



TESTAMENTARY TRUSTS

A testamentary trust is a trust established on and in consequence of a person's death, usually under a will. A will might, for example, direct an executor to hold an inheritance in a trust for children until they reach a certain age. Since only assets passing through the estate can be held in a testamentary trust, probate taxes must be paid on assets passing into a testamentary trust (except a trust of life insurance proceeds or a trust under a secondary non-probate will). Furthermore, once the testamentary trust is established, annual tax returns must be filed for the trust. For these reasons, many people avoid testamentary trusts, preferring outright gifts, joint tenancy, and registered plans to avoid probate, but the benefits of a testamentary trust may outweigh the drawbacks.

Taxation of Testamentary Trusts

Income earned in a testamentary trust is taxed at the same graduated tax rates as apply to an individual. Since this income earned is taxed on a separate tax return, an income splitting opportunity arises. For example, if an adult child in the top marginal tax bracket (approximately 46%) receives an inheritance of approximately \$250,000 outright, which produces annual taxable income of \$12,500 a year, the investment income will be taxed on the child's return at the marginal tax rate of 46%. If the same inheritance were held in a testamentary trust, however, the \$12,500 can be taxed on a separate trust tax return at graduated tax rates.

	Inheritance transferred outright	Inheritance in testamentary trust
Taxable income	\$12,500.00	\$12,500.00
Tax Payable	(\$5,750.00)	(\$2,756.00)
Trust tax return fees	\$0.00	(\$500.00)
Net income	\$6,750.00	\$9,244.00

The adult child saves \$2,494 (\$9,244 - \$6,750) per year. Even if the probate tax of \$3,750 is taken into account, after only two years the trust is more beneficial. The probate tax negates the tax savings of \$2,494 in the first two years, but the tax savings of approximately \$2,494 will continue year after year.

As an added benefit, assets remaining in a testamentary trust after the death of the child/beneficiary do not form part of his or her estate and so will not be subject to probate on his or her death. If the beneficiary is expected to have a low taxable income (less than \$32,000) however, there is likely no income splitting benefit from a testamentary trust.

Normally, income paid out of a trust to a beneficiary is taxable on the beneficiary's personal tax return. A trustee can elect, however, to have income that is paid to a beneficiary taxed in the testamentary trust at graduated tax rates.

Maintaining Control

Where a will-maker fears that assets given directly to a child will be invested poorly, spent irrationally or subject to claims by creditors or a spouse, a testamentary trust allows for a trustee to manage these assets which may also be protected from potential creditors or a spouse.

Registered Plans

Assets in an RSP/RIF can be transferred to a surviving spouse's plan on a tax-deferred basis. Once these assets are transferred, however, the surviving spouse controls them. No conditions or restrictions can be put on the use of these RSP/RIF assets unless they pass through the estate and into a testamentary trust. Probate taxes may have to be paid on the RSP/RIF assets and any portion of the RSP/RIF not rolled to the spouse's RSP/RIF will be fully taxable at death, which can be very punitive. A spouse must make a choice about what is more important: the tax deferred rollover or the restrictions.

Beneficiary Control

A testator can appoint the spouse or an adult child as trustee of the testamentary trust. The provisions of the testamentary trust can allow the spouse or adult child to use the annual income of the trust but also allow the capital of the trust to be taken out by the spouse or adult child at their own discretion.

Establishing a Testamentary Trust

A testamentary trust must be set up by will, so you will probably have to make a new will. Your assets may need to be restructured so that on your death they flow through your estate. Assets currently in joint tenancy, for example, must be put into sole ownership or tenancy in common (beware triggering capital gains on the transfer). Designated beneficiaries on RSP/RIF assets may have to be changed as well. The relative advantages of each of these steps need to be considered with your professional advisors.