BY JAMIE GOLOMBEK

New Year, New Rules

Testamentary trusts still make sense in some cases despite tax changes

2016 marks the first year that testamentary trusts will be taxed at the top marginal tax rate rather than at graduated rates. First announced in the 2013 federal budget, the change eliminated post-mortem income splitting, which was used by wealthy Canadians to reduce tax on the investment income earned by their beneficiaries, from their assets, for years after their death.

Let's review the new rules regarding the taxation of estates and testamentary trusts. Fortunately, several non-tax planning opportunities still remain when a testamentary trust is included as part of your client's will or estate plan.

A testamentary trust is an estate-planning tool and describes a relationship that allows property to be managed by one person — typically called your estate trustee — for the benefit of another, called your beneficiary. So, instead of leaving an asset directly to a beneficiary under your will, you could create a testamentary trust and name a trustee who would manage the assets on behalf of the beneficiary under terms you specify. The term "testamentary" means the trust arises as a consequence of your death.

Taxation of estate and trusts (2016 and future years)

Existing testamentary trusts will compute federal tax using graduated tax rates until December 31, 2015, but for the 2016 and subsequent taxation years the top federal marginal tax rate will apply. Graduated tax rates will only apply to "graduated rate estates," and "qualified disability trusts."

What is a graduated rate estate?

Starting this year, a graduated rate estate of an individual is the estate that arose on and as a consequence of the individual's death for the first 36 months after the death of the individual. There can only be one graduated rate estate in respect of a deceased individual.

What is a qualified disability trust?

For the 2016 and subsequent taxation years, a qualified disability trust is a testamentary trust that arose on the death of a particular individual that elects, with one or more beneficiaries under the trust, in its T3 trust tax return to be a qualified disability trust for the year. Each electing beneficiary must, for the beneficiary's taxation year in which the trust's year ends, be eligible for the disability tax credit.

Non-tax reasons for testamentary trusts

Although the new rules curtail the tax benefits available to testamentary trusts in that they eliminate the opportunity for post-mortem income splitting (other than with graduated rate estates for three years and qualified disability trusts), there are numerous other reasons why a testamentary trust may still make sense as part of a client's estate plan.

These include:

- Administration and management of inheritances for minor beneficiaries until they reach the age of majority.

- Control over the timing and amount of distributions to beneficiaries. For example, it can be specified that 50 per cent of an inheritance would be distributed when the beneficiary reaches age 25 and the remainder at age 35.

- Flexibility in structuring payments to beneficiaries. The trustee can be given discretion as to the amount and timing of distributions to beneficiaries, which may be particularly useful for spendthrift or incapacitated beneficiaries, who may not have the responsibility or capacity to manage funds themselves.

- Preservation of a family inheritance. For example, a will may specify that income from the assets in the estate will be available to provide for the needs of a surviving spouse or partner during his or her lifetime, but that the estate assets will ultimately go to the children of the marriage (or partnership) upon the surviving spouse's death, preserving the assets for the next generation.

- Professional investment management may be stipulated in the trust agreement, allowing funds to be handled by an experienced investment manager, rather than by beneficiaries who may be novice investors or prone to making poor investment decisions.

- Motivation of behaviour for a beneficiary. An "incentive trust" is generally designed to make distributions if a beneficiary engages in desired behaviours. For example, the trust agreement might stipulate that distributions will be made if a beneficiary completes post-secondary education, thus incenting the beneficiary to attend school. As another example, a beneficiary might be encouraged to work if trust distributions will be made in proportion to the beneficiary's income from employment or self-employment.

Establishing a testamentary trust is complex, and the rules vary from province to province, so you should encourage your clients to seek professional legal advice prior to setting one up.

JAMIE GOLOMBEK, CPA, CA, CFP, CLU, TEP is the Managing Director, Tax & Estate Planning with CIBC Wealth Advisory Services in Toronto. He can be reached at Jamie.golombek@cibc.com.

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