estate planning opportunities and should be considered for reasons other than taxation. In fact, testamentary trusts can be a useful tool in complex family situations — for example, a child with a disability, a beneficiary who can't manage their finances, children or grandchildren in need, or a second marriage.

Protecting beneficiaries with disabilities

If you have a child or grandchild with a disability, you may want to ensure they continue to be cared for following your passing. A testamentary trust, structured appropriately, may allow you to set aside funds and name a trusted individual to take care of your child's financial needs. In addition, if your child with a disability would otherwise qualify for provincial disability support and services, leaving the funds directly to that child may jeopardize the child's eligibility for these benefits.

Trusts for minor children or beneficiaries who can't manage their finances

Funds left outright to a minor child can't be paid directly to that child, as minors don't have the legal capacity to manage those funds. In Quebec, the funds may be paid to the minor child's legal tutor (generally the parent of the child) to manage the funds until the child reaches age 18. If the total value of the assets owned or received by the minor child is less than $40,000, their legal tutor has the power to make all of the decisions about managing the property. If the value of the minor child's assets exceeds $40,000, a tutorship council must be created to oversee the tutor's actions. In addition, if the assets being given to the minor are worth more than $40,000, a liquidator must submit a declaration to the Public Curator's office at least 15 days prior to handing over the assets to the tutor.

The investment and distribution of the funds by the tutor may be restricted. This may create inordinate delays, fees, and complexity in managing the child's inheritance. These potential difficulties may be avoided by establishing a testamentary trust for the benefit of your minor children and designating a trustee(s) to manage the funds. You may specify in your Will how the funds are to be used and when they can be used. Alternatively, you may choose to leave those decisions to the discretion of your chosen trustee(s).

If you have a child or grandchild with a disability, you may want to ensure they continue to be cared for following your passing. A testamentary trust, structured appropriately, may allow you to set aside funds and name a trusted individual to take care of your child's financial needs.

Even if you don't have minor children, you may have a particular child or person you want to benefit who may not be good at handling their financial affairs. A testamentary trust may allow you to ensure the beneficiary doesn't exhaust the trust assets too quickly.

Providing for education and other expenses of children and grandchildren

You may want to establish a trust for a very specific purpose, such as to fund the educational expenses of your children or grandchildren. Establishing a trust allows your trustee(s) to control how the inherited funds should be used.

Control over the timing of asset distributions

If you have a significant estate and your children or other beneficiaries are relatively young, you may feel it would not be a good idea to leave a significant amount of money to your beneficiaries until they've reached a certain level of maturity. You may feel they're too young to handle a sizable estate prior to attaining a specific age (age 30 or 35, for example). Establishing a trust may allow you to control the timing of the asset distributions to your beneficiaries.

Planning for blended families

Testamentary trusts are especially common in cases of second unions where one or both spouses have children from a previous marriage or from different relationships. For example, you may want to create a testamentary trust for the benefit of your spouse during their lifetime. However, on their passing, you may want to ensure that the remaining assets held in trust are distributed to your children and not the spouse's beneficiaries.

To preserve continuity of ownership (e.g. cottage property, family business)

Testamentary trusts are useful in the protection of a family asset, such as a cottage, that has sentimental

value. You may want to ensure, as much as possible, that it's kept in the family for future generations. As such, you may consider establishing a testamentary trust to hold the property instead of gifting the property outright to your children. Holding a cottage or other vacation property in a trust is discussed in the article on succession planning for your Canadian vacation property. If you're interested in learning more on that topic, ask your RBC advisor for a copy.

Other assets you may wish to preserve the ownership of, such as shares of a family business, may also be held in a testamentary trust.

Wealth protection and management

The family you leave behind may be accustomed to having you look after the financial affairs. Establishing a testamentary trust with a capable trustee(s) may be a way to preserve and protect your wealth for your intended beneficiaries. The trustee(s) can manage your investments and your other assets to provide for your family. If you don't have an appropriate individual to act as trustee and manage your assets, you may consider appointing a corporate trustee.

The role of a trustee is an extremely important one, involving several key legal obligations and fiduciary duties, as well as significant managerial and administrative responsibilities. Trustees are faced with many complexities and obligations and may feel burdened by the tasks of administering a trust, or simply lack the time or expertise to undertake such a role.

A trust company, like RBC Royal Trust, can help by acting as the trustee, co-trustee, or as an agent for the named trustee to administer the trust assets. Some of the advantages of a corporate trustee include neutrality, availability, expertise, and continuity for long-standing trusts. Appointing a corporate trustee can help ensure the administration of the trust is done in accordance with the relevant laws. It can relieve your family members and friends of the burden of administering the trust assets and mitigate any potential conflict among your trustees or among beneficiaries. A corporate trustee can either be appointed while the settlor is alive or be appointed by a trustee(s) as agent after the settlor's passing, according to a fee schedule determined while the testator is alive, similar to compensation that may be payable to family members, friends or other trusted professionals acting as trustee.

If you have questions about who to appoint as a trustee or the typical responsibilities of a trustee, please speak with your RBC advisor to find out more about the services provided by RBC Royal Trust.

Other assets you may wish to preserve the ownership of, such as shares of a family business, may also be held in a testamentary trust.

Creditor protection

If the testamentary trust is properly structured, it may be possible to protect the assets in the trust from the creditors of the beneficiaries.

Providing for successive generations

You may want to provide for more than one generation or you may wish to skip a generation and provide for your grandchildren and not your children. A testamentary trust can protect assets for future generations.

Fulfilling charitable intentions

Your assets may be more than enough to provide for your family during their lifetime. As such, you may wish to provide the assets that remain after your family members' deaths to a charity. This may be accomplished by establishing a testamentary trust for the benefit of your family members with any remaining assets after their death going to the charity of your or your trustee's(s') choice.

Taxation of testamentary trusts

For Canadian tax purposes, a trust, which includes an estate, is taxed as a separate entity. Prior to 2016, a testamentary trust benefited from the same graduated tax rates applicable to individuals. January 1, 2016, saw the elimination of the graduated tax rates for most testamentary trusts. The graduated tax rates for testamentary trusts were replaced with flat top-rate taxation, currently used for most inter vivos trusts (a trust created during the lifetime of an individual versus as a result of their death). Two exceptions were granted. First, an estate that designates itself as a "graduated rate estate" (GRE) will generally be subject to graduated rate taxation for the first 36 months of its existence. Second, graduated rates will continue to apply in respect of testamentary trusts created for the benefit of individuals with a disability who are eligible for the federal disability tax credit (DTC), where the trust and the qualifying beneficiary have jointly elected for the trust to be a "qualified disability trust" (QDT) for a particular taxation year.

As a result of the changes in 2016, all income and capital gains generated and taxed in a testamentary trust that do not meet one of the two previously mentioned exceptions are taxed at the top marginal tax rate. These negative tax implications may, however, be reduced by taking certain steps. For example, where the terms of

the trust allow income or capital gains to be distributed to the beneficiaries, the trustee can elect to pay out the trust income or capital gains or make it payable to the beneficiaries. In this case, the income and capital gains will be taxed in the hands of the beneficiaries at their marginal tax rates. This may result in some tax savings if the beneficiaries' marginal tax rates are lower than the trust's tax rate.

All testamentary trusts, except for GREs, are required to have a December 31 year-end. A testamentary trust, including an estate, may be required to file an annual T3 Trust Income Tax and Information Return (T3 return). The T3 return is due within 90 days from the end of the trust taxation year.

GRE

A GRE of an individual is an estate that arises on and as a consequence of the individual's death and satisfies the following conditions:

- the estate is a testamentary trust for tax purposes;
- no more than 36 months have passed since the deceased's date of death;
- the estate designates itself, in its T3 return of income for its first taxation year (or if the estate arose before 2016, for its first taxation year after 2015), as the individual's graduated rate estate;
- no other estate is designated as a graduated rate estate of the individual (there can only be one graduated rate estate); and
- the estate includes the deceased individual's Social Insurance Number in its return of income for each taxation year of the estate that ends after 2015.

GRE status is important for an estate to benefit from the graduated tax rates that apply to the income earned and taxed in the estate. It's also a crucial requirement to take advantage of certain estate and post-mortem tax planning strategies. For example, if the estate is a GRE, the liquidator will have more flexibility in determining in what year and in what return to claim the charitable donation tax credit when a donation is made in an individual's Will. A discussion of all the advantages of GRE status is beyond the scope of this article.

QDT

A QDT is a testamentary trust where the trust and one or more of the beneficiaries jointly elect, in the trust's T3 return of income for the year, to be a QDT for that tax year. In addition, all of the following conditions must be satisfied:

- the election must include each electing beneficiary's Social Insurance Number;

All testamentary trusts, except for GREs, are required to have a December 31 year-end. A testamentary trust, including an estate, may be required to file an annual T3 Trust Income Tax and Information Return (T3 return). The T3 return is due within 90 days from the end of the trust taxation year.

- the electing beneficiary must be an individual, named as a beneficiary (e.g. John Doe) in the instrument that created the trust. For example, if the deceased set up the trust for "my issue," then the beneficiary can't elect to have the trust treated as a QDT;
- the electing beneficiary must be eligible for the DTC for the year;
- the electing beneficiary must not make a QDT election in respect of any other trust for the year;
- the trust must be factually resident in Canada for the year (i.e. not a non-resident trust that's deemed to be resident in Canada); and
- the requirement to pay a recovery tax can't apply to the trust for the year (a detailed discussion on the recovery tax is beyond the scope of this article but is briefly mentioned later).

An electing beneficiary is an individual beneficiary under the trust who qualifies for the federal DTC, and who has jointly elected with the trust for the trust to be a QDT for the year.

It should be noted that a testamentary trust can be a QDT in one year but not in another year. It's an annual election that gives the testamentary trust its status as a QDT for the year in question.

Recovery tax, mentioned previously, is generally a clawback of tax savings enjoyed by a QDT for income taxed at graduated rates in a previous year but where that capital was, or will be, subsequently distributed to a non-electing beneficiary.

A QDT is liable for recovery tax if:

- none of the beneficiaries at the end of the year are an electing beneficiary for a preceding year;
- the trust ceased to be resident in Canada; or
- a capital distribution is made to a non-electing beneficiary.

Essentially, a QDT will be required to pay a "recovery tax" when it distributes income that has been taxed at

graduated tax rates to any beneficiary other than an electing beneficiary. This puts the trust back into the same position it would have been in had the income been retained in the trust and taxed in the trust at the top marginal tax rate.

Losing testamentary trust status

For a trust to qualify as a GRE or a QDT, it's very important to maintain its testamentary status. Losing this status will result in the loss of all the tax benefits enjoyed by these trusts, such as the loss of graduated tax rates. As mentioned previously, a trust, including an estate, can lose its status as a testamentary trust for tax purposes (commonly referred as "tainted") if any property is contributed to it by anyone other than a deceased individual as a consequence of that individual's death. The tainting of a trust can occur in a number of situations. In particular, if the assets are not distributed to the beneficiaries according to the terms of the Will, the trust may lose its testamentary status. A testamentary trust may become an inter vivos trust if the trust incurs a debt or other obligation to pay an amount to a beneficiary or any other person who does not deal at arm's length with a beneficiary (this doesn't include a situation where the trust owes funds to a beneficiary under the terms of the trust).

21-year deemed disposition rule

It's important to be aware of the deemed disposition rules for trusts. In general, a trust is deemed to dispose of certain capital property at fair market value (FMV) 21 years after the day the trust was created, and every 21 years thereafter, and to have reacquired the capital property at FMV. There are exceptions to the 21-year deemed disposition rule that apply to certain trusts. In the context of testamentary trusts, an exception to this rule applies to a testamentary spousal trust, where the first deemed disposition of the trust property is deferred until the death of the spouse beneficiary.

Where the deemed disposition rule applies, if the trust property has appreciated in value, any accrued capital gains will be deemed to be realized on the 21st anniversary of the trust. These capital gains are taxable in the trust at the highest marginal tax rate in the trust's province or territory of residence unless the trust agreement allows for this type of deemed income to be allocated to the beneficiaries and taxed in their hands.

Given the significant tax liabilities that may arise on the 21st anniversary of the trust, it's important to consult with a qualified legal and tax advisor when drafting the terms of the testamentary trust. More specifically, the terms of the trust may provide the trustee with the appropriate power and flexibility to implement strategies to minimize the effects of the deemed disposition.

Given the significant tax liabilities that may arise on the 21st anniversary of the trust, it's important to consult with a qualified legal and tax advisor when drafting the terms of the testamentary trust.

Alternative minimum tax (AMT)

AMT is a parallel tax calculation, designed to prevent individuals and certain trusts from paying little or no tax by limiting the tax advantages they could receive in a year through certain tax preferences, such as claiming certain deductions or earning tax-preferred income. A qualified tax advisor can help you determine if your testamentary will have an AMT liability for a given tax year. It should be noted that a GRE is exempt from AMT. As well, a QDT is the only type of testamentary trust that is eligible to apply a basic exemption to its AMT calculation. For more information on how the AMT rules may impact trusts, ask your RBC advisor for an article on this topic.

Winding up a testamentary trust

Your trustee will want to review the terms of the trust to determine how and when the testamentary trust can be wound up. From an income tax perspective, distributions of income will generally be taxable to the beneficiary. If your trustee makes a distribution of capital to a beneficiary, these assets can generally be received by the beneficiary tax-free.

The terms of the trust may provide the trustee with the flexibility to make distributions in cash or in-kind. From an income tax perspective, if the trustee makes the distribution in-kind to a Canadian resident beneficiary, this can generally be done on a tax-deferred basis The trustee may also distribute the assets at FMV, triggering the unrealized gain or loss.

In-kind capital distributions to a non-resident beneficiary must generally be done at FMV, triggering a taxable disposition in the trust. One exception to this rule is if you're distributing Canadian real estate to a non-resident beneficiary. In this case, the property can be transferred on a tax-deferred basis. There may also be other tax compliance obligations that must be satisfied when making an income or capital distribution to a non-resident beneficiary that are beyond the scope of this article. Your trustee should seek advice from a qualified tax advisor if a non-resident is a beneficiary of the testamentary trust.

Next steps in establishing a testamentary trust

It's possible that your Will may need to be reviewed and amended to provide for the establishment of a testamentary trust. This amendment will involve a

meeting with a notary and/or lawyer. As a result, there may be professional fees incurred to amend your Will or to create a new one if you don't already have a valid Will. Note that a notarial Will is generally the preferred and most common choice of Will in the province of Quebec.

Legal, accounting and trust administration fees

The creation of a testamentary trust will result in annual accounting and trust administration fees. It's imperative that a cost-benefit analysis be done to ensure this structure is a viable option for you and your beneficiaries.

Conclusion

It's important to consider all of the costs and complexities involved in setting up and administering a testamentary trust. You may still prefer an outright distribution of your estate due to its simplicity. If there are reasons that a testamentary trust makes sense for you and your family, you should consult with a qualified legal and tax advisor to determine how to achieve your estate planning objectives.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.



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