USE OF SPOUSAL TRUSTS IN ESTATE PLANNING

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This paper deals with the use of spousal trusts as part and parcel of a client's last will and testament. It deals with the tax advantages of such trusts, how they are drafted and used in estate planning context, and includes a precedent.

Testamentary Trusts

A testamentary trust is defined under the *Income Tax Act* (Canada) (the "ITA") as one that arises "on and as a consequence of the death of an individual."[1] Specifically included in the definition of a testamentary trust is the trust established under the terms of a will.[2] Thus, a trust established under the terms of your client's will should qualify as a testamentary trust. That assumes that the trust hasn't been established in some fashion prior to the death of your client and pre-funded.

Where a trust qualifies as testamentary, it qualifies as a separate tax payer. It is then taxed at graduated rates just as a flesh and blood individual would be.[3] That means that the first $40,726 in income is taxed on the bottom tax bracket, with the effective tax rate for interest income of 25% and capital gains income of 12.50%. As additional income is earned within the testamentary trust, it is taxed in successively higher tax brackets with the tax rates on interest income climbing from 25% to 32% in the second tax bracket, 36% in the third tax bracket before hitting the maximum rate of 39% on all income earned over $126,264. A testamentary trust is not entitled to use or claim any personal tax credits.[4] Only one testamentary trust can be established per income beneficiary or class of income beneficiaries.[5] The ability of a testamentary trust to qualify as a separate tax payer and enjoy taxation at graduated rates provides an income splitting opportunity. Some income will be reported in the trust, while other income can be reported in the hands of the beneficiary. This effectively allows the beneficiary to double their access to the bottom tax brackets. In the situation where the trust is large enough, or where the beneficiary has significant income of their own (through employment or otherwise), the ability to split income between two separate sets of graduated rates has a tax savings value in Alberta of roughly $10,000 per year for the beneficiary. Over ten years, you would expect the beneficiary to save roughly $100,000 in taxes. Those levels of tax savings are attained when the trust contains a fairly substantial sum, in the neighbourhood of $1,000,000, and enjoys a rate of return by way of income in the neighbourhood of 5%. The rules that work in income splitting through a testamentary trust have been in place since 1971. More detail is provided later in this paper.

[1] ITA subsection 108(1), definition of "testamentary trust"
[2] ITA paragraph 248(9.1)(a), this provision of the Act is brought into the main definition by a specific inclusion in subsection 108(1).
[3] ITA subsection 117(2).
[4] ITA subsection 122(1.1).
[5] ITA subsection 104(2).

As additional features of a testamentary trust, a testamentary trust (unlike an *inter vivos* trust), is entitled to select its own fiscal period.[6] The ability to manipulate the year end of the testamentary trust provides another opportunity for deferral. As a further deferral opportunity, a testamentary trust is not obliged to pay installment taxes, allowing the income to pool within the trust until the full 90 days from the end of the trusts taxation year before paying the taxes on it.[7] This provides a small measure of tax deferral on income tax in the hands of the trustees.

Spousal Trusts

The requirements for a testamentary spousal trust are set out in subsection 70(6) of the *ITA.* The following is a full statement of all of the requirements necessary for the establishment of a testamentary spousal trust (footnotes omitted):[8]

> For a trust established by a taxpayer to qualify for treatment as a testamentary spousal trust the requirements of subsection 70(6) must be met.
>
> - The deceased taxpayer must have been resident in Canada immediately before his or her death.
> - Property must be transferred or distributed to the trust.
> - The transfer or distribution must occur as a consequence of the taxpayer's death.
> - The property must:
>   - Be capital property of the taxpayer to which subsection 70(5) would otherwise apply.
>   - Vest indefeasibly in the trust within thirty-six months of the date of death of the taxpayer, or such longer time as the Minister considers reasonable on written request by the personal representatives of the deceased.
> - The Trust must:
>   - Be created by the taxpayer's will.
>   - Be resident in Canada immediately after the time that the property vests indefeasibly in the trust.
>   - Satisfy both of the following conditions:

[6] ITA paragraph 249.1(1)(b).
[7] ITA Paragraph 104(23)(e)
[8] Larry Frostiak, John Poyser, and Grace Chow *Taxation of Trusts and Estates, A Practitioner's Guide 2009,* 5th ed. (Toronto: Thompson Carswell, 2008), at pages 57 and 58.