



ANTHEA LAW
Partner
Suite 1050, 10201 Southport Road S.W.
Calgary, Alberta T2W 4X9
Telephone: 403.255.2636

Fax: 403.253.8036
www.vogellawyers.com

THE USE OF TESTAMENTARY TRUSTS IN ESTATE PLANNING

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As a principle of law, the concept of a trust is fairly static and has been part of our legal history since the operation of the Court of Chancery in England in the 13th century. To put it simply, a trust is a relationship under which a person, known as the settlor, transfers property to another person, known as the trustee, who holds that property for the benefit of another person, known as the beneficiary. In order to create a trust, the "three certainties" must be met:

- (a) certainty of intention – the person creating the trust must intend to create the trust, and that intention must be clearly shown;
- (b) certainty of subject matter – the property that is to be held in the trust must be known with sufficient certainty at the time the trust is to be created; and
- (c) certainty of object – the person or persons who are to benefit from the trust must be known with sufficient certainty.

Trusts are considered a separate taxpayer under the *Income Tax Act* (Canada) (the "Tax Act"), but are not a separate legal entity. They are of two varieties, and are either:

- *inter vivos*, or "living", meaning that the settlor transfers property to the trustee in his or her lifetime; or
- testamentary, meaning that the trusts are created by a will, which transfers the property of the deceased settlor to a trustee for the benefit of a beneficiary.

As an estate planning tool, the testamentary trust in particular is a dynamic and flexible tool that can be used to achieve a number of different goals and to address a wide variety of special situations:

Qualifying spousal trust

At death, the Tax Act deems us to dispose of our capital property, giving rise to a capital gain. A deferral of this capital gain can be effected if capital property is transferred to a spouse or spousal trust. Essentially, the property is transferred to the spouse or spousal trust on a "rollover" basis, and taxes would then be paid on the death of the second spouse. However, only a qualifying spousal trust ("QST") would be eligible for this income tax deferral. The requirements for a QST under the Tax Act are as follows: the trust must be created in the

deceased's will; the spouse must be entitled to all of the income from the trust during his or lifetime; no one other than the spouse is entitled to either the income or capital of the trust while the spouse is still alive; the testator must be resident in Canada immediately prior to death; and the trust must be tax resident in Canada.

In addition, a spousal trust can also be used as an income splitting device. While *inter vivos* trusts are taxed at the highest marginal rate (which in Alberta is currently 39%), testamentary trusts are taxed at graduated tax rates. Therefore, if property is left to a spouse outright on death, the income earned on the inheritance may be subject to the highest tax rate, but if property is left to a spousal trust, such income earned in the spousal trust would be taxed at the graduated tax rates, increasing the potential for tax savings.

Second marriages and blended families

One of the most common issues today with blended families is to how to divide wealth between a new spouse and children from a previous relationship. Although there are provisions in legislation such as the *Matrimonial Property Act* and the *Wills and Succession Act* that must be considered and evaluated, a spousal trust can be useful in such a situation.

If a spouse provides that on his death, his second spouse's inheritance is to be held in a spousal trust, and that on the second spouse's death, the residual monies remaining in the trust are to be given to the children from his first relationship, this now provides a mechanism by which both the second spouse and the children from the first relationship are provided for. If the spousal trust is set up properly as a QST, it can become quite tax efficient, as it allows capital gains to be deferred until the death of the second spouse, and the income generated from the spousal trust would be taxed at the graduated marginal rates.

Challenging adult beneficiaries

Often, testamentary trusts are used in wills to direct that inheritances to minor children not be given to them until they reach an age that is beyond the age of the majority, which in Alberta is 18. Staggered entitlements are often used, allowing for the transfer of wealth over a period of time.

However, there are many reasons that adult children may need trusts for their inheritances as well. If adult children have gambling issues, alcohol or drug addiction problems, poor financial judgement, or spendthrift ways, their receipt of a large inheritance from their parents can often lead to disastrous consequences. A testamentary trust can be set up for such adult beneficiaries until they reach a certain age, such as 55, or until they pass away, and the terms of the trust can state that the adult beneficiary is to receive income on an annual basis from the trust. The terms of the trust can also provide that the trustees have the power to encroach on the capital of the trust for the adult beneficiary's medical and health needs. A testamentary trust is therefore a useful tool that can provide some measure of protection to adult beneficiaries who may require it.

The choice of the trustee is therefore of critical importance for a trust that is set up for problematic adult beneficiaries or special needs beneficiaries, as discussed below. Trustees should be aware of the responsibilities that they will be taking on, and that they may often be called upon to make difficult decisions. The ideal trustee would be a person who is responsible, trustworthy, has expertise in managing trust property and handling investments, and who would be willing and able to act in such a capacity. It may also be of benefit in certain situations to consider a corporate trustee, which offers professional trustee services and charges accordingly. Such corporate trustees often set out their fees in advance by way of a fee agreement between the client and the corporate trustee.

Special needs beneficiaries

Individuals with special needs require particular attention when they are to be beneficiaries of an estate. If their special needs arise from a physical, emotional, and/or mental nature, it may be inappropriate to leave such beneficiaries a substantial inheritance outright on death, as they may be unable to cope with the proper management and distribution of such funds.

An absolute discretion trust, sometimes known as a “Henson trust” is often used as an estate planning strategy for special needs beneficiaries. In such a trust, the trustee is given the absolute and unfettered discretion to determine how much of the income or capital of a trust is given to or on behalf of a special needs beneficiary. The assets in the trust are never vested in the special needs beneficiary, and on his or her death, the trust provisions would provide for an alternate beneficiary or beneficiaries to receive any monies remaining in the trust.

Individuals with special needs who receive financial assistance from the Alberta government in the form of the Assured Income for the Severely Handicapped (“AISH”), merit particular attention in estate planning. In determining the initial and ongoing eligibility for AISH, an asset “threshold” test of \$100,000 is applied, and in the governing legislation (the “AISH Act”), some assets are exempt from this calculation, while others are deemed to be assets as part of this calculation. The concern is that the AISH Act contains a deeming provision whereby an AISH recipient, who is entitled to receive all or part of the income or capital from any trust, may be deemed to have those trust funds considered as part of their asset base. Depending on the amount of the special needs beneficiary’s trust, this may potentially extinguish their eligibility for AISH if the asset “threshold” is breached. It is advisable to speak with a lawyer who is knowledgeable about this area if you are contemplating leaving estate assets to a special needs individual who is an AISH recipient.

Successful adult beneficiaries

Adult children who are successful in life and are fortunate to earn high incomes may also benefit from the income-splitting benefits of a testamentary trust. Although a deferral of income tax cannot be achieved by transferring property to an adult child’s trust on death, as with a spousal trust, the adult child will still benefit, as income earned on the inheritance and held in the trust would be subject to the graduated tax rates. This would be particularly relevant if the beneficiary is to receive a large inheritance that has the potential to generate a sizeable income. Such forethought in tax planning for beneficiaries who are high income earners can result in tax savings for many years.

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It is important to keep in mind that under the Tax Act, trusts are subject to the deemed disposition of capital property every twenty-one years, resulting in what may be a significant tax liability, and planning for this deemed disposition should be considered at the outset. Provisions that allow for capital to be rolled out to the beneficiaries prior to the twenty-first anniversary of the trust are often included in the drafting of the governing document to deal with this potentially adverse tax consequence. As well, the Tax Act contains many rules and can produce unintended results. For example, the “kiddie tax” rules impose the highest marginal rate of tax on income that is split with minor beneficiaries.